Financial reporting developments

A comprehensive guide

Income taxes

June 2023

Building a better working world

To our clients and other friends

Our publication summarizes the guidance in Accounting Standards Codification 740 on accounting for and reporting on the effects of income taxes that result from an entity's activities during the current and preceding years and provides EY's interpretative guidance, including guidance on how to account for the most significant changes to US tax law in more than three decades.

We have updated this Financial reporting developments (FRD) publication to include further clarifications and enhancements to our interpretive guidance. Important updates are listed in Appendix D and indicated in section headings throughout this FRD publication.

This publication contains excerpts from and references to the Accounting Standards Codification (ASC). Guidance that may apply but is based on non-authoritative standards not included in the Accounting Standards Codification is included in Appendix C.

EY professionals are prepared to help you identify and understand the issues related to income taxes. In addition, our audit and tax professionals would be pleased to discuss with you any other issues related to your tax and financial reporting needs.

Ernst & Young LLP

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Contents

Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared, but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

1 Introduction

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Overview and Background

740-10-05-1

The Income Taxes Topic addresses financial accounting and reporting for the effects of income taxes that result from an entity's activities during the current and preceding years. Specifically, this Topic establishes standards of financial accounting and reporting for income taxes that are currently payable and for the **tax consequences** of all of the following:

a. Revenues, expenses, gains, or losses that are included in **taxable income** of an earlier or later year than the year in which they are recognized in financial income

b. Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting

c. Operating loss or tax credit **carrybacks** for refunds of taxes paid in prior years and **carryforwards** to reduce taxes payable in future years.

1.1 General

ASC 740, *Income Taxes,* addresses the financial accounting and reporting requirements for the effects of taxes based on income. It provides guidance for recognizing and measuring tax positions taken, or expected to be taken, in a tax return that directly or indirectly affect amounts reported in the financial statements. Generally, most items included in pretax income for financial reporting purposes are included in taxable income in the same year. However, certain items are recognized for financial reporting purposes before or after they are recognized for tax purposes.

As discussed in chapter 4, *Temporary differences,* ASC 740 uses the term "temporary difference" to describe the difference between the tax basis of an asset or liability and the amount reported in the financial statements (book basis) that will result in taxable or deductible amounts in future years. The tax effects of these differences are referred to as deferred tax assets or liabilities. Over time, these differences arise in one period, reverse in another period and eventually offset each other. Under ASC 740, these differences are recognized based on the effect on taxes payable as if all the entity's assets were converted to cash and liabilities settled at the amounts reported for financial statement purposes.

Illustration 1-1: Identifying book and tax temporary differences

Assume that in Year 1 Company LML:

- Received a $100 payment for services to be rendered the following year
- Concluded that one of its customers would not remit the $50 remaining balance due for services rendered in the previous year (but didn't write off the receivable until Year 4)
- Purchased an asset for $100 that was depreciable for financial reporting purposes over four years but the tax law allowed the asset to be depreciated over three years

The effect of these differences, as increases or (decreases) in financial reporting and taxable income, is as follows:

	Year 1 book/tax	Year 2 book/tax	Year 3 book/tax	Year 4 book/tax	Total book/tax
Deferred revenue — recognized for book when earned, taxed when received	–/100	100/–	–/–	–/–	100 /100
Bad debts — recognized for book when incurred, deducted for tax when written off	(50)/–	–/–	–/–	–/(50)	(50) /(50)
Depreciation — 4-year life for book, 3-year life for tax	(25)/(33)	(25)/(33)	(25)/(34)	(25)/–	(100)/(100)
Net book/tax differences	(75)/67	75/(33)	(25)/(34)	(25)/(50)	(50)/(50)

Absent guidance to the contrary, companies might account for income taxes on an "as-paid" basis. That is, the income tax expense recognized in a given period would equal the amount payable to the taxing authority. Although this approach would be reasonable if all items of income and expense were treated the same for financial and tax reporting purposes, that is not the case with most companies applying generally accepted accounting principles. Thus, recognition of income tax expense on an "as-paid" basis would not result in the recognition of all costs and benefits attributable to transactions recognized in the financial statements.

Illustration 1-2: Computation of income tax expense under the "as-paid" basis

Assume the same facts as Illustration 1-1, as well as the following:

- Company LML's book income, before consideration of the items in Illustration 1-1, was $100 in each period.
- There are no other differences between the financial and tax reporting.
- The enacted statutory tax rate for all periods is 25%.

Under the "as-paid" basis, Company LML's tax return statements would reflect the following:

	Year 1	Year 2	Year 3	Year 4	Total
Preliminary income	$ 100	$ 100	$ 100	$ 100	$ 400
Tax adjustments of items in Illustration 1-1	67	(33)	(34)	(50)	(50)
Taxable income	167	67	66	50	350
Statutory tax rate	25%	25%	25%	25%	25%
Current tax expense	$ 42	$ 17	$ 17	$ 12	$ 88

Under the "as-paid" basis, Company LML's financial statements would reflect the following:

	Year 1	Year 2	Year 3	Year 4	Total
Preliminary income	$ 100	$ 100	$ 100	$ 100	$ 400
Book adjustments of items in Illustration 1-1	(75)	75	(25)	(25)	(50)
Pretax book income	$ 25	$ 175	$ 75	$ 75	$ 350
Current tax expense	(42)	(17)	(17)	(12)	(88)
Net income (loss)	$ (17)	$ 158	$ 58	$ 63	$ 262

The "as-paid" basis does not accurately reflect the company's financial position or results of operations because a company would be subject to additional taxation if its assets were converted to cash and its liabilities extinguished at amounts reported in the financial statements.

Therefore, ASC 740 requires entities to account for income taxes in the income statement based on the taxes payable or refundable as if all of their assets were converted to cash and all of their liabilities were extinguished at their financial statement carrying amounts.

Revenues, expenses, gains or losses may be included in taxable income in an earlier or later year than the year in which they are recognized in financial income. Under ASC 740, companies must defer the tax effect of items (e.g., temporary differences) recognized in earnings or the income tax return, but not both. Thus, the income taxes payable due to differences in the timing of recognizing revenues and expenses for tax and financial reporting purposes (e.g., deferred revenue, recognition of bad debt expense for financial reporting but not tax purposes, depreciation of assets for tax purposes on an accelerated method relative to the method for financial reporting) create differences between the financial reporting basis and tax basis of those items.

The following illustration highlights the computation of the deferred tax assets (liabilities) and the deferred tax benefit (expense) for the period using the temporary differences identified in Illustration 1-1.

Illustration 1-3: Computation of deferred tax assets (liabilities) and deferred tax benefit (expense)

Assuming the same facts as in Illustrations 1-1 and 1-2 above, Company LML would compute its deferred tax assets (liabilities) and deferred tax benefit (expense) as follows:

	Year 1 Gross/DTA(DTL)[1]	Year 2 Gross/DTA(DTL)[1]	Year 3 Gross/DTA(DTL)[1]	Year 4 Gross/DTA(DTL)[1]
Deferred revenue	100/25	–/–	–/–	–/–
Bad debts	50/13	50/13	50/13	–/–
Depreciation	(8)/(2)	(16)/(4)	(25)/(6)	–/–
Gross book-tax difference/deferred tax asset (liability) at end of period	142/36	34/9	25/7	–/–
Less: net deferred tax asset (liability) at beginning of period	–	36	9	7
Change in net deferred tax assets (liabilities)	36	(27)	(2)	(7)

[1] The deferred tax asset (liability) reflects the tax-effected gross accumulated temporary differences (difference * enacted statutory tax rate of 25%).

A company's income tax expense (benefit) for financial reporting purposes is equal to the current tax expense (benefit) (i.e., amounts currently due in accordance with the income tax return) plus the deferred tax expense (benefit). As defined in the ASC Master Glossary, deferred tax expense (benefit) is the change during the year in an entity's deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a business combination during the year, it is the change since the combination date. That is, increases in deferred tax liabilities and reductions in deferred tax assets increase an entity's income tax expense, while reductions in deferred tax liabilities and increases in deferred tax assets reduce an entity's income tax expense.

Income tax expense (benefit) for the year is allocated among continuing operations, discontinued operations, other comprehensive income (OCI) and items charged or credited directly to shareholders' equity. Refer to chapter 15, *Intraperiod tax allocation,* for further information on allocating income tax expense (benefit).

Illustration 1-4: Computation of income tax benefit (expense) under ASC 740

Assuming the same facts as in Illustrations 1-1 through 1-3, Company LML's income tax benefit (expense) for financial reporting purposes, as computed in accordance with ASC 740, would equal the actual taxes due plus the net change in deferred taxes for the year.

	Year 1	Year 2	Year 3	Year 4	Total
Current tax expense	$ (42)	$ (17)	$ (17)	$ (12)	$ (88)
Deferred tax benefit (expense):					
Deferred revenue	25	(25)	–	–	–
Bad debts	13	–	–	(13)	–
Depreciation	(2)	(2)	(2)	6	–
Deferred tax benefit (expense)	36	(27)	(2)	(7)	–
Income tax expense under ASC 740	$ (6)	$ (44)	$ (19)	$ (19)	$ (88)

Under ASC 740, net income would be as follows:

	Year 1	Year 2	Year 3	Year 4	Total
Preliminary income	$ 100	$ 100	$ 100	$ 100	$ 400
Book adjustments of items in Illustration 1-1	(75)	75	(25)	(25)	(50)
Pretax book income	$ 25	$ 175	$ 75	$ 75	$ 350
Income tax expense under ASC 740	(6)	(44)	(19)	(19)	(88)
Net income	$ 19	$ 131	$ 56	$ 56	$ 262

2 Scope

2.1 General

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Scope and Scope Exceptions

740-10-15-2

The principles and requirements of the Income Taxes Topic are applicable to domestic and foreign entities in preparing financial statements in accordance with U.S. generally accepted accounting principles (GAAP), including not-for-profit entities (NFP) with activities that are subject to income taxes.

740-10-15-3

The guidance in the Income Taxes Topic applies to:

a. Domestic federal (national) income taxes (U.S. federal income taxes for U.S. entities) and foreign, state, and local (including franchise) taxes based on income

b. An entity's domestic and foreign operations that are consolidated, combined, or accounted for by the equity method.

The guidance on accounting for income taxes in ASC 740 applies to all federal, foreign, state and local (including franchise) taxes based on income. That is, any tax levied by a governmental taxing authority on a company based on its income is subject to the provisions of ASC 740.

ASC 740 requires reporting entities to apply the guidance to consolidated subsidiaries, investees accounted for under the equity method and entities that are combined due to common control, in addition to the company's standalone operations. Entities are required to apply the guidance to all financial statements prepared in accordance with US GAAP, including those prepared by foreign entities.

This publication focuses on the accounting for income taxes guidance provided in ASC 740 at the entity level — that is, after consideration of all taxes based on income. This approach considers the effect of state, local and foreign income taxes, net of any federal benefit, as well as federal income taxes on an entity's temporary differences. State and local income tax issues are addressed in section 5.8, *State and local income taxes*. Chapter 18, *Financial statement presentation and disclosures*, addresses the presentation of income taxes and related issues in a company's financial statements.

2.1.1 Scope exceptions

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Scope and Scope Exceptions

Transactions

740-10-15-4

The guidance in this Topic does not apply to the following transactions and activities:

a. A franchise tax to the extent it is based on capital and there is no additional tax based on income. If there is an additional tax based on income, that excess is considered an income tax and is subject to the guidance in this Topic. See Example 17 (paragraph 740-10-55-139) for an example of the determination of whether a franchise tax is an income tax.

b. A withholding tax for the benefit of the recipients of a dividend. A tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and is not an income tax if both of the following conditions are met:

1. The tax is payable by the entity if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the entity would otherwise pay.
2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

See the guidance in paragraphs 740-10-55-72 through 55-74 dealing with determining whether a payment made to a taxing authority based on dividends distributed is an income tax.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

The guidance in this Topic does not apply to the following transactions and activities:

a. A franchise tax (or similar tax) to the extent it is based on capital or a non-income-based amount and there is no portion of the tax based on income. If a franchise tax (or similar tax) is partially based on income (for example, an entity pays the greater of an income-based tax and a non-income-based tax), deferred tax assets and liabilities shall be recognized and accounted for in accordance with this Topic. Deferred tax assets and liabilities shall be measured using the applicable statutory income tax rate. An entity shall not consider the effect of potentially paying a non-income-based tax in future years when evaluating the realizability of its deferred tax assets. The amount of current tax expense equal to the amount that is based on income shall be accounted for in accordance with this Topic, with any incremental amount incurred accounted for as a non-income-based tax. See Example 17 (paragraph 740-10-55-139) for an example of how to apply this guidance.

b. A withholding tax for the benefit of the recipients of a dividend. A tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and is not an income tax if both of the following conditions are met:

1. The tax is payable by the entity if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the entity would otherwise pay.
2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

See the guidance in paragraphs 740-10-55-72 through 55-74 dealing with determining whether a payment made to a taxing authority based on dividends distributed is an income tax.

A franchise tax (or similar tax), to the extent it is based on capital or a non-income-based amount and there is no portion of the tax based on income, is not within the scope of ASC 740 (refer to section 5.8.4, *State taxes based on the greater of franchise tax or income tax*, for additional information on franchise taxes).

Withholding taxes paid to the tax authority by the dividend payor on behalf of its shareholders are also not included in the scope of ASC 740 if certain conditions are met (refer to section 5.3.2, *Shareholders' tax credits for dividends paid*, for additional information on taxes withheld). However, entities that receive dividends for which related taxes are withheld by the dividend payor on their behalf will need to determine whether the withholding taxes are income taxes in the scope of ASC 740.

2.2 State and local income taxes

See section 5.8, *State and local income taxes*.

2.3 Partnerships and other pass-through entities

Investments in partnerships generally can be accounted for on a consolidated or equity method basis, or at fair value (or a measurement alternative if fair value is not readily determinable). Partnerships and other entities treated as partnerships for tax purposes (e.g., limited liability companies, S corporations) are not taxable entities. Instead, the tax consequences of a partnership's transactions flow through to the partners (i.e., investors). The partners then report their proportionate share of the partnership's income or loss in their individual financial statements.

Under ASC 740, a partner recognizes the future tax consequences of recovering the financial reporting basis of its investment in the partnership as a deferred tax asset or liability, which is measured as the difference between the financial reporting basis and the tax basis of the investment in the partnership. See section 14.6, *Investments in partnerships and other pass-through entities*, for further discussion of the recognition and measurement of deferred tax assets and liabilities related to investments in partnerships and other pass-through entities.

For further information on state taxes for pass-through entities, refer to section 19.3.4.1.

2.4 Excise taxes — not-for-profit foundations

Not-for-profit foundations that make certain minimum distributions are generally exempt from federal income taxes. However, if the not-for-profit foundation is subject to an excise tax on its net investment income, that entity is subject to ASC 740 and is required to provide for deferred taxes for basis differences attributable to investment securities because the tax on the entity's net investment income is a tax "based on income" (ASC 740-10-15-3).

The basis difference is created by changes in the carrying amount of investment securities (due to unrealized gains and losses attributable to changes in the market value) for financial reporting purposes. The tax basis in those securities generally is not adjusted for (nor is the entity taxed on) unrealized gains and losses. An entity that recognizes a deferred tax asset would consider whether a valuation allowance is necessary (see chapter 6, *Valuation allowances*, for further discussion of valuation allowances).

2.5 Determining if a tax is within the scope of ASC 740

Excerpt from Accounting Standards Codification

ASC Master Glossary

Income Taxes

Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.

Taxable Income

The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority.

ASC 740-10-15-3 states that domestic and foreign federal (national), state and local taxes (including franchise taxes) based on income are the only taxes included in the scope of the guidance. However, ASC 740 does not define the term "taxes based on income." The Master Glossary defines taxable income as the excess of taxable revenues over tax-deductible expenses and exemptions for the year, as defined by the governmental taxing authority.

We believe that an income tax under the scope of ASC 740 is any tax levied on (or credited to) a company by a governmental taxing authority based on all, or a portion of, the company's revenues and gains, net of all, or a portion of, allowable expenses and losses incurred to generate the income. The tax does not need to be based on all revenues or all expenses to be in the scope of ASC 740. For example, in certain tax jurisdictions, revenue may only be reduced by a single type of expense (e.g., cost of goods sold) or based on net investment income (investment income less related expenses). We believe taxes based on these amounts generally would be included in the scope of ASC 740. However, a tax based solely on revenue (i.e., no permitted reduction for expenses), such as a gross receipts tax or a sales tax, generally would not be in the scope of ASC 740.

The following examples highlight common taxes levied by a government and whether they are typically in the scope of ASC 740. However, because the determination of these taxes could vary by jurisdiction, careful analysis based on an entity's facts and circumstances may also be necessary to determine whether the particular tax is in the scope of ASC 740. See additional discussion in section 5.8.4, *State taxes based on the greater of franchise tax or income tax*, for considerations when a franchise tax is based on two elements, a tax based on capital and a tax based on income.

Example taxes	**Generally within the scope of ASC 740?**
Tax based on company's revenues less cost of sales and operating expenses	Yes
Net worth tax based only on equity (e.g., a franchise tax)	No
Tax based on the value of purchases	No
Tax based on 5% of revenue for services performed	No
Tax levied on the distribution of income that is withheld by the distributing party on behalf of the investor[1]	Yes
Payroll taxes	No
Use taxes	No
Sales taxes	No
Property taxes	No
Government assistance received — investment tax credits or government grants that are collectible from government regardless of taxable income[2]	No
Government assistance received — investment tax credit that can only be realized through the existence of taxable income that is incremental to the portion of the credit that is able to be monetized without regard to taxable income[2]	Yes

[1] See chapter 14, *Foreign and domestic subsidiaries*, for further discussion.

[2] See section 2.5.1 below for additional discussion.

2.5.1 Determining whether government assistance is in the scope of ASC 740 (updated June 2023)

2.5.1.1 Overview

A number of government agencies, both domestic and foreign, have established programs to promote or guide the development of business activities by providing financial assistance to businesses. The form and type of government assistance received by entities vary, depending on the government program the funds were received under, with each program having differing terms.

A common question received on this topic is whether the receipt of government assistance falls within the scope of accounting for income taxes in ASC 740. Legislation for government assistance programs may use terms such as "grant" or "credit" to describe the form of the assistance. However, careful evaluation of the substance of the enacted legislation and whether a credit is required to be recovered through taxable income is necessary to determine the applicable accounting guidance. The accounting and financial reporting implications (e.g., timing of recognition and financial statement presentation) can vary significantly, for example, depending on whether the assistance is considered a loan, a grant, a payment for goods or services, a contribution or an income tax credit.

ASC 740 applies to all federal, foreign, state and local (including franchise) taxes based on income. That is, any tax levied on (or credited to) an entity based on the entity's income (or income tax liability) is generally subject to the provisions of ASC 740. Therefore, government assistance in the form of a credit that is not based on taxable income or that provides a means by which a credit can be received without regard to taxable income (e.g., a refundable tax credit) would generally be considered a government grant and would be outside the scope of ASC 740. While an entity that receives government assistance in the form of an income tax credit should account for it in accordance with ASC 740, the entity would need to carefully consider whether the income tax credit is refundable or transferable. See sections 2.5.1.3, *Accounting for refundable income tax credits*, and 2.5.1.4, *Accounting for nonrefundable tax credits with transferability features*.

The following examples illustrate some of the factors to consider when determining the applicable accounting model.

Illustration 2-1: Factors to consider when determining the applicable accounting model for an investment tax credit

XYZ Corporation (XYZ) is entitled to an investment tax credit for 30% of the purchase price of certain qualifying assets. In lieu of claiming the investment tax credit, XYZ may elect to receive a cash grant for an amount equal to the investment tax credit. Under both scenarios, XYZ must reduce its tax bases in the qualifying assets by 50% of the amount received. XYZ purchases $100 of qualifying assets and is, therefore, entitled to receive $30 as either a credit to income taxes payable or a cash grant. Further, XYZ reduces its tax bases in the assets by $15 (50% of the amount received).

Since XYZ is able to monetize the benefit (for the same amount) without regard to taxable income, we generally believe that the credit would not be within the scope of ASC 740. However, the temporary difference that arises from the reduced tax basis is within the scope of ASC 740 (as described in further detail in section 4.2.7.3, *Temporary differences related to government assistance received*).

Illustration 2-2: Factors to consider when determining the applicable accounting model under a government incentive program

Under a government incentive program, ABC Corporation (ABC) can either elect to receive 30% of the purchase price of certain qualifying assets as an investment tax credit or 10% of the purchase price of certain qualifying assets as a cash grant in lieu of the tax credit. The investment tax credit can only be realized through the existence of taxable income.

ABC purchases $100 of qualifying assets and is, therefore, entitled to receive either a $30 tax credit or a $10 cash grant. ABC elects to claim the tax credit on its tax return due to the disincentive to opt for the cash grant.

Since ABC is able to monetize a portion of the credit without regard to taxable income ($10), we believe that an appropriate methodology would be to account for $10 under grant accounting and the incremental $20 would be accounted for under ASC 740.

2.5.1.2 Grant accounting

A credit from a government entity that isn't dependent on taxable income to be realized (e.g., a refundable credit) would generally be considered a government grant and would, therefore, be outside of the scope of ASC 740. A company receiving assistance from a government entity that isn't based on taxable income considers whether the payment represents revenue in accordance with ASC 606, *Revenue from Contracts with Customers*, a loan in accordance with ASC 470, *Debt*, a contingency in accordance with ASC 450, *Contingencies*, or a government grant in accordance with other GAAP by analogy (e.g., International Accounting Standard (IAS) 20, *Accounting for Government Grants and*

Disclosure of Government Assistance; ASC 958-605, *Not-for-Profit Entities — Revenue Recognition (before the adoption of ASC 606);* or ASC 958-605, *Not-for-Profit Entities — Revenue Recognition — Contributions (after the adoption of ASC 606)*). A company receiving assistance will need to carefully evaluate the scope of the assistance received before concluding that the assistance is a government grant that should be accounted for by analogy to other GAAP. Refer to section G1.3 of the EY Accounting Manual, ***Government assistance,*** for additional discussion on grant accounting.

2.5.1.3 Accounting for refundable income tax credits

The Inflation Reduction Act (IRA) and the CHIPS and Science Act of 2022 created a number of tax credits available to US taxpayers. Many of these tax credits are refundable. That is, the taxpayer receives the tax credit regardless of whether they have taxable income. Refundable tax credits are generally not subject to the provisions of ASC 740 since receipt of such credits is not dependent upon having taxable income. Refer to section 4.2.7, *Government assistance received (investment tax credits and government grants)*, for further discussion of accounting for tax credits in the scope of ASC 740.

2.5.1.4 Accounting for nonrefundable tax credits with transferability features

A number of the tax credits created by the IRA are transferable, meaning an eligible taxpayer can apply the credit against its own tax liability or transfer (e.g., sell) the credit or a portion of it to an unrelated taxpayer. A transferable credit that is also refundable would not be subject to ASC 740, as discussed in section 2.5.1.3.

However, the only way a nonrefundable transferable credit can be used is to include it in an income tax return to offset an income tax liability of either the entity that generated (earned) the credit or the transferee. A transferee that cannot transfer the credits to another party (i.e., the transferee can only use the credits against its own tax liability) would account for them under ASC 740. See section 13.1.6, *Purchase of future tax credits*, for discussion of the accounting by an entity that purchases tax credits from a non-governmental third party.

US GAAP does not address how an entity that generates a nonrefundable transferable credit should consider its ability to transfer the credit when determining which accounting guidance to apply. However, there are several views in practice, including:

- **View A:** The entity applies ASC 740 to account for the credit. When the entity transfers the credit, the gain or loss on transfer is recognized in income tax expense (benefit) in the income statement.
- **View B:** The entity applies ASC 740 to account for the credit. When the entity transfers the credit, the gain or loss on transfer is recognized in pretax income.
- **View C:** The entity applies guidance other than ASC 740 to account for the credit. The ability to transfer or sell the credit allows the entity to realize the economic benefit of the credit without regard to incurring an income tax liability, similar to a refundable tax credit.

In response to a technical inquiry, the FASB staff said that because ASC 740 does not address this issue, any one of these views is acceptable. However, the staff said that view A is most appropriate. An entity should apply the view it elects consistently to all tax credits that can be monetized either as a reduction of its income tax liability or in a transfer to a third party.

Entities that generate tax credits and account for them under ASC 740 will need to determine whether the deferred tax assets for these credits are realizable or require a valuation allowance. Future realization of tax benefits of the generated credits ultimately depends on the existence of sufficient taxable income of appropriate character considering the four sources of taxable income noted in ASC 740. However, the FASB staff said that, under views A and B, an entity could also consider its ability to transfer the credits in determining whether a valuation allowance is necessary. See chapter 6, *Valuation allowances*.

3 Objectives and basic principles

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Objectives

740-10-10-1

There are two primary objectives related to accounting for **income taxes**:

a. To recognize the amount of taxes payable or refundable for the current year

b. To recognize deferred tax liabilities and assets for the future **tax consequences** of events that have been recognized in an entity's financial statements or tax returns.

As it relates to the second objective, some events do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. In some tax jurisdictions, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.

740-10-10-2

Ideally, the second objective might be stated more specifically to recognize the expected future tax consequences of events that have been recognized in the financial statements or tax returns. However, that objective is realistically constrained because:

a. The tax payment or refund that results from a particular tax return is a joint result of all the items included in that return.

b. Taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years.

c. Information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.

740-10-10-3

Conceptually, a **deferred tax liability** or **asset** represents the increase or decrease in taxes payable or refundable in future years as a result of **temporary differences** and **carryforwards** at the end of the current year. That concept is an incremental concept. A literal application of that concept would result in measurement of the incremental tax effect as the difference between the following two measurements:

a. The amount of taxes that will be payable or refundable in future years inclusive of reversing temporary differences and carryforwards

b. The amount of taxes that would be payable or refundable in future years exclusive of reversing temporary differences and carryforwards.

However, in light of the constraints identified in the preceding paragraph, in computing the amount of deferred tax liabilities and assets, the objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to **taxable income** in the periods in which the deferred tax liability or asset is expected to be settled or realized.

Recognition

740-10-25-2

Other than the exceptions identified in the following paragraph, the following basic requirements are applied in accounting for income taxes at the date of the financial statements:

a. A tax liability or asset shall be recognized based on the provisions of this Subtopic applicable to tax positions, in paragraphs 740-10-25-5 through 25-17, for the estimated taxes payable or refundable on tax returns for the current and prior years.

b. A **deferred tax liability** or **asset** shall be recognized for the estimated future tax effects attributable to **temporary differences** and **carryforwards**.

740-10-25-38

Conceptually, under an incremental approach as discussed in paragraph 740-10-10-3, the tax consequences of tax losses expected in future years would be anticipated for purposes of:

a. Nonrecognition of a deferred tax liability for taxable temporary differences if there will be no future sacrifice because of future tax losses that otherwise would expire unused

b. Recognition of a deferred tax asset for the carryback refund of taxes paid for the current or a prior year because of future tax losses that otherwise would expire unused.

However, the anticipation of the tax consequences of future tax losses is prohibited.

Initial Measurement

740-10-30-2

The following basic requirements are applied to the measurement of current and deferred **income taxes** at the date of the financial statements:

a. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.

b. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

740-10-30-3

Total income tax expense (or benefit) for the year is the sum of **deferred tax expense (or benefit)** and **income taxes currently payable or refundable**.

740-10-30-4

Deferred tax expense (or benefit) is the change during the year in an entity's deferred tax liabilities and assets. For deferred tax liabilities and assets recognized in a business combination or in an **acquisition by a not-for-profit entity** during the year, it is the change since the **acquisition date**. Paragraph 830-740-45-1 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred foreign tax liability or asset when the reporting currency is the functional currency.

3.1 Basic approach (updated August 2022)

The liability approach (as articulated in ASC 740) is based on an incremental concept — that is, a deferred tax liability represents the increase in taxes payable or decrease in taxes refundable while a deferred tax asset represents the decrease in taxes payable or an increase in taxes refundable in future years as a result of temporary differences and carryforwards that exist at the end of the current year (ASC 740-10-10-3). Applied literally, that concept would require measuring:

- The amount of taxes that will be payable or refundable in future years including the effects of reversing temporary differences and carryforwards
- The amount of taxes that would be payable or refundable in future years excluding the effects of reversing temporary differences and carryforwards

The difference between those two measurements would be the incremental tax effect of the temporary differences and carryforwards. Because a determination of the incremental difference between all future income tax cash flows with and without reversing temporary differences and carryforwards would be difficult in most situations, the FASB decided, for practical reasons, to measure deferred taxes using a tax rate convention and then to assess the need for a valuation allowance with respect to the realization of deferred tax assets (ASC 740-10-30-5). It is important to remember that deferred tax liabilities are required to be recognized as of the balance sheet date and cannot be mitigated by forecasted future tax losses, even if such losses are probable of occurrence (ASC 740-10-25-38).

Total income tax expense (benefit) = Current income tax expense (benefit) + Deferred income tax expense (benefit)

The total income tax expense or benefit for the year for financial reporting purposes represents the total of taxes currently payable or refundable (the amount computed per the tax return) and deferred tax expense or benefit (ASC 740-10-30-3). The current income tax expense (benefit) also includes items such as return-to-provision adjustments and changes to prior year uncertain tax positions (UTPs).

The liability method focuses on the balance sheet. Applying the liability method in a relatively simple situation involves multiplying the cumulative temporary differences and carryforwards existing at the balance sheet date by the applicable tax rate and assessing the need for a valuation allowance for deferred tax assets. The resulting amounts are deferred tax assets or liabilities, and the net changes in those amounts for a year represent the deferred tax expense or benefit for the year. For deferred tax liabilities and assets that are acquired during the year in a business combination or asset acquisition, the deferred tax expense or benefit is the change in deferred tax liabilities and assets since those balances were initially recorded by the acquirer, excluding any measurement period adjustments in a business combination (ASC 740-10-30-4). Deferred tax expense or benefit for the year includes the effects of changes in tax laws or rates and changes in the valuation allowance.

The following graphic summarizes the computations under the liability method:

	Ending deferred tax balance[1]
-	Beginning deferred tax balance
=	**Deferred tax expense or benefit**
+	Current taxes payable or refundable
=	**Total book tax expense or benefit**

[1] Exclusive of deferred tax balances acquired in a business combination or asset acquisition during the year. For deferred tax liabilities and assets that are acquired during the year in a business combination or asset acquisition, the deferred tax expense or benefit also includes the change in deferred tax liabilities and assets since those balances were initially recorded by the acquirer.

Computations become more complex in determining the effect of enacted tax rate changes, accounting for deferred taxes in connection with business combinations, assessing the need for and amount of a valuation allowance, and applying complexities in the tax law to complex business transactions. In addition, complexities arise due to recognition of the change in certain temporary differences in other comprehensive income rather than earnings (e.g., change in the fair value of available-for-sale debt securities). These and other issues are further discussed throughout this publication.

The basic model for computing deferred taxes under the liability method requires that companies follow a five-step formula (ASC 740-10-30-5):

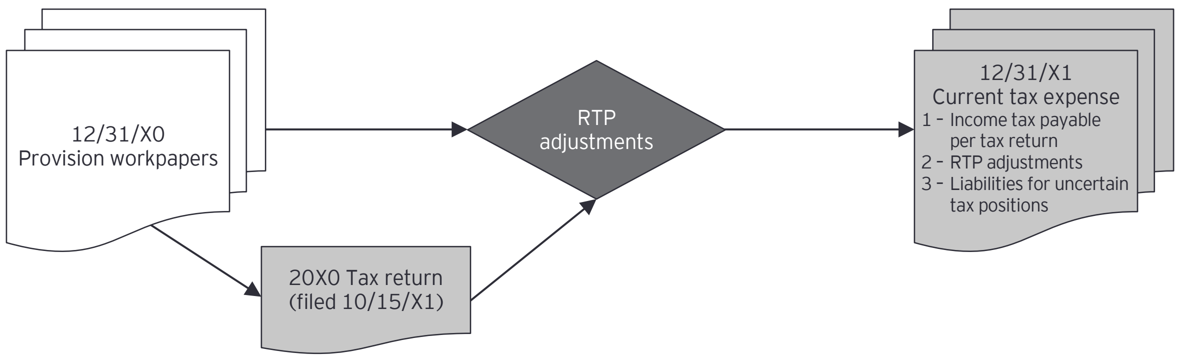
Step 1	**Identify (1) the types and amounts of all temporary differences and (2) the nature and amounts of all operating loss and tax credit carryforwards, including the remaining carryforward period.**
Step 2	**Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate.**
Step 3	**Measure the total deferred tax asset for deductible temporary differences and tax operating loss carryforwards using the applicable tax rate.**
Step 4	**Measure deferred tax assets for each type of tax credit carryforward.**
Step 5	**Reduce deferred tax assets by a valuation allowance, if it is more likely than not (a likelihood of more than 50%) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. See chapter 6, Valuation allowances, for a further discussion of valuation allowances.**

Return-to-provision adjustments

Because the financial statements are typically issued before tax returns are filed, there may be a difference between a company's estimated taxes payable in its financial statements (the provision) and the actual taxes reported in its tax return for the year. When there is a difference, a company will record a return-to-provision (RTP) adjustment to adjust its year-end estimates. The company should carefully evaluate whether this adjustment is a change in accounting estimate or an error correction under ASC 250. Refer to section 6.1.1, *Error correction versus a change in accounting estimate*, in our FRD, ***Accounting changes and error corrections***. Changes in estimates for RTP adjustments should be recorded in the interim period the change is identified, even if the return has not yet been filed.

Illustration 3-1: Return-to-provision adjustments

Assume that a calendar-year-end company issued financial statements for the year ended 12/31/X0 and filed the 20X0 tax return on 10/15/X1.



The tax provision reported in the 20X0 financial statements is the starting point for identifying RTP adjustments because this amount needs to be compared with the actual book-tax differences per the return.

The 20X0 tax provision is as follows (assuming a tax rate of 25%):

Pretax income	$ 1,000
Permanent differences: Meals	100
Temp difference: Depreciation	(35)
Total book-tax difference	65
Taxable income	1,065
Current tax expense	266
Deferred tax expense	9
Total tax expense reported as 20X0 tax provision	$ 275

In September 20X1, the 20X0 tax return is prepared. The 20X0 income statement and the 20X0 tax return are compared to determine actual book-tax differences:

	20X0 Income statement	20X0 Tax return	Actual book-tax difference
Sales revenue	$ 2,000	$ 2,000	$ 0
Meals	(200)	(100)	100
Salary	(380)	(380)	0
Depreciation	(420)	(475)	(55)
Pretax income/taxable income	$ 1,000	$ 1,045	$ 45

As part of the 20X0 tax return preparation process, the company will calculate any RTP adjustments that need to be reflected in the 20X1 tax provision by comparing the book-tax differences in the 20X0 provision with the actual book-tax differences:

	20X0 Income statement	20X0 Tax return	Actual book-tax difference	Book-tax difference per 20X0 provision	RTP adjustment
Sales revenue	$ 2,000	$ 2,000	$ 0	$ 0	$ 0
Meals	(200)	(100)	100	100	0
Salary	(380)	(380)	0	0	0
Depreciation	(420)	(475)	(55)	(35)	(20)
Pretax income/taxable income	$ 1,000	$ 1,045	$ 45	$ 65	$ (20)
Current tax expense	$ (266)	$ (261)	$ (11)	$ (16)	$ (5)
Deferred tax expense			$ (14)	$ (9)	$ 5

Any RTP adjustments are recorded as part of the current and deferred tax provision for which the adjustments are identified. Since the RTP adjustments were identified in September 20X1, they would be recorded in the financial statements for the third quarter of 20X1, even though the return will be filed in the fourth quarter of 20X1.

In this example, there is only one item that requires an RTP adjustment. The company estimated that tax depreciation would exceed book depreciation expense by $35,000. The actual amount was $55,000, which results in a $20,000 RTP adjustment (additional tax deduction).

The difference in meals expense between the income statement and the tax provision relates to a permanent difference and does not require an RTP adjustment because it was estimated accurately. This difference arose because US federal tax regulations only allow a deduction for 50% of expenses for meals.

3.2 Exceptions to comprehensive accounting for deferred taxes

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-3

The only exceptions in applying those basic requirements are:

a. Certain exceptions to the requirements for recognition of deferred taxes whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

1. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign **corporate joint venture** that is essentially permanent in duration. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.

2. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.

3. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.

4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. See paragraph 944-740-25-2 for the specific requirements related to this exception.

b. Subparagraph superseded by Accounting Standards Update No. 2017-15

c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Subtopic 840-30

d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3)

e. A prohibition on recognition of a deferred tax asset for the difference between the tax basis of **inventory** in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group. Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.

f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

The only exceptions in applying those basic requirements are:

a. Certain exceptions to the requirements for recognition of deferred taxes whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

1. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign **corporate joint venture** that is essentially permanent in duration. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.

2. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.

3. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.

4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. See paragraph 944-740-25-2 for the specific requirements related to this exception.

b. Subparagraph superseded by Accounting Standards Update No. 2017-15

> c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Subtopic 842-50
>
> d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3)
>
> e. A prohibition on recognition of a deferred tax asset for the difference between the tax basis of **inventory** in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group. Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.
>
> f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

ASC 740-10-25-2 requires deferred taxes to be provided for all temporary differences that will have future tax consequences. The only exceptions to providing deferred taxes are in the specific guidance in ASC 740-10-25-3 and include the following:

- A deferred tax liability is not recognized unless it becomes apparent that it will reverse in the foreseeable future for:
  - An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration.
  - Book/tax basis differences related to undistributed earnings of domestic subsidiaries and corporate joint ventures that arose in fiscal years beginning on or before 15 December 1992.
  - Temporary differences related to the policyholders' surplus account of stock life insurance companies in fiscal years beginning on or before 15 December 1992.
  - Temporary differences related to tax years beginning before 31 December 1987 for savings and loan association bad debt reserves.
- Leveraged leases recorded under ASC 840 or ASC 842, *Leases*. ASC 740 does not change the accounting for leveraged leases required by ASC 840 or ASC 842-50 (after the adoption of ASC 842). See section 3.2.1, *Leveraged leases*, for further discussion of leveraged lease income tax accounting.
- Deferred tax assets and liabilities related to goodwill (recognized after the adoption of ASC 805) for which the amortization is not deductible for tax purposes, as discussed in section 11.3.1, *Nondeductible goodwill*.
- Intercompany transfers of inventory within the consolidated financial reporting group as discussed in section 3.2.2, *Intercompany transactions*.
- Differences related to assets and liabilities of a foreign subsidiary that, under ASC 830, are remeasured from the local currency into US dollars using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes as discussed in section 3.2.3, *Foreign currency differences*.

In addition to the exceptions listed above, deferred taxes are not recognized on (1) basis differences related to cash surrender value amounts for life insurance if management has the ability and intention to hold the policy until the death of the insured so that the recovery of the asset (i.e., policy proceeds) is not included in taxable income (ASC 740-10-25-30) and (2) outside basis differences of a consolidated subsidiary (or corporate joint venture) if income taxes can be avoided by appropriate tax-planning elections (ASC 740-30-25-7, ASC 740-30-25-8 and ASC 740-30-25-9). See sections 14.4.4, *Basis differences without tax consequences*, and 4.2.7, *Tax-planning strategies*, for further discussion.

3.2.1 Leveraged leases

Note:

In February 2016, the FASB issued a new leases standard (ASC 842). ASC 842 supersedes ASC 840. ASC 842 eliminates leveraged lease accounting for new leases on its effective date. That is, after the effective date lessors account for all new leases, including those that would have qualified as leveraged leases under ASC 840, using the classification guidance in ASC 842. For such leases, entities apply other relevant US GAAP (e.g., ASC 740, ASC 470) to account for the non-lease components of such transactions.

Leveraged lease arrangements that exist before the effective date are grandfathered and therefore continue to follow the existing recognition, measurement, presentation and disclosure guidance for leveraged leases that was carried forward to ASC 842-50. If an existing leveraged lease is modified on or after the effective date of the new standard, the existing leveraged lease is required to be reclassified as a sales-type, direct financing or operating lease, as applicable, using the lease classification guidance in ASC 842.

Effective date

The adoption of ASC 842 was effective for annual periods beginning after 15 December 2018 (i.e., 1 January 2019 for a calendar-year public business entity), and interim periods within those years, for public business entities and both of the following:

- Not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market (except for those entities that had not yet issued their financial statements or made financial statements available as of 3 June 2020, for which the adoption of ASC 842 was effective for fiscal years beginning after 15 December 2019, and interim periods within those fiscal years)
- Employee benefit plans that file or furnish financial statements with or to the SEC

For all other entities, the adoption of ASC 842 was effective for annual periods beginning after 15 December 2021 (i.e., 1 January 2022 for a calendar-year entity), and interim periods beginning after 15 December 2022 (i.e., 1 January 2023 for a calendar-year entity). Early adoption is permitted for all entities.

Under ASC 840 (before the adoption of ASC 842) or ASC 842-50 (after the adoption of ASC 842), income tax rates are an important assumption in determining the rate of return on a leveraged lease. If tax rates change, lessors must recalculate the allocation of income on the leveraged lease based on after-tax cash flows as revised for the change in tax rates. ASC 740 does not change that requirement. In addition, ASC 740 does not change the accounting rules with respect to allocating the purchase price in a business combination to acquired leveraged leases as required by ASC 840-30-30-15 (before the adoption of ASC 842) or ASC 842-50-30-2 (after the adoption of ASC 842). Although the accounting for income taxes related to leveraged leases is not consistent with the requirements of ASC 740, the Board decided not to reopen the subject of leveraged lease accounting while deliberating Statement 109. For a comprehensive discussion of leveraged leases, see our separate FRDs, ***Lease accounting: Accounting Standards Codification 840, Leases*** and ***Lease accounting: Accounting Standards Codification 842, Leases***.

ASC 840-30-35-42 (before the adoption of ASC 842) or ASC 842-50-35-10 (after the adoption of ASC 842) requires companies to treat a change or projected change in the timing of cash flows relating to income taxes in a leveraged lease transaction as a change of an important assumption requiring a recalculation in accordance with ASC 840 (before the adoption of ASC 842) or ASC 842-50 (after the adoption of ASC 842).

3.2.1.1 Leveraged lease tax credits as source of taxable income

Integration of leveraged lease income tax accounting and accounting for other temporary differences is required by ASC 740 when deferred tax credits related to leveraged leases are the only source of taxable income when assessing the need for a valuation allowance for deferred tax assets not related to leveraged leases. A valuation allowance is not required when the deductible temporary differences and carryforwards will be offset by taxable amounts from future recoveries of the net investment in the leveraged lease. However, to the extent the leveraged-lease deferred tax credits, as determined by the leveraged lease guidance in ASC 840 (before the adoption of ASC 842) or ASC 842-50 (after the adoption of ASC 842), differ from the amount of the deferred tax liability that would result from applying the guidance for accounting for income taxes in ASC 740, that difference is preserved and is not considered a source of taxable income for purposes of recognizing the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards. In other words, the taxable temporary difference as computed under the general guidance for deferred income taxes in ASC 740 is the maximum amount to be considered in evaluating the need for a valuation allowance. Refer to section 6.4, *Source two — future reversals of existing temporary differences*, for more information on evaluating the need for a valuation allowance.

The following example, although somewhat simplified, illustrates the requirement to preserve the difference between deferred tax balances computed under the leveraged lease guidance in ASC 840 (before the adoption of ASC 842) or ASC 842-50 (after the adoption of ASC 842) and those computed under the accounting for income taxes guidance in ASC 740.

Illustration 3-2: Difference between deferred tax balances computed under the leveraged lease guidance in ASC 840 (or ASC 842-50 after adoption) and income taxes guidance in ASC 740

Assume a company entered a leveraged lease when tax rates were 45%, and tax rates are subsequently reduced to 35%.

At the end of year 2, deferred tax effects related to the leveraged lease are computed as follows:

	Leveraged lease guidance	Income taxes guidance
Net rentals receivable	$ 2,000	$ 2,000
Tax basis	1,500	1,500
Taxable temporary difference	500	500
Tax rate	40%[(a)]	35%
Deferred tax liability	$ 200	$ 175

(a) Derived. Deferred tax effects computed under ASC 840 (before the adoption of ASC 842) or ASC 842-50 (after the adoption of ASC 842), adjusting for the change in total net income from the lease as a result of the decrease in tax rates from 45% to 35%.

Also, assume at the end of year 2 the company has a deductible temporary difference of $1,500 scheduled to reverse in year 6 arising from a warranty accrual resulting in a gross deferred tax asset of $525 ($1,500 x 35%). Absent consideration of the deferred tax credits related to the leveraged lease, the weight of available evidence indicates a valuation allowance is required for the entire $525 deferred tax asset. In this case, a valuation allowance would be required for $350 ($525-$175) and a net deferred tax benefit of $175 is recognized. Although the recorded deferred tax credit related to the leveraged lease temporary difference is $200, $25 of that credit relates to special tax recognition provisions related to leveraged lease guidance in ASC 840 (before the adoption of ASC 842) or ASC 842-50 (after the adoption of ASC 842) and is not available for offsetting deferred tax assets.

3.2.1.2 Effect of change in effective tax rate

The lessor's income tax rate is an important assumption in determining the amount and timing of revenue recognition from a leveraged lease. Accordingly, the effect of a change in tax laws or rates on revenues from leasing activities should be recognized in the period in which the change in tax laws or rates is enacted. ASC 840-30-50-6 (before the adoption of ASC 842) or ASC 842-50-50-3 (after the adoption of ASC 842) requires disclosure of the reason for a significant variation from the customary relationship between income tax expense and pretax accounting income consistent with ASC 740-10-50-14 if the effect of a change in tax laws or rates on the timing and/or amount of revenue recognized from leveraged leasing activities results in a variation that is not otherwise apparent.

ASC 840-30-35-41 through ASC 840-30-35-47 (before the adoption of ASC 842) or ASC 842-50-35-9 through ASC 842-50-35-15 (after the adoption of ASC 842) requires all components of a leveraged lease be recalculated from inception of the lease based on the revised after-tax cash flows arising from a change in tax laws and/or rates or changes in tax positions, including repeal of the investment tax credit. The difference between the amounts originally recorded and the recalculated amounts are included as a cumulative catch-up in income of the period in which the tax law is enacted. For further discussion, see our FRDs, ***Lease accounting: Accounting Standards Codification 840, Leases*** and ***Lease accounting: Accounting Standards Codification 842, Leases***.

3.2.1.3 Effect of alternative minimum tax (AMT) on leveraged lease accounting (updated August 2022)

The lessor's income tax rate, and the amount of taxes paid, or tax benefits received, are important assumptions in a leveraged lease calculation. Any difference between AMT depreciation and the tax depreciation assumed in the leveraged lease or between income recognition for financial reporting purposes and AMT income could, depending on the lessor's overall tax situation, result in AMT or the utilization of AMT credits. In the circumstances in which AMT is paid or an AMT credit is utilized, the total cash flows from the leveraged lease could be changed, and the lessor's net investment in the leveraged lease and income recognition would be affected.

An entity should include assumptions regarding the effect of the AMT, considering its consolidated tax position, in leveraged lease computations. An entity whose tax position frequently varies between AMT and regular tax would not be required to recompute each year unless there was an indication that the original assumptions regarding total after-tax net income from the lease were no longer valid. In that circumstance, the entity would be required to revise the leveraged lease computations in any period in which management believes that total net income from the leveraged lease will be affected due to the effect of the AMT on cash flows for the lease (ASC 840-30-35-52 (before the adoption of ASC 842) or ASC 842-50-35-20 (after the adoption of ASC 842)). For further discussion, see our FRDs, ***Lease accounting: Accounting Standards Codification 840, Leases*** and ***Lease accounting: Accounting Standards Codification 842, Leases***.

3.2.1.4 Leveraged leases acquired in business combinations

The guidance for leveraged leases acquired in a business combination is found in ASC 840 (before the adoption of ASC 842) or ASC 842-50 (after the adoption of ASC 842) and provides that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the business combination date should not be accounted for as a deferred tax credit. Any tax effects included in unearned and deferred income are not offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss and tax credit carryforwards. However, deferred tax credits arising after the business combination date are accounted for in the same manner as deferred tax credits on leveraged leases not acquired in a business combination.

3.2.2 Intercompany transactions

ASC 740 generally requires companies to recognize the income tax effects of intercompany sales or transfers of assets in the income statement as income tax expense (or benefit) in the period the sale or transfer occurs. However, ASC 740-10-25-3(e) provides an exception to recognizing the deferred income tax effects of intercompany sales or transfers of inventory. ASC 810-10-45-8 also provides guidance that no tax effect should be recognized in earnings due to a sale or transfer of inventory among members of a consolidated group while the inventory remains within the consolidated group.

Companies should evaluate whether the tax effects of intercompany sales or transfers of non-inventory assets should be included in their estimates of annual effective tax rates by using existing interim guidance on income tax accounting. See chapter 20, *Interim reporting,* for additional information on interim reporting.

Excerpt from Accounting Standards Codification

Consolidation — Overall

Other Presentation Matters

810-10-45-1

In the preparation of **consolidated financial statements**, intra-entity balances and transactions shall be eliminated. This includes intra-entity open account balances, security holdings, sales and purchases, interest, dividends, and so forth. As consolidated financial statements are based on the assumption that they represent the financial position and operating results of a single economic entity, such statements shall not include gain or loss on transactions among the entities in the **consolidated group**. Accordingly, any intra-entity profit or loss on assets remaining within the consolidated group shall be eliminated; the concept usually applied for this purpose is gross profit or loss (see also paragraph 810-10-45-8).

810-10-45-8

If income taxes have been paid on intra-entity profits on **inventory** remaining within the consolidated group, those taxes shall be deferred or the intra-entity profits to be eliminated in consolidation shall be appropriately reduced.

Transactions may occur among entities that are part of a consolidated reporting entity. In accordance with ASC 810-10-45-1, intra-entity balances and transactions are eliminated in the preparation of the consolidated financial statements. However, income tax consequences may result from intra-entity transactions.

Assets are sometimes sold between affiliated companies that are consolidated for financial statement purposes but file separate income tax returns (either unconsolidated returns within the same tax jurisdiction or cross-border affiliates):[1]

- The seller generally reflects the profit or loss on the sale and the related income tax effect of that profit or loss.
- The buyer generally reflects the assets at the intercompany transfer price (including the seller's profit or loss), and the buyer's tax basis equals the transfer price.
- In consolidation, the seller's pretax profit is reversed, and the assets are carried at historical cost (that is, the seller's cost).

The buyer's tax basis in excess of the consolidated book basis meets the definition of a temporary difference that should be recognized in the financial statements. However, ASC 740-10-25-3(e) prohibits the recognition of deferred taxes for the difference between the tax basis of inventory in the buyer's

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[1] The analysis of intercompany transactions is made without regard to the guidance pertaining to common control transactions as, by their nature, intercompany transactions eliminate in consolidation.

jurisdiction and the carrying amount reported in the consolidated financial statements. This is consistent with the consolidation guidance in ASC 810-10-45-8. That is, no tax effect should be recognized in earnings due to a sale or transfer of inventory among members of a consolidated group (i.e., intercompany transfers). For example, the consolidation entries that eliminate intercompany profit due to sale of inventory will also defer the income taxes paid (or accrued) by the seller. Also noteworthy is that the prepaid tax is not a temporary difference. This approach requires companies to track (in the period of the intercompany sale or transfer of inventory and subsequent periods) intercompany activity and related income taxes to avoid misstatement of deferred taxes in the consolidated financial statements. In addition, this approach minimizes income statement volatility from intercompany inventory transactions as it precludes recognition of a tax benefit or expense attributable to intercompany inventory transactions in differing jurisdictions until the asset leaves the consolidated group (e.g., by sale to a third party).

The Master Glossary of the ASC describes inventory as tangible personal property that is awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process) and goods to be consumed directly or indirectly in production (raw materials and supplies). Long-term assets subject to depreciation (or amortization) accounting or goods that, when put into use, will be classified as long-term assets do not meet the definition.

For intercompany sales or transfers of assets other than inventory, a company recognizes the income tax effects in the period the intercompany sale or transfer occurs. Careful consideration of all facts and circumstances, including understanding the tax laws in both the buyer's and seller's tax jurisdiction, is necessary to determine the timing and measurement of the related tax effects. Refer to section 3.2.2.8, *Intercompany sale or transfer of assets other than inventory*, for further guidance. Also see section 11.2.1.3, *Post-combination intercompany transfers of acquired intellectual property*.

3.2.2.1 Measurement of prepaid tax on intercompany sales or transfers of inventory

Questions have arisen in practice regarding how to measure the amount of the tax paid by the seller on the intercompany profit from the sale of inventory. We believe that a with-and-without approach (that is, the intercompany profit should be considered the last item to enter into the seller's computation of taxes payable in the period of the sale) should generally be used. Under a with-and-without approach, the prepaid (accrued) tax associated with the intercompany transaction would be equal to the difference between the taxes payable (receivable) by the seller with and without the intercompany profit.

In addition, to the extent the sale affects deferred tax balances in the financial statements (for example, if the tax basis of the inventory sold is different from the seller's financial statement carrying amount of the inventory prior to the sale), that effect should also be accrued in the consolidated financial statements by the consolidating entry in the same manner as the taxes paid on the intercompany transfer. Under this method, the prepaid (accrued) amount includes the incremental taxes paid (avoided) by the seller and any deferred taxes related to temporary differences in the seller's tax jurisdiction before the transfer.

Effect of indirect taxes incurred when measuring prepaid tax on intercompany sales or transfers of inventory

If the intercompany sale of inventory from a foreign subsidiary results in incremental taxes paid (or changes to deferred taxes) by the US parent of the seller, the incremental taxes incurred in the buyer's jurisdiction should be considered when determining taxes payable (receivable) under the with-and-without approach in the consolidated financial statements. For example, this would be the case when a US parent is subject to the global intangible low-taxed income (GILTI) and the gross profit realized by the foreign affiliate on the intercompany sale of inventory is part of the GILTI amount included in the US parent's taxable income.

3.2.2.1.1 *Consideration of NOLs and intercompany sales or transfers of inventory*

A tax in the seller's jurisdiction that arises as a result of an intercompany transaction may be "paid" in cash or satisfied with existing tax attributes (i.e., existing net operating losses (NOLs)).

When a deferred tax asset (i.e., NOL) with a corresponding valuation allowance is used to "pay" the tax in the seller's jurisdiction, a question arises as to whether the intercompany inventory transaction results in a change in judgment about the realizability of the existing deferred tax asset. We believe that this assessment requires careful consideration of the facts and circumstances and the economics of the intercompany transaction on a consolidated basis. Further, the method by which a company pays the tax due on an intercompany transaction may not have an effect on the measurement of the prepaid tax associated with intercompany inventory transactions.

Deferred tax asset is realizable

If the net effect of the intercompany transaction is that a deferred tax asset that was not more likely than not to be realized in the seller's jurisdiction is shifted to the buyer's jurisdiction where the resultant tax basis is more likely than not to be realized ("true utilization"), the related valuation allowance would be reversed.[2] A change in judgment related to the beginning-of-the-year balance of a valuation allowance results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. Such a change is generally included in income from continuing operations (see section 6.11, *A change in valuation allowance*).

Additionally, to the extent the intercompany inventory transaction is within the seller's control, the reporting entity should consider the potential for such intercompany transactions when considering tax-planning strategies supporting the realizability of its deferred tax assets. See section 6.5, *Source three — tax-planning strategies*, for discussion of tax-planning strategies when considering the need for a valuation allowance.

Deferred tax asset is not realizable

If the intercompany sale or transfer of inventory results in a deductible temporary difference (albeit unrecorded) that is not more likely than not to be realized in the buyer's jurisdiction and the deferred tax asset in the seller's jurisdiction is also not more likely than not to be realized absent the intercompany transaction, no realization has occurred. The intercompany transaction represents a substitution of one deferred tax asset for another deferred tax asset — neither of which are more likely than not to be realized. The economics of the intercompany transaction in this instance are such that a previously unrealizable deferred tax asset remains an unrealizable benefit and has been merely transferred from the seller's jurisdiction to the buyer's jurisdiction and remains in the consolidated entity. There has been no true utilization of a deferred tax asset by the consolidated entity, and a valuation allowance is still required.

Difference in tax rates

An intercompany transaction may result in a difference in rates applicable in the seller's and buyer's jurisdictions. It may be necessary to include the effect of the difference in tax rates in the evaluation to the extent that the deferred tax asset is more likely than not to be realized. That is, the difference in the tax rate between the buying and selling jurisdictions results in the deferred tax asset (before consideration of the tax effects related to the intercompany transaction) being adjusted. We find that many intercompany transactions move an asset to a lower tax jurisdiction, resulting in only a portion of the deferred tax asset (as historically recognized in the seller's jurisdiction) remaining after the intercompany transaction.

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[2] This scenario assumes no difference in tax rates in the buyer's and seller's tax jurisdictions.

When a company sells or transfers inventory, the effect of a change in tax rates applied to the deductible temporary difference is included in the prepaid asset. However, if a valuation allowance is necessary in both the buyer's and the seller's jurisdictions, a determination of the effect of a rate differential may not be necessary as there is no recognition of a tax benefit related to the intercompany transaction.

The following illustrates these concepts when there are intercompany sales of inventory.

Illustration 3-3: Tax implications of transferring inventory via an intercompany sale

Facts

- Parent routinely sells inventory via an intercompany sale from wholly owned Subsidiary A (SubA) to wholly owned Subsidiary Z (SubZ) in the ordinary course of business.
- SubA and SubZ are taxable entities and are in different tax jurisdictions.
- SubA's statutory tax rate is 30%, and SubZ's statutory tax rate is 5%.
- SubA has existing net operating losses and has determined that the related deferred tax assets are not more likely than not to be realized (i.e., a valuation allowance has been recorded against SubA's deferred tax assets).
- The intercompany sale of inventory did not historically qualify as a tax-planning strategy (as described in section 6.5) and was, therefore, not considered to be a source of taxable income for realization of SubA's deferred tax assets.
- SubA expects to satisfy any tax due on an intercompany transaction through utilization of net operating losses.
- Just before the intercompany transaction, the inventory is valued by SubA as:

Carrying value	$ 10
Tax basis	10
Fair value	100

- SubZ has existing net operating losses that are not more likely than not to be realized.
- SubA sells its inventory to SubZ at fair value.

Analysis

SubA would record the following on its separate financial statements:

Cash	$ 100	
Gross profit		$ 90
Inventory		10
Sale of inventory to SubZ		
Tax expense	$ 27	
Taxes payable		$ 27
Tax due to SubA's taxing authority		

SubZ would record the following on its separate financial statements:

Inventory	$ 100	
Cash		$ 100
Acquisition of inventory		

SubZ's tax basis in the inventory is $100. Because the financial reporting basis and the tax basis of the inventory are both $100, no temporary difference exists on SubZ's separate financial statements.

In the preparation of Parent's consolidated financial statements, the profit on sale will be eliminated and the related income tax effects are considered in accordance with ASC 810-10-45-8.

The following elimination entries are recorded in consolidation:

SubA:		
Gross profit	$ 90	
Consolidation/elimination account		$ 90
Elimination of gain on intercompany sale in consolidation		
Prepaid tax	$ 27	
Tax expense		$ 27
Reversal of tax expense related to intercompany transaction and resulting recognition of prepaid tax		
SubZ:		
Consolidation/elimination account	$ 90	
Inventory		$ 90
Elimination of intercompany profit in inventory		

Subsequent to the consolidation, a basis difference exists related to the inventory (book basis is $10 and tax basis is $100 in SubZ's jurisdiction). As discussed in section 3.2.2, *Intercompany transactions*, this deductible temporary difference is not recognized. SubZ should monitor this deferred tax balance, ensuring it is properly excluded from the consolidated financial statements.

The evaluation of the need for a valuation allowance on existing tax attributes (i.e., net operating losses) in the selling jurisdiction requires additional consideration in the period of the transaction. When measuring the prepaid tax, the deductible temporary difference that is created (but not recognized in consolidated financial statements) should be evaluated to determine whether it is more likely than not to be realized by SubZ. Additionally, if the basis difference related to the inventory is determined to be realizable, only a portion of the existing net operating losses is truly realized because of the difference in rates applicable to SubA and SubZ. The true utilization of the deferred tax asset would be limited to the step-up in basis at the buying entity's tax rate.

In SubA's separate financial statements, the tax due as a result of the intercompany transaction is relieved through existing net operating losses.

Taxes payable	$ 27	
Net operating loss		$ 27
Payment of tax utilizing existing net operating losses		
Valuation allowance	$ 27	
Tax benefit		$ 27
Reversal of valuation allowance with use of tax attribute		

Scenario 1: Deferred tax asset is not realizable

Under this scenario, when measuring the prepaid tax, the benefit is not realized, as the unrecorded deferred tax asset in SubZ is not more likely than not to be realized. The net operating losses in SubA (that had a 100% valuation allowance) are simply replaced with another deferred tax asset (i.e., the step-up in tax basis) in SubZ. Parent has concluded that any deferred tax asset in SubZ also is not more likely than not to be realized and would require a 100% valuation allowance. Therefore, Parent will not recognize a benefit from the release of the valuation allowance on the date of the intercompany transaction but rather the valuation allowance will remain.

Tax benefit	$ 27	
Prepaid tax		$ 27

Reversal of tax benefit as no benefit is realized in consolidated financial statements

The valuation allowance included in the measurement of the prepaid tax account will be reduced as the prepaid tax is amortized.

Scenario 2: Deferred tax asset is realizable

Under this scenario, the unrecorded deferred tax asset in SubZ is more likely than not to be realized. That is, the net operating losses in SubA (that had a 100% valuation allowance) are replaced with another deferred tax asset (i.e., the step-up in tax basis) in SubZ that is realizable (no valuation allowance is necessary). However, the realizable deferred tax asset is at the lower rate in SubZ's jurisdiction. Parent will recognize a benefit from the release of the valuation allowance limited to the amount that is more likely than not to be realized by SubZ on the date of the intercompany transaction. However, because the tax rate differs between SubA (30% tax rate) and SubZ (5% tax rate), only a portion of the benefit ($4.5 = 5% tax rate * $90 unrecognized deductible temporary difference) is realizable.

Tax benefit	$ 22.5	
Prepaid tax		$ 22.5

Reversal of the tax benefit related to the portion of the deferred tax asset that is not realized due to the reduced tax rate in the buyer's jurisdiction ($22.5 = $27 (SubA DTA) less $4.5 (SubZ realizable DTA))

3.2.2.2 Classification of prepaid tax on intercompany sales or transfers of inventory

The general guidance for accounting of income taxes in ASC 740 does not specifically address the balance sheet classification of taxes paid (avoided) and accrued in accordance with ASC 810. We believe it would generally be appropriate to reflect the taxes paid (to be paid) as prepaid (accrued) taxes rather than as a component of the consolidated deferred tax accounts.

3.2.2.3 Effect of subsequent changes in tax rates on prepaid (accrued) taxes attributable to intercompany inventory transactions

Prepaid (accrued) taxes arising from intercompany transactions are different from deferred taxes under ASC 740. Generally, deferred taxes are subject to remeasurement if tax rates change as discussed in chapter 8, *An enacted change in tax laws or rates*. However, because prepaid (accrued) taxes on intercompany transactions are attributable to taxes paid (incurred) on prior transactions, the reversal of those amounts will generally not be subject to the new tax laws or rates and, therefore, are generally not subject to the remeasurement provisions of ASC 740-10-45-15.

Tax legislation may prescribe changes that become effective during an entity's fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. For example, in the US, existing tax law provides that if the taxable year includes the effective date of any rate changes (unless the effective date is the first day of the taxable year), taxes should be calculated by applying a blended rate to the taxable income for the entire year. Any tax rate changes in the US thus are administratively effective on the enactment date.

When a rate is administratively retroactive to the beginning of the year, companies may need to consider the effects of new corporate tax rates by applying a blended tax rate as if they were applied to the beginning of their fiscal year. These companies will need to consider the effects of using a blended tax rate and adjust the related prepaid or accrued income taxes from intercompany transfers arising in the fiscal year in the reporting period that includes the enactment date. See section 20.3, *Effect of new tax legislation (before the adoption of ASU 2019-12)*, and section 20.3A, *Effect of new tax legislation (after the adoption of ASU 2019-12)*, for discussion on the effect of new tax legislation on interim reporting.

3.2.2.4 Changes in realizability of prepaid (accrued) taxes attributable to intercompany transfers or sales of inventory

Unlike other deferred tax assets and liabilities, the prepaid (accrued) taxes associated with an intercompany transfer represent the tax effect of past events, and that tax effect is simply deferred. Therefore, ASC 740-10-30-17's requirement to evaluate the need for, and amount of, a valuation allowance at each balance sheet date for deferred tax assets is not generally applicable to prepaid (accrued) taxes attributable to prior intercompany inventory transactions because those amounts will generally not be changed by future events. Instead, the prepaid (accrued) tax attributable to prior intercompany transactions is affected by the sale, disposal or write-down in the carrying amount of the related asset. Thus, the only realization test that would apply would be the realization test under ASC 330, *Inventory*, for the related inventory (excluding the prepaid asset that was subject to the intercompany transaction).

However, as discussed in section 3.2.2.1.1, *Consideration of NOLs and intercompany sales or transfers of inventory*, a deferred tax asset and valuation allowance may be considered in the measurement of the prepaid taxes associated with an intercompany inventory transaction. In that circumstance, realizability of the unrecorded deferred tax asset would need to be assessed as part of the initial measurement of the prepaid tax asset. Refer to section 3.2.2.1.1, *Consideration of NOLs and intercompany sales or transfers of inventory*, for further discussion.

3.2.2.5 Uncertain tax position considerations for intercompany sales or transfers of inventory

In some circumstances, an intercompany transaction may result in uncertain tax positions being taken by the company (e.g., transfer pricing). Such uncertain tax positions should be recognized and measured in accordance with the guidance in ASC 740, similar to all other uncertain tax positions (see chapter 19, *Accounting for uncertainty in income taxes*).

However, since there is no immediate tax effect recognized as a result of an intercompany sale or transfer of inventory, we believe that the incremental tax effect of the uncertain tax position also is included in the prepaid tax and recognized when the inventory leaves the consolidated group. The following example illustrates this concept.

Illustration 3-4: Uncertain tax position considerations for intercompany sale of inventory

Company A is a multinational corporation that has inventory in the US. Company A transferred the inventory to its wholly owned subsidiary via an intercompany sale at fair value. Company A recognized an intercompany profit of $100 and owed taxes on the gain of $25. Company A determined at the date of the sale (based on the recognition and measurement guidance in ASC 740) an incremental tax liability of $10 should be recognized related to this uncertain tax position (i.e., uncertainty as to measurement versus recognition).

At the date of the sale, Company A would record the following entry:

Prepaid tax	$ 35	
Liability for uncertain tax positions		$ 10
Income taxes payable		25

Subsequent changes in recognition or measurement should be considered part of the intercompany transaction and included in the prepaid tax and recognized on a pro rata basis through a cumulative catch-up adjustment.

We believe that interest related to the uncertain tax position is a separate transaction with the taxing authority outside of the intercompany transaction. That is, while the interest due to the taxing authority is related to the uncertain tax position, the interest due is an indirect effect and should not be included in the prepaid tax. Instead, interest accrues on an uncertain tax position over time and continues to accrue until the position is ultimately settled. See section 19.8, *Interest and penalties*, for further discussion.

3.2.2.6 Business combinations

An acquiree may enter into intercompany sales or transfers of inventory, prior to being acquired in a business combination, that are subject to the guidance in ASC 740-10-25-3(e) and ASC 810-10-45-8. As a result, the acquiree (prior to the acquisition) (1) may have been prohibited from recording certain deferred tax assets for the tax basis in excess of the book basis in the buyer's jurisdiction and (2) may have recorded prepaid taxes for the taxes due in the seller's jurisdiction in accordance with those provisions. In the acquiree's pre-acquisition books, no tax effects would have been recognized in earnings from the sale or transfer of inventory among members of its consolidated group. Refer to section 3.2.2, *Intercompany transactions*, for additional discussion of this guidance.

The exception to recording deferred tax assets for an acquiree's intercompany inventory sales and transfers (ASC 740-10-25-3(e)) does not carry over to the acquirer in a business combination. That is, in a business combination, the acquirer recognizes deferred tax assets and liabilities for the tax effects of differences between assigned book values (generally fair value) and tax bases of assets acquired and liabilities assumed. In addition, any prepaid taxes recorded by the acquiree as part of the pre-acquisition intercompany sale or transfer of inventory do not represent an asset acquired by the acquirer. In other words, those prepaid taxes of an acquiree are not recorded in the business combination.

Subsequent to the acquisition date, intercompany sales and transfers of inventory of the combined entity are subject to the guidance in ASC 740-10-25-3(e) and ASC 810-10-45-8.

See section 11.2.1.2, *Post-combination intercompany transactions*, for considerations of intercompany transactions entered into subsequent to a business combination.

3.2.2.7 Intercompany sale or transfer of an investment in a consolidated entity

An entity may complete an intercompany sale or transfer of an investment in a consolidated entity (e.g., the stock of a subsidiary). While the transfer of a subsidiary is not in the scope of ASC 740-10-25-3(e), if the subsidiary's assets include inventory, the inventory balances would be subject to the intra-entity guidance. To the extent there are taxes paid or payable attributable to the sale or transfer of the inventory (and to the extent that the inventory remains in the group), the taxes would be deferred as a prepaid in the consolidated financial statements.

In addition, careful consideration of the tax implications of a sale or transfer of an investment in a consolidated entity is necessary. In particular, the parent may have previously applied an exception to recording the tax effects of the outside basis difference related to the investment in a subsidiary or foreign corporate joint venture (see chapter 14, *Foreign and domestic subsidiaries*, for additional discussion of those exceptions). Prior to a sale or transfer of an investment in a subsidiary or foreign corporate joint venture, a company must first consider whether to recognize a deferred tax asset or deferred tax liability on the outside basis difference associated with the investment.

For example, a company previously asserted that an investment in a foreign subsidiary was indefinitely reinvested. Further, in the current period, the company contemplates an intercompany transfer of the shares of the foreign subsidiary. If the contemplated intercompany share transfer occurs, the parent will incur taxes payable associated with the existing outside basis difference (i.e., the transfer will trigger a deemed repatriation). The parent can no longer assert that the investment is indefinitely reinvested. The parent records the deferred tax liability associated with the outside basis difference in the period in which they can no longer assert the earnings are indefinitely reinvested. See section 14.3.1, *Investments that are essentially permanent in duration*, for additional discussion on changes in indefinite reinvestment assertions.

For purposes of highlighting the income tax accounting consequences of intercompany transfers between entities of a consolidated group, the following illustrations do not consider the common control guidance in ASC 805-50. If the illustrations applied this guidance, the receiving entity would recognize the assets and liabilities transferred at their carrying amounts in the financial statements of the transferring entity on the date of the transfer. The use of these carrying amounts is required even if the fair value of the transferred amounts is reliably determinable. Further, if the receiving entity transfers cash in the exchange, any cash transferred in excess of the carrying amount of the assets and liabilities transferred is treated as an equity transaction (i.e., a dividend). If the receiving entity issues equity interests in the exchange, the equity interests issued are recorded at an amount equal to the carrying amount of the net assets transferred, even if the fair value of the equity interests issued is reliably determinable.

We generally would expect that the transferring entity would not recognize a gain or loss on the transaction. Any difference between the proceeds received by the transferring entity and the book value of the asset group (after impairment, if any) would be recognized as an equity transaction (i.e., dividend or capital transaction) and no gain or loss would be recorded.

See sections C.4 and C.5 of our FRD, ***Business combinations***, for further information on the accounting for assets transferred between entities under common control.

Illustration 3-5: Tax implications of transferring an investment in a consolidated entity

Assume Parent, through a domestic holding company (Hold Co), has a wholly owned foreign subsidiary (Sub A) and a wholly owned domestic subsidiary (Sub B). Parent decides to transfer all shares of Sub A via an intercompany sale from Hold Co to Sub B. Hold Co's statutory tax rate is 30%. Hold Co has historically asserted its intent and ability to indefinitely reinvest the undistributed earnings of Sub A. Therefore, no deferred taxes have been provided on the outside basis difference on Hold Co's books. Just prior to Hold Co no longer asserting it has indefinitely reinvested Sub A's earnings, the investment in Sub A is as follows:

Carrying value	$	150
Tax basis		100
Fair value		320

Change in indefinite reinvestment:

Tax expense	$	15		
Deferred tax liability			$	15

*Record the deferred tax liability on the investment in Sub A as Hold Co can no longer assert its intent and ability to indefinitely reinvest Sub A's earnings and it cannot recover its investment in a tax-free liquidation. Hold Co records the entry in the interim period of the change in indefinite reinvestment assertion (($150-100) * 30% = 15).*

Assume the same values associated with Sub A exist when Hold Co sells its shares of Sub A at fair value to Sub B. Hold Co would record the following on its separate financial statements (common control guidance is not considered for purposes of this example):

Cash	$	320		
Gain on sale			$	170
Investment in Sub A				150

Sale of shares of Sub A to Sub B

Deferred tax liability	$	15		
Tax expense		51		
Taxes payable			$	66

Tax due to Hold Co's taxing authority related to gain on sale ($170.30=51)*

Sub B would record the following on its separate financial statements (common control guidance is not considered for purposes of this example):

Investment in Sub A	$	320		
Cash			$	320

Acquisition of Sub A

In the preparation of Parent's consolidated financial statements, the gain on sale will be eliminated in consolidation and the related income tax effects are recognized in accordance with ASC 810-10-45-8. In addition, if Sub A held inventory at the date of transfer and that inventory remained in the group, any taxes paid (accrued) associated with the transfer of the inventory would be deferred as a prepaid tax.

The following entries are recorded in consolidation:

Hold Co:

Gain on sale	$	170		
Consolidation/elimination account			$	170

Elimination of gain on intercompany sale in consolidation

Sub B:

Consolidation/elimination account	$	170		
Investment in Sub A			$	170

Elimination of intercompany profit in investments

Note: This illustration ignores the rules for common control. Refer to sections C.4 and C.5 of our FRD, ***Business combinations***, for further information on the accounting for assets transferred between entities under common control.

3.2.2.8 Intercompany sale or transfer of assets other than inventory

Companies are required to recognize the income tax effects of intercompany sales or transfers of assets, other than inventory, in the income statement as income tax expense (or benefit) in the period the sale or transfer occurs.

Identifying an intercompany sale (for book purposes) of a physical asset (e.g., fixed assets) is typically not complicated. However, determining the income tax consequences of certain asset sales or transfers, such as transfers of intellectual property, can present unique challenges. Careful consideration of all facts and circumstances, including understanding the tax laws in both the buyer's and seller's tax jurisdiction, is necessary to determine the timing and measurement of the related tax effects. Also see section 11.2.1.3, *Post-combination intercompany transfers of acquired intellectual property*.

The following example illustrates the accounting for an intercompany non-inventory transaction:

Illustration 3-6: Tax implications of an intercompany transfer of IP

Assume Parent decides to transfer intellectual property (IP) in an intercompany sale from wholly owned Subsidiary A (SubA) to wholly owned Subsidiary Z (SubZ). SubA and SubZ are taxable entities and are in different tax jurisdictions. SubA's statutory tax rate is 30% and SubZ's statutory tax rate is 10%.

Just before the intercompany transaction, the IP is valued by SubA as:

Carrying value	$	10
Tax basis		10
Fair value		100

Assume SubA sells its IP to SubZ at fair value. SubA would record the following journal entries (common control guidance is not considered):

Cash	$	100		
Gain on sale			$	90
Intangible asset				10
Sale of IP to SubZ				
Current tax expense	$	27		
Taxes payable			$	27

Tax due to SubA's taxing authority

SubZ would record the following journal entry (common control guidance is not considered for purposes of this example):

IP	$ 100	
Cash		$ 100

Acquisition of IP

In the preparation of Parent's consolidated financial statements, the gain on the sale will be eliminated. The following entries are recorded in consolidation:

SubA:

Gain on sale	$ 90	
Consolidation/elimination account		$ 90

Elimination of gain on intercompany sale in consolidation

SubZ:

Consolidation/elimination account	$ 90	
IP		$ 90

Elimination of intercompany profit in IP

As a result of the above elimination entries, a basis difference exists related to the IP (book basis is $10 and tax basis is $100 in SubZ's jurisdiction). Because the tax basis exceeds the book basis of the IP, a deferred tax asset of $9 exists ($90 tax basis difference * SubZ's 10% statutory rate).

SubZ:

Deferred tax asset	$ 9	
Deferred tax benefit		$ 9

Tax effect of step-up in tax basis

Both SubA and SubZ will need to consider the effects of any uncertain tax position that might arise as a result of the intercompany sale. Further, the deferred tax asset recorded by Sub Z will need to be evaluated for realizability.

Note: This illustration ignores the rules for common control. Refer to sections C.4 and C.5 of our FRD, ***Business combinations***, for further information on the accounting for assets transferred between entities under common control.

The structuring of intellectual property sales and transfer transactions can be complex and often requires careful consideration of the tax law in both the seller's and buyer's jurisdictions to determine the accounting implications. In the US, accounting for the tax consequences in the seller's jurisdiction may be less complex when cash consideration is exchanged at the date of transfer or sale. However, other transactions may be more complex. For example, when intellectual property is transferred or sold from the US to a foreign corporation under Internal Revenue Code (IRC) Section 367(d), additional considerations may arise. Under a 367(d) transaction, a company transfers intellectual property in exchange for shares in the foreign corporation. For US tax purposes, the transaction is deemed to be a sale of property in exchange for payments (considered to be annual royalties) that are contingent upon the future revenues generated from the IP and is included as taxable income in future periods. In the foreign jurisdiction, the foreign corporation will often have a tax basis in the transferred IP equal to the fair value of the IP at the date of transfer. Often, after considering intercompany eliminations, the tax basis of the transferred IP will be in excess of book basis in the consolidated financial statements. As a result, the company will record a deferred tax asset measured using the foreign corporation's tax rate (prior to considering realizability of the deferred tax asset).

We often get questions as to whether, at the date of a transfer, a deferred tax liability arose in the US based on the expected contingent future royalty stream included in a Section 367(d) transaction. Based on informal discussion with the SEC staff, we understand that the staff would accept the view that a deferred tax liability does not arise at the date of transfer. However, the SEC staff have not reached a definitive conclusion on whether the alternative view to recognize a deferred tax liability (i.e., based on the expected tax consequences of the future contingent royalty stream) may also be acceptable. The SEC staff indicated that they would encourage a registrant that is interested in applying the alternative view and recognizing a deferred tax liability on the date of transfer in connection with a 367(d) transaction to consult with the SEC staff prior to applying this conclusion.

3.2.2.8.1 Consideration of NOLs and intercompany transactions other than sales or transfers of inventory

A tax in the seller's jurisdiction that arises as a result of an intercompany transaction may be paid in cash or satisfied with existing tax attributes (i.e., existing NOLs). When a deferred tax asset (i.e., NOL) with a corresponding valuation allowance is used to pay the tax in the seller's jurisdiction, a question arises as to whether the intercompany transaction results in a change in judgment about the realizability of the existing deferred tax asset. We believe that this assessment requires careful consideration of the facts and circumstances and the economics of the intercompany transaction on a consolidated basis.

A company that sells or transfers an asset (other than inventory) and realizes a gain on the transaction in the seller's jurisdiction may settle the tax that arises as a result of the gain with NOLs. If those NOLs were previously determined to not be realizable, the company reverses the valuation allowance previously recorded (i.e., recognizes a benefit in the financial statements), which offsets the obligation due from the gain. That is, the tax expense recognized as a result of the gain is offset by the benefit recognized from reversal of the valuation allowance (i.e., no tax effect in the seller's jurisdiction).

In the buyer's jurisdiction, a deferred tax asset is recognized on the excess tax basis over book basis of the transferred non-inventory asset. That deferred tax asset (DTA) must also be assessed for realizability. If the DTA is more likely than not to be realized, a benefit is recorded in the consolidated financial statements. If the DTA is not more likely than not to be realized, the net effect on the financial statements will be zero, as the expense from recording a valuation allowance in the buyer's jurisdiction will offset the benefit from recognition of the deferred tax asset.

Additionally, to the extent the intercompany transaction is within the seller's control, the reporting entity should consider the potential for such intercompany transactions when considering tax-planning strategies supporting the realizability of its deferred tax assets. See section 6.5, *Source three — tax-planning strategies*, for discussion of tax-planning strategies when considering the need for a valuation allowance.

In certain transactions, the tax consequences of transferring an asset are not recognized at the transfer date but are recognized over time (e.g., transfers of IP under Section 367(d)). In those cases, careful consideration is necessary to determine if there is a change in judgment about the realizability of the existing deferred tax asset.

When a change in judgment related to the beginning-of-the-year balance of a valuation allowance results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years, such a change is generally included in income from continuing operations. However, when a company transfers an asset other than inventory it may trigger a current taxable gain (taxes payable) in the seller's jurisdiction. If the current year taxable gain on the transfer causes a change in judgment about the realization of the beginning-of-the-year valuation allowance, such a change is generally reflected where the source of that income is generated (e.g., gain from a transfer of an available-for-sale debt security recorded in other comprehensive income). See section 6.11, *A change in valuation allowance*.

Consider the following examples:

Illustration 3-7: Consideration of NOLs in intercompany transactions other than sales or transfers of inventory

Assume the same facts as presented in Illustration 3-6. Recall that SubA had a gain of $90 on the sale and a current tax expense and payable of $27. Recall that SubZ set up a deferred tax asset and a corresponding deferred tax benefit of $9.

Scenario 1

Assume that SubA plans to settle its $27 payable with existing NOLs, and that those NOLs have been determined to be realizable (that is, no valuation allowance has been previously recognized in SubA).

If SubZ's deferred tax asset is fully realizable, the net tax effect of the transfer would be an expense of $18 (i.e., SubA's current tax expense of $27 is offset by SubZ's deferred tax benefit of $9).

If SubZ's deferred tax asset is not realizable (i.e., not more likely than not to be realized), the benefit is not recognized. Parent would record a valuation allowance on the date of the intercompany transaction.

Deferred tax expense	$ 9	
Valuation allowance		$ 9

Establish valuation allowance on temporary deductible benefit that is not expected to be recovered

Therefore, when a valuation allowance is necessary in SubZ, the tax effect of the transfer in the Parent's consolidated financial statements would be an expense of $27 (i.e., no net deferred tax benefit recorded by SubZ).

Note that the above scenario would have the same net income statement effect if SubA had no existing NOLs and the payable were to be settled in cash.

Scenario 2

Now assume that SubA plans to settle its $27 payable with existing NOLs, and that those NOLs had previously been determined to be not realizable (that is, a full valuation allowance has been set up in SubA). In order to settle the payable, SubA records the following entry:

Valuation allowance	$ 27	
Deferred tax benefit		$ 27

Release valuation allowance on temporary deductible benefit that is now expected to be recovered

If SubZ's deferred tax asset is fully realizable, the net tax effect of the transfer would be a benefit of $9 (i.e., SubA's current tax expense of $27 is fully offset by the release of SubA's valuation allowance, and the remaining effect is SubZ's deferred tax benefit of $9).

Also consider that, to the extent the intercompany transaction was within the seller's control, the reporting entity should have considered the potential for such intercompany transactions when considering tax-planning strategies supporting the realizability of its deferred tax assets (i.e., when considering the realizability of the $27 net operating loss (NOL) prior to the execution of the intercompany transaction).

If SubZ's deferred tax asset is not realizable (i.e., not more likely than not to be realized), the benefit is not recognized. Parent would record a valuation allowance on the date of the intercompany transaction.

Deferred tax expense	$ 9	
Valuation allowance		$ 9

Establish valuation allowance on temporary deductible benefit that is not expected to be recovered

Therefore, when a valuation allowance is necessary in both SubA and SubZ, and NOLs are used to pay the taxes due by the seller, the tax effect of the transfer in the Parent's consolidated financial statements would be an expense of $0 (i.e., no net deferred tax expense or benefit recorded by either SubA or SubZ).

Note: This illustration ignores the rules for common control. Refer to sections C.4 and C.5 of our FRD, ***Business combinations***, for further information on the accounting for assets transferred between entities under common control.

3.2.3 Foreign currency differences

The functional currency is the currency of the primary economic environment in which the foreign subsidiary operates. Although the local currency is the functional currency for many foreign operations, some subsidiaries' functional currency is the parent's currency because those operations are primarily an extension of the parent. Also, if the cumulative three-year inflation rate in the foreign country is approximately 100% or more, the foreign subsidiary's financial statements are required to be remeasured as if the functional currency were the reporting currency (ASC 830-10-45-11).

3.2.3.1 Nonmonetary temporary differences

When a foreign entity uses the parent's currency as its functional currency, nonmonetary assets such as inventory, land and depreciable assets are remeasured into the parent's currency at historical exchange rates. When exchange rates change, the amount of foreign currency revenues needed to recover the parent's currency cost of those assets also changes, but the foreign currency tax bases of those assets do not change. However, in certain countries, particularly those with hyperinflationary economies, the tax bases of such assets may be revalued, partially or fully, in line with inflation as discussed in section 3.2.3.3, *Tax indexation of nonmonetary assets*, and section 3.3, *Remeasurement in highly inflationary economies*. Following changes in exchange rates, there will be differences between the amount of foreign currency needed to recover the parent's currency cost of those assets and the foreign currency tax basis of those assets. Those differences are referred to as foreign exchange basis differences.

The FASB acknowledged that, technically, those differences meet the definition of a temporary difference and would, therefore, be subject to deferred taxes. However, the FASB concluded that the substance of this accounting would be to recognize deferred taxes on exchange gains and losses that are not recognized under ASC 830. As a result, the FASB decided to prohibit recognition of deferred taxes due to exchange rate changes as they relate to nonmonetary assets where the parent's reporting currency is the foreign subsidiary's functional currency (ASC 740-10-25-3(f)). The FASB concluded an exchange rate change on nonmonetary assets is not an event that gives rise to recognition of a deferred tax asset or liability — notwithstanding the temporary difference that theoretically results. The FASB believed this decision reduced complexity by eliminating many cross-currency (US dollar cost versus foreign tax basis) computations of deferred taxes.

Although deferred taxes are not recognized for these differences, deferred taxes must be provided for differences between the foreign currency financial reporting amount and the foreign currency tax bases of assets and liabilities. An illustration of deferred tax calculations under ASC 740 for a foreign subsidiary using the US dollar as its functional currency follows.

Illustration 3-8: Computation of deferred taxes for differences between the foreign currency financial reporting amount and the foreign currency tax bases of assets

Assume the foreign operations of a US parent purchased fixed assets in 20X0 costing FC1,000 when the exchange rate was FC1= $1. Beginning in 20X1, the assets are amortized on a 5-year straight-line basis for tax purposes and on a 10-year straight-line basis for financial reporting purposes. The foreign tax rate is 50%, and the exchange rate at 31 December 20X1 is FC1 = $0.80. The US dollar is the functional currency. For simplicity, US deferred tax consequences are ignored. Deferred taxes at 31 December 20X1 are computed in accordance with ASC 740 as follows:

Difference between the foreign currency book and tax basis of fixed assets

	Foreign historical cost	Foreign tax basis	Taxable temporary difference
Cost	FC 1,000	FC 1,000	FC –
Accumulated depreciation	(100)	(200)	100
	FC 900	FC 800	100
Foreign tax rate			50%
Deferred foreign tax liability			FC 50
Year-end exchange rate			0.80
Deferred foreign tax liability in US dollars at 31 December 20X1			$ 40

Under ASC 740, deferred taxes are provided for temporary differences between the foreign currency book basis and tax basis of assets and liabilities (i.e., the inside basis difference). In this example, the original cost of the assets is FC 1,000 and book accumulated depreciation would be FC 100 at 31 December 20X1, assuming straight-line depreciation over a 10-year life. Accumulated depreciation for tax purposes is 20% of the tax basis, assuming straight-line depreciation over a 5-year life, or FC200. The FC100 resulting taxable temporary difference is multiplied by the 50% foreign tax rate to arrive at the deferred foreign tax liability of FC50, which equals $40 when remeasured into US dollars at 31 December 20X1.

3.2.3.2 Monetary temporary differences

Some companies have operations in foreign jurisdictions whose functional currency is the reporting currency, notwithstanding the local currency used by the foreign operation for local regulatory and taxation reporting. Similarly, some foreign operations have monetary assets/liabilities denominated in the reporting currency rather than the foreign operation's functional currency. Two questions typically arise in these situations:

- Should the foreign operation's deferred taxes be computed based on the reporting currency or the local currency?
- Does the exception in ASC 740-10-25-3(f) apply to the monetary assets and liabilities of the foreign operation?

We believe ASC 740 is required to be applied on a "bottom-up" approach. That is, each taxpayer must first compute its current and deferred income taxes and then be consolidated by its immediate parent (either domestic or foreign) prior to the immediate parent company's computation of its current and deferred income taxes. This approach continues up the ownership chain until its conclusion at the reporting entity level. See section 14.3, *Investments in foreign subsidiaries, corporate joint ventures and foreign investees*, for additional discussion of foreign versus domestic subsidiary distinction when applying the exception to comprehensive recognition of deferred income taxes (ASC 740-30-25-17 through ASC 740-30-25-19). Under this approach, ASC 740 is applied at each tax paying component level, again on a bottom-up approach, such that consolidation of operations within a given tax jurisdiction would be considered (based on existing tax law and elections made by each taxpayer) as the intermediate and ultimate parent companies compute their current and deferred income tax provisions.

With respect to the application of ASC 740-10-25-3(f), the scope exception only applies to nonmonetary assets and liabilities because of the reference in that paragraph to remeasurement at historical exchange rates. Thus, monetary items, such as debt and receivables (including intercompany receivables), are not excluded from the general provisions for accounting of income taxes in ASC 740 because monetary items are remeasured at current exchange rates rather than historical exchange rates.

In the situations described in the following section (i.e., current or deferred taxation of gains and losses attributable to changes in the foreign currency exchange rates), the permanent item from the currency gain or loss associated with monetary assets and liabilities denominated in the reporting currency but subject to taxation in the local currency affects the company's effective tax rate in the period that the exchange rate changes.

3.2.3.2.1 Taxation of unrealized gains and losses

Some tax jurisdictions impose current income taxes on foreign currency gains and losses on monetary assets and liabilities (e.g., debt denominated in the reporting currency rather than the local currency) rather than deferring taxation on those gains and losses until realized. That is, unrealized foreign currency exchange gains are included as taxable income and unrealized foreign currency exchange losses are recognizable as tax deductions in the period in which the exchange rates increase or decrease relative to the prior period.

As a result of the current taxation of unrealized gains and losses attributable to changes in the foreign currency exchange rates, the tax basis of the entity's monetary assets and liabilities would equal the financial reporting basis of those monetary items. Therefore, the entity would not have a temporary difference related to the monetary assets and liabilities at the balance sheet date (i.e., when the debt is settled or the receivable is recovered at the carrying amount in the balance sheet, there would be no further tax consequences). Thus, deferred taxes are not recognized in these circumstances. However, in jurisdictions with this type of tax scheme and when the entity's functional currency is the reporting currency, the tax effect of foreign currency gains and losses attributable to the conversion of reporting currency denominated monetary items into local currency for local income tax purposes results in permanent differences in the parent company's effective tax rate reconciliation. That is, the parent company's consolidated tax provision includes a current tax expense (benefit) for the current period foreign exchange gains (losses) between the reporting currency and local currency.

3.2.3.2.2 Taxation of realized gains and losses

Many tax jurisdictions, including the United States, do not include foreign currency gains and losses in the determination of taxable income until such gains and losses are realized by the taxpayer. That is, foreign currency exchange gains or losses only enter into the determination of taxable income in the period in which the debt is extinguished or the receivable (including intercompany transactions) is recovered.

There is a question about the application of the guidance for accounting for income taxes in ASC 740 to the foreign currency exchange gains and losses attributable to monetary items in periods subsequent to their initial recognition when the functional currency is the parent's reporting currency. That is, does a temporary difference exist attributable to unrealized gains and losses on reporting currency denominated monetary assets and liabilities when the local currency tax basis in those items is based on the initial exchange rate? We believe unrealized gains and losses on monetary assets and liabilities are temporary differences (i.e., if the monetary item is recovered or settled at its carrying amount in the balance sheet, there would be a tax consequence). Thus, a deferred tax asset (or liability) should be recognized in the period in which the foreign currency exchange rate changes equal to the future tax deduction (or taxable income) at the applicable tax rate. As with all deferred tax assets, the deferred tax asset associated with foreign currency exchange losses should be evaluated for realization under the provisions for accounting of income taxes in ASC 740-10-30-18 (see chapter 6, *Valuation allowances*, for additional discussion regarding the assessing the need for, and amount of, a valuation allowance).

3.2.3.2.3 Foreign jurisdiction tax returns filed in functional currency

Some foreign jurisdictions allow an entity to file its tax return in its functional currency rather than the local currency when its functional currency is its reporting currency (e.g., a non-US entity files its tax return in US dollars when the US dollar is the functional currency and the income tax payable or receivable amount is settled in the foreign subsidiary's local currency). ASC 740 does not provide guidance on whether an entity's temporary differences should be denominated in functional or local currency when an entity can file its tax return in its functional currency rather than local currency. We understand that alternative views exist regarding whether the tax basis of the underlying assets and liabilities are denominated in the local currency or functional currency in these situations.

One view is that the tax bases of the assets and liabilities are denominated in the local currency. Under this view, an entity would recognize foreign currency transaction gains and losses from the related temporary differences through the income statement. This is because the temporary differences (denominated in the local currency), upon reversal in the future, will still result in an income tax payable or receivable in the local currency. This will result in future changes in the amount of taxes payable or receivable in the local currency due to changes in exchange rates.

An alternative view is that any temporary differences that arise are denominated in the functional currency because no tax basis has been established in the local currency. As a result, no foreign exchange transaction gain or loss would be recognized from the translation of the foreign subsidiary's temporary differences. However, any current income tax payable or receivable settled in the foreign subsidiary's local currency would be considered a foreign currency transaction and measured based on the current exchange rate. A foreign exchange transaction gain or loss would be recognized in pretax income for changes in the exchange rate between when the payable or receivable was established and when it was ultimately settled.

We believe a company may elect to apply either view as long as it is consistently applied.

3.2.3.3 Tax indexation of nonmonetary assets

Some countries, primarily those with significant inflation, permit indexing adjustments to increase the tax bases of nonmonetary assets to offset the effects of inflation, thereby creating differences between the parent's book and foreign tax bases of those assets. Amounts received upon future recovery of the recorded local currency historical cost of the assets will be less than the remaining tax bases of the assets, and the difference will be tax-deductible as the assets are recovered (through sale or depreciation).

ASC 740-10-25-3(f), however, prohibits recognition of deferred taxes for differences resulting from indexing for tax purposes whenever the reporting currency is the functional currency. The FASB concluded that it would be inappropriate to record a deferred tax asset related to indexing in highly inflationary economies because a deferred tax liability for currency devaluation is not permitted under ASC 740-10-25-3(f) on nonmonetary assets (i.e., recognition of deferred taxes due to exchange rate changes on nonmonetary assets is prohibited). See the illustration in the next section for further discussion. It is noteworthy that when the functional currency is the local currency no similar prohibition exists (see section 4.2.8, *Temporary differences — examples*, for additional discussion).

3.3 Remeasurement in highly inflationary economies

ASC 830-10-45-11 requires foreign companies that use the US dollar as the reporting currency to use the US dollar as if it were the functional currency, if the cumulative three-year inflation rate in the foreign currency is approximately 100% or more. The financial statements of a foreign entity in a highly inflationary economy are remeasured as if the functional currency were the reporting currency. Under ASC 740-10-25-3(f), companies are prohibited from recognizing deferred tax assets and liabilities for foreign currency basis differences on nonmonetary assets. There are two major ramifications to that prohibition:

1. Companies applying the provisions of ASC 740 will not recognize the deferred tax effects of differences arising from exchange rate changes on the remeasurement of nonmonetary assets.
2. Exchange rate devaluations of currencies in highly inflationary economies will have the effect of virtually eliminating deferred taxes otherwise recorded for differences between the foreign currency financial reporting amount and the "hypothetical" foreign currency tax bases of assets and liabilities.

The "hypothetical" tax bases (i.e., the original unindexed tax bases) must be used in calculating deferred taxes because the actual tax bases in countries with highly inflationary economies often reflect indexation as permitted by the local tax law and, as explained above, ASC 740 prohibits recognizing deferred taxes for the effects of indexation when the reporting currency is used as the functional currency. The following example illustrates the effect of using a hypothetical tax basis in calculating deferred taxes.

Illustration 3-9: Effect of using a hypothetical tax basis in calculating deferred taxes

Assume that a foreign operation of a US parent purchased fixed assets in 20X0 costing FC1,000 when the exchange rate was FC1 = $1. Beginning in 20X1, the assets are amortized on a 2-year straight-line basis for tax purposes and on a 10-year straight-line basis for financial reporting purposes. The foreign tax rate is 50%, and the exchange rate at 31 December 20X1 is FC1 = $0.10. Indexation is also allowed for local tax purposes at the rate of 10% per year.

The US dollar is the functional currency. For simplicity, US deferred tax consequences are ignored.

	Foreign historical cost	Hypothetical foreign tax basis	Taxable temporary difference
Cost	FC 1,000	FC 1,000	FC –
Accumulated depreciation	(100)	(500)	400
	FC 900	FC 500	400
Foreign tax rate			50%
Deferred foreign tax liability			FC 200
Year-end exchange rate			0.10
Deferred foreign tax liability in US dollars at 31 December 20X1			$ 20

In this example, it was necessary to use a hypothetical tax basis in order to ignore the effect of indexation. However, the tax depreciation life of two years was still used. The actual foreign tax bases of the fixed assets at 31 December 20X1 would have been FC550 because of the indexation provision ($500 * 110% allowed indexation).

Assuming the exchange rate at 31 December 20X2 is FC1 = $0.01, deferred taxes at 31 December 20X2 would be computed as follows:

	Foreign historical cost		Hypothetical foreign tax basis		Taxable temporary difference	
Cost	FC	1,000	FC	1,000	FC	–
Accumulated depreciation		(200)		(1,000)		800
	FC	800	FC	–		800
Foreign tax rate						50%
Deferred foreign tax liability					FC	400
Year-end exchange rate						0.01
Deferred foreign tax liability in US dollars at 31 December 20X2					$	4

In this example, despite the FC400 increase (FC800 — FC400) in the taxable temporary difference comparing 31 December 20X2 to 31 December 20X1, the deferred foreign tax liability in US dollars declined by $16 ($20 – $4).

Assuming there is continued 10 to 1 devaluation, deferred taxes at 31 December 20X3 would be computed as follows:

	Foreign historical cost		Hypothetical foreign tax basis		Taxable temporary difference	
Cost	FC	1,000	FC	1,000	FC	–
Accumulated depreciation		(300)		(1,000)		700
	FC	700	FC	–		700
Foreign tax rate						50%
Deferred foreign tax liability					FC	350
Year-end exchange rate						0.001
Deferred foreign tax liability in US dollars at 31 December 20X3					$	0.35

In this example, the deferred tax liability at 31 December 20X3 would be less than $1. Thus, the rapid devaluation of the foreign currency has the effect of virtually eliminating the US dollar equivalent of the deferred foreign tax liability recognized for temporary differences denominated in that foreign currency.

As discussed previously, companies are required to use the US dollar as the functional currency when a foreign subsidiary's economy is considered highly inflationary and the parent's reporting currency is the US dollar. When the US dollar is the functional currency, deferred taxes are not provided for temporary differences caused by exchange rate changes or indexation for nonmonetary assets. However, if the local currency is the functional currency, deferred taxes are provided for those temporary differences. ASC 830 addresses how to account for those temporary differences when the economy is no longer highly inflationary and the subsidiary's functional currency is the local currency. ASC 830-10-45-15 requires that a new functional currency amount should be established at the date of the change. The reporting currency amounts at the date of the change should be translated into the local currency using current exchange rates, and those amounts should become the new functional currency accounting basis for the nonmonetary assets and liabilities. The difference between the new functional currency basis and the tax basis would represent a temporary difference for which deferred taxes should be provided.

Excerpt from Accounting Standards Codification

Foreign Currency Matters — Income Taxes

Other Presentation Matters

830-740-45-2

The deferred taxes associated with the temporary differences that arise from a change in **functional currency** discussed in paragraph 830-740-25-3 when an economy ceases to be considered highly inflationary shall be presented as an adjustment to the cumulative **translation adjustments** component of shareholders' equity and therefore shall be recognized in other comprehensive income.

ASC 830-740-45-2 requires that the deferred taxes associated with the temporary difference that arises when an economy ceases to be considered highly inflationary should be reflected as an adjustment to the cumulative translation adjustment component of other comprehensive income as a separate component of shareholders' equity until sale or complete, or substantially complete, liquidation of the investment in the foreign entity, as opposed to income tax expense.

3.3.1 Highly inflationary economy — change in functional currency

The guidance in ASC 830-10-45-10 was not originally developed to address high-inflation situations; however, the FASB staff noted that the guidance should be used to account for a change in functional currency from the foreign currency to the reporting currency when an economy becomes highly inflationary.

ASC 830-10-45-10 prohibits removal of prior period translation adjustments from equity if the functional currency changes from a foreign currency to the reporting currency and the translated amounts for nonmonetary assets at the end of the prior period become the accounting bases for those assets in the period of change and subsequent periods.

When the functional currency is the reporting currency, ASC 740-10-25-3(f) prohibits recognition of deferred tax benefits resulting from indexing assets and liabilities for tax purposes that are remeasured into the reporting currency using historical exchange rates. Thus, deferred tax benefits attributable to indexing occurring after the change in functional currency to the reporting currency are recognized when realized on the tax return. Deferred tax benefits recognized for indexing prior to the change in functional currency to the reporting currency are eliminated when the related indexed amounts are realized as deductions for tax purposes.

3.3.2 General price-level changes — restatement of financial statements

Excerpt from Accounting Standards Codification

Foreign Currency Matters — Income Taxes

Recognition

830-740-25-5

When preparing financial statements restated for general price-level changes using end-of-current-year purchasing power units, temporary differences are determined based on the difference between the indexed tax basis amount of the asset or liability and the related price-level restated amount reported in the financial statements. Example 1 (see paragraph 830-740-55-1) illustrates the application of this guidance.

Initial Measurement

830-740-30-1

In foreign financial statements that are restated for general price-level changes, the deferred tax expense or **benefit** shall be calculated as the difference between the following two measures:

a. Deferred tax assets and liabilities reported at the end of the current year, determined in accordance with paragraph 830-740-25-5

b. Deferred tax assets and liabilities reported at the end of the prior year, remeasured to units of current general purchasing power at the end of the current year.

830-740-30-2

The remeasurement of deferred tax assets and liabilities at the end of the prior year is reported together with the remeasurement of all other assets and liabilities as a restatement of beginning equity.

Companies located in countries with high inflation may prepare financial statements restated for general price-level changes in accordance with ASC 255-10-45. The tax bases of assets and liabilities of those entities are often indexed for the effects of inflation.

When preparing financial statements restated for general price-level changes using end-of-current year purchasing power units, ASC 830-740-25-5 provides that temporary differences are determined based on the difference between the indexed tax basis amount of the asset or liability and the related price-level restated amount reported in the financial statements.

ASC 830-740-30-1 provides that the deferred tax expense or benefit should be calculated as the difference between (1) deferred tax assets and liabilities reported at the end of the current year, as discussed above, and (2) deferred tax assets and liabilities reported at the end of the prior year, remeasured to units of current general purchasing power at the end of the current year. The remeasurement of deferred tax assets and liabilities at the end of the prior year is reported together with the remeasurement of all other assets and liabilities as a restatement of beginning equity (ASC 830-740-30-2).

ASC 830-740-55-1 through ASC 830-740-55-3 provides an example (which has been updated as to dates) to illustrate the application:

Illustration 3-10: Foreign financial statements restated for general price-level changes

A company has one asset, a nonmonetary asset that is not depreciated for financial reporting or tax purposes. The local currency is FC. Units of current purchasing power are referred to as CFC. The enacted tax rate is 40%. The asset had a price-level-adjusted financial reporting amount of CFC350 and an indexed basis for tax purposes of CFC100 at 31 December 20X0, both measured using CFC at 31 December 20X0. The company has a taxable temporary difference of CFC250 (CFC350 — CFC100) and a related deferred tax liability of CFC100 (CFC250 x 40%) using CFC at 31 December 20X0.

General price levels increase by 50% in 20X1, and indexing allowed for 20X1 for tax purposes is 25%. At 31 December 20X1, the asset has a price-level-adjusted financial reporting amount of CFC525 (CFC350 x 150%) and an indexed basis for tax purposes of CFC125 (CFC100 x 125%), using CFC at 31 December 20X1. The company has a taxable temporary difference of CFC400 (CFC525 — CFC125) and a related deferred tax liability of CFC160 (CFC400 x 40%) at 31 December 20X1, using CFC at 31 December 20X1. The deferred tax liability at 31 December 20X0 is restated to units of current general purchasing power as of 31 December 20X1. The restated 31 December 20X0 deferred tax liability is CFC150 (CFC100 x 150%). For 20X1, the difference between CFC160 and CFC150 is reported as deferred tax expense in income from continuing operations. The difference between the deferred tax liability of CFC100 at 31 December 20X0 and the restated 31 December 20X0 deferred tax liability of CFC150 is reported in 20X1 as a restatement of beginning equity.

The following is a tabular presentation of this example:

	20X0		20X1
Financial reporting basis	CFC 350	x 1.50	CFC 525
Tax basis	CFC 100	x 1.25	CFC 125
Temporary difference	CFC 250		CFC 400
Tax rate	40%		40%
Deferred tax liability, end of year	CFC 100		CFC 160
Deferred tax liability (restated), beginning of year	CFC 100	x 1.50	CFC 150
Deferred tax expense	CFC –		CFC 10

4 Temporary differences

Section 3.1, *Basic approach*, introduces the liability method. The liability method requires companies to identify their cumulative temporary differences and measure the related deferred tax assets or liabilities using a tax rate convention.

A temporary difference is the difference between the tax basis of an asset or liability, (determined based on the recognition and measurement requirements for tax positions — refer to chapter 19, *Accounting for uncertainty in income taxes*) and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Generally, most items included in pretax income for financial reporting purposes are included in taxable income in the same year. However, certain items may be recognized for tax purposes in a different period than they are recognized for US GAAP. Therefore, the calculation of taxable income often differs from the calculation of book income as determined under US GAAP.

This chapter discusses the nature of temporary differences, the extent of scheduling required and methods used to estimate reversal dates.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Overview and Background

740-10-05-7

A temporary difference refers to a difference between the tax basis of an asset or liability, determined based on recognition and measurement requirements for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Deferred tax assets and liabilities represent the future effects on income taxes that result from temporary differences and carryforwards that exist at the end of a period. Deferred tax assets and liabilities are measured using enacted tax rates and provisions of the enacted tax law and are not discounted to reflect the time-value of money.

740-10-05-8

As indicated in paragraph 740-10-25-23, temporary differences that will result in taxable amounts in future years when the related asset or liability is recovered or settled are often referred to as taxable temporary differences. Likewise, temporary differences that will result in deductible amounts in future years are often referred to as deductible temporary differences. Business combinations may give rise to both taxable and deductible temporary differences.

Recognition

740-10-25-4

References in this Subtopic to **income taxes currently payable** and (total) income tax expense are intended to also include income taxes currently refundable and (total) income tax benefit, respectively.

740-10-25-18

Income taxes currently payable for a particular year usually include the **tax consequences** of most events that are recognized in the financial statements for that year.

740-10-25-19

However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

a. The amount of **taxable income** and pretax financial income for a year

b. The tax bases of assets or liabilities and their reported amounts in financial statements.

Guidance for computing the tax bases of assets and liabilities for financial reporting purposes is provided in this Subtopic.

740-10-25-20

An assumption inherent in an entity's statement of financial position prepared in accordance with generally accepted accounting principles (GAAP) is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples include the following:

a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.

b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.

c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.

d. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

e. A reduction in the tax basis of depreciable assets because of tax credits. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered. For example, a tax law may provide taxpayers with the choice of either taking the full amount of depreciation deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or taking the full tax credit and a reduced amount of depreciation deductions.

f. Investment tax credits accounted for by the deferral method. Under the deferral method as established in paragraph 740-10-25-46, investment tax credits are viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred investment tax credits may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

g. An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency. The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

h. Business combinations and combinations accounted for by **not-for-profit entities** (NFPs). There may be differences between the tax bases and the recognized values of assets acquired and liabilities assumed in a business combination. There also may be differences between the tax bases and the recognized values of assets acquired and liabilities assumed in an **acquisition by a not-for-profit entity** or between the tax bases and the recognized values of the assets and liabilities carried over to the records of a new entity formed by a **merger of not-for-profit entities.** Those differences will result in taxable or deductible amounts when the reported amounts of the assets or liabilities are recovered or settled, respectively.

i. Intra-entity transfers of an asset other than **inventory**. There may be a difference between the tax basis of an asset in the buyer's tax jurisdiction and the carrying value of the asset reported in the consolidated financial statements as the result of an intra-entity transfer of an asset other than inventory from one tax-paying component to another tax-paying component of the same consolidated group. That difference will result in taxable or deductible amounts when the asset is recovered.

740-10-25-21

The examples in (a) through (d) in paragraph 740-10-25-20 illustrate revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in pretax financial income. Those differences between taxable income and pretax financial income also create differences (sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in the financial statements. The examples in (e) through (i) in paragraph 740-10-25-20 illustrate other events that create differences between the tax basis of an asset or liability and its reported amount in the financial statements. For all of the examples, the differences result in taxable or deductible amounts when the reported amount of an asset or liability in the financial statements is recovered or settled, respectively.

740-10-25-22

This Topic refers collectively to the types of differences illustrated by the examples in paragraph 740-10-25-20 and to the ones described in paragraph 740-10-25-24 as temporary differences.

740-10-25-23

Temporary differences that will result in taxable amounts in future years when the related asset or liability is recovered or settled are often referred to as taxable temporary differences (the examples in paragraph 740-10-25-20(a), (d), and (e) are taxable temporary differences). Likewise, temporary differences that will result in deductible amounts in future years are often referred to as deductible temporary differences (the examples in paragraph 740-10-25-20(b), (c), (f), and (g) are deductible temporary differences). Business combinations and intra-entity transfers of assets other than inventory (the examples in paragraph 740-10-25-20(h) through (i)) may give rise to both taxable and deductible temporary differences.

4.1 Temporary versus permanent differences

The liability method requires companies to identify the types and amounts of their cumulative temporary differences. Applying the liability method requires identifying cumulative temporary differences and carryforwards determined based on the recognition and measurement requirements for tax positions (see chapter 19, *Accounting for uncertainty in income taxes*, for additional discussion), and multiplying them by the enacted tax rate expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be realized or settled, respectively (ASC 740-10-30-8). The net result represents the net tax position based on existing temporary differences.

ASC 740 uses the term "temporary differences" to describe book-tax basis differences that will result in taxable or deductible amounts in future years. The ASC Master Glossary defines temporary difference as follows:

Excerpt from Accounting Standards Codification

ASC Master Glossary

Temporary Difference

A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 25-25), but those temporary differences do meet both of the following conditions:

a. Result from events that have been recognized in the financial statements

b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.

Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

ASC 740 provides that some events recognized in financial statements do not have tax consequences and do not give rise to temporary differences. While the term is not defined in ASC 740, these differences are referred to as "permanent differences." See section 4.4, *Basis differences without future tax consequences — permanent differences*, for additional discussion of permanent differences.

4.2 Identifying cumulative temporary differences

Temporary differences essentially consist of differences between the book and tax bases of assets and liabilities, except for goodwill that is not deductible for income tax purposes and the other exceptions discussed in ASC 740-10-25-3 (see sections 3.2, *Exceptions to comprehensive accounting for deferred taxes*, and 11.3, *Identifiable intangible assets and goodwill*). Accordingly, for each asset and liability the book basis and the tax basis should be identified.

The book bases of assets and liabilities are simply the reported financial statement amounts. Therefore, much of the effort in identifying basis differences involves determining the tax bases of assets and liabilities, including considerations of the effects of accounting for tax uncertainties (see chapter 19, *Accounting for uncertainty in income taxes*, for additional discussion). The first step is to prepare a tax-basis balance sheet for comparison to amounts recorded in the financial statements. Many types of assets and liabilities, such as accounts receivable and payable, will often have the same book and tax basis. Other types of assets and liabilities may exist for tax purposes but not for financial reporting purposes and vice versa. For example, certain accruals, such as those for contingencies, are likely to have no tax basis. Likewise, certain accruals such as deferred revenues on installment sales for income taxes are likely to have no book basis. Comparing a detailed GAAP and tax basis balance sheet will result in the identification of temporary differences.

4.2.1 Temporary differences related to LIFO inventory

ASC 740-10-55-53 addresses the accounting for temporary differences related to last-in, first-out (LIFO) inventory (i.e., the excess of the amount of LIFO inventory for financial reporting over its tax basis).

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-53

Even though a deferred tax liability for the LIFO inventory of a subsidiary will not be settled if that subsidiary is sold before the LIFO inventory temporary difference reverses, recognition of a deferred tax liability is required regardless of whether the LIFO inventory happens to belong to the parent entity or one of its subsidiaries.

In ASC 740-10-55-59 through ASC 740-10-55-61, the FASB staff addressed the interaction of ASC 740 and the uniform cost capitalization rules. Refer to section 8.7.4, *Implementing a change in tax accounting method*, for additional discussion.

4.2.2 Temporary differences — effect on deferred taxes of ability to delay payment (updated June 2023)

A common question related to accounting for income taxes is whether a deferred tax liability should be recorded for a temporary difference whose reversal will not occur in the foreseeable future. Except for the temporary differences that are not required to be recorded as discussed in ASC 740-10-25-3 (see section 3.2, *Exceptions to comprehensive accounting for deferred taxes*), the timing of the reversal or the ability to delay reversals for the foreseeable future does not alleviate the requirement to establish a deferred tax liability. As noted in ASC 740-10-55-63, depending on the ability to delay reversals, a deferred tax liability may, however, result in a determination for scheduling purposes that the reversal date is indeterminate (e.g., indefinite-lived intangible assets and tax-deductible goodwill). That is, the company is not able to assume use as a source of future taxable income for purposes of evaluating realizability of a deferred tax asset. See section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*, for more information.

ASC 740-10-55-63 addresses the impact of a change in accounting method for income tax purposes on the recognition of temporary differences, as follows:

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-63

The Omnibus Budget Reconciliation Act of 1987 requires family-owned farming businesses to use the accrual method of accounting for tax purposes. The initial catch-up adjustment to change from the cash to the accrual method of accounting is deferred. It is included in taxable income if the business ceases to be family-owned (for example, it goes public). It also is included in taxable income if gross receipts from farming activities in future years drop below certain 1987 levels as set forth in the tax law. The deferral of the initial catch-up adjustment for that change in accounting method for tax purposes gives rise to a temporary difference because an assumption inherent in an entity's statement of financial position is that the reported amounts of assets and liabilities will be recovered and settled. Under the requirements of this Topic, deferred tax liabilities may not be eliminated or reduced because an entity may be able to delay the settlement of those liabilities by delaying the events that would cause taxable temporary differences to reverse. Accordingly, the deferred tax liability is recognized. If the events that trigger the payment of the tax are not expected in the foreseeable future, the reversal pattern of the related temporary difference is indefinite.

See section 8.7, *Changes in tax accounting methods*, for additional discussion of discretionary and nondiscretionary changes in accounting methods for tax purposes.

4.2.3 Tax-to-tax differences

ASC 740-10-25-31 provides guidance on the accounting for tax-to-tax differences.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-31

Tax-to-tax differences are not temporary differences. Recognition of a deferred tax asset for tax-to-tax differences is prohibited as tax-to-tax differences are not one of the exceptions identified in paragraph 740-10-25-3. An example of a tax-to-tax difference is an excess of the parent entity's tax basis of the stock of an acquired entity over the tax basis of the net assets of the acquired entity.

Temporary differences may exist for the difference between the parent or investor's financial statement carrying value and the tax basis in the stock of a subsidiary (or an equity method investee) referred to as an outside basis difference (see chapter 14, *Foreign and domestic subsidiaries*, for additional discussion on outside basis differences in subsidiaries and investments accounted for under the equity method). In addition, the parent or investor's tax basis in the stock of the subsidiary or investee may differ from the tax basis of the underlying net assets of the subsidiary or investee. This difference (i.e., the difference between the tax basis of the stock and the tax basis of the underlying net assets) is referred to as a tax-to-tax difference. Tax-to-tax differences are not temporary differences as they do not represent a difference between the tax basis of an asset or liability and the amount recognized in the financial statements. ASC 740-10-25-31 prohibits the recognition of these differences.

4.2.4 Temporary differences related to state income taxes

ASC 740-10-55-20 addresses temporary differences related to state and local income taxes and their interaction with federal temporary differences.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-20

State income taxes are deductible for U.S. federal income tax purposes and therefore a deferred state income tax liability or asset gives rise to a temporary difference for purposes of determining a deferred U.S. federal income tax asset or liability, respectively. The pattern of deductible or taxable amounts in future years for temporary differences related to deferred state income tax liabilities or assets should be determined by estimates of the amount of those state income taxes that are expected to become payable or recoverable for particular future years and, therefore, deductible or taxable for U.S. federal tax purposes in those particular future years.

4.2.5 Different tax and fiscal year ends

The guidance for the accounting of income taxes in ASC 740 does not specifically address how to determine temporary differences when a company uses different years for financial reporting and tax purposes (e.g., 30 September for book and 31 December for tax). We believe that a company in those circumstances must calculate temporary differences as of the financial reporting balance sheet date, based on the tax bases of assets and liabilities at that date. The tax bases of assets and liabilities would be determined as if the company were filing a tax return at the balance sheet date.

4.2.5.1 Payments to the IRS to retain fiscal year

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-68

The following guidance refers to provisions of the Tax Reform Act of 1986 and the Revenue Act of 1987; however, it shall not be considered a definitive interpretation of the Acts for any purpose.

740-10-55-69

The guidance addresses how a payment should be recorded in the financial statements of an entity for a payment to a taxing authority to retain their fiscal year.

740-10-55-70

On December 22, 1987, the Revenue Act of 1987 was enacted, which allowed partnerships and S corporations to elect to retain their fiscal year rather than adopt a calendar year for tax purposes as previously required by the Tax Reform Act of 1986. Entities that elected to retain a fiscal year are required to make an annual payment in a single installment each year that approximates the income tax that the partners-owners would have paid on the short-period income had the entity switched to a calendar year. The payment is made by the entity and is not identified with individual partners-owners. Additionally the amount is not adjusted if a partner-owner leaves the entity.

740-10-55-71

In this fact pattern, partnerships and S corporations should account for the payment as an asset since the payment is viewed as a deposit that is adjusted annually and will be realized when the entity liquidates, its income declines to zero, or it converts to a calendar year-end.

ASC 740-10-55-68 through ASC 740-10-55-71 provides guidance on payments made to a taxing authority to retain a fiscal year. Payments made to the Internal Revenue Service (IRS) by partnerships and S corporations to retain a fiscal year rather than adopt a calendar year for tax purposes should be recorded as an asset. The payment is a deposit with annual adjustments that will be realized when the entity liquidates, converts to a calendar year end or its income declines to zero. The payment is made by the entity and is not identified with individual partners-owners. In addition, the amount is not adjusted if a partner-owner leaves the entity.

4.2.6 Tax-planning strategies

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-46

Under this Subtopic, the requirements for consideration of tax-planning strategies pertain only to the determination of a valuation allowance for a deferred tax asset. A deferred tax liability ordinarily is recognized for all taxable temporary differences. The only exceptions are identified in paragraph 740-10-25-3. Certain seemingly taxable temporary differences, however, may or may not result in taxable amounts when those differences reverse in future years. One example is an excess of cash surrender value of life insurance over premiums paid (see paragraph 740-10-25-30). Another example is an excess of the book over the tax basis of an investment in a domestic subsidiary (see paragraph 740-30-25-7). The determination of whether those differences are taxable temporary differences does not involve a tax-planning strategy as that term is used in this Topic.

Tax-planning strategies are only considered in the determination of the need for, and amount of, a valuation allowance for a deferred tax asset. ASC 740-10-55-46 prohibits the use of tax-planning strategies when determining whether temporary differences are taxable temporary differences or basis differences that will not have future tax consequences. Deferred tax liabilities are recognized for all taxable temporary differences, except for those taxable temporary differences specifically excluded by ASC 740-10-25-3 (see section 3.2, *Exceptions to comprehensive accounting for deferred taxes*). However, certain seemingly taxable temporary differences may or may not result in taxable amounts when those differences reverse in future years, such as excess cash surrender value of life insurance over premiums paid[3] (ASC 740-10-25-30) or the excess of the book over the tax basis of an investment in a domestic subsidiary[4] (ASC 740-30-25-7). Those situations are, however, specific exceptions in ASC 740.

4.2.7 Government assistance received (investment tax credits and government grants) (updated June 2023)

A number of government agencies, both domestic and foreign, have established programs to promote or guide the development of business activities by providing financial assistance to businesses. The form and type of government assistance received by entities vary depending on the government program the funds were received under, with each program having differing terms.

Refer to section 2.5.1, *Determining if government assistance is within the scope of ASC 740*, for a discussion on whether the guidance in ASC 740 applies to the receipt of government assistance and section 2.5.1.2, *Grant accounting*, for a discussion on the scoping of government grants.

4.2.7.1 Investment tax credits

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-45

An investment credit shall be reflected in the financial statements to the extent it has been used as an offset against income taxes otherwise currently payable or to the extent its benefit is recognizable under the provisions of this Topic.

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[3] See section 4.4, *Basis differences without future tax consequences — permanent differences*, for further discussion.

[4] See section 14.4, *Investments in domestic subsidiaries, corporate joint ventures and domestic investees*, for further discussion.

740-10-25-46

While it shall be considered preferable for the allowable investment credit to be reflected in net income over the productive life of acquired property (the deferral method), treating the credit as a reduction of federal income taxes of the year in which the credit arises (the flow-through method) is also acceptable.

Other Presentation Matters

740-10-45-26

Paragraph 740-10-25-46 describes two acceptable methods for recognizing the benefit of investment tax credits. The following guidance addresses presentation matters related to one of those methods, the deferral method.

740-10-45-27

The reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) may be preferable in many cases. However, it is equally appropriate to treat the credit as deferred income, provided it is amortized over the productive life of the acquired property.

740-10-45-28

It is preferable that the statement of income in the year in which the allowable investment credit arises should be affected only by the results which flow from the accounting for the credit set forth in paragraph 740-10-25-46. Nevertheless, reflection of income tax provisions, in the income statement, in the amount payable (that is, after deduction of the allowable investment credit) is appropriate provided that a corresponding charge is made to an appropriate cost or expense (for example, to the provision for depreciation) and the treatment is adequately disclosed in the financial statements of the first year of its adoption.

ASC 740 provides guidance on the accounting for investment tax credits (ITCs). The guidance was created in the 1960s to address US federal investment tax credit programs that existed at that time. As a result, certain elements of those programs may be helpful in determining whether a tax credit qualifies and should be accounted for in accordance with the provisions of ASC 740 for ITCs.

An ITC is a credit that is realized by directly reducing a taxpayer's income tax liability. That is, an ITC is used to offset the entity's income tax liability, unlike a deduction that reduces taxable income. An ITC relates to the acquisition of a depreciable asset and is generally determined as a percentage of the cost of such asset. In some cases, an ITC may reduce the asset's tax basis and may be subject to recapture.

Once an entity determines that a tax credit qualifies as an ITC, the ITC is reflected in the financial statements to the extent that it has been used as an offset against income taxes that would otherwise be currently payable or to the extent its benefit is recognizable under the provisions of ASC 740 (i.e., qualifies as a deferred tax asset).

The following two methods for accounting for ITCs are acceptable:

- **Deferral method** — Under ASC 740-10-25-45 and ASC 740-10-25-46, the ITC is reflected in income over the productive life of the acquired property. The deferral of the ITC is presented as either (1) as a reduction in the carrying amount of the related asset, and thus reduced future depreciation of that asset, or (2) in a separate deferral account and is reflected in income tax expense over the productive life of the acquired property.
- **Flow-through method** — The ITC is treated as a reduction of federal income taxes in the year in which the credit arises (and should be recognized only after the taxpayer has no continuing obligation).

The use of the deferral method or flow-through method is an accounting policy election[5], and any change is subject to the requirements in ASC 250, *Accounting Changes and Error Corrections*. The guidance in ASC 740 would apply to comparable provisions that exist in foreign or state jurisdictions.

4.2.7.2 Investments in partnership or other pass-through entities that generate tax credits (updated June 2023)

While the guidance discussed above generally applies to tax credits resulting from the acquisition of depreciable property, we believe it may be applied to tax credits resulting from investments in certain partnerships or other pass-through entities (referred to herein as project entities) that acquire or construct assets that generate investment tax credits and pass those credits to their investors.

For example, project entities may invest in solar or wind energy projects or qualified affordable housing projects. An investor in these projects generally receives a return on its investment from the allocation of investment tax credits, an allocation of tax losses (that are available to offset the investor's taxable income from other sources) and/or cash distributions. Depending on the structure of the project entity, an investor may account for this type of investment using the equity method.[6] For additional information on the equity method, see our FRD, ***Equity method investments and joint ventures***.

The FASB issued Accounting Standards Update (ASU) 2023-02, *Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*, which amends ASC 323-740 to address the accounting for investments in tax equity structures. After its adoption, the ASU will allow entities to use the proportional amortization method to account for investments in all tax equity structures that meet the conditions in ASC 323-740-25-1, including the New Market Tax Credit (NMTC) program, the Historic Rehabilitation Tax Credit program and the Renewable Energy Tax Credit programs. See section 4.2.7.5A, *Proportional amortization method for equity investments in qualified tax credit programs (after the adoption of ASU 2023-02)*.

Previously, the use of the proportional amortization method was limited to investments in qualified low-income housing projects that generate low-income housing tax credits (LIHTCs) and met the conditions in ASC 323-740-25-1. See section 4.2.7.5, *Investments in qualified affordable housing projects*, for a discussion of the accounting for an investment in a qualified affordable housing project.

We believe that an investor in a project entity that accounts for its investment using the equity method (and does not qualify for, or has not elected to apply, the guidance in ASC 323-740 to its investment after the adoption of ASU 2023-02) could analogize to, and apply, the investment tax credit guidance in ASC 740-10-25-45 through 46 and ASC 740-10-45-26 through 28 to account for the tax benefits from the investment tax credits. That is, the investor could apply a method similar to the deferral or flow-through methods described in that guidance to account for the tax credits in its financial statements.

However, there may be other acceptable methods an investor can apply to account for the tax credits that are passed through from the project entity. An investor should carefully analyze its arrangement to determine when the tax credits are generated and whether there are any recapture provisions attached to the credits.

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[5] While both methods are acceptable, ASC 740 notes that the deferral method is the preferable method of accounting for investment tax credits.

[6] An investor will need to carefully evaluate the nature of investment to determine if it should consolidate the partnership following the guidance in ASC 810, account for its investment using equity method guidance in ASC 323 or at fair value (or measurement alternative) under ASC 321.

Deferral method

Under the deferral method, the investment tax credits are initially recorded as a reduction in income taxes payable and the benefit of the investment tax credits is deferred. An investor could present the deferral of the investment tax credit benefit either as a reduction in the carrying amount of the equity method investment (either directly or by inclusion in an offsetting account) or as deferred income.

An entity that elects to present the deferral of the tax credits as a reduction of its equity method investment should recognize the benefit as an adjustment to the equity method earnings over time. An investor that presents the deferral of the tax credits as deferred income should reflect the amortization of the tax benefit in income tax expense (benefit). This is similar to the accounting for investment tax credits discussed in section 4.2.7.1.

Under either presentation, ASC 740-10-25-46 indicates that an entity that applies the deferral method should reflect the financial statement benefit of the investment tax credit in income over the productive life of the acquired property. We believe one acceptable approach to determine an appropriate recognition period would be to look to the project entity's underlying property giving rise to the tax credit and recognize the benefit over the depreciable life of those assets.

Flow-through method

Under the flow-through method, the benefit of the investment tax credits passed to the investor are treated as a reduction of current income tax expense in the year in which the tax credit arises. An investor applying this method should consider whether it and/or the project entity has any continuing obligations or whether any recapture provisions exist before recognizing the tax credits.

Accounting for the outside basis difference in an equity method investment with investment tax credits accounted for using the deferral or flow-through method

Under both the deferral and flow-through methods, an investor should also record the deferred taxes for any initial and ongoing difference between the financial statement carrying amount and tax basis of its investment in the project entity. ASC 740-10-25-20(e) and 20(f) note that a temporary difference may arise when accounting for investment tax credits.

Generally, we believe that an investor may apply the guidance in ASC 740-10-25-51 to account for the temporary differences that arise at the date of initial investment. This guidance requires that the tax effect of an asset purchase that is not a business combination in which the amount paid for the asset differs from the tax basis of the asset should result in deferred taxes measured through a simultaneous equation resulting in a corresponding adjustment to the book basis of the asset rather than immediate income statement recognition.

When the underlying asset is an equity method investment, this would result in a corresponding adjustment to the initial measurement of the equity method investment. This is consistent with the initial measurement guidance in ASC 323-10-30-2, which states the initial measurement of an equity method investment is generally at cost in accordance with the asset acquisition guidance in ASC 805-50-30. We understand other methods to account for the temporary difference that arises on the date of initial investment may be applied in practice (e.g., immediate income statement recognition). See section 13.1, *Asset acquisitions*, and section 5.2 of our FRD, ***Equity method investments and joint ventures***, for further discussion.

4.2.7.3 Temporary differences related to government assistance received

ASC 740-10-25-20(e) and ASC 740-10-25-20(f) state that a temporary difference may arise when accounting for an ITC, depending on which accounting method is selected and the extent, if any, to which the tax law requires a tax basis reduction in the related qualifying assets. While not specifically addressed in ASC 740-10-25-20, similar temporary differences also may arise when accounting for government grants.

Generally, we believe that ASC 740-10-25-51 provides the most appropriate method of accounting for these temporary differences. ASC 740-10-25-51 states that the tax effect of asset purchases that are not business combinations in which the amount paid for an asset differs from the tax basis of the asset should not result in immediate income statement recognition. The guidance requires deferred taxes to be measured through a simultaneous equation that results in a corresponding adjustment to the book basis of the related asset. As a result, there is no immediate income statement recognition from recording these temporary differences upon acquisition of the asset. This guidance is discussed in further detail in section 13.1, *Asset acquisitions*.

The following example illustrates the approach outlined in ASC 740-10-25-51.

Illustration 4-1: Calculating temporary differences and deferred tax amounts related to government assistance received

XYZ Corp. receives a government grant for 30% of the purchase price of certain qualifying assets, and XYZ must reduce its tax basis in those assets by 50% of the grant received. XYZ's tax rate is 25%.

On 1 January 20X5, XYZ purchases $1,000 of qualifying assets. The assets will be depreciated for both financial statement and tax purposes over a 5-year period.

Upon purchasing the qualifying assets, XYZ would record the following entry:

PP&E	$ 700	
Grant receivable	300	
Cash		$ 1,000

In accordance with ASC 740, there is a $150 deductible temporary difference (i.e., the difference between the book basis of $700 ($1,000 purchase price less the $300 grant received) and the tax basis of $850 ($1,000 purchase price less $150, or 50% of the $300 grant received)). A DTA of $50[a] would be recognized using the following entry:

DTA	$ 50	
PP&E		$ 50

[a] A deferred tax asset is recognized for the difference between the financial statement carrying amount and the tax basis of the qualifying assets and is determined by applying the simultaneous equation formula (.25 ÷ (1-.25) = 0.33333). The deferred tax asset calculated using this formula is $50 ($150 x 0.33333). Per ASC 740-10-25-51, the simultaneous equations method is used to record the assigned value of the asset and the related deferred tax asset or liability for asset purchases in which the amount paid differs from the tax basis of the asset. This method is used to determine the final book basis and DTA with inputs of the cash purchase price ($700), the tax basis ($850) and the tax rate (25%). Refer to section 13.1, *Asset acquisitions*, for further discussion of the simultaneous equation formulas.

In subsequent years the following entries are recorded:

Depreciation expense	$ 130	
Accumulated depreciation		$ 130

To record annual depreciation expense over the book life of the asset ($650 book basis ÷ 5 years)

Income taxes payable	$ 42.5	
Current income tax expense		$ 42.5

To record the benefit from depreciation ($170 annual tax depreciation expense [$850 tax basis ÷ 5 years] x 25% tax rate])

Deferred tax expense	$ 10	
Deferred tax asset		$ 10

To adjust the deferred tax asset based on the book and tax depreciation (25% tax rate x $40 [$170 tax depreciation — $130 book depreciation])

We generally believe that ASC 740-10-25-51 provides the most appropriate method of accounting for these temporary differences. However, we understand that immediate income statement recognition may also be an acceptable method of accounting for such temporary differences, if applied on a consistent basis.

4.2.7.4 Other considerations (updated August 2022)

Once an entity determines the applicable guidance (i.e., in the scope of ASC 740 or another applicable standard), the accounting for government assistance may be relatively straightforward. However, entities may enter into transactions that are, in substance, transfers of tax benefits. Before the adoption of ASC 842, in order to be considered a sale of tax benefits for accounting purposes, the capital lease obligation or the operating lease obligation (leaseback) between the seller-lessee and the buyer-lessor must be considered extinguished under ASC 405-20. For further discussion related to the accounting for the transfer of tax benefits before the adoption of ASC 842, refer to our FRD, ***Lease accounting: Accounting Standards Codification 840, Leases***. After the adoption of ASC 842, in order to be considered a sale of tax benefits for accounting purposes, the seller-lessee and the buyer-lessor must apply the sale and leaseback guidance in ASC 842-40. For further discussion related to the accounting for the transfer of tax benefits after the adoption of ASC 842, refer to our FRD, ***Lease accounting: Accounting Standards Codification 842, Leases***.

4.2.7.5 Investments in qualified affordable housing projects (before the adoption of ASU 2023-02) (updated June 2023)

Standard setting

In March 2023, the FASB issued ASU 2023-02, *Investments–Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*, allowing entities to apply the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740-25-1, rather than just investments in qualified affordable housing projects that generate LIHTCs. Under the amended guidance, entities can elect the proportional amortization method on a tax-credit-program-by-tax-credit-program basis. If elected, the method should be applied consistently to all investments in the tax credit program.

The amendments also remove guidance from ASC 323-740 on the accounting for investments in LIHTC programs when the proportional amortization method is not applied to align this accounting with that for other investments in tax equity structures that do not apply the method.

The new guidance requires entities to make disclosures about investments in tax credit programs that they have elected to account for using the proportional amortization method. Entities are also required to make disclosures about investments in tax credit programs that do not meet the conditions in ASC 323-740-25-1 to use the proportional amortization method.

The guidance is effective for public business entities for fiscal years beginning after 15 December 2023, and interim periods within those fiscal years, and for all other entities for fiscal years beginning after 15 December 2024, and interim periods within those fiscal years. Early adoption is permitted for all entities in any interim period. If an entity adopts the amendments in an interim period, it needs to adopt them as of the beginning of the fiscal year that includes that interim period. Refer to our Technical Line, ***Expanded use of the proportional amortization method for equity investments in tax credit programs***.

4.2.7.5.1 Overview

In January 2014, the FASB issued ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*, allowing investors to use the proportional amortization method to account for investments in limited liability entities that manage or invest in affordable housing projects that qualify for low-income housing tax credits. For further discussion related to investments in tax credits other than affordable housing projects, refer to section 4.2.7.5.5, *Investments in other tax credits*.

The low-income housing tax credit program is designed to encourage investment in the construction and rehabilitation of low-income housing. An investor in a flow-through limited liability entity (e.g., limited partnership) that manages or invests in qualified projects receives tax benefits in the form of tax deductions from operating losses and low-income housing tax credits over 10 years. Entities typically invest in these limited liability entities to receive these tax benefits.

The guidance, which is based on a consensus of the Emerging Issues Task Force (EITF or Task Force), allows an investor that meets certain conditions to amortize the cost of its investment, in proportion to the tax credits and other tax benefits it receives, and present the amortization as a component of income tax expense. This method replaces the effective yield method,[7] which allows for amortization to be presented as income tax expense but is limited in its application because of certain criteria that are required to be met, including that the availability of the tax credits is guaranteed by a creditworthy entity.

4.2.7.5.2 *Qualifying for the proportional amortization method*

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Recognition

323-740-25-1[8]

A reporting entity that invests in qualified affordable housing projects through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) provided all of the following conditions are met:

a. It is **probable** that the tax credits allocable to the investor will be available.

aa. The investor does not have the ability to exercise **significant influence** over the operating and financial policies of the limited liability entity.

aaa. Substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment).

b. The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.

c. The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.

323-740-25-1A

In determining whether an investor has the ability to exercise significant influence over the operating and financial policies of the limited liability entity, a reporting entity shall consider the indicators of significant influence in paragraphs 323-10-15-6 through 15-7.

323-740-25-1B

Other transactions between the investor and the limited liability entity (for example, bank loans) shall not be considered when determining whether the conditions in paragraph 323-740-25-1 are met, provided that all three of the following conditions are met:

a. The reporting entity is in the business of entering into those other transactions (for example, a financial institution that regularly extends loans to other projects).

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[7] Investments in qualified affordable housing projects that existed prior to the adoption of ASU 2014-01 may also continue to be accounted for under the effective yield method.

[8] In the FASB online portal, references to section 323-740 may be displayed as 740-323. This does not change the Codification reference, which remains 323-740 for this section.

b. The terms of those other transactions are consistent with the terms of arm's-length transactions.

c. The reporting entity does not acquire the ability to exercise significant influence over the operating and financial policies of the limited liability entity as a result of those other transactions.

323-740-25-1C

At the time of the initial investment, a reporting entity shall evaluate whether the conditions in paragraphs 323-740-25-1 through 25-1B have been met to elect to apply the proportional amortization method on the basis of facts and circumstances that exist at that time. A reporting entity shall subsequently reevaluate the conditions upon the occurrence of either of the following:

a. A change in the nature of the investment (for example, if the investment is no longer in a flow-through entity for tax purposes)

b. A change in the relationship with the limited liability entity that could result in the reporting entity no longer meeting the conditions in paragraphs 323-740-25-1 through 25-1B.

323-740-25-2

For an investment in a qualified affordable housing project through a limited liability entity not accounted for using the proportional amortization method, the investment shall be accounted for in accordance with Subtopic 970-323. In accounting for such an investment under that Subtopic, the requirements in paragraphs 323-740-25-3 through 25-5 and paragraphs 323-740-50-1 through 50-2 of this Subsection that are not related to the proportional amortization method, shall be applied.

323-740-25-2A

Accounting for an investment in a qualified affordable housing project using the cost method may be appropriate. In accounting for such an investment using the cost method, the requirements in paragraphs 323-740-25-3 through 25-5 and paragraphs 323-740-50-1 through 50-2 of this Subsection that are not related to the proportional amortization method shall be applied.

323-740-25-3

A liability shall be recognized for delayed equity contributions that are unconditional and legally binding. A liability also shall be recognized for equity contributions that are contingent upon a future **event** when that contingent event becomes probable. Topic 450 and paragraph 840-30-55-15 provide additional guidance on the accounting for delayed equity contributions.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

A liability shall be recognized for delayed equity contributions that are unconditional and legally binding. A liability also shall be recognized for equity contributions that are contingent upon a future **event** when that contingent event becomes probable. Topic 450 and paragraph 842-50-55-2 provide additional guidance on the accounting for delayed equity contributions.

323-740-25-4

The decision to apply the proportional amortization method of accounting is an accounting policy decision to be applied consistently to all investments in qualified affordable housing projects that meet the conditions in paragraph 323-740-25-1 rather than a decision to be applied to individual investments that qualify for use of the proportional amortization method.

323-740-25-5

At the time of initial investment, immediate recognition of the entire benefit of the tax credits to be received during the term of an investment in a qualified affordable housing project is not appropriate (that is, affordable housing credits shall not be recognized in the financial statements before their inclusion in the investor's tax return).

Under the guidance, an entity that invests in qualified affordable housing projects through limited liability entities may elect the proportional amortization method if all of the following conditions are met:[9]

- It is probable that the tax credits allocable to the investor will be available.
- The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity.[10]
- Substantially all of the projected benefits are from tax credits and other tax benefits (e.g., operating losses).
- The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.
- The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.

ASU 2016-01 generally removed the concept of the cost method of accounting as it was historically applied for equity securities without readily determinable fair values and generally requires equity investments within its scope to be measured at fair value through net income in accordance with ASC 321, *Investments — Equity Securities*. However, the guidance on accounting for investments in qualified affordable housing projects in ASC 323-740 retains certain references to the cost method of accounting (e.g., ASC 323-740-25-2A). Because the guidance ASC 323-740-25-2 indicates that an investment in a qualified affordable housing project that is not accounted for using the proportional amortization method should be accounted for in accordance with ASC 970-323, *Real Estate — General — Investments — Equity Method and Joint Ventures*, a question arises as to whether it is appropriate to account for investments in qualified affordable housing projects under the cost method. That is because the references to the cost method of accounting were removed from ASC 970-323 following the adoption of ASU 2016-01. After adopting ASU 2016-01, an entity that applies the guidance in ASC 970-323 accounts for a noncontrolling investment in a limited partnership under the equity method in ASC 323, *Investments — Equity Method and Joint Ventures*, or in accordance with ASC 321, *Investments — Equity Securities* (i.e., measured at fair value through net income).

We believe that an investor that (1) does not qualify for the proportional amortization method or elects not to apply it and (2) does not apply the equity method of accounting can elect, as an accounting policy choice, to account for its investment in a qualified affordable housing project under the cost method (as described in ASC 323-740) or in accordance with ASC 321. The method (i.e., the cost method or ASC 321) elected must be applied consistently.

The examples below illustrate the application of the cost and equity methods to investments in qualified affordable housing projects. Refer to our FRD, ***Equity method investments and joint ventures***, for discussion of the general application of the equity method.

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[9] If ASC 810 requires an investor to consolidate a limited liability entity that manages or invests in a qualified affordable housing project, the investor does not qualify for the proportional amortization method and must consolidate that entity.

[10] As noted in ASC 323-740-25-1A, in determining whether an investor has significant influence for purposes of evaluating this condition, the investor considers the indicators of significant influence in ASC 323-10-15-6 and ASC 323-10-15-7. The EITF determined (as stated in paragraph 12 of the Basis for Conclusions to ASU 2014-01) that ASC 323-10-15-8 to 15-11, which states that an investment (direct or indirect) of 20% or more of the voting stock of an investee shall lead to a presumption that (in the absence of predominant evidence to the contrary) an investor has the ability to exercise significant influence over an investee, are not applicable in determining whether a limited liability investor has significant influence in an investment in a qualified affordable housing project for purposes of evaluating ASC 323-740-25-1(aa). Refer to our FRD, ***Equity method investments and joint ventures***, for guidance on ASC 323-10-15-6 and 15-7.

For investments in limited partnerships, the guidance in ASC 970-323-25-6 requires the use of the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies." The SEC staff understands that practice generally has viewed investments of more than 3% to 5% to be more than minor (ASC 323-30-S99-1). This guidance also is not applicable in determining whether a limited liability investor has significant influence in an investment in a qualified affordable housing project for purposes of evaluating ASC 323-740-25-1(aa).

Cost method

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Illustrations

323-740-55-4

This Example has the following assumptions:

a. All cash flows (except initial investment) occur at the end of each year.

b. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).

c. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.

d. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.

e. The annual tax credit allocation (equal to 4 percent of the project's original cost) will be received for a period of 10 years.

f. The investor's tax rate is 40 percent.

g. The project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.

h. The project's taxable loss will be equal to depreciation expense. The cumulative book loss (and thus the cumulative depreciation expense) recognized by the investor is limited to the $100,000 investment.

i. Subparagraph superseded by Accounting Standards Update No. 2014-01.

j. It is assumed that all requirements are met to retain allocable tax credits so there will be no recapture of tax credits.

k. The investor expects that the estimated residual value of the investment will be zero.

l. All of the conditions described in paragraph 323-740-25-1 are met to qualify the investment for the use of the proportional amortization method.

323-740-55-7

A detailed analysis of the cost method with amortization follows.

Year	Net Investment (1)	Amortization of Investment (2)	Tax Depreciation (3)	Tax Credit (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
1	$ 90,000	$ 10,000	$ 7,273	$ 8,000	$ 10,909	$ 1,091	$ 2,000
2	80,000	10,000	7,273	8,000	10,909	1,091	2,000
3	70,000	10,000	7,273	8,000	10,909	1,091	2,000
4	60,000	10,000	7,273	8,000	10,909	1,091	2,000
5	50,000	10,000	7,273	8,000	10,909	1,091	2,000
6	40,000	10,000	7,273	8,000	10,909	1,091	2,000
7	30,000	10,000	7,273	8,000	10,909	1,091	2,000
8	20,000	10,000	7,273	8,000	10,909	1,091	2,000
9	10,000	10,000	7,273	8,000	10,909	1,091	2,000
10	-	10,000	7,273	8,000	10,909	1,091	2,000
11	-	-	7,273	-	2,909	(2,909)	-
12	-	-	7,273	-	2,909	(2,909)	-
13	-	-	7,273	-	2,909	(2,909)	-
14	-	-	5,451	-	2,183	(2,183)	-
15	-	-	-	-	-	-	-
Total		$ 100,000	$ 100,000	$ 80,000	$ 120,000	$ -	$ 20,000

(1) End-of-year investment for a 5 percent limited liability interest in the project net amortization in column (2).
(2) Investment in excess of estimated residual value (zero in this case) amortized in proportion to tax credits received in the current year to total estimated tax credits.
(3) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years up to the amount of the initial investment of $100,000.
(4) 4 percent tax credit on $200,000 tax basis of the underlying assets.
(5) (Column [3] x 40% tax rate) + column (4).
(6) The change in deferred taxes resulting from the difference between the book and tax bases of the investments. In this Example, that amount can be determined as follows: (column [2] − column [3]) x 40% tax rate.
(7) Column (5) + column (6) − column (2).

In the example noted above, the investment is accounted for under the cost method (versus the equity method) presumably because the limited partner has virtually no influence over the limited partnership's financial and operating policies despite a 5% limited partnership interest.

Equity method

In December 2019, the FASB issued ASU 2019-12, which corrects an error in the example shown in paragraph ASC 323-740-55-8 related to when an impairment should be recognized in an equity method investment in a qualified affordable housing project. The following illustration shows the corrected equity method example included in ASC 323-740-55-8.

Illustration 4-2: Accounting for investments in qualified affordable housing projects under the equity method

Assume the assumptions as stated in ASC 323-740-55-4 (as shown above). A detailed analysis of the equity method follows.

Year	Net Investment (1)	Book Loss (2)	Tax Loss (Depreciation) (3)	Tax Credits (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
1	$ 92,727	$ 7,273	$ 7,273	$ 8,000	$ 10,909	$ -	$ 3,636
2	85,454	7,273	7,273	8,000	10,909	-	3,636
3	78,181	7,273	7,273	8,000	10,909	-	3,636
4	70,908	7,273	7,273	8,000	10,909	-	3,636
5	63,635	7,273	7,273	8,000	10,909	-	3,636
6(a)	32,000	31,635	7,273	8,000	10,909	9,746	(10,980)
7	24,000	8,000	7,273	8,000	10,909	291	3,200
8	16,000	8,000	7,273	8,000	10,909	291	3,200
9	8,000	8,000	7,273	8,000	10,909	291	3,200
10	-	8,000	7,273	8,000	10,909	291	3,200
11	-	-	7,273	-	2,909	(2,909)	-
12	-	-	7,273	-	2,909	(2,909)	-
13	-	-	7,273	-	2,909	(2,909)	-
14	-	-	5,451	-	2,183	(2,183)	-
15	-	-	-	-	-	-	-
Total		$ 100,000	$ 100,000	$ 80,000	$ 120,000	$ -	$ 20,000

(1) End-of-year investment for a 5 percent limited liability interest in the project less the investor's share of losses.
(2) The investor's share of book losses recognized under the equity method. The cumulative losses recognized are limited to the investment of $100,000. (See also (a) below).
(3) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years up to the amount of the initial investment of $100,000.
(4) 4 percent tax credit on $200,000 tax basis of the underlying assets.
(5) (Column [3] x 40% tax rate) + column (4).
(6) The change in deferred taxes resulting from differences between the book and tax bases of the investment and tax losses in excess of the at-risk investment. In this Example, that amount can be determined as follows: (column [2] − column [3]) x 40% tax rate.
(7) Column (5) + column (6) − column (2).

(a) *Projections of the total future tax benefits at the end of Year 6 indicate that a net loss will be recognized over the remaining term of the investment indicating an other-than-temporary impairment. For purposes of this example, in Year 6, impairment is measured as the excess of the carrying amount of the net investment over the remaining tax credits allocable to the investor, although an alternative measure could include other tax benefits to be generated by the investment. The impairment loss recognized in this Example in Year 6 ($24,362) is derived as follows: Investment at the end of Year 5 ($63,635) less the loss recognized in Year 6 ($7,273) before recognizing the impairment, the remaining tax credits allocable to the investor ($32,000), and the estimated residual value ($0). ASC 323-740-55-9 states that this is but one method for recognition and measurement of impairment of an investment accounted for by the equity method. Inclusion of this method in this example does not indicate that it is a preferred method.*

4.2.7.5.3 *Applying the proportional amortization method*

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Subsequent Measurement

323-740-35-1

This guidance addresses the methodology for measuring an investment in a qualified affordable housing project through a limited liability entity that is accounted for using the proportional amortization method.

323-740-35-2

Under the proportional amortization method, the investor amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits allocated to the investor. The amortization amount shall be calculated as follows:

a. The initial investment balance less any expected residual value of the investment, multiplied by

b. The percentage of actual tax credits and other tax benefits allocated to the investor in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the investor over the life of the investment.

323-740-35-4

As a practical expedient, an investor is permitted to amortize the initial cost of the investment in proportion to only the tax credits allocated to the investor if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result from applying the requirement in paragraph 323-740-35-2.

323-740-35-5

Any expected residual value of the investment shall be excluded from the proportional amortization calculation. Cash received from operations of the limited liability entity shall be included in earnings when realized or realizable. Gains or losses on the sale of the investment, if any, shall be included in earnings at the time of sale.

323-740-35-6

An investment in a qualified affordable housing project through a limited liability entity shall be tested for impairment when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized. An impairment loss shall be measured as the amount by which the carrying amount of an investment exceeds its fair value. A previously recognized impairment loss shall not be reversed.

Other Presentation Matters

323-740-45-2

Under the proportional amortization method, the amortization of the investment in the limited liability entity is recognized in the income statement as a component of **income tax expense (or benefit)**. The **current tax expense (or benefit)** shall be accounted for pursuant to the general requirements of Topic 740.

In applying the proportional amortization method, an investor amortizes the cost of its investment, in proportion to the tax credits and other tax benefits it receives and presents the amortization as a component of income tax expense. Refer to the illustration below for additional guidance on the application of the proportional amortization method.

Under the proportional amortization method, an investment must be tested for impairment when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized. An impairment loss is measured as the amount by which the carrying amount of the investment exceeds its fair value. Previously recognized impairment losses cannot be reversed.

We note that ASC 323-740 does not indicate whether deferred taxes should be recorded for the difference between the book and tax bases of an investment accounted for under the proportional amortization method, but the example included in the guidance does not illustrate deferred tax effects for this difference. While ASC 323-740 does not provide any specific exceptions to deferred tax accounting, some in practice interpret the example and other provisions of ASC 323-740 to mean that it is not necessary to account for the deferred tax effects of the difference between the book and tax bases of the investment, resulting in diversity in practice.

We have discussed with the FASB staff whether deferred taxes should be recorded for the difference between the book and tax bases of an investment in a qualified affordable housing project that is accounted for under the proportional amortization method. The FASB staff acknowledged the guidance is not clear and that ASU 2014-01 does not address whether deferred taxes should or should not be provided under the proportional amortization method for the difference between the book basis and tax basis of an investment in a qualified affordable housing project. Additionally, the FASB staff noted that ASC 740 was not amended by ASU 2014-01. Thus, ASC 740 provides no additional guidance or interpretation in general or specific to investments in qualified affordable housing projects on basis differences that should (or should not) result in deferred tax accounting.

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Illustrations

323-740-55-4

This example has the following assumptions:

a. All cash flows (except initial investment) occur at the end of each year.

b. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).

c. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.

d. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.

e. The annual tax credit allocation (equal to 4 percent of the project's original cost) will be received for a period of 10 years.

f. The investor's tax rate is 40 percent.

g. The project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.

h. The project's taxable loss will be equal to depreciation expense. The cumulative book loss (and thus the cumulative depreciation expense) recognized by the investor is limited to the $100,000 investment.

i. Subparagraph superseded by Accounting Standards Update No. 2014-01.

j. It is assumed that all requirements are met to retain allocable tax credits so there will be no recapture of tax credits.

k. The investor expects that the estimated residual value of the investment will be zero.

l. All of the conditions described in paragraph 323-740-25-1 are met to qualify the investment for the use of the proportional amortization method.

323-740-55-5

An analysis of the proportional amortization method follows.

Year	Net Investment (1)	Amortization of Investment (2)	Tax Credits (3)	Net Losses/Tax Depreciation (4)	Other Tax Benefits from Tax Depreciation (5)	Tax Credits and Other Tax Benefits (6)	Tax Credits and Other Tax Benefits, Net of Amortization (7)
1	$ 90,909	$ 9,091	$ 8,000	$ 7,273	$ 2,909	$ 10,909	$ 1,818
2	81,818	9,091	8,000	7,273	2,909	10,909	1,818
3	72,727	9,091	8,000	7,273	2,909	10,909	1,818
4	63,636	9,091	8,000	7,273	2,909	10,909	1,818
5	54,545	9,091	8,000	7,273	2,909	10,909	1,818
6	45,454	9,091	8,000	7,273	2,909	10,909	1,818
7	36,363	9,091	8,000	7,273	2,909	10,909	1,818
8	27,272	9,091	8,000	7,273	2,909	10,909	1,818
9	18,181	9,091	8,000	7,273	2,909	10,909	1,818
10	9,090	9,091	8,000	7,273	2,909	10,909	1,818
11	6,666	2,424	-	7,273	2,909	2,909	485
12	4,242	2,424	-	7,273	2,909	2,909	485
13	1,818	2,424	-	7,273	2,909	2,909	485
14	-	1,818	-	5,451	2,183	2,183	365
15	-	-	-	-	-	-	-
Total		$ 100,000	$ 80,000	$ 100,000	$ 40,000	$ 120,000	$ 20,000

(1) End-of-year investment for a 5% limited liability interest in the project net amortization in Column (2).

(2) Initial investment of $100,000 x (total tax benefits received during the year in Column (6) / total anticipated tax benefits over the life of the investment of $120,000).

(3) 4 percent tax credit on $200,000 tax basis of underlying assets.

(4) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years up to the amount of the initial investment of $100,000.

(5) Column (4) x 40% tax rate.

(6) Column (3) + Column (5).

(7) Column (6) − Column (2).

4.2.7.5.4 *Accounting for tax rate changes when applying the proportionate amortization method*

ASC 323-740-35 does not provide guidance on how to account for the effects of a change in a tax rate on investments in qualified affordable housing projects accounted for under the proportional amortization method. Upon the enactment date of a new tax law that changes the applicable income tax rate, investors in qualified affordable housing projects will first need to consider the effects of changes in the tax rate when applying the proportional amortization method. In accordance with ASC 323-740-35-6, investors should first consider whether it is more likely than not that the carrying amount of the investment will not be realized. If events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized, an impairment would be recorded. If a company concludes that the investment is not impaired, it should revise its proportional amortization schedule to reflect the revised expected future tax benefits from the remaining tax credits and the new corporate tax rate. We believe one acceptable approach is to record a "cumulative catch-up" adjustment to the proportional amortization balance so that it reflects the remaining tax benefits at the new rate. Consistent with the guidance in ASC 323-740-45-2, the catch-up charge should be recognized in the income statement as a component of income tax expense from continuing operations. We understand that there may be other acceptable ways to account for the effects of a tax rate change on investments in qualified affordable housing projects accounted for under the proportional amortization method.

4.2.7.5.5 *Investments in other tax credits*

Based on a consensus of the EITF, the FASB issued ASU 2023-02 to expand the use of the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740 (see section 4.2.7.5A, *Proportional amortization method for equity investments in qualified tax credit programs (after the adoption of ASU 2023-02)*). Prior to the adoption of this ASU, the guidance in ASU 2014-01 applies only to investments in qualified affordable housing projects, in which investors receive low-income housing tax credits and does not apply to investments that generate other credits.

4.2.7.5.6 *Disclosure requirements for investments in qualified affordable housing projects*

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Disclosure

323-740-50-1

A reporting entity that invests in a qualified affordable housing project shall disclose information that enables users of its financial statements to understand the following:

a. The nature of its investments in qualified affordable housing projects

b. The effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of operations.

323-740-50-2

To meet the objectives in the preceding paragraph, a reporting entity may consider disclosing the following:

a. The amount of affordable housing tax credits and other tax benefits recognized during the year

b. The balance of the investment recognized in the statement of financial position

c. For qualified affordable housing project investments accounted for using the proportional amortization method, the amount recognized as a component of income tax expense (benefit)

d. For qualified affordable housing project investments accounted for using the equity method, the amount of investment income or loss included in pretax income

e. Any commitments or contingent commitments (for example, guarantees or commitments to provide additional capital contributions), including the amount of equity contributions that are contingent commitments related to qualified affordable housing project investments and the year or years in which contingent commitments are expected to be paid

f. The amount and nature of impairment losses during the year resulting from the forfeiture or ineligibility of tax credits or other circumstances. For example, those impairment losses may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions, or other issues.

There are certain disclosure requirements for all investments in qualified affordable housing projects, regardless of the accounting method used for those investments. An investor must disclose information that enables users of its financial statements to understand (1) the nature of its investments in affordable housing projects and (2) the effect of the measurement of those investments and the related tax credits on its financial statements.

4.2.7.5A Proportional amortization method for equity investments in qualified tax credit programs (after the adoption of ASU 2023-02) (updated June 2023)

Standard setting

In March 2023, the FASB issued ASU 2023-02, *Investments–Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*, allowing entities to apply the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740-25-1, rather than just investments in qualified affordable housing projects that generate LIHTCs. Under the amended guidance, entities can elect the proportional amortization method on a tax-credit-program-by-tax-credit-program basis. If elected, the method should be applied consistently to all investments in the tax credit program.

The amendments also remove guidance from ASC 323-740 on the accounting for investments in LIHTC programs when the proportional amortization method is not applied to align this accounting with that for other investments in tax equity structures that do not apply the method.

The new guidance requires entities to make disclosures about investments in tax credit programs that they have elected to account for using the proportional amortization method. Entities are also required to make disclosures about investments in tax credit programs that do not meet the conditions in ASC 323-740-25-1 to use the proportional amortization method.

The guidance is effective for public business entities for fiscal years beginning after 15 December 2023, and interim periods within those fiscal years, and for all other entities for fiscal years beginning after 15 December 2024, and interim periods within those fiscal years. Early adoption is permitted for all entities in any interim period. If an entity adopts the amendments in an interim period, it needs to adopt them as of the beginning of the fiscal year that includes that interim period. Refer to our Technical Line, ***Expanded use of the proportional amortization method for equity investments in tax credit programs***.

4.2.7.5.1A *Overview*

The FASB had issued ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*, to allow investors to use the proportional amortization method (PAM) to account for investments in limited liability entities that manage or invest in affordable housing projects that qualify for low-income housing tax credits. Based on a consensus reached by the EITF, the FASB issued ASU 2023-02 to expand the use of PAM to equity investments in all tax credit programs that meet the criteria in ASC 323-740-25-1, including the NMTC program, the Historic Rehabilitation Tax Credit program and the Renewable Energy Tax Credit programs. Entities typically invest in these limited liability entities to receive these tax benefits.

Under PAM, the equity investment is amortized in proportion to the income tax credits and other income tax benefits received, with the amortization expense and the income tax benefits presented on a net basis in income tax expense or benefit on the income statement. The decision to apply PAM is an accounting policy election that is made on a tax-credit-program-by-tax-credit-program basis and should be applied consistently to all investments in an elected tax credit program that meet the conditions in ASC 323-740-25-1.

PAM may only be applied to equity investments made through limited liability entities that are flow-through entities for tax purposes (e.g., a limited liability partnership or a limited liability company). The method cannot be applied to investments in tax credit structures the investor is required to consolidate. In addition, the election would not apply to investments in tax credit structures that are classified as debt.

4.2.7.5.2A *Qualifying for the proportional amortization method*

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Recognition

Pending Content:

Transition Date: *(P) December 16, 2023; (N) December 16, 2024* | **Transition Guidance:** 323-740-65-2

323-740-25-1[11]

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met:

a. It is probable that the income tax credits allocable to the investor will be available.

aa. The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project.

aaa. Substantially all of the projected benefits are from income tax credits and other income tax benefits (for example, tax benefits generated from the operating losses of the investment). Projected benefits include, but are not limited to, income tax credits, other income tax benefits, and other non-income-tax-related benefits, including refundable tax credits (that is, those tax credits not dependent upon an investor's income tax liability). Tax credits accounted for outside of the scope of Topic 740 (for example, refundable tax credits) shall be included in total projected benefits, but not in income tax credits and other income tax benefits when evaluating this condition. This condition shall be determined on a discounted basis using a discount rate that is consistent with the cash flow assumptions utilized by the investor for the purpose of making a decision to invest in the project.

b. The investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive.

c. The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.

323-740-25-1A

In determining whether an investor has the ability to exercise significant influence over the operating and financial policies of the underlying project, a reporting entity shall consider the indicators of significant influence in paragraphs 323-10-15-6 through 15-7. In considering the operating and financial policies of the underlying project, the investor shall consider the operations, financial decisions, and related objectives of the project as a whole.

[11] In the FASB online portal, references to section 323-740 may be displayed as 740-323. This does not change the codification reference, which remains 323-740 for this section.

323-740-25-1B

Other transactions between the investor and the limited liability entity (for example, bank loans) shall not be considered when determining whether the conditions in paragraph 323-740-25-1 are met, provided that all three of the following conditions are met:

a. The reporting entity is in the business of entering into those other transactions (for example, a financial institution that regularly extends loans to other projects).

b. The terms of those other transactions are consistent with the terms of arm's-length transactions.

c. The reporting entity does not acquire the ability to exercise significant influence over the operating and financial policies of the underlying project as a result of those other transactions.

323-740-25-1C

At the time of the initial investment, a reporting entity shall evaluate whether the conditions in paragraphs 323-740-25-1 through 25-1B have been met to elect to apply the proportional amortization method on the basis of facts and circumstances that exist at that time. A reporting entity shall subsequently reevaluate the conditions upon the occurrence of either of the following:

a. A change in the nature of the investment (for example, if the investment is no longer in a flow-through entity for tax purposes)

b. A change in the relationship with the underlying project that could result in the reporting entity no longer meeting the conditions in paragraphs 323-740-25-1 through 25-1B.

323-740-25-2

Paragraph superseded by Accounting Standards Update No. 2023-02.

323-740-25-2A

Paragraph superseded by Accounting Standards Update No. 2023-02.

323-740-25-3

A liability shall be recognized for delayed equity contributions that are unconditional and legally binding. A liability also shall be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable. Topic 450 and paragraph 842-50-55-2 provide additional guidance on the accounting for delayed equity contributions.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

A liability shall be recognized for delayed equity contributions that are unconditional and legally binding. A liability also shall be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable. Topic 450 and paragraph 842-50-55-2 provide additional guidance on the accounting for delayed equity contributions.

Pending Content:

Transition Date: *(P) December 16, 2023; (N) December 16, 2024* | **Transition Guidance:** 323-740-65-2

A liability shall be recognized for delayed equity contributions that are unconditional and legally binding. A liability also shall be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable. Topic 450 and paragraph 842-50-55-2 provide additional guidance on the accounting for delayed equity contributions.

323-740-25-4

The decision to apply the proportional amortization method is an accounting policy decision to be elected on a tax-credit-program-by-tax-credit-program basis that shall be applied consistently to all investments within an elected tax credit program that meet the conditions in paragraph 323-740-25-1 rather than a decision to be applied to individual investments that meet the conditions in paragraph 323-740-25-1.

323-740-25-5

An entity shall recognize income tax credits in the period that they are allocated to the investor for tax purposes. Unless all income tax credits are allocated to the investor at the date of initial investment, immediate recognition of the entire benefit of the income tax credits to be received during the term of an investment that generates income tax credits and other income tax benefits from a tax credit program is not permitted (that is, income tax credits shall not be recognized in the financial statements before the year in which the credit arises).

The guidance allows investors to elect to use PAM to account for equity investments in income tax credit projects through limited liability entities if the following conditions are met:

- It is probable that the income tax credits allocable to the investor will be available. (ASC 323-740-25-1(a))
- The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project. (ASC 323-740-25-1(aa))
- Substantially all of the projected benefits are from income tax credits and other income tax benefits. This condition is determined on a discounted basis. (ASC 323-740-25-1(aaa))
- The investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive. (ASC 323-740-25-1(b))
- The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment. (ASC 323-740-25-1(c))

Significant influence

ASC 323-740-25-1(aa) requires that an investor determine it does not have the ability to exercise significant influence over the operating and financial policies of the underlying project, rather than the limited liability entity through which it receives tax benefits, as was required under the legacy guidance.

The Task Force said this change was needed to address multitiered structures that may exist in tax credit programs (e.g., NMTC tax structures). In multitiered structures, there are several flow-through entities between the tax equity investor and the project itself, and without this amendment it was unclear which entity in the structure should be the focus of the evaluation. The Task Force also wanted to eliminate opportunities to structure a project to achieve a desired result (i.e., structuring opportunities).[12]

Substantially all of projected benefits

Projected benefits under ASC 323-740-25-1(aaa) include all the benefits that will be received from the equity investment, including income tax credits, other income tax benefits (e.g., the investor's share of tax benefits from the operating losses of the project) and non-income-tax-related benefits. The guidance clarifies that when determining whether substantially all of the projected benefits are from income tax credits and other income tax benefits, an entity includes tax credits accounted for outside of ASC 740 (e.g., refundable tax credits or other non-income-based credits) in the total projected benefits (denominator) but not in the amount of income tax credits and other income tax benefits (numerator).

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[12] Paragraph BC17 from ASU 2023-02.

To evaluate whether it meets the substantially all threshold, the investor will need to project all of its future tax benefits and determine the nature of the credits (e.g., refundable, transferable). In performing the calculation, the investor will need to follow its policy election on whether it accounts for any nonrefundable transferable tax credits under ASC 740 or under other guidance (see section 2.5.1.4, *Accounting for nonrefundable tax credits with transferability features*).

An investor should determine whether the tax credits it receives are transferable or refundable based on the nature of the credit it receives even if that differs from the nature of the credits received by the investee entity. For example, the investee may generate a transferable tax credit. However, once that credit is allocated to the investor, the investor may not have the right to transfer that credit to another party. In this case, the investor has received a nontransferable credit.

The guidance requires an entity to use discounted amounts when assessing whether ASC 323-740-25-1(aaa) is met (i.e., substantially all of the projected benefits are from income tax credits and other income tax benefits). The discount rate selected should be consistent with the cash flow assumptions used by the investor for purposes of making a decision to invest in the project.

How we see it

ASC 323-740-25-1(aaa) does not address whether a quantitative threshold needs to be met to satisfy the "substantially all" criterion. We generally believe an entity has met the substantially all threshold in ASC 323-740-25-1(aaa) when 90% or more of the projected benefits of the tax equity investment results from income tax credits or other income tax benefits. The Task Force indicated that it did not intend to change practice regarding the application of the "substantially all" criterion.[13]

Projected yield

ASC 323-740-25-1(b) requires the investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits to be positive. This assessment requires an entity to make sure the income tax credits and other income tax benefits provide a positive yield when compared to its initial equity investment. When an entity determines the initial equity investment to include in this assessment, we believe the entity should use an amount consistent with the initial measurement in accordance with ASC 323-10-30-2, using a cost accumulation model in which the investment is recognized based on the cost to the investor. This cost is generally based on the fair value of the consideration paid, including transaction costs.

Evaluation of other transactions with investee

Investors may have additional transactions with their investee (for example, bank loans) that provide benefits beyond those of tax credit programs. These transactions should not be considered when determining whether the eligibility criteria are met, as long as all three of the following conditions are met (323-740-25-1B):

- The reporting entity is in the business of entering into these other transactions (for example, a financial institution that regularly extends loans to other projects).
- The terms of these transactions are consistent with the terms of arm's-length transactions.
- The reporting entity does not acquire the ability to exercise significant influence over the operating and financial policies of the underlying project as a result of these other transactions.

[13] Paragraph BC19 in ASU 2023-02.

Investors should carefully assess all transactions with the limited liability entity (generally the direct investee) and any other entity in a multitiered structure, and other investors in the program when assessing these criteria.

Timing of assessment of eligibility and policy election

The eligibility conditions in ASC 323-740-25-1 are assessed at the time of the initial investment. A reporting entity is required to reevaluate the conditions if there is a change in the nature of the investment or in the relationship with the underlying project that could result in the required criteria no longer being satisfied. For example, this may occur when a project no longer qualifies for the income tax credits or the investor determines it might not realize some or all the expected income tax benefits.

The decision to apply PAM is an accounting policy election that is applied on a tax-credit-program-by-tax-credit-program basis and should be applied consistently to all investments within an elected tax credit program that meet the criteria in ASC 323-740-25-1.

For tax credit programs that do not qualify to use PAM or if the investor elected not to use the PAM, the investor will need to determine if the investment meets the conditions to apply the equity method or the guidance in ASC 321, *Investments — Equity Securities*. See section 4.2.7.2, *Investments in partnership or other pass-through entities that generate tax credits*, for additional discussion on accounting for tax credits received from pass-through entities that generate tax credits.

4.2.7.5.3A *Applying the proportional amortization method*

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Pending Content:

Transition Date: *(P) December 16, 2023; (N) December 16, 2024* | **Transition Guidance:** 323-740-65-2

Subsequent Measurement

323-740-35-1

This guidance addresses the methodology for measuring an investment that is accounted for using the proportional amortization method.

323-740-35-2

Under the proportional amortization method, the investor amortizes the initial cost of the investment in proportion to the income tax credits and other income tax benefits allocated to the investor. The amortization amount shall be calculated as follows:

a. The initial investment balance less any expected residual value of the investment, multiplied by

b. The percentage of actual income tax credits and other income tax benefits allocated to the investor in the current period divided by the total estimated income tax credits and other income tax benefits expected to be received by the investor over the life of the investment.

323-740-35-4

As a practical expedient, an investor is permitted to amortize the initial cost of the investment in proportion to only the income tax credits allocated to the investor if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result from applying the requirement in paragraph 323-740-35-2.

323-740-35-5

Any expected residual value of the investment shall be excluded from the proportional amortization calculation. Non-income-tax-related benefits received from operations of the limited liability entity shall be included in pre-tax earnings when realized or realizable. Gains or losses on the sale of the investment, if any, shall be included in pre-tax earnings at the time of sale.

323-740-35-6

An investment shall be tested for impairment when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized. An impairment loss shall be measured as the amount by which the carrying amount of an investment exceeds its fair value. A previously recognized impairment loss shall not be reversed.

Other Presentation Matters

323-740-45-2

Under the proportional amortization method, the amortization of the investment in the limited liability entity is recognized in the income statement as a component of income tax expense (or benefit). The current tax expense (or benefit) shall be accounted for pursuant to the general requirements of Topic 740.

In applying PAM, an investor amortizes the cost of its investment, in proportion to the tax credits and other tax benefits it receives and presents the amortization as a component of income tax expense.

Under PAM, the amortization of the investment is calculated by multiplying:

- The initial investment balance minus any expected residual value of the investment, by
- The percentage of actual income tax credits and other income tax benefits allocated to the investor in the current period divided by the total estimated income tax credits and other income tax benefits expected to be received by the investor over the life of the investment

The amortization of the investment is recognized in the income statement as a component of income tax expense or benefit, which results in the net presentation of the amortization of the investment, income tax credits and other income tax benefits. Non-income-tax-related benefits received from operations of the investment should be included in pretax earnings when realized or realizable. Gains or losses on the sale of the investment, if any, should be included in pretax earnings at the time of sale.

ASC 323-740-35-4 provides for a practical expedient to amortize the investment in proportion to only the income tax credits allocated to the investor (i.e., other income tax benefits are not included in the calculation) if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result from the inclusion of other income tax benefits within the calculation.

Under PAM, an investment must be tested for impairment when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized. An impairment loss is measured as the amount by which the carrying amount of the investment exceeds its fair value.

The amendments require entities to apply the flow-through method to investments in tax credit structures that qualify and are accounted for using PAM. That is, entities that use PAM do not have the ability to apply the deferral method under ASC 740-10-25-46. Entities that have applied the deferral method to existing tax equity structures (LIHTC and other-than-LIHTC tax structures) and elect to use PAM will need to change to the flow-through method (see section 4.2.7.2, *Investments in partnership or other pass-through entities that generate tax credits*, for discussion of the flow-through method).

We note that ASC 323-740 does not indicate whether deferred taxes should be recorded for the difference between the book and tax bases of an investment accounted for under PAM, but the example included in the guidance does not illustrate deferred tax effects for this difference. While ASC 323-740 does not provide any specific exceptions to deferred tax accounting, some in practice interpret the example and other provisions of ASC 323-740 to mean that it is not necessary to account for the deferred tax effects of the difference between the book and tax bases of the investment, resulting in diversity in practice.

We have discussed with the FASB staff whether deferred taxes should be recorded for the difference between the book and tax bases of an investment in a qualified affordable housing project that is accounted for under PAM. The FASB staff acknowledged the guidance is not clear and that ASU 2014-01, which created PAM with the scope restricted to low-income housing tax credits, does not address whether deferred taxes should or should not be provided under PAM for the difference between the book basis and tax basis of an investment in a qualified affordable housing project. Additionally, the FASB staff noted that ASC 740 was not amended by ASU 2014-01. Thus, ASC 740 provides no additional guidance or interpretation in general or specific to investments in qualified affordable housing projects on basis differences that should (or should not) result in deferred tax accounting. Though the discussion was regarding ASU 2014-01, and therefore limited to LIHTC projects, we believe the same conclusion would apply for any tax credits accounted for under PAM.

The guidance provides illustrative examples of how PAM would be applied by an investor that has elected to apply the method and has met the conditions in ASC 323-740-25-1, as follows:

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Proportional Amortization Method

Illustrations

Pending Content:

Transition Date: *(P) December 16, 2023; (N) December 16, 2024* **| Transition Guidance:** 323-740-65-2

323-740-55-2

This Example illustrates the application of the proportional amortization method of accounting for a limited liability investment in a low-income housing tax credit structure, which is a type of investment that may be eligible to be accounted for using the proportional amortization method.

323-740-55-3

The following are the terms for this Example.

Date of investment	January 1, 20X1
Purchase Price of Investment	$100,000

323-740-55-4

This Example has the following assumptions:

a. All cash flows (except initial investment) occur at the end of each year.

b. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).

c. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.

d. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.

e. The annual tax credit allocation (equal to 4 percent of the project's original cost) will be received for a period of 10 years.

f. The investor's tax rate is 40 percent.

g. The project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.

h. The project's taxable loss will be equal to depreciation expense. The cumulative book loss (and thus the cumulative depreciation expense) recognized by the investor is limited to the $100,000 investment.

i. Subparagraph superseded by Accounting Standards Update No. 2014-01.

j. It is assumed that all requirements are met to retain allocable tax credits so there will be no recapture of tax credits.

k. The investor expects that the estimated residual value of the investment will be zero.

l. All of the conditions described in paragraph 323-740-25-1 are met to apply the proportional amortization method, and the entity has elected to use the proportional amortization method to account for its tax equity investments in this tax credit program in accordance with paragraph 323-740-25-4.

323-740-55-5

An analysis of the proportional amortization method follows.

Year	Net Investment (1)	Amortization of Investment (2)	Income Tax Credits (3)	Net Losses/Tax Depreciation (4)	Other Income Tax Benefits from Tax Depreciation (5)	Income Tax Credits and Other Income Tax Benefits (6)	Income Tax Credits and Other Income Tax Benefits, Net of Amortization (7)
1	$ 90,909	$ 9,091	$ 8,000	$ 7,273	$ 2,909	$ 10,909	$ 1,818
2	81,818	9,091	8,000	7,273	2,909	10,909	1,818
3	72,727	9,091	8,000	7,273	2,909	10,909	1,818
4	63,636	9,091	8,000	7,273	2,909	10,909	1,818
5	54,545	9,091	8,000	7,273	2,909	10,909	1,818
6	45,454	9,091	8,000	7,273	2,909	10,909	1,818
7	36,363	9,091	8,000	7,273	2,909	10,909	1,818
8	27,272	9,091	8,000	7,273	2,909	10,909	1,818
9	18,181	9,091	8,000	7,273	2,909	10,909	1,818
10	9,090	9,091	8,000	7,273	2,909	10,909	1,818
11	6,666	2,424	–	7,273	2,909	2,909	485
12	4,242	2,424	–	7,273	2,909	2,909	485
13	1,818	2,424	–	7,273	2,909	2,909	485
14	-	1,818	-	5,451	2,183	2,183	365
15	-	-	-	-	-	-	-
Total		$ 100,000	$ 80,000	$ 100.000	$ 40,000	$ 120,000	$ 20,000

(1) End-of-year investment for a 5% limited liability interest in the project net amortization in Column (2).

(2) Initial investment of $100,000 x (total Income tax benefits received during the year in Column (6) / total anticipated income tax benefits over the life of the investment of $120,000).

(3) 4 percent Income tax credit on $200,000 tax basis of underlying assets.

(4) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years up to the amount of the initial investment of $100,000.

(5) Column (4) x 40% tax rate.

(6) Column (3) + Column (5).

(7) Column (6) − Column (2).

323-740-55-13

This Example has the following assumptions:

a. All cash flows (except the initial investment) occur at the end of each year.

b. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 10-year life (the same method is used for simplicity).

c. The investor contributed $102,000, or 5 percent of the equity capital, for an interest in the limited partnership at the beginning of the first year of eligibility for the income tax credit.

d. The partnership will receive income tax credits from an income tax credit program. The income tax credits will be received over a four-year period.

e. There is no reduction of tax basis as a result of the income tax credits.

f. The investor will receive cash proceeds based on a fixed percentage of the project's cash generated during the life of the project.

g. The investor's tax rate is 40 percent.

h. The income tax credits are not subject to recapture

i. The investor expects that the estimated residual investment will be nominal (zero is assumed for simplicity).

j. All of the conditions described in paragraph 323-740-25-1 are met to apply the proportional amortization method, and the entity has elected to use the proportional amortization method to account for its tax equity investments in this tax credit program in accordance with paragraph 323-740-25-4.

k. After 10 years, the investor has a right to require that the project sponsor purchase the investor's equity interest for a nominal amount (zero is assumed for simplicity). It is assumed that the option will be exercised.

323-740-55-14

An analysis of the proportional amortization method follows.

Year	Net Investment (a)	Amortization of Investment (b)	Income Tax Credits (c)	Net Losses/ Tax Depreciation (d)	Other Income Tax Benefits from Tax Depreciation (e)	Income Tax Credits and Other Income Tax Benefits (f)	Income Tax Credits and Other Income Tax Benefits, Net of Amortization (g)	Non-Income-Tax-Related Cash Returns (h)
1	$ 81,600	$ 20,400	$ 20,000	$ 10,000	$ 4,000	$ 24,000	$ 3,600	$ 200
2	61,200	20,400	20,000	10,000	4,000	24,000	3,600	200
3	40,800	20,400	20,000	10,000	4,000	24,000	3,600	200
4	20,400	20,400	20,000	10,000	4,000	24,000	3,600	200
5	17,000	3,400	-	10,000	4,000	4,000	600	200
6	13,600	3,400	-	10,000	4,000	4,000	600	200
7	10,200	3,400	-	10,000	4,000	4,000	600	200
8	6,800	3,400	-	10,000	4,000	4,000	600	200
9	3,400	3,400	-	10,000	4,000	4,000	600	200
10	-	3,400	-	10,000	4,000	4,000	600	200
Total	$ -	$ 102,000	$ 80,000	$ 100,000	$ 40,000	$ 120,000	$ 18,000	$ 2,000

(a) End-of-year carrying amount of the investment net of amortization in Column (b).

(b) Initial investment of $102,000 x (total income tax credits and other income tax benefits received during the year in Column (f)/total anticipated income tax credits and other income tax benefits over the life of the investment of $120,000).

(c) Represents the income tax credits allocated to the investor.

(d) Income tax losses, principally from depreciation, passed on to the investor

(e) Column (d) x 40% tax rate.

(f) Column (c) + Column (e).

(g) Column (f) — Column (b).

(h) Non-income-tax-related benefits recognized in current-period pre-tax earnings when received. This represents the cash proceeds received by the investor based on the cash generated from the project.

4.2.7.5.4A Accounting for tax rate changes when applying the proportionate amortization method

ASC 323-740-35 does not provide guidance on how to account for the effects of a change in a tax rate on investments accounted for under PAM. Upon the enactment date of a new tax law that changes the applicable income tax rate, investors in qualified income tax credits that have elected PAM will first need to consider the effects of changes in the tax rate when applying the method. In accordance with ASC 323-740-35-6, investors should first consider whether it is more likely than not that the carrying amount of the investment will not be realized. If events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized, an impairment would be recorded. If a company concludes that the investment is not impaired, it should revise its proportional amortization schedule to reflect the revised expected future tax benefits from the remaining tax credits and the new corporate tax rate. We believe one acceptable approach is to record a "cumulative catch-up" adjustment to the proportional amortization balance so that it reflects the remaining tax benefits at the new rate. Consistent with the guidance in ASC 323-740-45-2, the catch-up charge should be recognized in the income statement as a component of income tax expense from continuing operations. We understand that there may be other acceptable ways to account for the effects of a tax rate change on investments accounted for under PAM.

4.2.7.5.5A Disclosure requirements for the proportional amortization method

Excerpt from Accounting Standards Codification

Investments — Equity Method and Joint Ventures — Income Taxes

Disclosure

Pending Content:

Transition Date: *(P) December 16, 2023; (N) December 16, 2024* **| Transition Guidance:** 323-740-65-2

323-740-50-1

A reporting entity shall disclose information in annual and interim periods that enables users of its financial statements to understand the following information about its investments that generate income tax credits and other income tax benefits from a tax credit program for which it has elected on a tax-credit-program-by-tax-credit-program basis to apply the proportional amortization method, including investments within that elected tax credit program that do not meet the conditions in paragraph 323-740-25-1:

a. The nature of its investments

b. The effect of the recognition and measurement of its investments and the related income tax credits and other income tax benefits on its financial position and results of operations.

323-740-50-1A

To meet the objectives in paragraph 323-740-50-1, a reporting entity shall disclose the following information about its investments that generate income tax credits and other income tax benefits from a tax credit program for which it has elected on a tax-credit-program-by-tax-credit-program basis to apply the proportional amortization method, including investments within that elected tax credit program that do not meet the conditions in paragraph 323-740-25-1:

a. The amount of income tax credits and other income tax benefits recognized during the period, including the line item in the statement of operations and statement of cash flows in which it has been recognized

b. The amount of investments and the line item in which the investments are recognized in the statement of financial position

c. For investments accounted for using the proportional amortization method, the amount of investment amortization recognized as a component of income tax expense (benefit)

d. For investments accounted for using the proportional amortization method, the amount of non-income-tax-related activity and other returns received that is recognized outside of income tax expense (benefit) and the line item in the statement of operations and statement of cash flows in which it has been recognized

e. For investments accounted for using the proportional amortization method, significant modifications or events that resulted in a change in the nature of the investment or a change in the relationship with the underlying project.

323-740-50-2

To meet the objectives in paragraph 323-740-50-1, a reporting entity may consider disclosing the following about its investments that generate income tax credits and other income tax benefits from a tax credit program for which it has elected on a tax-credit-program-by-tax-credit-program basis to apply the proportional amortization method, including investments within that elected tax credit program that do not meet the conditions in paragraph 323-740-25-1:

a. Subparagraph superseded by Accounting Standards Update No. 2023-02.

b. Subparagraph superseded by Accounting Standards Update No. 2023-02.

c. Subparagraph superseded by Accounting Standards Update No. 2023-02.

d. For investments accounted for using the equity method, the amount of investment income or loss included in pretax income

e. Any commitments or contingent commitments (for example, guarantees or commitments to provide additional capital contributions), including the amount of delayed equity contributions and the year or years in which contingent commitments are expected to be paid

f. The amount and nature of impairment losses during the year resulting from the forfeiture or ineligibility of income tax credits or other circumstances. For example, in a qualified affordable housing project investment, those impairment losses may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions, or other issues.

The amendments require entities to make disclosures about all investments in a tax credit program(s) that they have elected to account for using PAM, including those investments in an elected tax credit program(s) that do not meet the conditions to use PAM.

For example, an entity may have multiple investments in tax equity structures that generate tax credits under a tax program for which it has elected to use PAM, but not all investments meet the conditions to use PAM (i.e., they are accounted for using the equity method or ASC 321). The disclosure requirements in ASC 323-740-50 would apply to all investments in the tax credit program, regardless of whether PAM is applied to the individual investment.

ASC 323-740-50-1 requires entities to disclose the following:

- The nature of the investments
- The effect of the recognition and measurement of its investments and the related income tax credits and other income tax benefits on its financial position and results of operations

ASC 323-740-50-1A requires the following additional disclosures to meet the objectives in ASC 323-740-50-1:

- The amount of income tax credits and other income tax benefits recognized during the period, including the line item in the statement of operations and statement of cash flows in which it has been recognized
- The amount of investments and the line item in which the investments are recognized in the statement of financial position
- For investments accounted for using PAM, the amount of investment amortization recognized as a component of income tax expense (benefit)
- For investments accounted for using PAM, the amount of non-income-tax-related activity and other returns received that are recognized outside of income tax expense (benefit) and the line item in the statement of operations and statement of cash flows in which it has been recognized
- For investments accounted for using PAM, significant modifications or events that resulted in a change in the nature of the investment or a change in the relationship with the underlying project.

Additionally, ASC 323-740-50-2 states that an entity may consider disclosing the following:

- For investments accounted for using the equity method, the amount of investment income or loss included in pretax income
- Any commitments or contingent commitments (e.g., guarantees or commitments to provide additional capital contributions), including the amount of delayed equity contributions and the year or years in which contingent commitments are expected to be paid
- The amount and nature of impairment losses during the year resulting from the forfeiture or ineligibility of income tax credits or other circumstances (e.g., in a qualified affordable housing project investment, impairment losses based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions or other issues)

4.2.7.5.6A *Transition*

Entities may apply the guidance on a retrospective or modified retrospective basis. In addition, entities that hold investments in LIHTC programs are flow-through entities for tax purposes and need to make changes to their accounting because they are no longer permitted to apply (1) the cost method, (2) the impairment guidance included in the legacy example in ASC 323-740-55-8 through ASC 323-740-55-9 or (3) the delayed equity contribution guidance may do so using a prospective approach. Entities that elect to apply these specific amendments prospectively are still required to apply all other amendments on a retrospective or modified retrospective basis, if applicable.

For both the retrospective and modified retrospective approaches, an entity that elects to apply PAM should determine whether the investment qualifies for PAM as of the date that investment was originally entered into and considering any modifications (including those that would require the reassessment in ASC 323-740-25-1C).

Retrospective approach

An entity applying a retrospective approach should identify all investments in tax credit structures that are still expected to generate either income tax credits or other income tax benefits as of the beginning of the earliest comparative period presented. To make this determination, the entity should use the actual tax credits and other income tax benefits received and the remaining benefits expected to be received as of the beginning of the earliest period presented. For those identified investments, the entity will need to determine whether those tax credit investments qualify for PAM as of the date the investment was originally made. An entity should record a cumulative-effect adjustment to the opening balance of retained earnings in the earliest period presented for the difference caused by applying the amended guidance.

Modified retrospective approach

An entity applying a modified retrospective approach should identify all investments in tax credit structures that are still expected to generate income tax credits or other income tax benefits as of the adoption date. To make that determination, the entity should use the actual tax credits and other income tax benefits received and the remaining benefits expected to be received from a tax credit investment as of the adoption date. For those identified investments, the entity will need to determine whether those tax credit investments would qualify for PAM as of the date the investment was originally made. An entity would record a cumulative effect adjustment to the opening balance of retained earnings at the beginning of the fiscal year of adoption for the difference caused by applying the amended guidance.

Other transition considerations

Entities electing to use PAM for investments in tax credit structures and that did not apply the legacy delayed equity contribution guidance will need to include both the actual equity contributions made and the expected equity contributions to be made in accordance with ASC 323-740-25-3.

Entities that have investments in LIHTC programs that are not accounted for using PAM and are no longer permitted to use (1) the cost method, (2) the alternative equity method impairment guidance in ASC 323-740-55-8 through ASC 323-740-55-9 or (3) the delayed equity contribution guidance, may apply the guidance by using either (1) the modified retrospective or retrospective methods or (2) a prospective transition method (as of the beginning of the fiscal year of adoption).

If a prospective approach is applied, a cumulative effect adjustment as a result of applying the new guidance would be recognized as an adjustment to current-period earnings, the balance sheet or both on the date of adoption. An entity may individually select a transition method for each of the three adjustment types (i.e., the cost method, the alternative equity method impairment guidance and the delayed equity contribution guidance), and the transition method selected should be applied consistently for that adjustment type.

The amendments in ASU 2023-02 eliminate certain guidance on the accounting for investments in LIHTC programs to align it with the accounting for investments in other types of tax credit equity investment structures. The amendments will affect investments in LIHTC programs that were accounted for under the legacy proportional amortization guidance, as well as investments accounted for under the legacy guidance using the equity method or cost method.

Entities applying the legacy equity or cost method guidance to their investments in LIHTC programs will need to consider the amendments which:

- No longer permit the use of the cost method to account for equity investments in income tax credit structures (including LIHTC structures) but require entities that do not either qualify or elect to use PAM and do not qualify for the use of the equity method to apply the guidance in ASC 321, *Investments — Equity Securities*. If the cost method was used, the entity should make necessary changes to account for the investment in accordance with ASC 321.
- Eliminate an alternative method to measure impairments for investments accounted for using the equity method in ASC 323-740-55-8 through ASC 323-740-55-9 and require entities to apply the impairment guidance in ASC 323 to their income tax credit investments accounted for under the equity method. If the alternative impairment method was used, the entity should make necessary changes to account for the investment in accordance with the impairment guidance in ASC 323.
- No longer permit entities with investments in LIHTC structures that did not use PAM (e.g., those that applied the equity method or cost method) to use the delayed equity contribution guidance in ASC 323-740-25-3 and now will require entities to apply the delayed equity contribution guidance if they account for the investment (including LIHTC investments) using PAM. If the delayed equity contribution method was used, the entity should derecognize any liability related to delayed equity contributions and adjust the corresponding LIHTC investment and other accounts as necessary.

4.2.8 Temporary differences — examples

All temporary differences must be considered in terms of the expected future tax consequences when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Those future tax consequences are recorded either as deferred tax assets or as liabilities. This concept is illustrated by the way ASC 740-10-25-20 (excerpted in this chapter) explains the following temporary differences:

- **Revenues or gains that are taxable after they are recognized in financial income** — An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in taxable amounts in a future year when the asset is recovered (i.e., taxable temporary differences).
- **Expenses or losses that are deductible after they are recognized in financial income** — A liability (for example, a product warranty liability, the allowance for bad debts before the adoption of ASU 2016-13[14] or the allowance for credit losses after the adoption of ASU 2016-13) may be recognized for expenses or losses that will result in tax-deductible amounts in a future year when the liability is settled (i.e., deductible temporary differences).
- **Revenues or gains that are taxable before they are recognized in financial income** — A liability (e.g., a subscription received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payments are included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) that settle the liability will result in tax-deductible amounts in a future year (i.e., deductible temporary differences).
- **Expenses or losses that are deductible before they are recognized in financial income** — The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting purposes (e.g., 100% expensing or other accelerated depreciation for tax purposes versus straight line for financial reporting purposes). Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset and thereby result in taxable amounts in a future year (i.e., taxable temporary differences).
- **Deferred investment tax credits (ITC) —** Under ASC 740-10-25-45 through 25-46, ITC is viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred ITC may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax-deductible when the asset is recovered. The ITC Tax Act of 1986 repealed the US ITC tax provisions. However, ASC 740's provisions also would apply to comparable provisions that exist in foreign or state jurisdictions. See section 4.2.7, *Government assistance received (investment tax credits and government grants)*, for further discussion.
- **An increase in the tax bases of assets because of indexing whenever the local currency is the functional currency —** Some foreign tax jurisdictions permit adjustments of the tax bases of depreciable (or other) assets for inflation. The increase in tax basis (used to compute future tax depreciation or gain or loss on the sale of the asset) creates a deductible temporary difference or may reduce a taxable temporary difference because the amount received upon future recovery of

[14] ASC 326, *Financial Instruments — Credit Losses*, requires the recognition and measurement of credit losses for financial instruments using the current expected credit loss model instead of an incurred loss model required under legacy guidance. The new model requires entities to recognize their current estimate of all expected credit losses using both historical and forward-looking information. ASU 2016-13, which created the new guidance, is effective for public business entities (PBEs) that are US Securities and Exchange Commission (SEC) filers but not smaller reporting companies for annual periods beginning after 15 December 2019 (i.e., 2020 for a calendar-year entity), including interim periods within those annual periods. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of 15 November 2019, in accordance with SEC regulations. The guidance is effective for all other entities for annual periods beginning after 15 December 2022, including interim periods within those annual periods.

the local currency historical cost of the asset will be less than the remaining tax basis of the asset. In other words, the excess tax basis of the asset will result in future tax deductions in excess of those recognized for financial reporting purposes. The tax benefit related to the increased tax basis is recognized in the period when the basis adjustment occurs. Noteworthy is that when the functional currency is the reporting currency, this asset cannot be recorded (see ASC 740-10-25-3(f) and section 3.2.3.2, *Monetary temporary differences*, for additional discussion).

- **Differences between the financial reporting bases of identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree and the tax bases of assets acquired and liabilities assumed in a business combination** — There may be differences between the values recognized for financial reporting of the identifiable assets acquired, liabilities assumed and any noncontrolling interest in the acquiree and the tax bases of the assets and liabilities recognized in a business combination accounted under ASC 805. Those differences (except for nondeductible goodwill and the other exceptions noted in ASC 740-10-25-3 (see section 3.2, *Exceptions to comprehensive accounting for deferred taxes*)) will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively. See chapter 11, *Business combinations*, for further discussion.

- **Intra-entity transfers of an asset other than inventory —** There may be a difference between the tax basis of an asset in the buyer's tax jurisdiction and the carrying value of the asset reported in the consolidated financial statements as the result of an intra-entity transfer of an asset other than inventory from one tax-paying component to another tax-paying component of the same consolidated group. That difference will result in taxable or deductible amounts when the asset is recovered. See section 3.2.2, *Intercompany transactions*, for additional discussion.

- **Obligations to safeguard crypto-assets an entity holds for its platform users** — We believe that the crypto safeguarding asset and related liability required by Staff Accounting Bulletin (SAB) 121 both give rise to temporary differences that should be recognized in the period the safeguarding asset and related liability first arise.

4.2.9 Temporary differences — financial services industry

The nature of the financial services industry, as well as existing tax, accounting and regulatory rules, generally result in substantial deductible temporary differences that are often well in excess of taxable temporary differences. In addition to the types of temporary differences applicable to other companies (see sections 4.2.9, *Temporary differences — examples*, and 4.3.2, *Examples of temporary difference reversal patterns*), companies in the financial services industry oftentimes have temporary differences unique to that industry. Furthermore, the magnitude of certain deductible temporary differences may be much greater than for companies in other industries.

Some of the common sources of deductible temporary differences include:

- Large institutions are not permitted to use the reserve method of accounting for bad debt deductions for tax purposes. This results in a deferral of the deductions attributable to book loan loss provisions (before the adoption of ASU 2016-13) or the allowance for credit losses (after the adoption of ASU 2016-13) recorded for financial reporting purposes, the largest temporary difference for many financial institutions. (See chapter 14, *Foreign and domestic subsidiaries*, for a discussion regarding temporary differences related to bad debt reserves of thrifts.)

- In many cases, interest income continues to be recognized for tax purposes after loans have been placed on non-accrual status for financial reporting purposes. This additional taxable income, which can be significant, gives rise to a deductible temporary difference because the tax basis of the asset (i.e., loan receivable plus accrued interest) exceeds the recorded amount for financial reporting purposes (i.e., loan receivable less loan loss reserve).

- Financial institutions, including those that issue credit cards, often offer rewards and incentives for using their services. These rewards are typically not deductible for tax purposes until paid, but they are generally recognized over a shorter term for financial reporting purposes. This could then result in a deductible temporary difference.
- Financial institutions make equity investments that qualify for the use of the proportional amortization method. When an investor applies this method of accounting for financial reporting purposes, the financial reporting amortization of the investments differs from the tax basis recovery leading to temporary differences. In addition, if an entity is unable to fully use the tax credits generated, the entity may have tax credit carryover deferred tax assets.
- For accounting and regulatory reporting purposes, ASC 310-40-40-3 requires financial institutions that receive long-lived assets that will be sold from a debtor in full satisfaction of a receivable to account for those assets at their fair value less cost to sell, as that term is used in ASC 360-10-35-43. The excess of (1) the recorded investment in the receivable satisfied over (2) the fair value of assets received (less cost to sell) is a loss to be recognized. Because the recognized loss is generally not recognized for tax purposes until disposition of the long-lived asset, a deductible temporary difference is created.
- Loan origination fees, recognized over the life of the loans for accounting purposes, are generally recognized when received for tax purposes. Again, this results in a deductible temporary difference.

Deductible temporary differences, such as those discussed above, often result in the recognition of significant deferred tax assets. As discussed in chapter 6, *Valuation allowances*, ASC 740 requires an evaluation to determine whether a valuation allowance is necessary to reduce the gross deferred tax asset to the amount that is *more likely than not* to be realized. This evaluation is based on the "gross" deferred tax asset rather than the "net" deferred tax asset (i.e., reduced by an existing deferred tax liability amount).

4.3 Scheduling the reversal of temporary differences

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-8

To the extent that evidence about one or more sources of **taxable income** is sufficient to eliminate any need for a valuation allowance, other sources need not be considered. Detailed forecasts, projections, or other types of analyses are unnecessary if expected future taxable income is more than sufficient to realize a tax benefit.

740-10-55-9

The terms *forecast* and *projection* refer to any process by which available evidence is accumulated and evaluated for purposes of estimating whether future taxable income will be sufficient to realize a deferred tax asset. Judgment is necessary to determine how detailed or formalized that evaluation process should be. Furthermore, information about expected future taxable income is necessary only to the extent positive evidence available from other sources (see paragraph 740-10-30-18) is not sufficient to support a conclusion that a valuation allowance is not needed. The requirements of this Subtopic do not require either a financial forecast or a financial projection within the meaning of those terms in the Statements on Standards for Attestation Engagements and Related Attest Engagements Interpretations [AT], AT section 301, *Financial Forecasts and Projections* issued by the American Institute of Certified Public Accountants.

740-10-55-138

Temporary differences usually do not reverse in equal annual amounts as in the Example above, and a different average graduated tax rate might apply to reversals in different future years. However, a detailed analysis to determine the net reversals of temporary differences in each future year usually is not warranted. It is not warranted because the other variable (that is, taxable income or losses exclusive of reversing temporary differences in each of those future years) for determination of the average graduated tax rate in each future year is no more than an estimate. For that reason, an aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income in future years is sufficient. Judgment is permitted, however, to deal with unusual situations, for example, an abnormally large temporary difference that will reverse in a single future year, or an abnormal level of taxable income that is expected for a single future year. The lowest graduated tax rate should be used whenever the estimated average graduated tax rate otherwise would be zero.

Generally, ASC 740 does not require a detailed scheduling of the reversals of existing temporary differences. ASC 740-10-55-138 states that "a detailed analysis to determine the net reversals of temporary differences in each future year usually is not warranted. It is not warranted because the other variables (that is, taxable income or losses exclusive of reversing temporary differences in each of those future years) … is no more than an estimate." ASC 740-10-55-8 states that "detailed forecasts, projections, or other types of analyses are unnecessary if expected future taxable income is more than sufficient to realize a tax benefit."

However, assessing whether a valuation allowance is required for deferred tax assets or determining the applicable tax rate when phased-in rate changes are significant might require companies to determine the future reversal years of existing temporary differences.

Scheduling of the appropriate reversal pattern may be necessary when the timing of the reversal of existing temporary differences materially affects the determination of the need for a valuation allowance or affects the enacted tax rate applied to deferred tax balances (see section 5.1.1, *Average graduated tax rates*, for additional discussion of when a detailed analysis of the net reversals of temporary differences may be necessary when measuring deferred tax balances). In such instances, a company's judgment about the need for a valuation allowance or the application of the appropriate enacted tax rate to deferred tax balances is supported by the reversal pattern of existing temporary differences.

4.3.1 Determining reversal dates

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-13

The particular years in which temporary differences result in taxable or deductible amounts generally are determined by the timing of the recovery of the related asset or settlement of the related liability. However, there are exceptions to that general rule. For example, a **temporary difference** between the tax basis and the reported amount of inventory for which cost is determined on a last-in, first-out (LIFO) basis does not reverse when present inventory is sold in future years if it is replaced by purchases or production of inventory in those same future years. A LIFO inventory temporary difference becomes taxable or deductible in the future year that inventory is liquidated and not replaced.

The future years when temporary differences reverse generally are determined by the timing of the recovery of the related asset or settlement of the related liability;[15] however, there are some exceptions (ASC 740-10-55-13). One exception would be the temporary difference related to LIFO inventory. The FASB believes that this temporary difference reverses when the inventory is liquidated and not replaced rather than when the inventory is sold and replaced by subsequent purchases or production.

The future years when temporary differences reverse may be known based on the transactions underlying the temporary differences. For example, the reversal of installment sales, prepaid subscription revenues and the deferred gain on a sale-leaseback transaction (for leases commencing before the adoption of ASC 842) generally would reverse based on their respective contractual terms. However, for certain temporary differences, the future reversal dates will have to be estimated. Generally, estimates should be based on experience and other pertinent factors, including a company's ability to control reversal of existing temporary differences. For example, the reversal of temporary differences related to warranty accruals would be based on warranty terms and past experience in incurring costs. The reversal of a temporary difference related to bad debt reserves (before the adoption of ASU 2016-13) or allowances for credit losses (after the adoption of ASU 2016-13) should consider charge-off experience and estimates of when losses on specific loans or receivables will become deductible, as well as a company's ability to apply tax-planning strategies to maximize the benefit of the charge-off.

The reversal periods of other temporary differences can be determined based on appropriate estimation techniques, considering the nature of the temporary differences. For example, a company's lease portfolio might comprise a large number of individually insignificant contracts. If the contracts' terms are similar, it generally would be appropriate to calculate the reversal of temporary differences for a representative sample of contracts and estimate the reversal of the aggregate temporary difference based on the calculated reversal patterns of the representative lease contracts.

For purposes of scheduling the reversal of assets and liabilities that are measured at their present values at the date of the balance sheet, the use of either the loan amortization or the present-value method may be used. Under the loan amortization method, future payments (collections) would be presumed to relate first to interest and then to principal. The amount represented by the principal portion represents the amount of the temporary difference that is presumed to reverse. Under the present value approach, reversal would be presumed to occur based on the present value of future payments (collections).

4.3.2 Examples of temporary difference reversal patterns

Determining the reversal patterns of temporary differences, if necessary to do so, will require the use of estimates and judgments. The guidance in ASC 740 does not specify how different types of temporary differences should be scheduled to reverse, only that the method used should be systematic and logical (ASC 740-10-55-22). A general approach to determining reversal dates for various types of temporary differences is summarized below. Qualified tax-planning strategies also should be considered to change reversal patterns to reduce the amount of a valuation allowance for deferred tax assets.

- **Allowance for bad debts/loan losses (before the adoption of ASU 2016-13)/allowance for credit losses (after the adoption of ASU 2016-13)** — Reversal periods for temporary differences should be estimated based on projected charge-offs related to existing receivables/loans. Future originating differences for expected additions to the allowance are considered only to the extent that future taxable income (exclusive of reversals of existing temporary differences) is considered as a source of taxable income in determining the deferred tax asset valuation allowance (see section 14.8, *Bad debt reserves of savings and loan associations*, for additional discussion).

[15] See section 4.3.2, *Examples of temporary difference reversal patterns*, for examples of reversal patterns for various temporary differences.

- **Capital leases — lessee (before the adoption of ASC 842)** — The temporary differences related to a capital lease should be viewed as two separate temporary differences. From the standpoint of a lessee, a capital lease would be viewed as follows: a capitalized asset and a capitalized lease obligation, each with a tax basis of zero (assuming the lease is an operating lease for tax purposes). The capitalized leased asset would reverse based on the scheduled amortization of the asset and impairment of the asset, if any. The capitalized lease obligation would reverse as lease payments are made.
- **Sales-type or direct financing leases — lessor (before the adoption of ASC 842)** — A sales-type or direct financing lease would be viewed as an investment (receivable) for financial reporting purposes with a zero tax basis and for tax purposes (assuming it is an operating lease for tax purposes) an asset subject to lease with a zero carrying value for financial reporting purposes. See section 3.2.1, *Leveraged leases*, for discussion of leveraged leases.
- **Finance and operating leases — lessee (after the adoption of ASC 842)** — The temporary differences related to a finance or an operating lease should be viewed as two separate temporary differences. A finance or an operating lease would be viewed as follows: a capitalized asset (i.e., the right-of-use asset) and a lease obligation (i.e., the lease liability), each with a tax basis of zero (assuming the lease is an operating lease for tax purposes). For a finance lease, the temporary differences related to a right-of-use asset would reverse based on the scheduled amortization of the asset, adjusted for any impairment of the right-of-use asset, if any. For an operating lease, the temporary differences related to a capitalized lease asset would reverse as the asset is subsequently remeasured and adjusted for any impairment of the asset. The temporary differences related to the finance and operating lease obligation would reverse as lease payments are made.
- **Sales-type or direct financing leases — lessor (after the adoption of ASC 842)** — The temporary differences related to a sales-type or direct financing lease should be viewed as two separate temporary differences. A sales-type or direct financing lease would be viewed as an investment (receivable) for financial reporting purposes with a zero tax basis and for tax purposes (assuming it is an operating lease for tax purposes) an asset subject to lease with a zero carrying value for financial reporting purposes. The temporary differences related to the investment (receivable) would reverse as lease payments are received. The temporary differences related to the tax asset would reverse based on the scheduled amortization of the asset. See section 3.2.1, *Leveraged leases*, for discussion of leveraged leases.
- **Company-owned life insurance** — The cash surrender value of company-owned life insurance in excess of premiums paid is considered a temporary difference if the cash surrender value is expected to be recovered by surrendering the policy. That excess amount is not a temporary difference if the cash surrender value is expected to be recovered without tax consequence by holding the policy until the death of the insured. If the cash surrender value is expected to be recovered by surrendering the policy, companies should schedule reversal of the taxable temporary difference in the period that the policy is expected to be surrendered.
- **Contingency accruals** — Deductible temporary differences arising from accruals for losses under ASC 450 should be scheduled to reverse in period(s) in which the liabilities are anticipated to be settled.
- **Deferred compensation** — Deductible temporary differences arising from deferred compensation should be scheduled to reverse in the period principal payments of the liability give rise to tax deductions. Use of either the loan amortization or the present-value method of determining the principal payments is appropriate.
- **Depreciation** — The reversal pattern of temporary differences related to depreciation should be scheduled whereby future-originating differences would not be scheduled. Alternatively, originating and reversing differences could be scheduled. Future-originating differences and reversals for existing assets and expected additions would be considered to the extent that future taxable income

(exclusive of reversals of existing temporary differences) is considered as a source of taxable income in determining the deferred tax asset valuation allowance (see section 6.2, *Sources of taxable income*, for further discussion of sources of future taxable income).

- **Indefinite-lived intangible assets and tax-deductible goodwill** — Some intangible assets are amortized for tax purposes and only subject to impairment write-downs for financial reporting purposes. To the extent the book bases exceeds those assets' (other than nondeductible goodwill) tax bases (that is, the intangible is amortized for tax purposes before an impairment write-down is recognized for book purposes), a deferred tax liability is recognized for financial reporting purposes, which will reverse when the asset is disposed or as impairment write-downs are recognized in earnings. By their nature, indefinite-lived intangible reversal periods are indefinite (that is, the reversal of the deferred tax item cannot be scheduled in a particular period). See sections 4.2.6, *Effect on deferred taxes of ability to delay payment*, 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*, and 11.3.4, *Tax-deductible goodwill*, for further discussion.

- **Acquired in-process research and development (IPR&D)** — ASC 350 specifies that intangible assets acquired in a business combination for use in a particular research and development (R&D) project are considered indefinite-lived intangible assets, subject to impairment, until the completion or the abandonment of the associated R&D efforts. Once the R&D efforts are completed or abandoned, the book basis of the acquired IPR&D is expensed, therefore reversing the related temporary differences. A company may not be able to predict the timing of when the R&D project will be completed or abandoned, and consistent with the limitations on indefinite-lived intangibles noted above, should not anticipate impairment. A company will need to consider its specific facts and circumstances when scheduling the reversal of the related deferred tax item (or determine that it cannot be scheduled in a particular period). See section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*, for related discussion on the effects of acquired IPR&D on assessing the realizability of temporary deductible differences.

- **Installment sale receivables** — Reversal should be scheduled based on contract terms.

- **Amortizing intangible assets** — Some intangible assets are amortized for book but not tax purposes. Instead, tax deductions are permitted only when the assets are disposed. Existing net deductible temporary differences for intangible assets generally should be scheduled based on the expected disposal dates.

- **Inventories — LIFO basis differences** — Reversal occurs when the inventory is liquidated and not replaced. The reversal does not occur if present inventory is sold in the future and replaced by purchases or production of inventory in those future years.

- **Inventories — obsolescence reserves** — Temporary differences for obsolescence reserves should be scheduled to reverse based on the estimated disposal dates of the obsolete inventory.

- **Investments accounted for under the equity method** — Temporary differences related to investments accounted for by the equity method generally should be scheduled to reverse in a manner consistent with the expected recovery of the portion of investment representing a temporary difference (i.e., by receipt of dividends of underlying earnings or by sale of the investment). See sections 14.4, *Investments in domestic subsidiaries, corporate joint ventures and domestic investees*, and 14.4.2.2, *Outside basis differences in equity method investees — applicable rate*, for further discussion.

- **Investment tax credits — basis reduction** — Temporary differences resulting from ITC basis reduction provisions of the tax code should be scheduled to reverse as part of the depreciation temporary difference reversals. Scheduled tax depreciation should reflect lower tax deductions as a result of the ITC basis reduction. See section 4.2.7, *Government assistance received (investment tax credits and government grants)*, for further discussion.

- **Investment tax credits — deferral method** — Deferred ITC (including amounts related to leases) is considered as a reduction of the financial statement asset cost, and any difference between the book and tax bases of the asset is considered a temporary difference. The temporary difference for deferred ITC would reverse as part of the depreciation temporary difference reversals, in the form of lower scheduled amounts of future book depreciation. See section 4.2.7, *Government assistance received (investment tax credits and government grants)*, for further discussion.
- **Land** — Basis differences related to land should be scheduled to reverse based on the expected disposal date. Reversal generally would be scheduled in an indefinite future year for land held for operations. See section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*, for further discussion.
- **Pensions and other postretirement benefits (OPEBs)** — A detailed analysis should be performed based on how and when the pension assets will be recovered or the pension (OPEB) liabilities will be settled (funded). See section 15.3.4, *Deferred taxes for postretirement benefit plans*, for further discussion.
- **Sales returns and allowances** — Reversal should be based on estimated return patterns.
- **Stock appreciation rights** — Compensation expense recognized for financial reporting generally is not deductible for tax purposes until rights are exercised. Companies should schedule reversal in periods that employees are expected to exercise the rights, considering applicable contractual limitations.
- **Stock options** — Stock options may provide companies with a tax deduction as employees exercise options. Reversal of deductible temporary differences for accrued compensation expense should be scheduled to reverse in the period options are expected to be exercised. See chapter 21, *Share-based payments to employees*, for further discussion of the accounting for tax benefits of stock options.
- **Vacation accruals** — Reversal should be estimated based on plan terms and the likely date the existing accrual will be deductible.
- **Warranty accruals** — Reversal should be estimated based on contract terms and experience.

4.3.3 Change in method used to determine reversal pattern

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-22

Minimizing complexity is an appropriate consideration in selecting a method for determining reversal patterns. The methods used for determining reversal patterns should be systematic and logical. The same method should be used for all temporary differences within a particular category of temporary differences for a particular tax jurisdiction. Different methods may be used for different categories of temporary differences. If the same temporary difference exists in two tax jurisdictions (for example, U.S. federal and a state tax jurisdiction), the same method should be used for that temporary difference in both tax jurisdictions. The same method for a particular category in a particular tax jurisdiction should be used consistently from year to year. A change in method is a change in accounting principle under the requirements of Topic 250. Two examples of a category of temporary differences are those related to liabilities for deferred compensation and investments in direct financing and sales-type leases.

ASC 740 does not specify in detail how the reversal patterns for specific temporary differences should be determined. The FASB acknowledged that, in many cases, there is more than one logical approach and that minimizing complexity was an appropriate objective. The methods used for determining reversal patterns should be systematic and logical. The same method should be used for all temporary differences within a particular category for a particular tax jurisdiction. The method used should be applied on a consistent basis from year to year.

A change in the method used for determining reversal patterns is a change in the method of applying an accounting principle under ASC 250 and would require a preferability letter for public companies. Different methods may be used for different categories of temporary differences in the same tax jurisdiction. However, if the same temporary difference exists in different tax jurisdictions, the same method should be used for that temporary difference in all tax jurisdictions.

4.4 Basis differences without future tax consequences — permanent differences

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Overview and Background

740-10-05-9

As indicated in paragraph 740-10-25-30, certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized.

Recognition

740-10-25-30

Certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized. One example, depending on the provisions of the tax law, could be the excess of cash surrender value of life insurance over premiums paid. That excess is a temporary difference if the cash surrender value is expected to be recovered by surrendering the policy, but is not a temporary difference if the asset is expected to be recovered without tax consequence upon the death of the insured (if under provisions of the tax law there will be no taxable amount if the insurance policy is held until the death of the insured).

A basis difference may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be a temporary difference for which a deferred tax asset or liability is recognized. As discussed in section 4.1, *Temporary versus permanent differences*, the term "permanent difference" is not used in ASC 740. However, ASC 740-10-25-30 discusses the concept of certain basis differences that do not result in taxable or deductible amounts when the related asset or liability is recovered or settled. These differences are referred to as permanent differences. The following are common examples of permanent differences under current US federal income tax law:

- Compensation expense to covered employees in excess of $1 million under Section 162(m) of US Federal Income Tax Code (see section 21.2.2, *The effect on deferred tax assets of the IRC Section 162(m) limitation*, for additional information on the accounting considerations related to compensation limited under Section 162(m))
- Business meals (e.g., 50% nondeductible under the US Federal Income Tax Code)
- Payment of fines and penalties to a government (e.g., 100% nondeductible under the US Federal Income Tax Code)

- Interest income exempt from taxation
- Non-tax-deductible goodwill impairment or amortization expense
- Foreign-derived intangible income (FDII) (see section 5.9.1, *Foreign-derived intangible income incentive*, for additional discussion on FDII)

4.5 Temporary differences without financial reporting asset or liability

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-24

Some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting.

740-10-25-25

That occurs, for example, when **revenue** on a long-term **contract** with a **customer** is recognized over time using a measure of progress to depict performance over time in accordance with the guidance in Subtopic 606-10, for financial reporting that is different from the recognition pattern used for tax purposes (for example, when the contract is completed). The temporary difference (income on the contract) is deferred income for tax purposes that becomes taxable when the contract is completed. Another example is organizational costs that are recognized as expenses when incurred for financial reporting and are deferred and deducted in a later year for tax purposes

740-10-25-26

In both instances, there is no related, identifiable asset or liability for financial reporting, but there is a temporary difference that results from an **event** that has been recognized in the financial statements and, based on provisions in the tax law, the temporary difference will result in taxable or deductible amounts in future years.

Some temporary differences result from events that have been recognized in the financial statements but result in balances on the tax balance sheet. These temporary differences are not identified to a particular financial reporting asset or liability. Taxable or deductible amounts in future years are based on provisions in the tax law and not upon the expected recovery or settlement of a financial reporting asset or liability. This commonly occurs when an entity uses differing methods for financial reporting and tax accounting (e.g., using an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation under ASC 606 for financial reporting purposes and a different revenue recognition method for tax purposes or direct and indirect acquisition-related costs that are charged to expense in the period in which the related services are rendered and may not be immediately deductible for tax purposes (see section 11.5, *Deferred taxes for acquisition-related costs*)).

4.6 Asset retirement obligations

For financial accounting purposes, the legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or the normal operation of a long-lived asset are accounted for as an asset retirement obligation (ARO) under ASC 410-20. Once the criteria for recognition are met, a company records a liability based on the net present value of the ARO. ASC 410-20-25-5 requires that "upon initial recognition of a liability for an asset retirement obligation, an entity shall capitalize an asset retirement cost by increasing the carrying amount of the related long-lived asset by the same amount as the liability." Refer to our FRD, ***Asset retirement obligations***, for additional discussion of the accounting for the long-lived asset and related liability.

The recognition of the ARO liability and the capitalization to fixed assets of the related asset retirement costs result in temporary differences that require the recognition of deferred taxes. The capitalized retirement costs increase a company's book bases but do not increase the tax bases of the fixed assets, while the ARO liability is a book obligation without a corresponding tax basis.

The following example illustrates the accounting for an ARO liability and related effects on fixed assets and deferred taxes.

Illustration 4-3: Accounting for an ARO liability and the related effects on fixed assets and deferred taxes

Company A purchases an asset for $20 million with a related asset retirement obligation of $9 million. The amount recorded for book purposes related to the fixed asset includes the estimated ARO costs ($20 million + $9 million = $29 million). ARO costs are fully deductible when paid, but the ARO capitalized in fixed assets is not deductible. The effective tax rate is 25%.

(In millions)	Book basis	Tax basis	Temporary difference	Deferred tax balance
Fixed asset	$ 29	$ 20	$ 9	$ 2.25
ARO liability	(9)	0	(9)	(2.25)

A taxable temporary difference exists related to the $9 million basis difference of the fixed asset. Additionally, a separate deductible temporary difference exists related to the basis difference of the ARO liability.

The following journal entry is recorded to recognize the deferred tax liability related to the fixed asset (inclusive of the ARO capitalized):

Deferred tax expense [$9,000,000 x 25%]	$ 2,250,000	
Deferred tax liability		$ 2,250,000

The following journal entry is recorded to recognize the deferred tax asset related to the ARO liability:

Deferred tax asset [$9,000,000 x 25%]	$ 2,250,000	
Deferred tax benefit		$ 2,250,000

As the deferred tax expense recorded for the book-tax basis difference on the fixed asset is fully offset by the deferred tax benefit recorded for the book-tax basis difference on the ARO liability, there is no effect on net income.

In many jurisdictions, both the ARO liability as well as the cost of the fixed asset (i.e., the fixed asset exclusive of the capitalized ARO) are equally deductible and the same rate is applicable. However, in certain jurisdictions (e.g., the United Kingdom) an ARO liability is not deductible or is only partially deductible. We believe the deferred tax consequences of the fixed asset and the ARO should be considered separately (i.e., a deferred tax liability is recognized for the taxable temporary difference associated with the fixed asset, and a deferred tax asset is recognized for the deductible temporary difference associated with the ARO). Because they must be accounted for separately, the deferred tax asset related to the ARO and the deferred tax liability related to the fixed asset will not be the same when limitations are placed on the deductibility of ARO costs or a rate differential exists.

When the deferred tax asset related to the ARO and the deferred tax liability related to the fixed asset are not the same when an asset is purchased, a question arises as to whether the difference should be considered an acquired temporary difference from an asset acquisition or whether the difference should be included in the tax provision in the period in which the asset is acquired. ASC 740-10-25-51 states that "the tax effect of asset purchases that are not business combinations in which the amount paid differs from the tax basis of the asset shall not result in immediate income statement recognition." See chapter 13, *Asset acquisitions*, for additional discussion of the application of ASC 740-10-25-51. When an asset is acquired and the deferred tax asset related to the ARO and the deferred tax liability related to the fixed asset are not the same, we believe it is most appropriate for a company to consider the guidance under ASC 740-10-25-51 and not include income tax expense (or benefit) in the income statement as a result of the acquisition of an asset that is not part of a business combination. However, we also believe that it is acceptable as an accounting policy election to include the difference between the deferred tax liability related to the fixed asset and the deferred tax asset related to the ARO as income tax expense (benefit) in continuing operations in the period in which the asset is acquired.

Refer to chapter 8, *An enacted change in tax laws or rates*, for guidance on accounting for instances in which the deductibility of ARO expenditures changes subsequent to the initial recognition of an ARO.

Illustration 4-4: Accounting for an ARO liability and the related effects on fixed assets and deferred taxes

Assume the same facts as Illustration 4-3. Assume further that Company A operates in a country in which only 50% of the ARO costs are deductible for income tax purposes.

Company A applies ASC 740-10-25-51 and does not recognize an income statement effect in the period in which the asset is acquired for the differing deductibility of the asset retirement costs. Using simultaneous equations as described ASC 740-10-25-51 (and discussed in chapter 13, *Asset acquisitions*), Company A's cash purchase price (CPP) of the fixed asset is $29 million ($20 million purchase price + $9 million ARO)[16] and the tax basis (TB) in the fixed asset is $20 million. The tax rate is 25%.

Equation A — computation of final book basis (FBB) of the fixed asset at a 25% tax rate is:	FBB = (CPP − 0.25TB) ÷ 0.75
Equation B — computation of amount assigned to the DTL at a 25% tax rate is:	DTL = 0.25FBB − 0.25TB

The unknown variables (FBB and deferred tax liability (DTL)) are solved as follows (dollars in millions):

Equation A:	FBB = $ 32 = ($29 − $5) ÷ 0.75
Equation B:	DTL = $ 3 = $8 − $5

Similarly, Company A's CPP of the ARO is $9 million and the tax basis is $4.5 million ($9 million x 50% tax deductible) uses simultaneous equations to calculate the deferred tax asset (DTA) related to the ARO liability (dollars in millions).

Equation A:	FBB = $ 10.5 = ($9 − $1.125[(1)]) ÷ 0.75
Equation B:	DTA = $ 1.5 = $2.625 − $1.125

[(1)] TB for the ARO is calculated as: ($9 million ARO x 50% tax deductible) x 25%

The following journal entry is recorded to record the purchase of the fixed asset.

Fixed asset	$ 32,000,000	
Deferred tax asset	1,500,000	
Cash		$ 20,000,000
ARO liability		10,500,000
Deferred tax liability		3,000,000

[16] While Company A paid only $20 million cash for the asset, the cash purchase price for purposes of applying the simultaneous equations is equal to the capitalized book value of the asset (prior to the application of the simultaneous equations).

5 Recognition and measurement

Section 4.1, *Temporary versus permanent differences*, introduces the concept of book-tax basis differences in assets and liabilities that can result in either deductible or taxable temporary differences. Generally, these temporary differences are recognized in a company's financial statements as a deferred tax asset or deferred tax liability.

A deferred tax asset reflects the deferred or future tax consequences attributable to deductible temporary differences and carryforwards. That is, the tax effected amount of the cumulative deductible temporary differences and carryforwards, measured using the applicable enacted tax rate expected to apply to taxable income in the periods in which the deferred tax asset is expected to be realized. Deductible temporary differences represent the expected future tax benefit that arises from temporary differences that will cause future taxable income to be less than book income. A deferred tax asset is reduced by a valuation allowance if it is more likely than not some portion or all of the deferred tax asset will not be realized.

A deferred tax liability reflects the deferred or future tax consequences attributable to taxable temporary differences. That is, the tax effected amount of the cumulative taxable temporary differences, measured using the enacted tax rate expected to apply to taxable income in the periods in which the deferred tax liability is expected to be settled. Taxable temporary differences result in an increase to taxable income in future years when compared to the book income.

Entities must separately determine deferred tax asset and deferred tax liability balances and the related deferred tax expense recognized in the financial statements for each tax-paying component in each tax jurisdiction. This chapter discusses the recognition and measurement of deferred tax assets and deferred tax liabilities. See chapter 19, *Accounting for uncertainty in income taxes*, for additional discussion on the accounting for the uncertainty in tax positions.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Overview and Background

740-10-05-7

A temporary difference refers to a difference between the tax basis of an asset or liability, determined based on recognition and measurement requirements for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Deferred tax assets and liabilities represent the future effects on income taxes that result from temporary differences and carryforwards that exist at the end of a period. Deferred tax assets and liabilities are measured using enacted tax rates and provisions of the enacted tax law and are not discounted to reflect the time-value of money.

Recognition

740-10-25-27

An entity might be able to delay the future reversal of taxable temporary differences by delaying the events that give rise to those reversals, for example, by delaying the recovery of related assets or the settlement of related liabilities.

740-10-25-28

A contention that those temporary differences will never result in taxable amounts, however, would contradict the accounting assumption inherent in the statement of financial position that the reported amounts of assets and liabilities will be recovered and settled, respectively; thereby making that statement internally inconsistent. Because of that inherent accounting assumption, the only question is when, not whether, temporary differences will result in taxable amounts in future years.

740-10-25-29

Except for the temporary differences addressed in paragraph 740-10-25-3, which shall be accounted for as provided in that paragraph, an entity shall recognize a deferred tax liability or asset for all temporary differences and operating loss and tax credit carryforwards in accordance with the measurement provisions of paragraph 740-10-30-5.

Initial Measurement

740-10-30-3

Total income tax expense (or benefit) for the year is the sum of **deferred tax expense (or benefit)** and **income taxes currently payable or refundable**.

740-10-30-4

Deferred tax expense (or benefit) is the change during the year in an entity's deferred tax liabilities and assets. For deferred tax liabilities and assets recognized in a business combination or in an **acquisition by a not-for-profit entity** during the year, it is the change since the **acquisition date**. Paragraph 830-740-45-1 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred foreign tax liability or asset when the reporting currency is the functional currency.

740-10-30-5

Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

a. Identify the types and amounts of existing temporary differences and the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period.

b. Measure the total **deferred tax liability** for taxable temporary differences using the applicable tax rate (see paragraph 740-10-30-8).

c. Measure the total **deferred tax asset** for deductible temporary differences and operating loss carryforwards using the applicable tax rate.

d. Measure deferred tax assets for each type of tax credit carryforward.

e. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance shall be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

740-10-30-8

Paragraph 740-10-10-3 establishes that the objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to **taxable income** in the periods in which the deferred tax liability or asset is expected to be settled or realized. Deferred taxes shall not be accounted for on a discounted basis.

> *740-10-30-9*
>
> Under tax law with a graduated tax rate structure, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate shall be used for measurement of a deferred tax liability or asset by entities for which graduated tax rates are not a significant factor. Entities for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized. See Example 16 (paragraph 740-10-55-136) for an illustration of the determination of the average graduated tax rate. Other provisions of enacted tax laws shall be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

5.1 Applicable tax rates

Deferred tax assets and liabilities generally are measured using the enacted tax rates expected to apply to taxable income in the periods in which the deductible or taxable temporary difference is expected to be realized or settled, respectively (ASC 740-10-30-8). Additionally, deferred tax assets and liabilities are not discounted to reflect the time value of money (ASC 740-10-05-7 and 740-10-30-8). When graduated tax rates are not applicable, a single tax rate would be used. However, if graduated tax rates are a significant factor for a company, ASC 740-10-30-9 requires deferred taxes to be computed using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods the deferred tax asset or liability is expected to be realized or settled.

When a company is subject to an alternative tax system, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction between the two systems, such as when alternative tax credits are available. For example, after the enactment of the IRA in August 2022, the applicable tax rate in the US is determined under the regular tax system, even if a company is subject to the Corporate Alternative Minimum Tax (CAMT)[17] and expected to remain as a CAMT taxpayer for the foreseeable future (ASC 740-10-30-10). The FASB believes that no one can predict whether a company always will be subject to an alternative tax system, and it is counterintuitive for alternative tax system provisions to reduce income tax expense for financial reporting purposes when an alternative tax system is either neutral or adverse but never beneficial to a company.

Tax elections expected to be made in future years (as discussed in section 6.5.3, *Tax elections*) and presently enacted changes in tax laws and rates that become effective in future years must be considered in determining the applicable tax rate to apply to reversing temporary differences in those future years (ASC 740-10-30-8). All provisions of the enacted tax law are to be considered (e.g., tax rates applicable to ordinary income and capital gains rates would be considered based on the expected type of taxable or deductible amounts in future years). For example, an investor's liability for the tax consequences of temporary differences related to its equity in the earnings of an investee should be measured using tax rates applicable to a capital gain or a dividend based on the relevant facts and circumstances. See section 14.4, *Investments in domestic subsidiaries, corporate joint ventures and domestic investees*, for further discussion.

A deferred tax asset for deductible temporary differences expected to be realized by carryback would be measured using the tax law and rates for the year the refund is expected to be realized (i.e., the year to which the loss is expected to be carried back). If there is a phase-in change in tax rates, or graduated tax rates are a significant factor, determining the applicable tax rate requires some knowledge of when deferred tax liabilities and assets will be settled or realized (ASC 740-10-30-9).

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[17] See section 5.5, *Alternative minimum tax*, for further discussion of AMT and the related AMT credit.

5.1.1 Average graduated tax rates

When graduated tax rates are a significant factor, the average graduated tax rate will differ depending on the expected level of annual taxable income, including reversing temporary differences, in the future years when the temporary differences are expected to reverse.

Illustration 5-1: Average graduated tax rates

Assume at the end of 20X0, a company's only temporary differences are a $260,000 reserve for expenses related to a litigation accrual (deductible temporary difference) and a $300,000 deferred gross profit for tax purposes on an installment sale (taxable temporary difference). The reversal of the temporary differences is expected to result in net taxable amounts of $20,000 in both 20X1 and 20X2. Enacted tax rates are 15% for the first $50,000, 25% for the next $50,000 and 35% for all amounts over $100,000.

- If the estimated annual level of taxable income (including reversing temporary differences) in 20X1 and 20X2 is $50,000 or less, the average graduated tax rate would be 15%.
- If the estimated annual level of taxable income (including reversing temporary differences) in 20X1 and 20X2 is $100,000, the average graduated tax rate would be 20% (average value of 15% and 25%).
- If the estimated annual level of taxable income (including reversing temporary differences) in 20X1 and 20X2 is $150,000, the average graduated tax rate would be 25% (average value of all three percentages).

The above illustration is relatively straightforward and assumes temporary differences will reverse in equal amounts in the future, which generally will not be the case. Accordingly, different average graduated tax rates might apply to reversals in different future years. However, the guidance in ASC 740 provides that an aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income in future years ordinarily will be sufficient provided there are no unusual situations such as unusually large temporary differences that will become taxable in a single future year or an abnormally high level of taxable income for a given future year. Care and judgment are required to identify and address those types of unusual situations. A detailed analysis of the net reversals of temporary differences in each future year generally is not warranted because the other variable (annual taxable income) in determining the average graduated tax is itself an estimate.

If tax losses are expected in future years or the estimated average graduated tax rate would otherwise be zero, the lowest graduated tax rate applicable to total temporary differences would be used, rather than a zero tax rate.

5.1.2 Applicable tax rate to measure temporary differences related to indefinite-lived intangible assets

As discussed in section 5.1, *Applicable tax rates*, deferred tax assets and liabilities are generally measured using the enacted tax rates expected to apply to taxable income in the periods in which the deductible or taxable temporary difference is expected to be realized or settled, respectively. In the case of many assets (e.g., fixed assets and inventory), the realization or settlement of the temporary difference is most often expected to occur through ordinary income (i.e., through use of the asset or settlement of the liability in continuing operations). As a result, the enacted tax rate applicable to ordinary income is generally used in measuring any associated deferred taxes.

An indefinite-lived intangible asset acquired in a business combination does not have a foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity without declining in value. The indefinite-lived intangible asset is recovered either upon amortization (when it is determined that the intangible asset no longer has an indefinite life), through impairment or through sale. An intangible asset that is deemed to have an indefinite life should not be amortized until its useful life is determined to be finite (ASC 350-30-05-04). Likewise, it is not appropriate to consider future impairments for financial reporting purposes.

In a nontaxable acquisition, while a book basis is assigned to an acquired indefinite-lived intangible asset, an acquired indefinite-lived intangible asset is unlikely to have a corresponding tax basis. As a result, a taxable temporary difference exists related to the acquired indefinite-lived intangible asset. We believe that it is most appropriate to measure the deferred taxes related to indefinite-lived intangible assets using the enacted tax rate applicable to ordinary income. When a company has a committed plan to dispose of an indefinite-lived intangible asset through a sale, we believe the company should consider the rate applied to the temporary difference as a different tax rate may apply to a sale of an asset (capital rate) and ordinary income (ordinary rate).

Illustration 5-2: Applicable tax rate to measure temporary differences related to indefinite-lived intangible assets

Assume at the beginning of 20X0, Company A's only temporary difference is a $100,000 taxable temporary difference related to a nondeductible intangible asset with an indefinite life (i.e., book basis of $100,000 and tax basis of $0). The enacted tax rate is 15% for capital transactions and 30% for ordinary income. Company A has recorded a $30,000 ($100,000 x 30%) deferred tax liability related to the indefinite-lived intangible asset.

At the end of 20X0, Company A has a committed plan to sell an asset group, including the indefinite-lived intangible asset, and has classified the asset group as held for sale. Given the asset group in question (a portion of the assets of a larger tax-paying component/legal entity), the company anticipates the sale will be a sale of the individual assets. Company A reduces the deferred tax liability to $15,000 ($100,000 x 15%) related to the indefinite-lived intangible asset. Company A measures the taxable temporary difference related to the indefinite-lived intangible asset using the capital rate as the asset is held for sale and the settlement of the taxable temporary difference will be capital in nature. The $15,000 reduction in the deferred tax liability should be included in income tax expense in the income statement in the period in which the change in expected manner of recovery occurs (in this case, when the held-for-sale criteria are met).

5.2 Enacted tax rate

The enacted tax rate(s) expected to apply to taxable income in future years is used to measure:

1. The total deferred tax liability for taxable temporary differences
2. The total deferred tax asset for deductible temporary differences and operating loss carryforwards

Measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law. That is, the effects of future changes in tax laws or rates are not anticipated. The tax rate that is used to measure deferred tax liabilities and deferred tax assets is the enacted tax rate(s) expected to apply to taxable income in the years that the liabilities are expected to be settled or the assets realized. Measurements are based on elections (for example, an election for loss carryforward instead of carryback in jurisdictions where carrybacks are permitted) that are expected to be made for tax purposes in future years. Presently enacted changes in tax laws and rates that become effective for a particular future year or years must be considered when determining the tax rate to apply to temporary differences reversing in that year or years. Tax laws and rates in effect for the current year are used if changes in tax laws have not been enacted that would affect future years. An asset for a deductible temporary difference that is expected to be realized in future years through carryback of a future loss, if permitted, to the current or a prior year (or a liability for a taxable temporary difference that is expected to reduce the refund claimed for the carryback of a future loss to the current or a prior year) is measured using tax laws and rates for the current or a prior year (i.e., the year for which a refund is expected to be realized based on a loss carryback provision of the tax laws).

See chapter 8, *An enacted change in tax laws or rates*, for a discussion of enactment dates and chapter 19, *Accounting for uncertainty in income taxes*, for a discussion of how enacted tax rates affect existing uncertain tax positions.

5.3 Dividends received deductions

Deferred tax liabilities and assets are measured using enacted tax rates applicable to capital gains, ordinary income and so forth, based on the expected type of taxable or deductible amounts in future years. For example, evidence based on all facts and circumstances should determine whether an investor's liability for the tax consequences of temporary differences related to its equity in the earnings of an investee should be measured using enacted tax rates applicable to a capital gain or a dividend. Computation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related dividends received deductions or foreign tax credits, and taxes that would be withheld from the dividend. See section 5.3.2, *Shareholders' tax credits for dividends paid*, below, for an exception.

5.3.1 Rate differences between distributed and undistributed earnings (including subsidiary dividend paid tax credits)

Certain foreign jurisdictions tax corporate income at different rates depending on whether (and, in some cases, when) that income is distributed to shareholders. For example, in some foreign jurisdictions, income distributed to shareholders may be taxed at a lower rate than undistributed income, (e.g., distributed income taxed at 30% as compared to undistributed income that is subject to a corporate tax rate of 45%). In other jurisdictions, the reverse situation may exist whereby income distributed to shareholders may be taxed at a higher rate than undistributed income. This may be because it is subject to both the corporate income tax and an incremental distribution tax. As discussed below, in jurisdictions with differing rates for distributed or undistributed income, it is important to identify which reporting entity's financial statements (i.e., the consolidated parent company or standalone subsidiary) are under consideration as it will affect the rate applied.

5.3.1.1 Consolidated financial statements

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-39

Certain foreign jurisdictions tax corporate income at different rates depending on whether that income is distributed to shareholders. For example, while undistributed profits in a foreign jurisdiction may be subject to a corporate tax rate of 45 percent, distributed income may be taxed at 30 percent. Entities that pay dividends from previously undistributed income may receive a tax credit (or tax refund) equal to the difference between the tax computed at the undistributed rate in effect the year the income is earned (for tax purposes) and the tax computed at the distributed rate in effect the year the dividend is distributed.

740-10-25-41

The accounting required in the preceding paragraph may differ in the consolidated financial statements of a parent that includes a foreign subsidiary that receives a tax credit for dividends paid, if the parent expects to remit the subsidiary's earnings. Assume that the parent has not availed itself of the exception for foreign unremitted earnings that may be available under paragraph 740-30-25-17. In that case, in the consolidated financial statements of a parent, the future tax credit that will be received when dividends are paid and the deferred tax effects related to the operations of the foreign subsidiary shall be recognized based on the distributed rate because, as assumed in that case, the parent is not applying the indefinite reversal criteria exception that may be available under that paragraph. However, the undistributed rate shall be used in the consolidated financial statements to the extent that the parent has not provided for deferred taxes on the unremitted earnings of the foreign subsidiary as a result of applying the indefinite reversal criteria recognition exception.

In the consolidated financial statements of a parent, the tax effects related to operations of a foreign subsidiary that receives tax credits related to dividend payments is dependent on whether the parent expects to remit the subsidiary's earnings. That is, the parent company should either consider such credits if the foreign subsidiary's earnings are not indefinitely reinvested or disregard those credits if the parent is indefinitely reinvested (ASC 740-30-25-17). See section 14.3, *Investments in foreign subsidiaries, corporate joint ventures and foreign investees*, for further discussion.

The future tax credit received by the foreign subsidiary upon payment of dividends by the foreign subsidiary to the parent company and the deferred tax effects related to the operations of the foreign subsidiary should be recognized based on the distributed rate if the parent is not applying the indefinite reinvestment exception of ASC 740-30-25-17. However, if the parent company is applying the indefinite reinvestment exception and thus has not provided for deferred taxes on the unremitted earnings of the foreign subsidiary, the undistributed rate should be used for the deferred tax effects related to the operations of the foreign subsidiary in the consolidated financial statements (ASC 740-10-25-41). See chapter 14, *Foreign and domestic subsidiaries*, for further discussion.

The following table summarizes the rate that is applicable in the consolidated financial statements when there is a different rate applied to distributed or undistributed earnings of a subsidiary:

Are the earnings of the foreign subsidiary indefinitely reinvested?	Consolidated financial statements
Yes	Apply undistributed rate
No	Apply distributed rate

The rate applied in the consolidated financial statements on the parent's investment in the foreign subsidiary and the deferred tax effects related to operations of the foreign subsidiary may be different from the rate applied by the foreign subsidiary in its separate financial statements. See section 5.3.1.2, *Separate financial statements of a subsidiary*, for further discussion.

5.3.1.2 Separate financial statements of a subsidiary

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-40

In the separate financial statements of an entity that pays dividends subject to the tax credit to its shareholders, a deferred tax asset shall not be recognized for the tax benefits of future tax credits that will be realized when the previously taxed income is distributed; rather, those tax benefits shall be recognized as a reduction of income tax expense in the period that the tax credits are included in the entity's tax return.

In some jurisdictions, entities paying dividends from previously undistributed income may receive a tax credit (or tax refund) equal to the difference between (1) the tax computed at the undistributed rate in effect the year the income is earned (for tax purposes) and (2) the tax computed at the distributed rate in effect the year the dividend is distributed. In other jurisdictions, income distributed to shareholders may be subject to both a corporate income tax and an incremental distribution tax (i.e., higher distributed rate). In the subsidiary's separate financial statements, careful consideration of whether a lower or higher rate is applicable to distributed earnings is necessary.

Lower tax rate on distributed earnings

A subsidiary that pays dividends subject to the tax credit to its shareholders (or parent) does not recognize a deferred tax asset for the tax benefits of future tax credits that will be realized until the previously taxed income is distributed. That is, the subsidiary cannot give consideration to future tax credits attributable to future distributions when computing its current period income tax provision. Those tax benefits are recognized as a reduction of income tax expense in the period that the tax credits are included in the subsidiary's tax return.

Higher tax rate on distributed earnings

In some jurisdictions, the tax related to income distributed to shareholders is primarily the obligation of the recipient (i.e., parent) but the tax is withheld from the distribution by the distributing entity (i.e., a withholding tax). While in other jurisdictions, the tax related to income distributed to shareholders is primarily the obligation of the entity making the distribution. For example, at one time, South Africa had a dual corporate tax system. While this system is no longer in place in South Africa, we believe other jurisdictions may have similarly enacted dual rate systems. South African resident companies were subject to a 30% corporate tax rate on current period earnings (undistributed rate). When a distribution was made out of a resident company to its shareholders, an additional 12.5% Secondary Tax on Companies (STC) was imposed to the resident company (i.e., dividend payor). Therefore, a South African resident company that had current period earnings and made shareholder distributions was liable for both the corporate income tax and the STC on distributed earnings, resulting in a 37.78% effective tax rate (distributed rate). The STC differs from a withholding tax as the distributing entity, and not the recipient, is the primary obligor to the taxing authority.

Questions have arisen as to which tax rate should be applied to measure temporary differences when the tax regime imposes two corporate taxes (e.g., should a resident company account for an STC in measuring current and deferred taxes or solely when a distribution is made?). At the November 2002 meeting of the American Institute of Certified Public Accountants (AICPA) International Practices Task Force, the AICPA International Practices Task Force and SEC staff discussed the following two views:

- View A — Record deferred taxes at the distributed rate of 37.78% (including STC)
- View B — Record deferred taxes at the undistributed rate of 30% (excluding STC)

While the AICPA International Practices Task Force considered View A preferable, it noted the accounting for dual-rate jurisdictions is not addressed in ASC 740. The AICPA International Practices Task Force would not object to View B provided the appropriate disclosures were included. Also, the SEC staff advised the AICPA International Practices Task Force it would not object to either view. When a company applies the undistributed rate (View B), the following disclosures should be made:

- A statement that if dividends are distributed the entity will have to pay additional taxes at a rate of X% on all distributions, and that this amount will be recorded as an income tax expense in the period in which the company declares the dividends
- A statement of when the additional taxes will be owed to the government

- The amount of retained earnings that, if distributed, would be subject to the tax
- The amount of tax that would be owed if the company distributed all of the retained earnings that would be subject to the tax
- If dividends were declared and additional tax provision recorded during the year an income statement is presented, this item would need to be separately presented in the effective rate reconciliation. That is, the materiality criteria in Rule 4-08(h) of Regulation S-X would not be applied to justify combining with other items. If the registrant is not providing an effective rate reconciliation on a US GAAP basis (i.e., disclosure of the effective rate reconciliation is presented in the primary financial statements), the effect on the income tax provision would need to be separately disclosed.

The AICPA International Practices Task Force further indicated all companies subject to the STC should provide disclosure to include the basis on which tax liabilities had been computed and, to the extent provision for the STC was made, the amount of undistributed earnings on which such provision has been made. Also, regardless of the accounting followed, companies subject to the STC should describe the tax concept (i.e., what it is and how it works) and how it is accounting for the tax (i.e., View A or B).

Consistent with the conclusion reached by the AICPA International Practices Task Force, we believe either application of the distributed or undistributed rate is acceptable and prefer the application of the distributed rate when the distributed rate exceeds the undistributed rate. An entity should select an accounting policy to apply either the distributed or undistributed rate (when appropriate) and consistently apply such policy to measure temporary differences in dual-rate jurisdictions.

See chapter 17, *Separate financial statements of a subsidiary*, for further discussion of a subsidiary's reporting considerations for separate financial statements.

5.3.2 Shareholders' tax credits for dividends paid

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Scope and Scope Exception

740-10-15-4

The guidance in this Topic does not apply to the following transactions and activities:

a. A franchise tax to the extent it is based on capital and there is no additional tax based on income. If there is an additional tax based on income, that excess is considered an income tax and is subject to the guidance in this Topic. See Example 17 (paragraph 740-10-55-139) for an example of the determination of whether a franchise tax is an income tax.

b. A withholding tax for the benefit of the recipients of a dividend. A tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and is not an income tax if both of the following conditions are met:

    1. The tax is payable by the entity if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the entity would otherwise pay.

    2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

See the guidance in paragraphs 740-10-55-72 through 55-74 dealing with determining whether a payment made to a taxing authority based on dividends distributed is an income tax.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

The guidance in this Topic does not apply to the following transactions and activities:

a. A franchise tax (or similar tax) to the extent it is based on capital or a non-income-based amount and there is no portion of the tax based on income. If a franchise tax (or similar tax) is partially based on income (for example, an entity pays the greater of an income-based tax and a non-income-based tax), deferred tax assets and liabilities shall be recognized and accounted for in accordance with this Topic. Deferred tax assets and liabilities shall be measured using the applicable statutory income tax rate. An entity shall not consider the effect of potentially paying a non-income-based tax in future years when evaluating the realizability of its deferred tax assets. The amount of current tax expense equal to the amount that is based on income shall be accounted for in accordance with this Topic, with any incremental amount incurred accounted for as a non-income-based tax. See Example 17 (paragraph 740-10-55-139) for an example of how to apply this guidance.

b. A withholding tax for the benefit of the recipients of a dividend. A tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and is not an income tax if both of the following conditions are met:

   1. The tax is payable by the entity if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the entity would otherwise pay.

   2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

See the guidance in paragraphs 740-10-55-72 through 55-74 dealing with determining whether a payment made to a taxing authority based on dividends distributed is an income tax.

Implementation Guidance and Illustrations

740-10-55-72

The following guidance refers to provisions which may be present in the French tax structure; however, it shall not be considered a definitive interpretation of the historical or current French tax structure for any purpose.

740-10-55-73

The French income tax structure is based on the concept of an integrated tax system. The system utilizes a tax credit at the shareholder level to eliminate or mitigate the double taxation that would otherwise apply to a dividend. The tax credit is automatically available to a French shareholder receiving a dividend from a French corporation. The precompte mobilier (or precompte) is a mechanism that provides for the integration of the tax credit to the shareholder with the taxes paid by the corporation. The precompte is a tax paid by the corporation at the time of a dividend distribution that is equal to the difference between a tax based on the regular corporation tax rate applied to the amount of the declared dividend and taxes previously paid by the corporation on the income being distributed. In addition, if a corporation pays a dividend from earnings that have been retained for more than five years, the corporation loses the benefit of any taxes previously paid in the computation of the precompte.

740-10-55-74

Paragraph 740-10-15-4(b) sets forth criteria for determining whether a tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend to be recorded in equity as part of the dividend distribution in that entity's separate financial statements. A tax that is assessed on a corporation based on dividends distributed that meets the criteria in that paragraph, such as the French precompte tax, should be considered to be in effect a withholding of tax for the recipient of the dividend and recorded in equity as part of the dividend paid to shareholders.

In some jurisdictions, the tax related to income distributed to shareholders is primarily the obligation of the parent, but the tax is withheld from the distribution. A tax assessed on a corporation based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and, therefore, not within the scope of ASC 740. The tax should be recorded in equity as part of the dividend distribution in the corporation's separate financial statements if both of the following conditions are met:

1. The tax is payable by the corporation if, and only if, a dividend is distributed to shareholders. The tax does not reduce future income taxes the corporation would otherwise pay.
2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the corporation and the credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

If both of the above conditions are not met, or the tax is not assessed based on dividends distributed, the tax should be recorded as a component of income tax expense.

5.4 Tax holidays

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-35

There are tax jurisdictions that may grant an entity a holiday from income taxes for a specified period. These are commonly referred to as tax holidays. An entity may have an expected future reduction in taxes payable during a tax holiday.

740-10-25-36

Recognition of a deferred tax asset for any tax holiday is prohibited because of the practical problems in distinguishing unique tax holidays (if any exist) for which recognition of a deferred tax asset might be appropriate from generally available tax holidays and measuring the deferred tax asset.

The FASB considered whether a deferred tax asset should ever be recognized for the expected reduction in taxes payable during a "tax holiday." In this regard, the FASB considered tax holidays generally available to all entities, as well as unique tax holidays made available in certain circumstances (ASC 740-10-25-35 and ASC 740-10-25-36). Because of the practical problems associated with distinguishing "unique" tax holidays from "generally available" tax holidays, the FASB concluded to prohibit the recognition of a deferred tax asset for all "tax holidays."

5.4.1 Applicable tax rate in a tax holiday period

As noted above, the FASB addressed tax holidays in ASC 740-10-25-35 and ASC 740-10-25-36. However, the Board only considered the issue of whether a deferred tax asset should be established for the future tax savings of a tax holiday on the premise that such savings are analogous to a net operating loss carryforward. The Board concluded that no such deferred tax asset should be recognized.

The FASB did not, however, consider the applicable rate companies should use when measuring deductible and taxable temporary differences expected to reverse during the tax holiday period. We believe companies should consider the terms and conditions of the tax holiday (including recapture provisions, if any) and scheduled reversal patterns of existing deductible and taxable temporary differences when evaluating the applicable tax rate during a tax holiday period. That is, existing deductible and taxable temporary differences would generally be measured at the tax rates expected to apply (including consideration of the tax holiday rate) in the periods in which those temporary differences are scheduled to reverse.

Illustration 5-3: Applicable tax rate in a tax holiday period

Assume a foreign tax jurisdiction grants Company MLS a 10-year tax holiday, which is not linked to any other performance criteria, and reduces Company MLS's taxable income by 100%. Further, assume the enacted tax rate is 25% and Company MLS has $1,000 of deductible temporary differences and $250 of taxable temporary differences, all of which have a 15-year reversal period.

In the period in which Company MLS obtains the tax holiday, it would remeasure its deductible and taxable temporary differences that are expected to reverse in the tax holiday period (i.e., the next 10 years) and recognize a $125 deferred tax expense (or [$750 x 25%] — $63) in earnings, computed as follows:

	Expected reversal pattern			
	Before consideration of tax holiday	**During holiday period**	**After holiday period**	**After consideration of tax holiday**
Gross deductible temporary differences	$ 1,000	$ 667	$ 333	$ 1,000
Gross taxable temporary differences	(250)	(167)	(83)	(250)
	750	500	250	750
Applicable tax rate	25%	0%	25%	-
	$ 188	$ –	$ 63	$ 63

It should be noted that detailed scheduling of the expected reversal patterns of existing deductible and taxable temporary differences to determine the applicable tax rate is typically required whenever a company obtains a tax holiday. This is the same scheduling to estimate the applicable tax rate required for phased-in changes in tax rates detailed in section 8.3, *Effects of rate changes on deferred taxes*. In addition, temporary differences that arise during the tax holiday period will also require detailed scheduling to determine the appropriate tax rate expected to be applied. For example, a taxable temporary difference that reverses after the tax holiday period would result in a deferred tax expense computed at the enacted tax rate rather than the tax holiday rate even though it arises during the tax holiday period.

5.5 Alternative minimum tax (updated June 2023)

The Tax Reform Act of 1986 established a corporate alternative minimum tax system in the US, which was repealed in December 2017 by the Tax Cuts and Jobs Act (TCJA). In August 2022, the US enacted the IRA, which implemented a new CAMT. The following guidance should be applied by entities subject to the CAMT.

The FASB issued guidance related to alternative minimum tax (AMT) systems in response to the Tax Reform Act of 1986 (740-10-25-42). Because that tax regime is no longer in effect, we address the application of ASC 740's AMT accounting guidance with respect to the CAMT in section 5.5.3. Details related to the Tax Reform Act of 1986 are retained at the end of this section for reference (see section 5.5.5, *Overview of the legacy US corporate AMT system (before enactment of TCJA)*).

Further, where alternative tax systems exist in jurisdictions other than the US, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction between the two systems. The guidance that follows continues to be applicable in these cases.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Initial Measurement

740-10-30-10

In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 740-10-30-5 (d) through (e).

740-10-30-11

The objective established in paragraph 740-10-10-3 relating to enacted tax rate(s) expected to apply is not achieved through measurement of deferred taxes using the lower alternative minimum tax rate if an entity currently is an alternative minimum tax taxpayer and expects to always be an alternative minimum tax taxpayer. No one can predict whether an entity will always be an alternative minimum tax taxpayer. Furthermore, it would be counterintuitive if the addition of alternative minimum tax provisions to the tax law were to have the effect of reducing the amount of an entity's income tax expense for financial reporting, given that the provisions of alternative minimum tax may be either neutral or adverse but never beneficial to an entity. It also would be counterintuitive to assume that an entity would permit its alternative minimum tax credit carryforward to expire unused at the end of the life of the entity, which would have to occur if that entity was always an alternative minimum tax taxpayer. Use of the lower alternative minimum tax rate to measure an entity's deferred tax liability could result in understatement for either of the following reasons:

a. It could be understated if the entity currently is an alternative minimum tax taxpayer because of temporary differences. Temporary differences reverse and, over the entire life of the entity, cumulative income will be taxed at regular tax rates.

b. It could be understated if the entity currently is an alternative minimum tax taxpayer because of preference items but does not have enough alternative minimum tax credit carryforward to reduce its deferred tax liability from the amount of regular tax on regular tax temporary differences to the amount of **tentative minimum tax** on alternative minimum tax temporary differences. In those circumstances, measurement of the deferred tax liability using alternative minimum tax rates would anticipate the tax benefit of future special deductions, such as statutory depletion, which have not yet been earned.

740-10-30-12

If alternative tax systems exist in jurisdictions other than the U.S. federal jurisdiction, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction (that is, a mechanism similar to the U.S. alternative minimum tax credit) between the two systems.

Implementation Guidance and Illustrations

740-10-55-33

Paragraph 740-10-30-18 identifies four sources of taxable income that shall be considered in determining the need for and amount of a valuation allowance. No valuation allowance is necessary if the deferred tax asset for alternative minimum tax credit carryforward can be realized in any of the following ways:

a. Under paragraph 740-10-30-18(a), by reducing a deferred tax liability from the amount of regular tax on regular tax temporary differences to not less than the amount of tentative minimum tax on alternative minimum taxable temporary differences

b. Under paragraph 740-10-30-18(b), by reducing taxes on future income from the amount of regular tax on regular taxable income to not less than the amount of tentative minimum tax on alternative minimum taxable income

c. Under paragraph 740-10-30-18(c), by loss carryback

d. Under paragraph 740-10-30-18(d), by a **tax-planning strategy** such as switching from tax-exempt to taxable interest income.

ASC 740 applies to all taxes based on income. Therefore, the effects of any alternative tax must be considered when measuring the tax effects of temporary differences.

As discussed in ASC 740-10-30-11, the objective established in paragraph 740-10-10-3 relating to enacted tax rates that are expected to apply is not achieved through the measurement of deferred taxes using the lower AMT rate merely because an entity currently is an AMT taxpayer and expects to always be an AMT taxpayer. The FASB noted that no one can predict whether an entity will always be an AMT taxpayer. Thus, it would be counterintuitive if the effect of adding AMT provisions to the tax law reduced the amount of an entity's income tax expense for financial reporting purposes, given that the effect of the provisions may be either neutral or adverse but never beneficial to an entity.

It also would be counterintuitive to assume that an entity would permit its AMT credit carryforward to expire unused at the end of the life of the entity, which would occur if the entity was always an AMT taxpayer. Accordingly, the FASB concluded that deferred taxes should be measured using the *regular* tax rate — not the AMT rate — and a deferred tax asset should be recognized for any AMT credit carryforwards allowed (ASC 740-10-30-10). The regular tax rate must be used in computing deferred taxes even if the company anticipates remaining subject to an AMT system for the foreseeable future. Accordingly, the tax consequences of an AMT are recognized as current period tax expense in the period incurred.

As with other deferred tax assets, a valuation allowance is recognized against recorded tax benefits of AMT credit carryforwards, if necessary, to reduce the net deferred tax asset to the amount that is more likely than not to be realized.

In assessing the need for a valuation allowance for AMT credit carryforwards, ASC 740-10-55-33 states a valuation allowance is not necessary if the deferred tax asset can be realized in one of the following ways:

- By reducing a deferred tax liability from the amount of regular tax on regular tax temporary differences to not less than the amount of tentative minimum tax (TMT) on AMT temporary differences
- By reducing taxes on future income from the amount of regular tax on regular taxable income to not less than the amount of TMT on AMT income
- By employing a tax-planning strategy, such as changing from tax-exempt to taxable interest income
- By loss carryback

The recognition of a valuation allowance for the deferred tax asset recognized as a result of an AMT credit carryforward will have the effect of recording an asset that is considered more likely than not to be realized. However, with respect to deferred tax liabilities, if the AMT considers the effect of temporary differences in the computation of the TMT, the converse may not be true. Requiring companies that expect to be AMT taxpayers for the foreseeable future to use the regular tax rate could result in the recognition of deferred tax liabilities greater than the amount to be paid in the future. This potential overstatement was recognized by the FASB when deliberating ASC 740; however, it was viewed as a lesser issue to the alternative — a potential understatement of deferred tax liabilities.

5.5.1 Effect of an AMT on deferred tax calculations

By design, AMT systems are intended to prevent companies with substantial economic income from avoiding income tax payments by using exclusions, deductions and credits. In this regard, AMT systems are designed to produce a higher current tax liability than might otherwise result under the regular tax laws.

Total taxes paid over a company's life generally are based on the regular tax system, not an AMT system. This occurs because the primary reason AMT liabilities exist is due to temporary differences that ultimately will reverse. In addition, in some jurisdictions, part or all of AMT paid by a company may be carried forward indefinitely and credited against regular tax in later years to the extent the regular tax liability exceeds AMT in those years.

Illustration 5-4: Effect of an AMT on deferred tax calculations

Assume Company LML's regular taxable income and average annual financial statement income (AFSI) were both $1 million, and the regular and AMT tax rates are 21% and 15%, respectively. Company LML's regular tax liability would be $210,000, and its tentative minimum tax (TMT) would be $150,000. If Company LML had AMT credit carryforwards from prior years, its regular tax liability could be reduced to $150,000 by those AMT credit carryforwards. However, Company LML could not reduce its tax liability to less than $150,000 because the tax paid would, at a minimum, have to equal the TMT.

While the AMT credit cannot be carried back, it can be carried forward indefinitely. Temporary differences will ultimately reverse, and previous AMT payments generally can be credited against those future reversals. Therefore, ASC 740-10-30-10 requires deferred taxes to be measured using the regular tax rate, not the AMT system, and a deferred tax asset should be recognized for AMT credit carryforwards. The regular tax rate must be used even if the company anticipates being subject to the AMT for the foreseeable future (ASC 740-10-30-11).

As with other deferred tax assets, a valuation allowance is also recognized against recorded tax benefits of any AMT credit carryforward, if necessary, to reduce the net deferred tax asset to the amount that is more likely than not to be realized.

Illustration 5-5: Effect of an AMT on deferred tax calculations

Assume a company had as of 31 December 20X0 cumulative net taxable temporary differences of $1 million, no taxes payable under the regular tax system, an AMT payable of $100,000 and expected future taxable income that would result in at least $100,000 of regular tax in excess of the TMT. If the regular tax rate is 21%, the company would provide a deferred tax liability of $210,000 for the $1 million taxable temporary differences as of 31 December 20X0.

Because the company is expecting its future regular tax liability to be in excess of the TMT, the credit carryforward for taxes due under the AMT system would permit the recognition of a deferred tax asset for $100,000, with no valuation allowance required because the realization of the deferred tax asset is considered more likely than not as of 31 December 20X0.

5.5.2 Accounting for an AMT in interim periods

If a company determines it is subject to an AMT, it will need to consider the effects of the AMT on its estimated annual effective tax rate (EAETR) at interim periods. A company is required at the end of each interim reporting period to make its best estimate of the annual effective tax rate for the full fiscal year and use that rate to provide for income taxes on a current year-to-date basis.

In addition, if being subject to an AMT results in a significant variation in the customary relationship between income tax expense and pretax income in the interim period financial statements, a company should disclose the reasons for the variation in its interim financial statements if they are not otherwise apparent from the financial statements or from the nature of the company's business.

5.5.3 The US corporate alternative minimum tax (CAMT)

The IRA, enacted in 2022, created a new corporate alternative minimum tax in the US. The CAMT applies to an "applicable corporation," which is defined as any corporation (other than an S corporation, a regulated investment company or a real estate investment trust) with average annual financial statement income (AFSI) exceeding $1 billion over any consecutive three-tax-year period ending after 31 December 2021 and before the current tax year. Once a corporation is an applicable corporation, it remains an applicable corporation, even if its average AFSI is less than $1 billion, unless an exception applies.

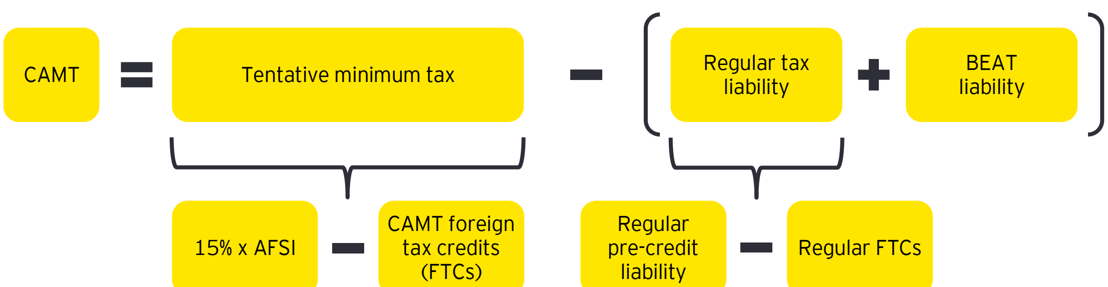
A corporation that is a member of an international financial reporting group with a foreign parent is considered an applicable corporation if its average AFSI exceeds the $1 billion and its average US-related AFSI (i.e., income of the US corporation(s), income of controlled foreign corporations and effectively connected US income) is $100 million or more.

A taxpayer's AFSI is generally the net income or loss reported on its annual financial statements (e.g., annual financial statements included in Form 10-K filed with the Securities and Exchange Commission (SEC)), with certain adjustments. The calculation of AFSI starts with a company's financial statement net income or loss attributable to members of the taxpayer's US consolidated tax return group. Adjustments are then made to increase or decrease AFSI, including an adjustment to conform income and expense items related to pensions to those for regular federal income tax, accelerated tax basis depreciation for tangible assets and amortization on certain assets (e.g., qualified wireless spectrum) and financial statement NOLs carryforwards, which are limited to 80% of AFSI. Financial statement NOLs are the amount of net loss reported in the entity's consolidated financial statements for tax years ending after 31 December 2019. Financial statement NOLs can be carried forward indefinitely.

Calculating the CAMT

The CAMT is calculated by first determining the TMT, which is done by multiplying AFSI by 15% and reducing that amount by CAMT foreign tax credits. The TMT is compared to an applicable corporation's regular tax liability, plus its base erosion and anti-abuse tax (BEAT) liability. The applicable corporation's regular tax liability is the tax liability before consideration of tax credits other than foreign tax credits.

If the CAMT liability is greater than the regular tax liability plus the BEAT liability, the applicable corporation pays the CAMT. After determining the CAMT, a company will then determine the amount of general business credits (GBCs) to be used in a particular tax year, since the IRA amends the limitation on GBCs to include the amount of CAMT paid.



A CAMT credit will be earned for taxes paid on the CAMT basis and carried forward indefinitely. It will be used to reduce the regular tax liability in future years if the regular tax liability exceeds the CAMT liability.

The IRA directs the Treasury Department to issue regulations[18] or other guidance relating to the CAMT, including clarifying the definition of an applicable corporation and providing guidance on the starting point for, and adjustments to, AFSI. Regulations and additional guidance may also address further AFSI adjustments to prevent duplication or omission of items, treatment of financial statement NOLs and determination of the CAMT foreign tax credit.

To determine its US federal income tax liability, a company will need to compute taxes under both systems — the regular tax system and the CAMT system. The company then will pay the larger amount as its tax liability in any given year.

5.5.3.1 Valuation allowance considerations when subject to the CAMT

Questions have arisen about whether a company should consider the effects of being subject in the future to the CAMT when it assesses the realizability of tax benefits from deductible temporary differences and carryforwards, as well as tax credits.

In response to a technical inquiry, the FASB staff said because ASC 740 does not specifically address this issue, a company could make an accounting policy election to either consider the effect of the CAMT system when evaluating the need for, and the amount of, a valuation allowance or account for the effects on deferred tax assets and carryforwards and tax credits in the period they arise. The policy elected should be consistently applied. The FASB staff said the application of this view is limited to the accounting for the US CAMT, and a company should have transparent disclosures about its policy election.

Companies that are subject to the CAMT will need to assess the realizability of CAMT credit carryforwards that are generated. Refer to section 5.5, *Alternative minimum tax*, for further details.

5.5.3.2 Examples of CAMT calculation and related tax provision

The following examples illustrate the calculation of the CAMT and the related effects on a company's financial statements. Illustration 5-6 demonstrates the effects of the CAMT when the company determines it is more likely than not the CAMT credit carryforward benefit will be fully realized. Illustration 5-7 demonstrates the effects of the CAMT when the company determines it is not more likely than not that the CAMT tax credit carryforward is realizable.

Illustration 5-6: Effect of the CAMT when it is more likely than not the CAMT credit carryforward benefit will be realized

Company A has the following as of 31 December 20X1:

- Pretax book income of $1,000
- No temporary difference at the beginning of the year
- Total taxable temporary differences originating during the year under the regular tax system of $600 (before consideration of CAMT)
- A temporary difference of $200 related to accelerated depreciation on certain qualifying tangible assets arising in the year, which is also allowed under the CAMT (before consideration of CAMT tax credit carryforwards generated in the period)
- The conclusion that any CAMT tax credits generated will be realizable (i.e., Company A expects to generate current tax liabilities under the regular tax system in future periods in excess of TMT under the CAMT)

[18] Additional US federal regulations are expected that may change the CAMT. Companies should continue to monitor developments.

	Regular Tax	CAMT
Book pre-tax income	$ 1,000	$ 1,000
Temporary differences	(600)	(200)
Taxable income	400	800
Tax rate (regular and CAMT)	21%	15%
Financial reporting tax expense before CAMT		
Deferred tax expense	126	
Current tax expense	84	
Financial reporting tax expense (before CAMT)	210	
ETR before consideration of CAMT	*21%*	
TMT liability		120
CAMT liability (TMT less current tax expense of $84)	36	36
Deferred tax benefit from CAMT credit carryforward generated in the period	(36)	
Financial reporting tax expense after CAMT		
Deferred tax expense	90	
Current tax expense	120	
Financial reporting tax expense after considering CAMT	$ 210	
ETR after CAMT	*21%*	

In 20X2, assume the same facts as above, except the temporary differences originating in Year 1 reverse.

	Book	CAMT
Book pre-tax income	$ 1,000	$ 1,000
Temporary differences	600	200
Taxable income	1,600	1,200
Tax rate (regular and CAMT)	21%	15%
Financial reporting tax expense before CAMT		
Deferred tax benefit	(126)	
Current tax expense	336	
Financial reporting tax expense (before CAMT)	210	
ETR before consideration of CAMT	*21%*	
TMT liability		180
CAMT liability (no tax due as CAMT is less than the regular tax liability)	-	-
CAMT tax credit carryforward applied	(36)	
Reversal of deferred CAMT carryforward	36	
Financial reporting tax expense after CAMT		
Deferred tax benefit	(90)	
Current tax expense	300	
Financial reporting tax expense after considering CAMT	$ 210	
ETR after CAMT	*21%*	

As demonstrated above, when a company is subject to the CAMT, the effect of the CAMT is to accelerate the timing of current income taxes that are payable. However, because the CAMT provides the company with a tax credit carryforward equal to the incremental taxes paid that can be used to reduce regular income taxes payable in future periods when the company is not subject to the CAMT, the total amount of taxes paid overtime will eventually be the same. In this illustration, the total income taxes paid over the two-year period is $420 under both the regular tax system ($84+$336) and the CAMT ($120+$300). However, because the company is subject to the CAMT, $36 of this amount has been accelerated into 20X1. Conversely, because the company also generated a CAMT tax credit carryforward, the amount of taxes paid in 20X2 is reduced by $36 compared to the amount that would have been due under the regular tax system.

Illustration 5-7: Effect of the CAMT when it is more likely than not the CAMT credit carryforward benefit will not be fully realized and a full valuation allowance is recognized

Company A has the following as of 31 December 20X1:

- Pretax book income of $1,000
- No existing temporary difference at the beginning of the year, and none generated during the year
- Total taxable temporary differences originating during the year under the regular tax system of $600 (before consideration of CAMT)
- A temporary difference of $200 related to accelerated depreciation on certain qualifying tangible assets arising in the year, which is also allowed under the CAMT (before consideration of CAMT tax credit carryforwards generated in the period)
- The conclusion that any CAMT tax credits generated were not more likely than not to be realizable under 740-10-55-33 (i.e., Company A does not have reversing DTLs, does not expect regular tax to be greater than TMT in future years, cannot carry back losses and doesn't have a tax-planning strategy that would allow it to utilize the credit carryforward)

	Book	**CAMT**
Book pre-tax income	$ 1,000	$ 1,000
Temporary differences	(600)	(200)
Taxable income	400	800
Tax rate	21%	15%
Financial reporting tax expense before CAMT		
Deferred tax expense	126	
Current regular tax expense	84	
Financial reporting tax expense	210	
TMT liability		120
CAMT liability (TMT less regular current tax expense)	36	36
Deferred CAMT carryforward	(36)	
Valuation allowance on CAMT carryforward	36	
Financial reporting tax expense after CAMT		
Deferred tax expense	126	
Current tax expense	120	
Financial reporting tax expense after considering CAMT	$ 246	
ETR after CAMT	25%	

As demonstrated above, when a company is subject to the CAMT but determines that the credit carryforward is not more likely than not to be used, the effect of the CAMT is to increase the amount of taxes paid and the financial reporting tax expense (and effective tax rate), since the current expense is not offset by deferred tax expense due to the CAMT credit carryforward.

5.5.4 Accounting for the global minimum tax under the OECD's Pillar Two Global Anti-Base Erosion model rules

The Organisation for Economic Co-operation and Development (OECD) Inclusive Framework on Base Erosion and Profit Shifting addresses the tax challenges arising from the digitalization of the global economy and aims to restore confidence in the international tax system by determining that profits are taxed where economic activities take place and value is created.

To that end, the OECD released Pillar Two Global Anti-Base Erosion (GloBE) model rules to introduce a global minimum tax of 15% that would apply to multinational enterprise (MNE) groups with revenue of more than EUR750 million in their consolidated financial statements. The GloBE rules must be implemented by individual jurisdictions before they can take effect and, therefore, require local legislation to be enacted.

At the FASB meeting on 1 February 2023, the FASB staff responded to a technical inquiry about whether an entity should record deferred taxes for the GloBE minimum tax by recognizing GloBE-specific deferred taxes or remeasuring existing deferred taxes at the GloBE minimum tax rate. The staff stated it believes that the GloBE minimum tax as illustrated in the inquiry is an alternative minimum tax as discussed in ASC 740, and therefore, deferred tax assets and liabilities would not be recognized or adjusted for the estimated future effects of the minimum tax. The FASB staff believes ASC 740-10-30-10 and 30-12 and ASC 740-10-55-31 and 55-32 support this conclusion. The GloBE minimum tax should be viewed as a separate but parallel tax system that is imposed to make sure certain taxpayers pay at least a minimum amount of income tax.

MNEs should monitor developments related to the enactment of the GloBE rules in all of the jurisdictions where they operate either through wholly or partially owned subsidiaries, joint ventures, flow-through entities or permanent establishments. Because a country will need to enact tax laws to implement the GloBE rules, entities will need to evaluate the provisions of laws enacted in each jurisdiction to determine whether they are consistent with the OECD's model rules in order to apply the accounting indicated by the view of the FASB staff. Refer to our Technical Line, ***Preparing for a global minimum tax under the OECD's Pillar Two Global Anti-Base Erosion model rules***.

5.5.5 Overview of the legacy US corporate AMT system (related to the Tax Reform Act of 1986)

While the AMT under the Tax Reform Act of 1986 has been repealed by the TCJA in 2017, we have retained the following guidance and illustrations on the application of ASC 740's AMT guidance that is applicable to all AMT tax regimes. Refer to section 5.5.3, *The US corporate alternative minimum tax (CAMT)*, for details on the currently enacted AMT system in the US.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-42

The following guidance refers to provisions of the Tax Reform Act of 1986; however, it shall not be considered a definitive interpretation of the Act for any purpose.

740-10-25-43

The Tax Reform Act of 1986 established an **alternative minimum tax** system in the United States. Under the Act, an entity's federal income tax liability is the greater of the tax computed using the regular tax system (regular tax) or the tax under the alternative minimum tax system. A credit (alternative minimum tax credit) may be earned for tax paid on an alternative minimum tax basis that is in excess of the amount of regular tax that would have otherwise been paid. With certain exceptions, the alternative minimum tax credit can be carried forward indefinitely and used to reduce regular tax, but not below the alternative minimum tax for that future year. The alternative minimum tax system shall be viewed as a separate but parallel tax system that may generate a credit carryforward. Alternative minimum tax in excess of regular tax shall not be viewed as a prepayment of future regular tax to the extent that it results in alternative minimum tax credits.

Under the legacy AMT system, a company was required to compute taxes under two systems — the regular tax system and the AMT system — to determine its US federal income tax liability. The AMT is equal to the excess of the TMT for the year over the "regular tax" each year. A company's tax is determined and paid based on the system that produces the higher current tax amount. Generally, AMT differs from the regular system by disallowing or limiting certain deductions, accelerating recognition of certain items of taxable income, extending the depreciation periods, disallowing the use of accelerated depreciation methods for certain assets or requiring the tax payable to be calculated on a different basis. AMT is a complex calculation that requires the involvement of a qualified tax professional.

5.5.5.1 Examples of legacy AMT calculations and related tax provisions (related to the Tax Reform Act of 1986)

The following example illustrates the effect of the legacy AMT (related to the Tax Reform Act of 1986) when the company determines it is more likely than not the AMT credit carryforward benefit will be fully realized.

Illustration 5-8: Effect of the legacy AMT when it is more likely than not the AMT credit carryforward benefit will be realized

Assume that pretax financial income for 20X0 is $1,000 and there were $700 of taxable temporary differences originating in 20X0. The regular tax rate is 35% for all years and the AMT rate is 20%. The income tax provision for 20X0 would be computed as follows:

	Current payable	Deferred liability
Regular tax:		
Pretax financial income	$ 1,000	$ –
Temporary differences	(700)	700
Taxable income	300	700
Regular tax rate	35%	35%
Regular tax before AMT credit	$ 105	$ 245

Note: *The "deferred liability" AMT calculation (right column under this caption) is relevant only if necessary to assess the need for a valuation allowance against any deferred tax asset arising from an AMT credit carryforward — such as when sufficient future regular taxable income is not considered to be more likely than not and tax-planning strategies are not available to permit realization of the deferred tax asset.*

	Current payable	Deferred liability
AMT before AMT credit:		
Taxable income	$ 300	$ 700
AMT preferences and adjustments	500	–
AMT income	800	700
AMT rate	20%	20%
Tentative Minimum Tax (TMT)	$ 160	$ 140
AMT credit:		
Beginning balance	$ –	$ –
Excess of TMT over regular tax	55	55[a]
Applied to reduce regular deferred tax to amount no less than TMT	–	(55)
Ending balance	$ 55	$ –

[a] Carried forward from current provision ($160-$105)

	Current payable	Deferred liability
Applicable tax:		
AMT currently payable	$ 160	N/A
Regular tax before AMT credit	N/A	245
AMT credit	N/A	(55)
Net tax	$ 160	$ 190

The total income tax provision for 20X0 is the sum of the current payable per the tax return ($160) plus the deferred tax provision ($190), or $350. The effective tax rate of 35% equals the statutory rate because the AMT credit originating in 20X0 is fully used in the calculation. The example also illustrates the acceleration of current taxes payable caused by the AMT system.

The following example illustrates the effect of the legacy AMT (related to the Tax Reform Act of 1986) when the company determines it is more likely than not the AMT credit carryforward benefit will not be fully realized and a partial valuation allowance is recognized in the period in which the AMT credit carryforward is created.

Illustration 5-9: Effect of the legacy AMT when it is more likely than not the AMT credit carryforward benefit will not be fully realized and a partial valuation allowance is recognized

In some cases, AMT could significantly affect a company's effective income tax rate. For example, assume that pretax financial income for 20X0 is $1,000 including $700 of nonpreference tax-exempt bond income. Depreciation on assets acquired in 20X0 was $500 for financial reporting purposes, $600 for AMT purposes and $800 for regular tax purposes. The regular tax rate is 35% and the AMT rate is 20%. Assuming realization of the deferred tax asset through future taxable income (exclusive of reversing temporary differences) is not considered to be more likely than not, the total provision for 20X0 would be computed as follows:

	Current payable	Deferred liability
Regular tax:		
Pretax financial income	$ 1,000	$ –
Nonpreference tax-exempt bond income	(700)	–
Tax over AMT depreciation	(200)	200
AMT over book depreciation	(100)	100
Taxable income	–	300
Regular tax rate	35%	35%
Regular tax before AMT credit	$ –	$ 105

	Current payable	Deferred liability
AMT before AMT credit:		
Taxable income	$ –	$ 300
Tax over AMT depreciation	200	(200)
AMT income before adjustment	200	100
ACE adjustment (assumed)	400	–
Taxable income	600	100
AMT tax rate	20%	20%
Tentative Minimum Tax (TMT)	$ 120	$ 20

	Current payable	Deferred liability
AMT credit:		
Beginning balance	$ –	$ –
Excess of TMT over regular tax	120	120[(a)]
Applied to reduce regular deferred tax to amount no less than TMT ($105 – $20)	–	(85)
Ending balance	$ 120	$ 35

[(a)] Carried forward from current provision ($120 – $0)

	Current payable	Deferred liability
Applicable tax:		
AMT currently payable	$ 120	N/A
Regular tax before AMT credit	N/A	105
AMT credit	N/A	(85)
Net tax	$ 120	$ 20

For tax purposes, there is an AMT credit carryforward of $120, which is the excess of the AMT over regular tax. For financial reporting, the AMT credit carryforward of $120 is recorded as a deferred tax asset, offset by a $35 valuation allowance at the end of 20X0 because realization of the deferred tax asset through future taxable income (exclusive of reversing temporary differences) is not considered to be more likely than not.

The total income tax provision on 20X0 pretax income of $1,000 is ($140), the sum of the current provision ($120) plus the deferred provision ($20). Thus, the effective tax rate is 14% ($140 tax divided by $1,000 pretax income). However, in terms of book taxable income ($1,000 – $700), the total tax rate of 47% is significantly higher than the regular tax rate of 35%. The 12% excess effective tax rate over the statutory rate is due to the AMT liability in 20X0 and the inability to recognize the full benefit of the AMT credit carryforward ($35 valuation allowance ÷ $300 adjusted pretax income = 12%).

5.6 Tax on certain payments to related foreign corporations

The TCJA established a tax on certain payments from corporations subject to US tax to related foreign persons, also referred to as base erosion payments. Base erosion payments generally include payments from a corporation to foreign related parties for any amounts that are deductible, including royalty payments or payments to acquire depreciable or amortizable property. Base erosion payments do not include payments for costs of goods sold, payments for certain qualified services and qualified derivative payments, if certain requirements are met.

US companies that meet certain thresholds are required to pay the minimum BEAT. The minimum BEAT is based on the excess of a percentage of the corporation's modified taxable income over its regular tax liability for the year reduced by certain credits, but the amount cannot be less than zero. The modified income is taxed at 5% in 2018, 10% in 2019 through 2025 and 12.5% for years beginning after 31 December 2025.

This provision generally applies to corporations that are subject to US net income tax with average annual gross receipts of at least $500 million and that have made related-party deductible payments totaling 3% (2% for banks and securities dealers) or more of the corporation's total deductions for the year.

5.6.1 Accounting considerations for BEAT provisions

For US companies that meet certain thresholds, BEAT creates additional tax on net income by effectively excluding deductions on certain payments to foreign related entities.

At the time the TCJA was enacted, questions existed about whether this tax should be considered part of the regular US tax system, which would require the effects of the BEAT to be included in income tax in the period the tax arises, or a separate parallel tax regime. If the tax is determined to be part of a separate parallel tax regime, a question would arise about the appropriate tax rate to be applied in measuring certain US deferred taxes, including temporary differences existing on the enactment date, by entities subject to the BEAT regime (i.e., the US corporate tax rate of 21% or the BEAT rate).

In response to these questions, the FASB staff issued a Staff Q&A where it indicated that it believes an entity that is subject to BEAT should measure deferred tax assets and liabilities using the statutory tax rate under the regular tax system. The FASB staff believes that measuring a deferred tax liability at the lower BEAT rate would not reflect the amount an entity would ultimately pay because the BEAT would exceed the tax under the regular tax system using the 21% statutory tax rate. The staff also noted that an entity would not need to evaluate the effect of potentially paying the BEAT in future years on the realization of deferred tax assets recognized under the regular tax system because the realization of the deferred tax asset (for example, a tax credit) would reduce its regular tax liability, even when an incremental BEAT liability would be owed in that period. Regardless of any year-over-year effective tax rate fluctuations, the effective tax rate (excluding other permanent items) under this approach would always be equal to or in excess of the statutory tax rate of 21%.

FASB staff question and answer on the accounting for the base erosion anti-abuse tax

Question

Does the FASB staff believe that deferred tax assets and liabilities should be measured at the statutory tax rate of the regular tax system or the lower BEAT rate if the taxpayer expects to be subject to BEAT?

Response

The FASB staff believes that the BEAT is similar to the alternative minimum tax (AMT) under prior tax law. The AMT was a parallel tax system that resulted in a minimum level of corporate taxation in situations in which regular taxable income was lower than the alternative minimum taxable income due to "preference items" that were not deductible for AMT purposes. An entity that paid the AMT received a tax credit for the tax paid in excess of the amount computed on the basis of the regular tax system. An entity subject to the BEAT does not receive a tax credit for the tax paid in excess of the amount computed on the basis of the regular tax system, but the FASB staff believes that the BEAT is similar to the AMT in that it is designed to be an incremental tax in which an entity can never pay less, and may pay more, than its regular tax liability.

Paragraphs 740-10-30-11 and 740-10-55-32 address the AMT and require an entity to measure deferred taxes using the statutory tax rate under the regular tax system. Paragraph 740-10-30-11 states:

> *"… [I]t would be counterintuitive if the addition of alternative minimum tax provisions to the tax law were to have the effect of reducing the amount of an entity's income tax expense for financial reporting, given that the provisions of alternative minimum tax may be either neutral or adverse but never beneficial to an entity."*

Therefore, the FASB staff believes that an entity that is subject to BEAT should measure deferred tax assets and liabilities using the statutory tax rate under the regular tax system. The FASB staff believes that measuring a deferred tax liability at the lower BEAT rate would not reflect the amount an entity would ultimately pay because the BEAT would exceed the tax under the regular tax system using the 21% statutory tax rate.

Although an entity may believe that it expects to be subject to the BEAT for the foreseeable future, paragraph 740-10-30-11 further states that "no one can predict whether an entity will always be an alternative minimum tax taxpayer." The FASB staff believes that a similar conclusion could be applied to BEAT. In addition, taxpayers may take measures to reduce their BEAT exposure and, therefore, ultimately pay taxes at or close to the 21% statutory tax rate.

The FASB staff believes that the guidance in Topic 740 therefore indicates that the incremental effect of BEAT should be recognized in the year the BEAT is incurred. The staff also believes that an entity would not need to evaluate the effect of potentially paying the BEAT in future years on the realization of deferred tax assets recognized under the regular tax system because the realization of the deferred tax asset (for example, a tax credit) would reduce its regular tax liability, even when an incremental BEAT liability would be owed in that period. Regardless of any year-over-year effective tax rate fluctuations, the effective tax rate (excluding other permanent items) under this approach would always be equal to or in excess of the statutory tax rate of 21%.

5.7 Global intangible low-taxed income

A US shareholder is subject to current tax on global intangible low-taxed income (GILTI) of its controlled foreign corporations (CFCs). The GILTI inclusion is calculated based on the following formula: the excess of the aggregate of a US shareholder's pro rata share of net income of all its CFCs over a calculated return on specified tangible assets of the CFCs. The GILTI inclusion is eligible for a deduction (also referred to as the Section 250 (a)(1)(B) deduction) that is intended to lower the effective tax rate on the GILTI inclusion to 10.5% for taxable years beginning after 31 December 2017 and ending in 2025. The deduction applied to GILTI income will be lowered resulting in the intended effective rate rising to 13.125% for taxable years beginning after 31 December 2025.

Further, US tax law provides a US shareholder with a deemed paid foreign tax credit (FTC) for up to 80% of the foreign tax paid and properly attributable to GILTI income. However, a company cannot use these FTCs against other foreign source income or carry these FTCs back or forward to other years.

See section 14.3.6.2, *Accounting for GILTI in deferred taxes*, for additional information on accounting for GILTI in deferred taxes.

5.7.1 Accounting considerations for GILTI provisions

The income subject to tax under the GILTI provisions will be treated in a manner similar to a Subpart F income inclusion (i.e., it should be included in the US shareholder's taxable income in the current year) and included in its US income tax provision. See section 14.3.6.4, *Subpart F income*, for additional discussion on the accounting for Subpart F income.

At the time TCJA was enacted, questions existed about whether companies should include GILTI in income tax in the period the tax arises or as part of deferred taxes on the related investments. In response to these questions, the FASB staff issued a Staff Q&A which stated they believe that ASC 740 is not clear as it relates to the accounting for GILTI, and an entity may apply either interpretation of ASC 740. The staff believes that an entity must disclose its accounting policy related to GILTI inclusions in accordance with ASC 235-10-50-1 through 50-3. The FASB staff indicated that they plan to monitor developments in this area and companies should continue to monitor for standard development activities related to the accounting for GILTI.

FASB staff question and answer on the accounting for global intangible low-taxed income

Question

Does the FASB staff believe that an entity should recognize deferred taxes for temporary basis differences expected to reverse as global intangible low-taxed income (GILTI) in future years or should the tax on GILTI be included in tax expense in the year it is incurred?

Response

The FASB staff does not believe that Topic 740 is clear as to the treatment of GILTI.

Some stakeholders believe that it would not be appropriate to provide deferred taxes on individual inside basis differences or the outside basis difference (or portion thereof) because a taxpayer's GILTI is based on its aggregate income from all foreign corporations. Because the computation is done at an aggregate level, the unit of account is not the taxpayer's investment in an individual foreign corporation or that corporation's assets and liabilities. These stakeholders believe that the guidance on deferred tax accounting in Topic 740 using the asset and liability approach does not address taxes on aggregated income because basis differences of a foreign corporation in one jurisdiction may be offset by basis differences in a foreign corporation in another jurisdiction and ultimately may never be taxed. Furthermore, these stakeholders believe that the GILTI computation is dependent on contingent or future events (for example, future foreign income versus loss, the amount of foreign qualified business asset investment in a given year, future foreign tax credits or future taxable income), which suggests that taxes on GILTI should be accounted for as period costs similar to special deductions.

Other stakeholders believe that the current tax imposed on GILTI is similar to the tax imposed on existing Subpart F income. Deferred taxes generally are provided under Topic 740 for basis differences that are expected to result in Subpart F income upon reversal. Because GILTI is included in the US shareholder's taxable income when earned by the foreign corporations, similar to Subpart F income, these stakeholders believe that a US shareholder should recognize deferred tax assets and liabilities when basis differences exist that are expected to affect the amount of GILTI inclusion upon reversal.

Based on the different views provided, the FASB staff believes that Topic 740 is not clear as it relates to the accounting for GILTI, and an entity may apply either interpretation of Topic 740. The staff believes that an entity must disclose its accounting policy related to GILTI inclusions in accordance with paragraphs 235-10-50-1 through 50-3.

The staff plans to monitor how entities that pay tax on GILTI are accounting for and disclosing its effects by reviewing annual or quarterly reports issued over the next few quarters. Following this review, the staff will provide an update to the Board so it can consider whether improvements may be needed for the accounting or disclosures for the tax on GILTI.

See section 14.3.6.2, *Accounting for GILTI in deferred taxes*, for additional discussion on when electing to account for GILTI in deferred taxes.

5.8 State and local income taxes

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-25

If deferred tax assets or liabilities for a state or local tax jurisdiction are significant, this Subtopic requires a separate deferred tax computation when there are significant differences between the tax laws of that and other tax jurisdictions that apply to the entity. In the United States, however, many state or local income taxes are based on U.S. federal taxable income, and aggregate computations of deferred tax assets and liabilities for at least some of those state or local tax jurisdictions might be acceptable. In assessing whether an aggregate calculation is appropriate, matters such as differences in tax rates or the loss carryback and carryforward periods in those state or local tax jurisdictions should be considered. Also, the provisions of paragraph 740-10-45-6 about offset of deferred tax liabilities and assets of different tax jurisdictions should be considered. In assessing the significance of deferred tax expense for a state or local tax jurisdiction, it is appropriate to consider the **deferred tax consequences** that those deferred state or local tax assets or liabilities have on other tax jurisdictions, for example, on deferred federal income taxes.

When deferred tax assets and liabilities attributable to state or local tax jurisdictions are significant, a separate deferred tax computation may be required when there are significant differences between the tax laws of that state or local tax jurisdiction and other tax jurisdictions applicable to the company (i.e., the US federal and other state or local tax jurisdictions). For example, many states have limited carryback and carryforward provisions, which could result in limited asset recognition under the liability method. In assessing whether an aggregate calculation is appropriate, matters such as differences in tax rates or the loss carryback and carryforward periods in those state or local tax jurisdictions should be considered.

5.8.1 State applied versus enacted tax rates

ASC 740 requires the use of currently enacted tax rates in computing deferred taxes. However, when considering state and local income taxes, companies must consider the federal tax benefits, if any, related to those state and local taxes and adjust the enacted tax rates by the expected federal benefit. That is, if the enacted income tax rate for a given state is 10% and the company anticipates receiving a federal tax deduction in the period that tax liability becomes payable to the state taxing authority, and the company's federal tax rate is 21%, the company would compute its state deferred taxes using 7.9% (or 10% x (1-0.21)). Despite the computation of the state tax, public entities are required by Regulation S-X to separately disclose the state income tax expense exclusive of the federal tax benefit when disclosing the components of income tax expense. In addition, the guidance for accounting of income taxes in ASC 740 does not permit netting of deferred tax assets and liabilities related to different tax jurisdictions (e.g., federal and state) in the statement of financial position (ASC 740-10-45-6). See section 18.1.1.1, *State and local income taxes and valuation allowance*, for further discussion, including when a state deferred tax asset is not more likely than not to be realized.

In addition to the effect of federal tax benefits attributable to state and local income taxes, companies with operations in multiple state and local taxing jurisdictions must also consider the various allocation methodologies under state income tax laws and regulations. See section 5.8.3, *Income apportionment*, for additional discussion.

5.8.2 Estimating deferred state income taxes

In some jurisdictions, state and local taxes are based on US federal taxable income, and aggregate computations of deferred tax assets and liabilities for at least some of those state or local tax jurisdictions might be acceptable. In assessing whether an aggregate calculation is appropriate, matters such as differences in tax rates or the loss carryback and carryforward periods should be considered. In addition, in assessing the significance of deferred tax expense with respect to state or local taxes, consideration should be given to the deferred tax consequences that those deferred state or local tax assets or liabilities have on other tax jurisdictions, for example, on the computation of deferred federal income taxes. Consideration must also be given to the prohibition against offsetting deferred tax liabilities and assets attributable to different tax jurisdictions under ASC 740-10-45-6. (See chapter 18, *Financial statement presentation and disclosures*, for further discussion.) Companies with a majority of their taxable income allocated to a few states ordinarily should be able to analyze the tax effects in those states and estimate an overall provision for remaining operations.

Additional state and local income tax considerations as a result of the TCJA and the CARES Act

The TCJA and CARES Act also have state and local tax implications. Most state income tax laws use federal taxable income as a starting point for determining state income tax. While some states automatically adopt federal tax law changes, other states conform their laws with federal law on specific dates. States also may have chosen or will choose to decouple from new federal tax provisions and continue to apply the old tax law. As a result, a company may need to follow one set of rules when determining taxable income for US income tax purposes and multiple sets of rules when determining state and local taxable income. Companies will need to understand the conformity rules and changes to the tax laws in the states in which they operate so they can appropriately account for the effects on their state income taxes. As a result, depending on whether a state adopted or decoupled from federal tax law, additional complexities may result in the computation of deferred state tax liabilities and assets.

5.8.3 Income apportionment

Many states require apportionment of taxable income to the states in which companies operate based on various factors. Taxable income is typically apportioned based on sales, payroll costs and assets ("three factors") in each state.

Illustration 5-10: Apportionment of taxable income to the states in which companies operate based on sales, payroll costs and assets

Assume Company LML has $10,000 income before taxes from its operations in Connecticut, New York, Illinois and Virginia. Further, assume there are no temporary differences and all state apportionment factors are consistent.

	CT	NY	IL	VA	Total
Apportionment factors:					
Sales	$ 5	$ 15	$ 20	$ 60	$ 100
Payroll costs	15	5	70	10	100
Tangible assets	5	5	80	10	100
	$ 25	$ 25	$ 170	$ 80	$ 300
State taxable income	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000
State tax rate	x 4%	x 7%	x 10%	x 5%	
Apportionment factor	x 25/300	x 25/300	x 170/300	x 80/300	
State income taxes	$ 33	$ 58	$ 567	$ 133	$ 791
Federal taxable income					9,209
Federal tax rate					21%
Federal income taxes					1,934
Net income					$ 7,275

Because not all state and local taxing authorities require or permit the same allocation methodologies, a portion of the company's income may be taxable in more than one jurisdiction or may not be subject to taxation in any jurisdiction.

ASC 740 does not specifically address the apportionment of income for purposes of determining the state tax rates to apply to temporary differences. However, the apportionment factors utilized to measure deferred tax assets and liabilities generally should be those that are expected to apply when those deferred tax assets and liabilities are settled or realized. One approach would be to estimate future allocations to states based on historical relationships.

A company may expect future changes in its business that will affect its state apportionment factors. For example, a company may expect a shift in operations or employees from one state to another state. Additionally, a company may plan on expanding operations or adding employees in a state (e.g., construction of a new manufacturing facility may result in more employees in that state). We believe the effects of these anticipated changes are generally included in the measurement of deferred tax balances when the company has committed to a sufficiently developed plan to carry out the actions that will result in the change in operations and the remaining steps to complete the plan are within the company's control.

Business combinations

We often receive questions regarding the effects that a future business combination may have on tax apportionment. A business combination is defined in ASC 805 as "[a] transaction or other event in which an acquirer obtains control of one or more businesses." We do not believe that a company should anticipate obtaining control of a business for purposes of measuring its deferred taxes. That is, changes in the measurement of an acquirer's deferred taxes as a result of a business combination should be recorded when the business combination occurs. This view is consistent with the fact that a business combination is a non-recognized subsequent event.[19]

If the tax rate (including consideration of income apportionment) applicable to existing deductible or taxable temporary differences of the acquirer changes as a result of a business combination, the effect of the change should be reported in the current operating results and not in acquisition accounting. See section 11.13.2, *Apportioned tax rates*, for additional discussion of apportioned tax rate considerations in accounting for a business combination.

Change in apportionment method

A company's apportionment method for a state might change for various reasons, including those listed below. The accounting for the change will depend on the specific facts and circumstances surrounding that change.

- Change in state tax law — A state may change its tax law as to how income is apportioned. For example, a state may no longer require all three factors to determine the amount of income apportioned, but the state may require income be apportioned based on a single factor (e.g., sales). Alternatively, for example, a state may no longer require a single factor (e.g., sales), but the state may require all three factors to determine the amount of income apportioned. Changes in tax laws are recognized at the date of enactment. Refer to chapter 8, *An enacted change in tax laws or rates*, for additional discussion.

- Resolution of income tax uncertainty — The resolution of an income tax uncertainty with respect to a state apportionment method would be accounted for in the period of change under the guidance on uncertainty in income taxes in section 19.7, *Subsequent recognition, derecognition and measurement*.

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[19] ASC 855-10-55-2 provides examples of non-recognized subsequent events and includes a business combination that occurs after the balance sheet date but before financial statements are issued or available to be issued.

- Change in state regulations — A new state regulation might result in a change to a state apportionment method. Care should be taken in determining whether the change is akin to change in state tax law (refer to chapter 8, *An enacted change in tax laws or rates*) or the resolution of an income tax uncertainty (refer to section 19.7, *Subsequent recognition, derecognition and measurement*).
- Voluntary change in tax accounting method — A company may voluntarily change its state apportionment method by a change in tax accounting method. Refer to section 8.7, *Changes in tax accounting methods.*

5.8.4 State taxes based on the greater of franchise tax or income tax

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12 that simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the legacy guidance to promote more consistency. The amendments require entities to recognize a franchise tax by (1) accounting for the amount based on income under ASC 740 and (2) accounting for any residual amount as a non-income-based tax.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Early adoption is permitted in interim or annual periods for all other entities (i.e., entities that are not PBEs) that have not made financial statements available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply the amendment related to franchise taxes either retrospectively for all periods presented or using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.

Before the adoption of ASU 2019-12

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Scope and Scope Exception

Transactions

740-10-15-4

The guidance in this Topic does not apply to the following transactions and activities:

a. A franchise tax to the extent it is based on capital and there is no additional tax based on income. If there is an additional tax based on income, that excess is considered an income tax and is subject to the guidance in this Topic. See Example 17 (paragraph 740-10-55-139) for an example of the determination of whether a franchise tax is an income tax.

b. A withholding tax for the benefit of the recipients of a dividend. A tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and is not an income tax if both of the following conditions are met:

1. The tax is payable by the entity if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the entity would otherwise pay.
2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

See the guidance in paragraphs 740-10-55-72 through 55-74 dealing with determining whether a payment made to a taxing authority based on dividends distributed is an income tax.

Implementation Guidance and Illustrations

740-10-55-139

The guidance in paragraph 740-10-55-26 addressing when a tax is an income tax is illustrated using the following historical example.

740-10-55-140

In August 1991, a state amended its franchise tax statute to include a tax on income apportioned to the state based on the federal tax return. The new tax was effective January 1, 1992. The amount of franchise tax on each corporation was set at the greater of 0.25 percent of the corporation's net taxable capital and 4.5 percent of the corporation's net taxable earned surplus. Net taxable earned surplus was a term defined by the tax statute for federal taxable income.

740-10-55-141

In this Example, the total computed tax is an income tax only to the extent that the tax exceeds the capital-based tax in a given year.

740-10-55-142

A deferred tax liability is required to be recognized under this Subtopic for the amount by which the income-based tax payable on net reversing temporary differences in each future year exceeds the capital-based tax computed for each future year based on the level of capital that exists as of the end of the year for which deferred taxes are being computed.

740-10-55-143

The portion of the current tax liability based on income is required to be accrued with a charge to income during the period in which the income is earned. The portion of the deferred tax liability related to temporary differences is required to be recognized as of the date of the statement of financial position for temporary differences that exist as of the date of the statement of financial position.

740-10-55-144

Because the state tax is an income tax only to the extent that the tax exceeds the capital-based tax in a given year, under the requirements of this Subtopic, deferred taxes are recognized for temporary differences that will reverse in future years for which annual taxable income is expected to exceed 5.5% (.25% of net taxable capital/4.5% of taxable income) of expected net taxable capital. In measuring deferred taxes, see paragraph 740-10-55-138 to determine whether a detailed analysis of the net reversals of temporary differences in each future year is warranted. While the tax statutes of states differ, the accounting described above would be appropriate if the tax structure of another state was essentially the same as in this Example.

Franchise taxes are often referred to as "privilege" taxes because the tax is levied on all entities granted authority by the state to conduct business within its jurisdiction (i.e., the state allows the company to have the privilege of operating within the state). An example of a state franchise tax is included in ASC 740-10-55-139 through ASC 740-10-55-144. In this example, the amount of franchise tax owed by a corporation was the greater of 0.25% of the corporation's net taxable capital, as defined, or 4.5% of the corporation's net taxable earned surplus. Net taxable earned surplus was a term defined by the tax statute and is based on federal taxable income. Additionally, the total computed tax is an income tax only to the extent that the tax exceeds the capital-based tax in a given year (ASC 740-10-55-141).

We believe a franchise tax with essentially the same tax structure as the example above comprises two elements under ASC 740, that is, a tax based on net taxable capital and a tax based on income. To the extent the tax is based on net taxable capital, it is a franchise tax that should be accrued in the year to which the privilege relates. If there is additional tax due based on income, that excess is considered to be an income tax that should be accrued in the year the income was earned. The income-based franchise tax is an income tax and should be included in a company's estimated annual effective tax rate for purposes of applying ASC 740-270 to interim financial statements.

Illustration 5-11: State taxes based on the greater of franchise tax or income tax

Assume net taxable capital at 31 December 20X0 is $10 million and net taxable earned surplus is $1 million for the year ended 31 December 20X0. Also, assume that the privilege period to which the franchise tax relates is 20X1 franchise taxes for 20X0 and would be computed as follows:

Net taxable capital at 31 December 20X0	$ 10,000,000	
Tax rate	0.25%	
Franchise tax based on capital	$ 25,000	A
Net taxable earned surplus — 20X0	$ 1,000,000	
Tax rate	4.50%	
Franchise tax based on income	$ 45,000	B
Additional tax based on income	$ 20,000	B – A

The company would recognize $20,000 of the tax as income tax expense in 20X0 ($45,000 franchise tax based on income less $25,000 based on capital). Because the tax on net earned surplus is based on income reported in the 20X0 financial statements, the $20,000 franchise tax based on this amount should also be accrued and reported in the 20X0 financial statements. The remaining franchise tax due of $25,000 for the taxpayer's privilege of doing business in the taxing jurisdiction in 20X1, which is calculated on capital, would be recognized as an operating expense in the 20X1 financial statements. That is, the $25,000 is not a tax based on current-year income. If the $25,000 franchise tax based on capital had exceeded the $45,000 franchise tax based on earnings, no amount would be recognized in 20X0.

After the adoption of ASU 2019-12

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Scope and Scope Exception

Transactions

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

740-10-15-4

The guidance in this Topic does not apply to the following transactions and activities:

a. A franchise tax (or similar tax) to the extent it is based on capital or a non-income-based amount and there is no portion of the tax based on income. If a franchise tax (or similar tax) is partially based on income (for example, an entity pays the greater of an income-based tax and a non-income-based tax), deferred tax assets and liabilities shall be recognized and accounted for in accordance with this Topic. Deferred tax assets and liabilities shall be measured using the applicable statutory income tax rate. An entity shall not consider the effect of potentially paying a non-income-based tax in future years when evaluating the realizability of its deferred tax assets. The amount of current tax expense equal to the amount that is based on income shall be accounted for in accordance with this Topic, with any incremental amount incurred accounted for as a non-income-based tax. See Example 17 (paragraph 740-10-55-139) for an example of how to apply this guidance.

b. A withholding tax for the benefit of the recipients of a dividend. A tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and is not an income tax if both of the following conditions are met:

   1. The tax is payable by the entity if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the entity would otherwise pay.

   2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

See the guidance in paragraphs 740-10-55-72 through 55-74 dealing with determining whether a payment made to a taxing authority based on dividends distributed is an income tax.

Implementation Guidance and Illustrations

740-10-55-139

The guidance in paragraph 740-10-55-26 addressing when a tax is an income tax is illustrated using the following example.

740-10-55-140

A state's franchise tax on each corporation is set at the greater of 0.25 percent of the corporation's net taxable capital and 4.5 percent of the corporation's net taxable earned surplus. Net taxable earned surplus is a term defined by the tax statute for federal taxable income.

740-10-55-141

In this Example, the amount of franchise tax equal to the tax on the corporation's net taxable earned surplus is an income tax.

740-10-55-142

Deferred tax assets and liabilities are required to be recognized under this Subtopic for the temporary differences that exist as of the date of the statement of financial position using the tax rate to be applied to the corporation's net taxable earned surplus (4.5 percent).

740-10-55-143

The portion of the total computed franchise tax that exceeds the amount equal to the tax on the corporation's net taxable earned surplus should not be presented as a component of income tax expense during any period in which the total computed franchise tax exceeds the amount equal to the tax on the corporation's net taxable earned surplus.

740-10-55-144

While the tax statutes of states or other jurisdictions differ, the accounting described in paragraphs 740-10-55-140 through 55-143 would be appropriate if the tax structure of another state or jurisdiction was essentially the same as in this Example.

Franchise taxes are often referred to as "privilege" taxes because the tax is levied on all entities granted authority by the state to conduct business in its jurisdiction. Certain jurisdictions impose franchise taxes (or other similar taxes) that are calculated using the greater of two tax computations, one based on income and one based on items other than income. ASC 740-10-15-4(a) requires entities to recognize the franchise tax by (1) accounting for the amount based on income under ASC 740 and (2) accounting for any residual amount as a non-income-based tax.

ASC 740-10-15-4(a) provides guidance on the measurement of deferred tax assets and liabilities when the entity is subject to a franchise tax that is partially based on income, stating that deferred tax assets and liabilities should be measured using the applicable statutory income tax rate.

An example of a state franchise tax is included in ASC 740-10-55-139 through ASC 740-10-55-144. In this example, the amount of franchise tax owed by a corporation is the greater of 0.25% of the corporation's net taxable capital or 4.5% of the corporation's net taxable earned surplus. Net taxable earned surplus is a term defined by the tax statute and is based on federal taxable income. Therefore, the amount of franchise tax equal to the tax on the corporation's net taxable earned surplus is an income tax (ASC 740-10-55-141).

We believe a franchise tax with essentially the same tax structure as the example above comprises two elements under ASC 740, that is, a tax based on income and a tax based on net taxable capital. To the extent the tax is based on income, deferred tax assets and liabilities are required to be recognized for the temporary differences that exist as of the date of the financial statements by applying the applicable income tax rate (e.g., 4.5%). The income-based franchise tax is an income tax and should be included in a company's estimated annual effective tax rate for purposes of applying ASC 740-270 to interim financial statements. If there is any portion of the total franchise tax that exceeds the tax on income, that excess is not recognized as a component of income tax expense.

Illustration 5-11A: State taxes based on the greater of franchise tax or income tax

Facts

- The Company operates in a jurisdiction that assesses a franchise tax based on the greater of tax based on net taxable capital or net taxable earned surplus.
- The Company's net taxable earned surplus for the year ended 31 December 20X0 is $1 million.
- The Company's net taxable capital at 31 December 20X0 is $15 million.
- The privilege period to which the franchise tax relates is 20X1.
- The franchise tax for 20X0 is computed as the greater of 0.40% of net taxable capital or 4.5% of net taxable earned surplus.

Analysis

Net taxable earned surplus for 20X0	$ 1,000,000	
Tax rate	4.5%	
Franchise tax based on income	$ 45,000	A
Net taxable capital at 31 December 20X0	$ 15,000,000	
Tax rate	0.40%	
Franchise tax based on capital	$ 60,000	B
Additional non-income tax	$ 15,000	B − A

After the adoption of ASU 2019-12, the Company would recognize $45,000 as current income tax expense in 20X0. Because the tax on net earned surplus is based on income reported in the 20X0 financial statements, the $45,000 franchise tax based on this amount should also be accrued and reported in the 20X0 financial statements. The remaining franchise tax due of $15,000 for the taxpayer's privilege of doing business in the taxing jurisdiction in 20X1, which is calculated on capital, would be recognized as an operating expense in the 20X1 financial statements. That is, the $15,000 is not a tax based on current-year income.

Deferred tax assets and liabilities are required to be recognized for the temporary differences that exist as of the date of the 20X0 financial statements by applying the applicable income tax rate (in this example, 4.5%).

5.8.4.1 Texas franchise tax

The Texas franchise tax is a tax based on "taxable margin." Taxable margin is defined as the entity's "total revenues" less (at the election of the taxpayer) the greater of "cost of goods sold" or "compensation" (compensation would include wages and cash compensation as well as benefits). However, the entity's taxable margin would be capped at 70% of the entity's total revenues. The Texas franchise tax also provides for the carryforward of prior tax credits, subject to limitations, as well as a temporary tax credit.

We believe the Texas franchise tax, while based on an entity's margins (as discussed above), is nonetheless a tax based substantially on income, and as such is subject to the provisions of ASC 740. Companies with qualifying tax credit carryforwards would continue to analyze the realizability of those credits to determine the need for a valuation allowance as required by ASC 740. Shortly after the Texas franchise tax was enacted, the FASB declined to add to its agenda a project to provide guidance relating to the accounting implications of the Revised Tax — principally whether it should be accounted for under ASC 740. In their deliberations, the FASB staff noted that the tax is based substantially on a measure of income and as a result believes it is subject to ASC 740.

5.8.4.2 Franchise tax effect on deferred state income taxes

ASC 740 does not require specific accounting for deferred state income taxes. The guidance for the accounting of income taxes in ASC 740 requires recognition of a current tax asset or liability for the estimated taxes payable or refundable on tax returns for the current year and a deferred tax asset or liability for the estimated future tax effects attributable to temporary differences and carryforwards that are measured at the enacted tax rates.

Accordingly, under ASC 740 before the adoption of ASU 2019-12, deferred taxes are recognized for temporary differences that will reverse in future years for which annual taxable income is expected to exceed the capital-based tax computation based on the level of existing capital at year-end.

After ASU 2019-12 is adopted, if a franchise tax (or similar tax) is partially based on income (for example, an entity pays the greater of an income-based tax and a non-income-based tax), deferred tax assets and liabilities are recognized and accounted for in accordance with ASC 740 and measured using the applicable statutory income tax rate. An entity should not consider the effect of potentially paying a non-income-based tax in future years when evaluating the realizability of its deferred tax assets.

ASC 740-10-55-138 and its discussion of graduated tax rates should be considered when determining whether a detailed analysis of the net reversals of temporary differences in each future year (i.e., scheduling) is warranted. In most cases ASC 740 does not require temporary difference to be scheduled. See section 4.3, *Scheduling the reversal of temporary differences*, for further discussion.

5.8.5 State taxes based on items other than income

Some state/local taxing authorities compute taxes due from business operations based on income plus or minus payroll, capital expenditures, net capital, and/or other items. Based on a company's actual operating results, the income tax component of the state/local taxation scheme may not be applicable (e.g., when the company is in a loss position) or may be the most significant component of the total state/local tax liability. In determining whether these taxation schemes are income taxes or other taxes (e.g., payroll, sales/use, franchise), companies should consider the current and future effect of the various components of the state/local tax scheme. In addition, companies should note that the ASC Master Glossary defines income tax expense (or benefit) as the sum of current tax expense (or benefit) (that is, the amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year) and deferred tax expense (or benefit) (that is, the change during the year (or since the acquisition date for acquired temporary differences) in an entity's deferred tax liabilities and assets). Further, public companies should consider Rule 5-03(b)(11) of Regulation S-X, which requires public companies to include only taxes based on income under the caption income tax expense.

In other words, taxes based on net capital are generally regarded as franchise taxes and recognized in the period the company has the privilege to operate in the taxing authority's jurisdiction. Likewise, taxes based on payroll or capital expenditures are generally regarded as payroll or use taxes and recognized in the period those costs are incurred. Conversely, taxes based on income should be recognized in the period in which the income is reported for financial reporting purposes (including the recognition of deferred tax assets and liabilities). Before adoption of ASU 2019-12, deferred taxes are recognized based on the incremental effect caused by reversals of temporary differences in future years for which annual taxable income is expected to exceed the other components (based on the existing relative significance) of the taxation scheme. After the adoption of ASU 2019-12, if a franchise tax (or similar tax) is partially based on income (for example, an entity pays the greater of an income-based tax and a non-income-based tax), deferred taxes are recognized and accounted for in accordance with ASC 740 and calculated using the applicable statutory income tax rate.

Illustration 5-12:	State taxes based on items other than income (before the adoption of ASU 2019-12)

Jurisdiction M's business tax is based on income for the period plus payroll costs less construction expenditures. In many situations, the payroll and construction expenditures components may be more significant than the income component. Although Jurisdiction M's tax law clearly states the tax is not an income tax, the starting point for the tax is income for the period and therefore meets ASC 740's definition of a "tax on income." Refer to chapter 2, *Scope*, for further discussion on the scope of ASC 740.

Some diversity in practice arises because companies may have losses for both financial reporting and US federal income tax purposes and still have a tax liability for Jurisdiction M's business tax due to the payroll component of the base computation. Thus, some companies may consider classifying this tax (1) as income tax expense, (2) partially as income tax expense and partially as general expense, or (3) as general expense. We believe tax allocation is appropriate for the Jurisdiction M business tax — that is, the income tax portion of the tax should be reported as a component of income tax expense, while the payroll cost and construction expenditures are treated as payroll taxes and use taxes, respectively, and typically reported as general expenses.

Note: Subsequent to the adoption of ASU 2019-12, companies subject to the Jurisdiction M business tax would first compute the tax for the component based on income and account for it under ASC 740. Any excess above the tax for the income-based component would be accounted for as a non-income tax, outside the scope of ASC 740.

5.9 Special deductions

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-37

The tax benefit of statutory depletion and other types of special deductions such as those that may be available for certain health benefit entities and small life insurance entities in future years shall not be anticipated for purposes of offsetting a deferred tax liability for taxable temporary differences at the end of the current year. The tax benefit of special deductions ordinarily is recognized no earlier than the year in which those special deductions are deductible on the tax return. However, some portion of the future tax effects of special deductions are implicitly recognized in determining the average graduated tax rate to be used for measuring deferred taxes when graduated tax rates are a significant factor and the need for a **valuation allowance** for deferred tax assets. In those circumstances, implicit recognition is unavoidable because those special deductions are one of the determinants of future taxable income and future taxable income determines the average graduated tax rate and sometimes determines the need for a valuation allowance. See Section 740-10-30 for measurement requirements related to determining tax rates and a valuation allowance for deferred tax assets.

Certain extractive industries, such as oil and gas and mining, are permitted a depletion deduction in computing taxable income. The depletion deduction for a taxable year is the greater of cost depletion or percentage depletion. Cost depletion is based on the cost of the reserves, and percentage depletion is based on multiplying gross income from the property by a specified statutory percentage, subject to certain limitations. ASC 740-10-25-37 prohibits anticipating the tax benefit from statutory depletion to offset a taxable temporary difference (deferred tax liability) at year-end. The statutory depletion tax benefit would be recognized, at the earliest, in the year the deduction is taken on the company's income tax return. The FASB concluded the necessary past event for recognition of the tax benefit has not occurred until the production of the oil, mining of the copper, and so forth (or its subsequent sale) takes place. This prohibition also applies to tax benefits for other special deductions, such as those for Blue Cross Blue Shield and small life insurance companies.

Although the tax benefit for special deductions would ordinarily not be recognized until the year in which the deduction is taken on the company's income tax return, some portion of the future tax effects of special deductions are implicitly recognized in determining (1) the average graduated tax rate when graduated tax rates are a significant factor and (2) the need for a valuation allowance for deferred tax assets. Implicit recognition is unavoidable in those circumstances because (1) special deductions are one of the determinants of future taxable income and (2) future taxable income determines the average graduated tax rate and sometimes determines the need for a valuation allowance.

5.9.1 Foreign-derived intangible income incentive

The TCJA provides tax incentives to US companies to earn income from the sale, lease or license of goods and services abroad in the form of a deduction for FDII. After considering the deduction, foreign-derived intangible income is taxed effectively at a rate of 13.125% for taxable years beginning after 31 December 2017 and 16.406% for taxable years beginning after 31 December 2025 subject to taxable income limitations.

Because FDII is dependent upon future sales, we believe the accounting for the deduction for foreign-derived intangible income is similar to a special deduction and should be accounted for based on the guidance in ASC 740-10-25-37. The tax benefits for special deductions ordinarily are recognized no earlier than the year in which they are deductible on the tax return.

5.9.2 Domestic production activities deduction

On 22 October 2004, the American Jobs Creation Act of 2004 (Jobs Act) was enacted into law in the US that, in part, repealed certain extra-territorial income tax provisions and provided additional US tax deductions for qualifying domestic production activities. In December 2017, the TCJA was enacted in the US and repealed the Section 199 domestic production activities deduction for tax years beginning after 31 December 2017. Therefore, the following discussion may not be relevant to companies in years following that repeal.

ASC 740-10-55-29 states that the qualified production activities deduction's characteristics are similar to special deductions and should be accounted for as a special deduction in accordance with ASC 740-10-25-37.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-27

The following discussion and Example 18 (see paragraph 740-10-55-145) refer to and describe a provision within the American Jobs Creation Act of 2004; however, they shall not be considered a definitive interpretation of any provision of the Act for any purpose.

740-10-55-28

On October 22, 2004, the Act was signed into law by the president. This Act includes a tax deduction of up to 9 percent (when fully phased-in) of the lesser of qualified production activities income, as defined in the Act, or taxable income (after the deduction for the utilization of any net operating loss carryforwards). This tax deduction is limited to 50 percent of W-2 wages paid by the taxpayer.

740-10-55-29

The qualified production activities deduction's characteristics are similar to special deductions discussed in paragraph 740-10-25-37 because the qualified production activities deduction is contingent upon the future performance of specific activities, including the level of wages. Accordingly, the deduction should be accounted for as a special deduction in accordance with that paragraph.

740-10-55-30

The special deduction should be considered by an entity in measuring deferred taxes when graduated tax rates are a significant factor and assessing whether a valuation allowance is necessary as required by paragraph 740-10-25-37. Example 18 (see paragraph 740-10-55-145) illustrates the application of the requirements of this Subtopic for the impact of the qualified production activities deduction upon enactment of the Act in 2004.

The following example, from ASC 740-10-55-146, illustrates how an entity with a calendar year-end would apply ASC 740-10-25-37 and ASC 740-10-35-4 to the qualified production activities deduction at 31 December 2004. In particular, this example illustrates the methodology used to evaluate the qualified production activities deduction's effect on determining the need for a valuation allowance on an entity's existing net deferred tax assets.

Illustration 5-13: Methodology used to evaluate the need for a valuation allowance on an entity's existing net deferred tax assets

Assume the following facts:

Expected taxable income (excluding the qualified production activities deduction and net operating loss carryforwards) for 2005	$	21,000
Expected qualified production activities income (QPAI) for 2005	$	50,000
Net operating loss carryforwards at 31 December 2004, which expire in 2005	$	20,000
Expected W-2 wages for 2005	$	10,000
Assumed statutory income tax rate		35%
Qualified production activities deduction: 3% of the lesser of (1) QPAI or (2) taxable income (after deducting the net operating loss carryforwards). Limited to 50% of W-2 wages.	$	30

Conclusion:

The entity would not recognize a valuation allowance for the net operating loss carryforwards at 31 December 2004, because expected taxable income in 2005 (after deducting the qualified production activities deduction) of $20,970 exceeds the net operating loss carryforwards of $20,000, as presented below:

Analysis to compute the qualified production activities deduction:

Expected taxable income (excluding the qualified production activities deduction and net operating loss carryforwards) for 2005	$ 21,000
Less net operating loss carryforwards	20,000
Expected taxable income (after deducting the net operating loss carryforwards)	$ 1,000
Qualified production activities deduction	$ 30

Analysis to determine the effect of the qualified production activities deduction on the need for a valuation allowance for deferred tax assets for the net operating loss carryforwards:

Expected taxable income after deducting the qualified production activities deduction	$ 20,970
Net operating loss carryforwards	20,000
Expected taxable income exceeding the net operating loss carryforwards	$ 970

6 Valuation allowances

ASC 740 requires an assessment of the future realization of the tax benefit of an entity's existing deductible temporary differences and carryforwards. This evaluation requires an analysis of all available evidence, both positive and negative, to determine the amount of any required valuation allowance. The future realization of the tax benefit of deferred tax assets will ultimately depend on the existence of enough taxable income of the appropriate character within the carryback and carryforward periods. A valuation allowance is recognized if, based on the weight of available evidence, it is more likely than not (likelihood of more than 50%) that some portion or all the deferred tax asset will not be realized.

This chapter discusses assessing the need for a valuation allowance and the four possible sources of future taxable income available under the tax law to realize the tax benefit.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Measurement

740-10-30-17

All available evidence, both positive and negative, shall be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed. Information about an entity's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.

740-10-30-18

Future realization of the tax benefit of an existing **deductible temporary difference** or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences

b. Future taxable income exclusive of reversing temporary differences and carryforwards

c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law

d. Tax-planning strategies (see paragraph 740-10-30-19) that would, if necessary, be implemented to, for example:

   1. Accelerate taxable amounts to utilize expiring carryforwards

   2. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss

   3. Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

740-10-30-19
In some circumstances, there are actions (including elections for tax purposes) that:

a. Are prudent and feasible

b. An entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused

c. Would result in realization of deferred tax assets.

This Subtopic refers to those actions as tax-planning strategies. An entity shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a **tax-planning strategy** or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. See paragraphs 740-10-55-39 through 55-48 for additional guidance. Implementation of the tax-planning strategy shall be primarily within the control of management but need not be within the unilateral control of management.

Under ASC 740-10-25-29, a deferred tax asset is recognized for deductible temporary differences and operating loss and tax credit carryforwards (see chapter 5, *Recognition and measurement*, for further discussion). Deferred tax assets are measured using the applicable enacted tax rate and provisions of the enacted tax law. Generally, deferred tax assets are recorded when the event giving rise to the tax benefit has been recognized in the company's financial statements (i.e., the tax benefit exists). The existence of deductible temporary differences, operating loss carryforwards and tax credit carryforwards is generally fairly straightforward based on the application of tax law. However, in some cases, the existence of tax benefits may be subject to significant judgment requiring careful consideration of the facts and circumstances (e.g., tax benefits based on complex provisions of tax law or tax positions subject to a high likelihood of challenge by the Internal Revenue Service). Valuation allowances under ASC 740 do not deal with existence; instead, they address the realizability of an asset. For a further discussion of issues associated with the existence of deferred tax assets, see chapter 19, *Accounting for uncertainty in income taxes*.

6.1 Evaluating if a valuation allowance is required

ASC 740-10-30-2(b) states that the measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on the evaluation of available evidence, are not expected to be realized. Determining whether a valuation allowance for deferred tax assets is necessary often requires an extensive analysis of positive and negative evidence regarding the realization of the deferred tax assets and, inherent in that, an assessment of the likelihood of sufficient future taxable income. This analysis typically includes determining the refund potential in the event of NOL carrybacks, scheduling reversals of temporary differences, evaluating potential tax-planning strategies and evaluating expectations of future profitability.

A valuation allowance is recognized if, based on the weight of available evidence, it is more likely than not (likelihood of more than 50%) that some portion or all of the deferred tax asset will not be realized (ASC 740-10-30-5(e)). It is important to emphasize that, when assessing the realizability of deferred tax assets, an entity evaluates the gross balance of deferred tax assets rather than the net amount after considering deferred tax liabilities. In other words, all companies with significant deductible temporary differences and operating loss and tax credit carryforwards are required to evaluate the realizability of their deferred tax assets, not only those companies in a net deferred tax asset position.

Additionally, the need for a valuation allowance should be determined for each individual entity (or group of entities that are consolidated for tax purposes) in each jurisdiction and tax-paying component. Therefore, a company in a consolidated net deferred tax liability position still needs to determine whether the nature and character of existing deferred tax liabilities provide an appropriate source of future taxable income for the deferred tax assets in each individual entity (or group of entities that are consolidated for tax purposes).

Companies that have historically been profitable and expect that trend to continue need less judgment to conclude the future realization of deferred tax assets is more likely than not to occur. However, the assessment is more difficult when there is negative evidence, which generally is the case for unprofitable companies, marginally profitable companies, or companies experiencing a high degree of volatility in earnings. Further discussion about evaluating the realizability of deferred tax assets in those situations is included in this chapter.

6.1.1 Evaluation of positive and negative evidence

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Initial Measurement

740-10-30-21

Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include, but are not limited to, the following:

a. A history of operating loss or tax credit carryforwards expiring unused

b. Losses expected in early future years (by a presently profitable entity)

c. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years

d. A carryback, carryforward period that is so brief it would limit realization of tax benefits if a significant deductible temporary difference is expected to reverse in a single year or the entity operates in a traditionally cyclical business.

740-10-30-22

Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include, but are not limited to, the following:

a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures

b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset

c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual or infrequent item) is an aberration rather than a continuing condition.

740-10-30-23

An entity shall use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome.

740-10-30-24

Future realization of a tax benefit sometimes will be expected for a portion but not all of a deferred tax asset, and the dividing line between the two portions may be unclear. In those circumstances, application of judgment based on a careful assessment of all available evidence is required to determine the portion of a deferred tax asset for which it is more likely than not a tax benefit will not be realized.

The weight given to the potential effects of negative and positive evidence should be commensurate with the extent to which the evidence can be objectively verified. The further into the future the estimates go, the less objectively verifiable the evidence becomes. Furthermore, estimates about uncertain future events, such as future taxable income, are much less objectively verifiable than historical results, such as recent cumulative losses. The more negative the evidence, the more positive evidence is needed and the more difficult it will be to support a conclusion that a valuation allowance is not needed.

Assessing the evidence to determine the need for, and amount of, a valuation allowance requires the application of judgment. The most straightforward cases are those in which either no valuation allowance is deemed necessary because it is more likely than not that the full amount of the deferred tax asset will be realized or when the available evidence clearly indicates a full valuation allowance is deemed necessary because it is not more likely than not that the full amount of the deferred tax assets will be realized. Situations in which a benefit is expected for a portion, but not all, of the deferred tax asset are often more difficult to assess.

All available evidence, both positive and negative, should be considered in determining whether a valuation allowance is needed.

Examples of negative evidence include:

- Cumulative losses in recent years (see section 6.1.1.1, *Cumulative losses*)
- History of net operating losses or tax credit carryforwards expiring unused
- Unsettled circumstances which, if resolved unfavorably, would affect future operations and profits on a continuing basis in the future
- A carryforward (or carryback if permitted) is so brief it would limit realization of tax benefits if a significant deductible temporary difference is expected to reverse in a single year

Examples of positive evidence that might support the conclusion a valuation is not required include:

- Based on an entity's existing sales prices and cost structure there are existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax assets
- Excess of the asset market value over the tax basis in an amount sufficient to realize a deferred tax asset and the company has the intent and ability to realize that excess amount
- A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual or infrequent item) is an aberration rather than a continuing condition (see section 6.1.1.1.1, *Unusual, nonrecurring and noncash charges*)

In addition to these examples, other factors may significantly influence the likelihood of realizing deferred tax assets. Economic conditions, both national and regional, play a major role in the evaluation of an entity's prospects of generating future taxable income. Although companies cannot be expected to have a crystal ball, evidence of expected future results may be gleaned from an analysis of data, such as:

- Concentrations of risk within specific industries and geographical areas
- Historical levels and trends in earnings
- Sensitivity analysis

In analyzing historical information, care should be taken to consider trends within the industry or for a particular company that may render some of the historical data somewhat irrelevant. Continuing consolidation within some industries, as well as potential cost-cutting through outsourcing or downsizing, for example, may be expected to significantly affect the future profitability of some companies. Actual results achieved to date under an existing operating plan would presumably be given much more weight than projected results under a pending plan.

6.1.1.1 Cumulative losses (updated August 2022)

While this statement is not included in the Accounting Standards Codification, the FASB said, in the Basis for Conclusions of Statement 109 (non-authoritative), that it considered whether the criteria for recognizing deferred tax assets should be established at a higher level (such as "probable" or "assured beyond a reasonable doubt") when there is a cumulative pretax loss for financial reporting for the current year and the two preceding years (i.e., a three-year cumulative loss). In this regard, the FASB concluded that more restrictive criteria were not necessary because a cumulative loss in recent years is a significant piece of negative evidence that would be difficult to overcome on a more-likely-than-not or any other basis. While the FASB also rejected the use of cumulative losses as a bright line (or "on/off switch") requiring a valuation allowance, the FASB did specifically incorporate guidance in ASC 740-10-30-21 that forming a conclusion that a valuation allowance is not needed is difficult when there is significant negative evidence such as cumulative losses in recent years.

ASC 740 does not specifically define "cumulative losses in recent years." However, in discussing cumulative losses, the FASB did note, in Statement 109.100 (non-authoritative), that the Board considered losses in the context of a three-year period. Although interpretations might vary, we believe a company is in a cumulative loss position for financial reporting purposes when it has a cumulative loss for the latest three years (see Basis for Conclusions of Statement 109 [non-authoritative]). This means that a company with a loss from all sources (e.g., discontinued operations, other comprehensive income) in the current year in excess of income from all sources in its previous two years would be in a cumulative loss position.

We believe the evaluation of the three-year cumulative loss position for this purpose includes pretax results from all sources except for the cumulative effect of changes in accounting principles. In other words, pretax results from continuing operations, discontinued operations and other comprehensive income items should be combined to determine whether a company is in a cumulative loss position.

In certain situations, a company may not be in a cumulative loss position in the current year but may expect to be in a cumulative loss position in the near future. We do not believe there is a significant difference between being in a cumulative loss position and expecting to be in one. That is, we believe that both being in a cumulative loss position and expecting to be in one provide significant negative evidence such that projections of future taxable income will rarely be sufficient to substantiate that a deferred tax asset is realizable at a more-likely-than-not level of assurance.

Because recent cumulative losses constitute significant negative evidence, positive evidence of equal or greater significance is needed at a minimum to overcome that negative evidence before a tax benefit is recognized for deductible temporary differences and loss carryforwards based on a projection of future taxable income. In evaluating the positive evidence available (that is, the four sources of taxable income[20]), expectations about future taxable income would rarely be sufficient to overcome the negative evidence of recent cumulative losses, even if they were supported by detailed forecasts and projections. In such cases, expectations about future taxable income are generally overshadowed by a company's historical loss experience in recent years. Estimating future taxable income in such cases often necessitates the prediction of a turnaround or other change in circumstances, which typically cannot meet the objective verification requirement of ASC 740. On the other hand, taxable income available in prior carryback years (which generally would be limited in circumstances where pretax losses were incurred for the last few years), reversals of existing taxable temporary differences and qualifying tax-planning strategies generally would represent positive evidence in these cases.

While we recognize that differences exist in practice with respect to the definition of cumulative losses, ASC 740 is very clear that the FASB specifically rejected using cumulative losses as a bright-line or "on/off switch" related to valuation allowances. As a result, the determination of whether a company is, or is not, in a cumulative loss position does not, in and of itself, result in a conclusion with respect to the realizability of deferred tax assets. However, ASC 740 also is clear that losses are negative evidence and that consistent with the conclusion reached by the FASB in ASC 740-10-30-21 and ASC 740-10-30-23, a company that is in a cumulative loss position must consider the weight of this significant negative evidence together with the weight of other positive and negative evidence that is available from the four sources of taxable income to determine the realizability of deferred tax assets and that overcoming negative evidence such as cumulative losses in recent years is difficult.

The need for a valuation allowance is assessed by tax component and by tax jurisdiction. That is, realization of a deferred tax asset depends on adequate taxable income in the carryback or carryforward period in the appropriate tax jurisdiction. As a result, positive and negative evidence, including cumulative losses, should also be considered at that level. Therefore, when evaluating all available evidence, we believe the negative evidence from cumulative losses at the consolidated financial statements level would need to be considered when evaluating the realizability of deferred tax assets of a company's subsidiaries (in separate tax jurisdictions).

For example, when a company is in a cumulative loss position on a consolidated basis, the company would consider this negative evidence when evaluating the realizability of deferred tax assets of a subsidiary (in a separate tax jurisdiction) that is relying on projections of future taxable income to realize a deferred tax asset, even if the subsidiary is not in a cumulative loss position. The negative evidence of the consolidated group's cumulative loss may be difficult to overcome when there are intercompany arrangements and transactions that contribute to the subsidiary's profitability (e.g., financing, sales, purchases). In these cases, the results of the consolidated parent are likely a source of negative evidence for the subsidiary. However, if the subsidiary is in a separate tax jurisdiction, has transactions with third parties (e.g., sales) and has a history of generating taxable income without such intercompany transactions, it may be possible for the negative evidence of the parent to be overcome when determining whether a valuation allowance is needed for the subsidiary's deferred taxes. Similarly, if a subsidiary (in a separate tax jurisdiction) is in a cumulative loss position but on a consolidated basis the parent is not, it is possible certain strategies are available (e.g., changing intercompany arrangements) to direct profits of the consolidated entity to the subsidiary in the future (subject to the appropriateness of such actions as valid tax-planning strategies as well as an ability to rely on projections of future taxable income). However, if those strategies create taxable losses at the parent or other subsidiaries (in a separate tax jurisdiction) and those tax benefits cannot be realized, the strategy would not result in the realization of the deferred tax assets of the subsidiary in the cumulative loss position.

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[20] See section 6.2, *Sources of taxable income*, for further discussion of these items.

6.1.1.1.1 *Unusual, nonrecurring and noncash charges*

We believe all items, except for changes in accounting principles, should generally be considered as a starting point in evaluating whether a company is in a cumulative loss position. Thus, restructuring charges would not be eliminated from the cumulative losses even though future operating results may be improved due to plant closings or similar reductions in fixed operating costs. Likewise, impairments of goodwill or other assets also would be included in the cumulative loss evaluation even if those items were acquired through the issuance of the company's equity securities. That does not, however, mean that qualitatively all cumulative losses are the same. For example, a company that is in a three-year cumulative loss position due to a loss on the disposal of a discontinued operation in the prior year may be more likely to generate future taxable income than a company in a cumulative loss position as a result of recurring operating losses. A company would need to carefully consider the factors associated with the cumulative loss as part of its evaluation of all available evidence.

6.1.1.1.2 *Emergence from bankruptcy*

We often receive questions regarding the cumulative loss considerations for an entity that emerges from bankruptcy and applies fresh-start accounting pursuant to ASC 852. Generally, we have found that entities emerging from bankruptcy experienced significant financial and operating difficulty immediately before bankruptcy. While the company may have realized substantial improvements in operating results while subject to the bankruptcy court oversight, had certain costs not been set aside during bankruptcy, most companies would have continued to experience losses. As such, the weight of the significant negative evidence of prior losses and the bankruptcy itself must be considered with the other positive and negative evidence available from the four sources of taxable income before concluding on the realizability of the deferred tax assets.

6.1.1.2 Other negative evidence

As noted in ASC 740-10-30-21, other negative evidence may exist and should be considered when determining the need for, and amount of, a valuation allowance. Although the types of other negative evidence are fairly straightforward, it should be noted that an absence of those other forms of negative evidence is not considered positive evidence as described in ASC 740-10-30-22. For example, if a company has not had net operating loss or tax credit carryforwards expire unused, it does not indicate positive evidence exists of a sufficient quality and quantity to obviate the need for a valuation allowance.

6.1.1.2.1 *Going-concern opinion*

If an auditor modified its opinion to state a substantial doubt exists about an entity's ability to continue as a going concern, we believe, for all practical purposes, projections of future taxable income will not be sufficient to overcome the negative evidence related to the entity's ongoing existence. Accordingly, other sources of taxable income (e.g., reversal of existing taxable temporary differences) would be necessary to conclude that a full valuation allowance was not necessary for deferred tax assets.

6.1.2 Carryforwards and other tax attributes that do not expire

The future realization of deferred tax assets ultimately depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period under the tax law. In certain tax jurisdictions, operating loss and/or tax credit carryforwards do not expire. For example, US federal NOL carryforwards arising in taxable years ending after 31 December 2017 do not expire (see section 6.4.1, *Considerations when NOL carryforwards do not expire or when tax law limits the use of NOL carryforwards*, for additional information). In such situations, it is still necessary for a company to evaluate the deferred tax assets for realizability.

It is not appropriate to assume that the carryforward will ultimately be realized simply because the carryforward does not expire or has a long period of carryforward (e.g., 20 years). A valuation allowance would still be necessary if, based on the weight of available evidence, it cannot be determined that it is more likely than not (likelihood of more than 50%) that the deferred tax asset will be realized. Refer to section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*, for discussion of whether a deferred tax liability related to an indefinite-lived intangible asset (including tax-deductible goodwill) may be used as a source of income to realize a deferred tax asset relating to a loss carryforward that does not expire.

6.2 Sources of taxable income

The future realization of the tax benefits of existing deductible temporary differences or carryforwards ultimately depend on the existence of sufficient taxable income in the carryback (if permitted under the tax law) and carryforward periods. The four possible sources of taxable income to be considered in determining whether a valuation allowance is required include (from least to most subjective):

Least subjective	One	Taxable income in prior carryback years, if carryback is permitted under the tax law
	Two	Future reversals of existing taxable temporary differences
	Three	Tax-planning strategies
Most subjective	Four	Future taxable income exclusive of reversing temporary differences and carryforwards

ASC 740-10-30-17 requires an assessment of all available evidence, both positive and negative, to determine the amount of any required valuation allowance. In general terms, positive evidence refers to factors affecting the predictability of one or more of the four sources of taxable income described above, including qualitative information about those sources, particularly future taxable income. For example, what has been the company's experience with respect to achieving its forecasted results over various periods?

If a single source of taxable income (e.g., future reversal of existing taxable temporary differences) is sufficient to support a conclusion that a valuation allowance is not necessary, other sources do not need to be considered. If that is not the case, before determining whether a valuation allowance is necessary, consideration of each source of taxable income is required. For example, if a company has existing taxable temporary differences greater than its deductible temporary differences and loss carryforwards, and the general reversal patterns are such that offset would be expected under the tax law, there is no need to consider other sources of taxable income in concluding that a valuation allowance is not necessary. Alternatively, if taxable income from carryback and reversal of existing taxable temporary differences is insufficient in eliminating the need for a valuation allowance, tax-planning strategies and future taxable income must be considered. A company cannot choose to simply ignore one or more of its available sources of taxable income in assessing the need for a valuation allowance.

In determining the need for a valuation allowance, we believe a company should consider the four sources of taxable income in order of least subjective to most subjective. That order is: carrybacks, reversals of existing temporary differences, tax-planning strategies and, lastly, future taxable income exclusive of reversals of existing temporary differences. In that way, subjective assumptions about future taxable income will be necessary only if the more objectively determinable sources of taxable income are inadequate to reduce the potential balance in the valuation allowance to zero. However, in cases where deferred tax assets are significant (e.g., a company with few taxable temporary differences and limited carryback ability), future taxable income will need to be considered. In such cases, forecasts, projections or other types of forward-looking analyses might be required.

6.2.1 Appropriate character of taxable income

The future realization of deferred tax assets ultimately depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period under the tax law. The character of taxable income addresses the nature of the taxable income, such as tax jurisdiction, ordinary income, capital gains or losses, or operations of an entity that is not included in a company's consolidated income tax return. For example, if a company has substantial capital loss carryforwards, those losses may be available to offset only capital gains rather than ordinary taxable income. Another example is acquired net operating loss carryforwards subject to subsidiary loss limitation rules (i.e., acquired net operating losses may be restricted so as to only offset ordinary taxable income generated by the entity that created the losses). In these cases, although a company may have positive taxable income on a consolidated basis, it may be more likely than not that one or more of its deferred tax assets will not be realized due to the lack of taxable income of the appropriate character.

The respective tax law also governs whether future reversals of taxable temporary differences will generate appropriate forms of taxable income for a company to use the benefit generated by the future reversals of deductible temporary differences. For example, the tax law determines whether capital gains or losses may offset ordinary income or losses. If capital losses are deductible only to the extent of capital gains, a tax benefit is not recognized without a corresponding valuation allowance for temporary differences that will result in capital losses unless those deductions will offset (1) other existing temporary differences that will result in future capital gains, (2) capital gains that are expected to occur in future years, or (3) capital gains of the current year or prior years if carryback (of those capital loss deductions from the future reversal years) is expected.

6.2.2 Liabilities for uncertain tax positions as a source of taxable income

The guidance for accounting for uncertainty in income taxes in ASC 740 applies to all tax positions related to income taxes subject to ASC 740. After evaluating the uncertain tax position, a company may determine that it has a liability (the difference between the amount of the as-filed tax position and the amount meeting the recognition criteria that is more likely than not of being sustained) (see chapter 19, *Accounting for uncertainty in income taxes*). These liabilities for uncertain tax positions should be considered a "source of taxable income" for purposes of assessing the realizability of a deferred tax asset. Consistent with all sources of taxable income, the character and timing of the taxable income should be carefully considered.

6.3 Source one — taxable income in prior carryback years

Source one	Source two	Source three	Source four
Taxable income in prior carryback years, if carryback is permitted under the tax law	Future reversals of existing taxable temporary differences	Tax-planning strategies	Future taxable income exclusive of reversing temporary differences and carryforwards

In some tax jurisdictions, current year losses (and potentially other tax credits arising in the current year) may be carried back for refund of taxes paid in prior years. In addition, when an entity is in a net operating loss position and/or has taxable deductible temporary differences that are expected to result in future taxable losses upon their reversal, the entity should consider whether the tax benefit from such amounts could be carried back to offset taxable income in prior years when determining the need for a valuation allowance.

For US net operating losses created in taxable years beginning after 31 December 2020, the tax law prohibits the carryback of these losses to offset taxable income in prior years at the US federal income tax level.[21] However, other jurisdictions allow companies to carryback operating losses to offset taxable income in prior years. A company should understand the carryback rules for each tax jurisdiction it operates in to determine whether carryback rules provide a source of taxable income when evaluating the realizability of deferred tax assets.

Illustration 6-1: Operating loss and tax credit carrybacks — Valuation allowance no longer required

20X1 Facts

- An entity generates deductible temporary differences of $300, expected to reverse in 20X3.
- After considering all four sources of taxable income, the entity does not believe the deductible temporary differences are realizable, and a valuation allowance is properly recognized as of 31 December 20X1.

20X2 Facts

- At the end of 20X2, the $300 deductible temporary differences remain unchanged.
- The entity generates taxable income of $500 during the 20X2 year.

Other relevant facts

- No taxable temporary differences exist in any of the relevant periods.
- Carryback of operating losses is permitted in the jurisdiction and carryback period is one year.
- The entity does not expect taxable income exclusive of reversing temporary differences in future years[a] and has no tax planning strategies.

Analysis

At 31 December 20X2, the entity reassesses the previously recorded valuation allowance related to the deductible temporary differences.

Based on the carryback provision of the tax law, the $300 loss that will be generated in 20X3 from the reversal of existing deductible temporary differences are available to be carried back to taxable income in 20X2. Based on the facts, the entity determined that taxable income of $500 in 20X2 allows for realization of the deductible temporary differences that will reverse in 20X3. Therefore, the benefit of the deductible temporary difference (i.e., a reversal of the valuation allowance) of $300 is recognized in 20X2.

In making this assessment, the reversal pattern of temporary differences must be considered together with the statutory tax rules regarding loss carrybacks. In more complicated scenarios, this analysis would require extensive scheduling, including consideration of related carryforward and carryback periods.

(a) While the entity may currently expect that they will generate losses in future years exclusive of the reversal of existing temporary differences, considering those losses is prohibited (ASC 740-10-25-38).

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[21] The CARES Act allows corporate taxpayers to carry back NOLs arising in tax years beginning after 31 December 2017 and before 1 January 2021 (e.g., calendar-year companies can carry back NOLs arising in 2018, 2019 and 2020) and use them to offset taxable income in each of the five years preceding the tax year when the loss was generated.

Illustration 6-2: Operating loss and tax credit carrybacks — Valuation allowance is required

Facts

- A company in a loss position has a deductible temporary difference of $500 at 31 December 20X3.
- There are no other temporary differences.
- The taxable loss for 20X3 was carried back and a receivable recognized (i.e., current recoverable taxes), leaving the following amounts of taxable income in carryback years available (a two-year carryback period (current year and prior year) is allowed under the tax law):

20X0	$ 400
20X1	800
20X2	200

- The entire $500 deductible temporary difference is expected to reverse in 20X4.

Analysis

Only $200 of the carryback potential can be considered as a source of taxable income for purposes of determining the need for a valuation allowance (i.e., when it reverses in 20X4, the deductible temporary difference could be carried back no further than 20X2). In the absence of appropriate other positive evidence, a valuation allowance would be established at 31 December 20X3 for $300 of the deductible temporary difference ($90 assuming a 30% tax rate).

This determination also should be made by taxing jurisdiction (and tax-paying component) because the loss carryback rules vary among tax jurisdictions. For example, many states in the US and US federal tax law following the TCJA do not allow the carryback of operating losses and allow such losses only to be carried forward. In addition, the character of the loss (i.e., capital loss or ordinary loss) must be considered in determining the carryback benefit.

If a company plans to realize a deferred tax asset (i.e., NOL or tax credit) through carryback, it would be measured using the tax law and rates for the year to which the benefit is expected to be carried back, presuming the refund would be based on the prior year tax rate.

6.3.1 Availability of tax credits

The future reversal of deductible temporary differences that can be carried back to prior years may result in the re-creation of previously utilized tax credits. For example, if previously used tax credits become available as a result of a loss carryback and those tax credits would expire unused after application of the loss carryback, a valuation allowance may be necessary for the deferred tax assets relating to the deductible temporary differences equal to the amount of re-created tax credits that will require a valuation allowance. In other words, although the carryback of the current period deductible temporary difference would result in the realization of those deferred tax assets, the previously realized tax credits would no longer be realizable. This situation results in the same tax position as deeming it to be more likely than not that all or a portion of the current period deductible temporary differences will not be realized and recognizing a valuation allowance in the current period on those deferred tax assets. See section 6.4.2, *Tax benefit substitution versus realization*, for a related discussion.

6.4 Source two — future reversals of existing taxable temporary differences

Source one	Source two	Source three	Source four
Taxable income in prior carryback years, if carryback is permitted under the tax law	Future reversals of existing taxable temporary differences	Tax-planning strategies	Future taxable income exclusive of reversing temporary differences and carryforwards

Existing taxable temporary differences should be evaluated to determine whether they are a source of future taxable income that supports the realization of existing deductible temporary differences and carryforwards.

Determining the reversal patterns of temporary differences, if the company needs to do so, will require the use of estimates and judgment (refer to section 4.3, *Scheduling the reversal of temporary differences*, for additional information on determining the reversal of existing temporary differences).

While ASC 740 does not require the scheduling of the reversals of existing temporary differences, the extent of scheduling will depend on each company's circumstances — mainly, its tax position, its expectations of future profitability, the nature of its temporary differences and carryforwards, and predictability of reversal patterns.

Scheduling of the appropriate reversal pattern may be necessary when the timing of the reversal of existing temporary differences materially affects the determination of the need for a valuation allowance or affects the enacted tax rate applied to deferred tax balances (see section 5.1.1, *Average graduated tax rates*, for additional discussion of when a detailed analysis of the net reversals of temporary differences may be necessary when measuring deferred tax balances). In such instances, a company's judgment about the need for a valuation allowance or the application of the appropriate enacted tax rate to deferred tax balances is supported by the reversal pattern of existing temporary differences. For example, we sometimes find that a scheduling exercise is necessary when a company evaluates whether the future reversal of existing taxable and deductible temporary differences will result in the realization of the entity's deferred tax assets, including when there is taxable income in prior carryback year(s), assuming carryback is permitted under the tax law. Refer to section 6.6.4, *Weighing evidence when evaluating operating loss and tax credit carryforwards*, for additional discussion. When scheduling the reversal of temporary differences, it is important to consider carryforward and carryback periods available under tax law.

Most consistently profitable operating companies will be able to avoid extensive scheduling efforts. Those companies first would determine the nature of their temporary differences and carryforwards and whether a valuation allowance might be required. If sufficient taxable income to offset deductible temporary differences and carryforwards is expected in the future (exclusive of reversals of existing temporary differences and carryforwards), further consideration of the pattern and timing of the reversals of temporary differences generally will not be necessary (ASC 740-10-30-18). In other cases, the consideration of tax-planning strategies might alter the timing of reversal of the temporary differences and mitigate the need for detailed scheduling (e.g., tax planning readily available to extend the reversal of deferred tax assets such that the period before expiration is long enough that extensive scheduling is not required).

See section 6.3, *Source one — taxable income in prior carryback years*, for US federal carryback rules. The illustrations below contemplate tax laws that permit carrybacks. A company will need to understand whether taxable income can be carried back to prior years based on each tax jurisdiction's rules.

Illustration 6-3: Scheduling of reversal pattern for existing temporary differences

Facts

- A company has the following temporary differences:
  - $10 million in deductible temporary differences related to a warranty program providing coverage for three years
  - $20 million in taxable temporary differences related to depreciation on equipment acquired 10 years ago.
- In the jurisdiction in which the company operates, the following rules apply:
  - Losses in any year may be carried back two years.
  - NOLs can be carried forward for 20 years.

Analysis

If available positive evidence indicates sufficient taxable income is expected in the future, the deferred tax benefits related to the warranty accrual could be realized by offsetting taxable income in the future. Even if sufficient taxable income is not expected in the future and the benefits of the deductible temporary differences could not be realized by carryback, the taxable temporary differences related to equipment would most likely reverse within the 20-year carryforward period that would start when the deductible temporary differences reverse. That would enable recognition of the deferred tax benefits by offsetting the effects of the taxable temporary differences related to depreciation with the deductible temporary differences related to the warranty program.

Alternatively, if some of the taxable temporary differences will reverse after the 20-year carryforward period, the deductible temporary differences would not be completely offset by those taxable temporary differences. The company would then determine whether tax-planning strategies could be employed to delay reversal of the deductible temporary differences or accelerate reversal of the taxable temporary differences.

Illustration 6-4: Scheduling of reversal pattern for existing temporary differences

Facts

Losses in any year may be carried back two years under the tax law. If a loss carryback is not permitted under the tax law, the scheduling exercise and related evaluation of realizability would be altered.

- At 31 December 20X1, an entity has deductible temporary differences of $1,000 and taxable temporary differences of $700.
  - These temporary differences are ordinary in nature (no capital gains or losses).
  - The deductible temporary differences are expected to reverse over the next five years while the taxable temporary differences are expected to reverse over four years starting in 20X3 (see table below).
- The entity did not have any taxable income in 20X1 exclusive of reversing temporary differences (i.e., it broke even).

Analysis

In determining the realizability of deductible temporary differences, the entity considers the four sources of taxable income (as discussed in section 6.2, *Sources of taxable income*) in order of least subjective to most subjective.

Step 1: Identify existing temporary differences

	Balance as of 12/31/20X1	Expected period of reversal				
		20X2	20X3	20X4	20X5	20X6
Deductible temporary differences	$ (1,000)	$ (200)	$ (200)	$ (200)	$ (200)	$ (200)
Taxable temporary differences	700	–	300	250	100	50

Step 2: Identify taxable income in carryback years (source one)

Assume the entity had taxable income of $200 in 20X0 and, on the date of the evaluation, the carryback period under the tax law for losses occurring in 20X2 is two years. The entity anticipates $200 of deductible temporary differences reversing in 20X2 and schedules the taxable income based on carryback as follows, concluding this amount is more likely than not to be realized:

	20X0	20X1	20X2
Taxable income from 20X0	$ 200	$ –	$ –
Carryback 20X2 to 20X0	(200)	–	200

Step 3: Identify future reversal of existing taxable temporary differences (source two)

After consideration of taxable income in prior carryback years, the entity has $800 of deductible temporary differences remaining to evaluate for realizability. The entity then schedules the reversal of temporary differences. Once the reversals are scheduled, the entity will have to also consider the applicable carryback and carryforward provisions of the tax jurisdiction. As a result, scheduling expected taxable income could be an iterative process:

	20X2	20X3	20X4	20X5	20X6
Deductible temporary differences (after consideration of carryback in Step 2)	$ –	$ (200)	$ (200)	$ (200)	$ (200)
Taxable temporary differences	–	300	250	100	50
Remaining taxable (deductible) temporary differences	–	100	50	(100)	(150)

The reversal of taxable temporary differences creates the following carryback potential:

	20X2	20X3	20X4	20X5	20X6
Carryback 20X5 to 20X3	–	(100)	–	100	–
Carryback 20X6 to 20X4	–	–	(50)	–	50
Remaining deductible temporary differences after carryback	$ –	$ –	$ –	$ –	$ (100)

Based on the steps performed to schedule sources of taxable income above, $100 of deductible temporary differences is not realizable from the reversal of existing taxable temporary differences or taxable income in carryback years. The entity would need to evaluate the realizability of the remaining $100 deductible temporary differences by considering its projected future taxable income. The entity could also consider the tax-planning strategies, being careful to differentiate tax-planning strategies from its projected future taxable income.

6.4.1 Considerations when NOL carryforwards do not expire or when tax law limits the use of NOL carryforwards

Several jurisdictions, including the US federal government, have enacted tax laws that limit utilization of NOL carryforwards. While the application of the limitation varies by jurisdiction, the tax laws are often designed and intended to limit an entity's ability to use NOL carryforwards. In determining the applicable limitations on NOL carrybacks and NOL carryforwards, it is critical to determine the taxable year in which the NOL is generated.

In the US, NOLs generated in taxable years beginning before 1 January 2018 may be carried forward for up to 20 years and may offset 100% of the taxpayer's taxable income. For NOLs generated in taxable years beginning after 31 December 2017 and beginning before 1 January 2021 ("TCJA/CARES Act losses"), the NOL may be carried back five years and carried forward indefinitely. For the TCJA/CARES Act losses, the NOL carryforward is not subject to any taxable income limitations if utilized in a year beginning before 1 January 2021 and is subject to 80% of the taxpayer's taxable income if utilized in a year beginning after 31 December 2020.

Because US tax laws require taxpayers to use their earliest NOLs generated first, entities with US NOLs generated in taxable years beginning prior to 1 January 2018 should analyze and schedule the expected usage of those NOLs separately from NOLs generated after that date.

It is not appropriate to assume that NOL carryforwards will ultimately be realized simply because the carryforward does not expire. Therefore, an evaluation of their realizability is still required (see section 6.1.2, *Carryforwards and other tax attributes that do not expire*, for further discussion on carryforwards that do not expire). Companies that cannot rely on projections of future taxable income (e.g., in a three-year cumulative loss) and rely on the reversal of taxable temporary differences as a source of future taxable income should carefully consider the reversal pattern of temporary differences and the applicable NOL limitation rules when evaluating the realizability of deferred tax assets. A company may need to schedule the reversal of its temporary differences when performing this evaluation.

When assessing the realizability of loss carryforwards that do not expire, we believe it is appropriate for an entity to consider the reversal of a taxable temporary difference from an indefinite-lived intangible asset as a source of future taxable income when the loss carryforward is in the same jurisdiction and of the same taxable income character. We also believe it is appropriate to consider the reversal of taxable temporary differences related to indefinite-lived intangible assets when assessing the realizability of deferred tax assets that upon reversal would give rise to NOLs that do not expire (i.e., NOLs that can be carried forward indefinitely). However, we understand that under an alternative view it would not be appropriate to consider the future reversal of a taxable temporary difference associated with indefinite-lived assets (including tax-deductible goodwill) as the timing of recognition of the necessary taxable income cannot be predicted. We do not object to either view as long as it is applied on a consistent basis.

For a company with NOL carryforwards that expire, we believe it is not appropriate to consider the reversal of taxable temporary differences related to indefinite-lived intangible assets when evaluating the realizability of those NOLs. While such taxable temporary differences would reverse on impairment or sale of the related assets, those events are not anticipated under ASC 740 for purposes of predicting the reversal of the related taxable temporary difference. That is, a company cannot predict that the reversal of a taxable temporary difference related to an indefinite-lived intangible asset (including tax-deductible goodwill) would occur before the expiration of those NOLs. See section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*, for additional discussion.

Illustration 6-5: Assessing the realizability of deductible temporary differences that will reverse and generate NOLs with an indefinite carryforward

Facts

Assume the following facts:

- At 31 December 20X1, Company MHP has deductible temporary differences of $500 and taxable temporary differences of $700.
  - These temporary differences are ordinary in nature (no capital gains or losses) and are in the same jurisdiction.
  - The deductible temporary differences are expected to reverse over the next two years and will generate NOLs with an indefinite carryforward period.
  - The taxable temporary differences relate to indefinite-lived intangible assets.
- Company MHP is projecting that it will break even in 20X2 and 20X3 and have no pretax book income in the related jurisdiction.
- Loss carryback is prohibited.

Analysis

		Expected period of reversal	
	Balance as of 31 December 20X1	20X2	20X3
Deductible temporary differences	$ 500	$ (250)	$ (250)
Taxable temporary differences (related to indefinite-lived intangible assets)	(700)	-	-
		$ (250)	$ (250)

In determining the realizability of the deductible temporary differences, Company MHP may consider the $700 of taxable temporary differences related to the indefinite-lived intangible assets that currently exist, subject to the limits on using NOLs discussed below.

Companies need to consider that the usage of NOLs generated in the example is limited to 80% of annual taxable income[a] when performing this analysis. For example, when the taxable temporary difference reverses in the future, the NOLs could offset up to 80% of that year's taxable income. Therefore, if the $700 of taxable temporary differences related to indefinite-lived intangible assets reverses in the future and is the only source of taxable income in that year, Company MHP could use the NOL carryforwards up to $560 in that year (80% of $700). Because the expected future taxable income of $560 is greater than the $500 of deductible temporary differences, Company MHP may be able to conclude that those deductible temporary differences are realizable at 31 December 20X1.

[a] Currently, under US federal NOL carryforward rules, the use of TCJA/CARES Act NOLs is limited to 80% of taxable income in tax years beginning after 31 December 2020.

Illustration 6-6: Limits on usage of NOLs

Facts

Assume the following facts:

- At 31 December 20X1, Company A has $1,200 of deductible temporary differences and $1,200 of taxable temporary differences.
  - These temporary differences are ordinary in nature (no capital gains or losses).
  - The deductible and taxable temporary differences are expected to reverse over the next three and four years, respectively, starting in 20X2.
  - When the differences reverse, a portion of the deductible temporary differences will create NOLs with an indefinite carryforward but the usage of these NOLs is limited to 80% of the taxpayer's taxable income. All Company A's NOLs are subject to an 80% limitation.
- Loss carrybacks are prohibited.
- For each year presented, the company breaks even and has no pretax book income, the company cannot rely on its projections of taxable income and there are no available tax planning strategies.

Analysis

Company A assesses the realizability of its deductible temporary differences as of 31 December 20X1, and schedules the reversal of its existing taxable temporary differences as follows:

	Balance at 31 December 20X1	20X2	20X3	20X4	20X5
Deductible temporary differences	$ 1,200	$ (400)	$ (400)	$ (400)	$ 0
Taxable temporary differences	(1,200)	300	300	300	300
Taxable income (loss)		$ (100)	$ (100)	$ (100)	$ 300
NOL used subject to limit of 80% of current year taxable income[a]		N/A	N/A	N/A	240
NOL carryforward generated		(100)	(100)	(100)	-
Cumulative NOL carryforward		(100)	(200)	(300)	(60)

In 20X5, Company A uses a portion of its NOL carryforwards that is limited to 80% of that year's taxable income, or $240. Based on this analysis, even though Company A has $1,200 of taxable temporary differences at 31 December 20X1, it can consider only $1,140 ($300 in each year from 20X2 to 20X4 and $240 in 20X5) of the taxable temporary differences as a source of future taxable income when assessing the realizability of its deductible temporary differences. Assuming Company A had no other available sources of future taxable income, including the ability to rely on projections of future taxable income, it records a valuation allowance of $13 ($60 x 21% tax rate).

[a] Currently, under US federal NOL carryforward rules, the use of TCJA/CARES Act NOLs is limited to 80% of taxable income in tax years beginning after 31 December 2020.

While the discussion above is focused on US federal NOLs, this guidance should be considered when evaluating the realizability of deferred tax assets and carryforwards in other jurisdictions with NOLs that do not expire.

6.4.1.1 Considerations when a tax law change limits the usage of NOL carryforwards

When a change in tax law limits or further limits an entity's ability to use existing NOLs, an entity may need to change its judgment about the realization of a deferred tax asset that was previously assumed to be realizable. An entity that previously relied on the reversal of existing taxable temporary differences may need to further evaluate the timing of reversal patterns or look to other sources of taxable income (e.g., projections, tax planning strategies).

For example, before a law change, an entity may have relied on a future reversal of existing taxable temporary differences of equal or greater amount as a source of taxable income to realize a DTA for a net operating loss carryforward. However, a limitation on the amount of taxable income that can be offset with net operating loss carryforwards may cause an entity to not be able to realize the full amount of the deferred tax asset despite sufficient taxable temporary differences in the carryforward period. The effects of changes in tax laws and rates on deferred tax balances (including a related reevaluation of valuation allowance on deferred tax assets) are included in income from continuing operations for the period that includes the enactment date. See section 8.1, *Changes in tax laws and rates*, for further discussion on when to recognize the tax effects related to new tax legislation.

Illustration 6-7: Enactment of a tax law that limits the use of NOL carryforwards

Facts

- A Hungarian subsidiary has a deferred tax asset related to a net operating loss of $500 and a deferred tax liability of $700 at 20X0.
- The Hungarian subsidiary previously concluded that a valuation allowance was not required on the deferred tax asset relying solely on future taxable income from the anticipated reversal of the deferred tax liability during the carryforward period. In 20X1, Hungary enacted a tax law change that limits the amount of taxable income that can be offset with net operating loss carryforwards to 50% of taxable income for any particular year.
- Before the change in tax law, only one source of taxable income was necessary to determine that a valuation allowance was not necessary.

Analysis

Upon the enactment of the limitation on the use of net operating losses in a particular year, the entity must consider the limitation on the use of the NOL in its determination of whether a valuation allowance is necessary. The Hungarian subsidiary should consider the amount of taxable income (from all four sources of taxable income subject to the limitations of relying on such sources under ASC 740) that is expected in each period of the carryforward. To the extent that the net operating loss carryforward is not expected to be used due to the newly enacted limitation, and after consideration of all four sources of taxable income, the change in the valuation allowance is included in income from continuing operations in the period including the enactment date.

Illustration 6-8: Enactment of a tax law that limits the use of NOL carryforwards

Facts

- Assume similar facts as those in Illustration 6-7 except the Hungarian subsidiary has a net operating loss deferred tax asset of $500 and a deferred tax liability of $400 before the change in tax law.
- Assuming there are no other sources of taxable income, the Hungarian subsidiary would have previously recorded a valuation allowance of $100 ($500 deferred tax asset less $400 of expected reversal of the deferred tax liability in the carryfoward period).
- After the change in tax law, the subsidiary believes that the net operating losses are further limited such that only $200 of the deferred tax liability are expected to be a source of taxable income.

Analysis

Assuming no other sources of taxable income, the Hungarian subsidiary would increase its existing $100 valuation allowance by $200 ($300 valuation allowance in total). The $200 increase in valuation allowance would be recorded in continuing operations in the period including the enactment date. This may result in the deferred tax liabilities exceeding the deferred tax assets on a gross basis.

6.4.2 Tax benefit substitution versus realization

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-37

An operating loss or tax credit carryforward from a prior year (for which the deferred tax asset was offset by a valuation allowance) may sometimes reduce taxable income and taxes payable that are attributable to certain revenues or gains that the tax law requires be included in taxable income for the year that cash is received. For financial reporting, however, there may have been no revenue or gain and a liability is recognized for the cash received. Future sacrifices to settle the liability will result in deductible amounts in future years. Under those circumstances, the reduction in taxable income and taxes payable from utilization of the operating loss or tax credit carryforward gives no cause for recognition of a tax benefit because, in effect, the operating loss or tax credit carryforward has been replaced by temporary differences that will result in deductible amounts when a nontax liability is settled in future years. The requirements for recognition of a tax benefit for deductible temporary differences and for operating loss carryforwards are the same, and the manner of reporting the eventual tax benefit recognized (that is, in income or as required by paragraph 740-20-45-3) is not affected by the intervening transaction reported for tax purposes. Example 20 (see paragraph 740-10-55-156) illustrates recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years when a valuation allowance is necessary in the loss year.

An operating loss or tax credit carryforward from a prior year (for which the related deferred tax asset was reduced by a valuation allowance) may sometimes reduce taxable income and taxes payable that are attributable to revenues that are taxable in the year received but deferred for financial reporting purposes. For example, the taxable gain from a sale-leaseback transaction that in certain tax jurisdictions is recognized currently for income tax purposes while deferred and amortized for financial reporting purposes under the guidance in ASC 840 or is not recognized at all for financial reporting purposes when considered a failed sale and lease-back after the adoption of ASC 842. A failed sale after the adoption of ASC 842 is accounted for by the seller-lessee as a financing for financial reporting purposes. See section 7.4, *Transactions in which the transfer of an asset is not a sale*, of our FRD, ***Lease accounting: Accounting Standards Codification 842, Leases***, for additional information.

In this case, the taxable gain recognized for income tax reporting purposes would result in a deductible temporary difference (i.e., rent expense that will be incurred in the future under ASC 840 or debt service under a failed sale and lease-back after the adoption of ASC 842). The reduction in taxable income and taxes payable from using the operating loss or tax credit carryforward would not result in the recognition of a tax benefit because, in essence, the operating loss or tax credit carryforward has been replaced by a deductible temporary difference. This is commonly referred to as substitution, because the recognition requirements are the same for both deductible temporary differences and operating loss carryforwards.

In other words, simply converting net operating loss carryforwards into a deferred tax asset is not the realization of that asset. In the example of a tax-planning strategy to sell and lease back an asset to accelerate taxable temporary difference reversals to use an operating loss carryforward that would otherwise expire, it is important to remember that such a strategy does not result in the recognition of a tax benefit because the operating loss carryforward is essentially replaced by a deductible temporary difference (related to the deferred gain on the sale-leaseback transaction that is accounted for under ASC 840 or the financing obligation on a failed sale and leaseback accounted for under ASC 842) that also would have to be assessed for realizability. ASC 740-10-55-37 states the manner of reporting the eventual tax benefit recognized is not affected by intervening transactions reported for tax purposes.

The above discussion of the interaction of operating losses and deductible temporary differences also should be considered when evaluating the effectiveness of tax-planning strategies (e.g., a sale-leaseback transaction that is accounted for under ASC 840 or a failed sale under ASC 842). As illustrated by the example that follows, a sale-leaseback transaction that is accounted for under ASC 840 (or a failed sale under ASC 842) could be used to "freshen" an operating loss that would otherwise have expired unused by converting the operating loss to future deductible temporary differences. Recognition of the deferred tax asset related to the deductible temporary difference (i.e., the taxable gain from the sale-leaseback transaction that is accounted for under ASC 840 or the financing obligation for a failed sale-leaseback under ASC 842) would be evaluated like any other deductible temporary difference. In this regard, the freshening of the net operating loss carryforward coupled with other tax-planning strategies or prospects as to future taxable income may, in certain cases, permit the reduction of the deferred tax asset valuation allowance.

The following example, from ASC 740-10-55-156 through ASC 740-10-55-158, illustrates the interaction of operating loss carryforwards and deductible temporary differences that will result in net deductible amounts in future years.

Illustration 6-9: Interaction of operating loss carryforward and deductible temporary differences that will result in net deductible amounts in future years

Facts

Assume a company's pretax loss for financial reporting purposes and the loss reported on its tax return are the same in years 1 and 2, but the loss for tax purposes in year 2 includes a gain of $2,500 from a transaction that is a sale for tax purposes but does not meet the sale recognition criteria for financial reporting purposes.

Analysis

		Financial income	Taxable income
Year 1:	Income (loss) from operations	$(4,000)	$(4,000)
Year 2:	Income (loss) from operations	$ –	$ –
	Taxable gain on sale		2,500
	Taxable income before loss carryforward		2,500
	Partial utilization of loss carryforward from year 1[a]		(2,500)
	Taxable income		$ –

The $4,000 operating loss carryforward at the end of year 1 is reduced to $1,500 at the end of year 2 because $2,500 of it is used to reduce taxable income. The $2,500 reduction in the loss carryforward becomes $2,500 of deductible temporary differences that will reverse and result in future tax deductions when the sale occurs (i.e., control of the asset transfers to the buyer-lessor). The entity has no deferred tax liability to be offset by those future tax deductions, the future tax deductions cannot be realized by loss carryback because no taxes have been paid, and the entity has had pretax losses for financial reporting since inception.

Unless positive evidence exists that is sufficient to overcome the negative evidence associated with those losses, a valuation allowance is recognized at the end of year 2 for the full amount of the deferred tax asset related to the $2,500 of deductible temporary differences and the remaining $1,500 of operating loss carryforward.

[a] Under US federal NOL carryforward rules, the use of NOLs is limited to 80% of taxable income in tax years beginning after 31 December 2020. Therefore, if this example were in the US federal tax jurisdiction in year 2021, the use of loss carryforwards from year 1 would be limited to $2,000 ($2,500 x 80%).

6.4.3 Consideration of the limits of interest expense deduction

US federal tax law limits the deduction for net interest expense that exceeds 30% of the taxpayer's adjusted taxable income (ATI) for that year.[22]

ATI currently is computed excluding depreciation, amortization or depletion (approximating earnings before interest, taxes, depreciation and amortization) and includes these items beginning in 2022 (approximating earnings before interest and taxes). Additionally, US federal tax law permits an indefinite carryforward of any disallowed business interest. This provision provides exceptions to the interest limitation for companies with gross receipts not exceeding $25 million.

Companies with interest limited under the law need to assess the realizability of any resulting deferred tax assets for interest carried forward. A company whose interest deduction is limited may not be able to realize the benefits of amounts carried forward. This is because the annual limitation on deductions for interest expense will also apply in future years, and it applies not only to the interest expense incurred in those future years but also to the utilization of any amounts carried forward.

While the resulting deferred tax asset for disallowed business interest deduction can be carried forward indefinitely, a company may be prevented from considering the full amount of the taxable income from the reversal of an indefinite-lived intangible asset (or the reversal of other taxable temporary differences) as a source of future taxable income when assessing the realizability of interest carryforwards due to the limitation on the amount of net interest a company can deduct in an annual period. For example, if a company recorded a $1,000 deferred tax asset related to interest carryforwards and a $2,000 deferred tax liability related to an indefinite-lived intangible asset, because of the taxable income limitation on the deduction of interest, the company could only consider $600 ($2,000 x 30%) as a source of future taxable income from the reversal of the deferred tax liability. The effect would be similar to the NOL limitation discussed above. See section 6.4.1, *Considerations when NOL carryforwards do not expire or when tax law limits the use of NOL carryforwards*, for further discussion on using the reversal of an indefinite-lived intangible asset as a source of future income.

[22] The CARES Act temporarily changes this interest deduction limitation from 30% to 50% of a taxpayer's ATI for tax years that begin in 2019 and 2020. Additionally, for 2020, the CARES Act provides taxpayers with the option to use their 2019 ATI to calculate their interest deduction limitation instead of their 2020 ATI.

In addition, if a company is relying on projections of future taxable income, it will also need to consider the effects of the limitations in its projections of future taxable income, including any projections of future interest expense, as it does for other originating temporary differences.

6.4.3.1 Consideration of tax law ordering rules when interest deductions are limited

Under US federal tax law ordering rules, an entity is required to deduct interest expense incurred in the current year before it can use an interest deduction that was disallowed in a previous year and carried forward. Questions often arise whether the ordering rules affect a company's evaluation of the realizability of its deferred tax assets related to disallowed interest deductions.

For example, assume a company determines, based on its projections of future taxable income (source four), that it will continue to generate interest deductions that will be disallowed for the foreseeable future. As a result, the company does not expect to be able to use its existing disallowed interest deduction carryforwards because of the tax law ordering rules. However, the company also determines that the reversal of existing taxable temporary differences (source two) will generate sufficient future taxable income (after considering any limitations) to realize its existing deferred tax assets, including those related to disallowed interest deductions.

Because of the tax law ordering rules, we have received questions as to whether a company must consider the future taxable income projections (source four), including future expected interest deductions, even when the company concludes it has sufficient future taxable income from the reversal of its existing taxable temporary differences (source two) to support the realization of its deferred tax assets related to its current disallowed interest deduction carryovers. We believe that if the reversal of existing taxable temporary differences (source two) provides enough evidence to support the realizability of its existing deferred tax assets related to disallowed interest deductions, a company does not need to consider other sources of taxable income. We base this belief on ASC 740-10-30-18, which states that, if evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered.

However, if the reversal of taxable temporary differences does not provide sufficient future taxable income to support the realization of these deferred tax assets, other sources of taxable income, such as tax planning strategies and projections of future taxable income, would need to be considered. If all or a part of projected future taxable income relates to the future origination of deductible temporary differences (e.g., disallowed interest deductions under section 163(j)), the entity will need consider whether the projected future taxable income will result in the realization of existing deferred tax assets or whether the originating DTAs would just be replacing the existing DTAs (i.e., substitution). For example, this distinction may be necessary when a company is projecting that it will be near breakeven or incur book losses in future years but is projecting taxable income because of the future originating deductible temporary differences. In this case, when assessing whether the NOL carryforwards are realizable based on its projection of future taxable income, it will need to consider the fact that the future utilization of existing NOLs would result from substituting the new DTAs for the existing NOLs and, therefore, would not result in the recognition of a tax benefit. See section 6.4.2 for additional discussion on substitution.

6.4.4 Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income

In order to be a source of future taxable income to support realizability of a deferred tax asset, a taxable temporary difference must reverse in a period such that it would result in the realization of the deferred tax asset (e.g., before a loss carryforward expires). Taxable temporary differences related to indefinite-lived assets, such as intangibles, land and tax-deductible goodwill (related to goodwill that is not amortized for book purposes, discussed further below) are problematic in this regard because, by their nature, they are not predicted to reverse (commonly referred to as naked credits).

While such temporary differences would reverse if the related assets were impaired or sold, those events are not anticipated under ASC 740 for purposes of predicting the reversal of the related taxable temporary difference. That is, predicting the reversal of a temporary difference related to an indefinite-lived intangible asset, land and tax-deductible goodwill for tax accounting purposes would be inconsistent with the financial reporting assertion that the asset is indefinite-lived. As a result, the reversal of taxable temporary differences with respect to indefinite-lived assets, land and goodwill should not be considered a source of future taxable income in accordance with ASC 740.

However, there are possible exceptions to this general rule, as described in the sections below.

Tax loss carryforwards that do not expire

While tax loss carryforwards do not expire in some jurisdictions, a deferred tax asset is not realizable (in accordance with ASC 740) simply because it can be carried forward indefinitely. Instead, the deferred tax asset or NOL that does not expire is realizable only if it can be sustained through the existence of sufficient taxable income of the appropriate character in the carryback or carryforward period available under the tax law (i.e., the four sources of taxable income).

Questions often arise about whether a deferred tax liability related to an indefinite-lived intangible asset (including tax-deductible goodwill) may be used as a source of income to realize a deferred tax asset relating to a loss carryforward that does not expire. We believe it is appropriate for a company to consider the reversal of a taxable temporary difference from an indefinite-lived intangible asset as a source of future taxable income when assessing the realizability of loss carryforwards that do not expire when they are in the same tax-paying component and jurisdiction and of the same character. We understand that an alternative view exists that it would not be appropriate to consider the future reversal of a taxable temporary difference associated with an indefinite-lived intangible asset (including tax-deductible goodwill) because the timing of recognition of the necessary taxable income cannot be predicted. We do not object to either view as long as it is applied on a consistent basis. See section 6.4.1, *Considerations when NOL carryforwards do not expire or when tax law limits the use of NOL carryforwards*, for additional discussion on NOLs that do not expire.

Held for sale

When an indefinite-lived asset, such as an intangible asset or goodwill, is included in an asset group that is classified as held for sale (in accordance with ASC 360), we believe the reversal of any related temporary difference may be scheduled to coincide with the expected disposal date and looked to as a source of future taxable income in that period, as appropriate. We believe this exception to the limitation noted above is appropriate because, while the assets still qualify as indefinite-lived (intangibles and goodwill), the inclusion in a held-for-sale asset group means the group as a whole has satisfied all of the held-for-sale criteria, including the requirement that the sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify as a completed sale, within one year. If at any point the asset (disposal group) no longer qualifies as held for sale, the reversal of the associated temporary difference should no longer be relied on as a source of taxable income.

Acquired in-process research and development (IPR&D)

ASC 350 says intangible assets acquired in a business combination for use in a particular R&D project are considered indefinite-lived intangible assets until the completion or abandonment of the associated R&D efforts. Once the R&D efforts are completed or abandoned, the IPR&D will either be impaired or amortized over the asset life as a finite-lived intangible. A company may determine for scheduling purposes that the reversal date is indeterminate (that is, the company is not able to assume use as a source of future taxable income for purposes of evaluating realizability of a deferred tax asset). Because the IPR&D (before the completion or abandonment of the R&D) is considered indefinite-lived for accounting purposes, we generally believe the most appropriate conclusion in those periods is that the reversal of an IPR&D-related deferred tax liability should not be used as a source of future taxable income under ASC 740. For further discussion of evaluating deferred tax assets that do not expire, see section 6.4.1.

That being said, for certain temporary differences, the future reversal dates will have to be estimated and we do not object to a view (if it is consistently applied) that if the deferred tax liability associated with IPR&D is expected to reverse before the expiration of the carryforward period for a deferred tax asset, it may be used as a source of future taxable income to realize the deferred tax asset. That is, to the extent acquired IPR&D is expected to be impaired during the carryforward period of a deferred tax asset or if R&D efforts are expected to be completed and will result in a finite-lived intangible asset (i.e., commercialization of a drug) that will be amortized during the carryforward period, the deferred tax liability associated with the IPR&D may be used as a source of taxable income to realize the deferred tax asset. This alternate view requires careful consideration of impairment/commercialization timing and likelihood.

Book amortization of tax-deductible goodwill

Under ASC 350, a company that is not a PBE may elect to amortize goodwill. Because goodwill is being amortized for financial reporting purposes when a company elects to apply this accounting alternative, any taxable temporary difference associated with the first component of goodwill would be expected to reverse. As a result, a company that applies the alternative should consider the taxable temporary differences associated with the first component of goodwill as a source of taxable income when evaluating whether its deferred tax assets are more likely than not to be realized. Further, in the period a company adopts the alternative, a company may reverse all, or a portion, of its valuation allowance. There are no transitional provisions under ASC 350 for this alternative. As a result, a company should recognize the change in the valuation allowance due to the adoption of the alternative as an income tax benefit included in continuing operations in the period of adoption.

6.4.5 Accounting considerations for the effect of GILTI on the realizability of US federal DTAs

A US shareholder includes GILTI in its taxable income, which generally is the excess of the aggregate of a US shareholder's pro rata share of net income of all its CFCs over a calculated return on specified tangible assets of the CFCs. US tax law also provides the US shareholder with:

- A deduction (Section 250(a)(1)(B) deduction) for up to 50% of GILTI through 2025 and up to 37.5% of GILTI for taxable years beginning after 31 December 2025 (the GILTI deduction)
- A deemed paid FTC of up to 80% of foreign taxes paid and properly attributable to GILTI income with a deemed dividend inclusion equal to the full amount of foreign taxes deemed paid (Section 78 gross-up). However, unused FTCs associated with GILTI cannot be carried forward or back or used against other foreign source income

US tax law requires a US shareholder to first use available NOL carryforwards to offset its US taxable income, including any GILTI, before FTCs can be applied against taxes due. Therefore, when a US shareholder uses NOL carryforwards that fully offset the current year's US taxable income, the US shareholder will not realize any additional tax benefit from the GILTI deduction or the GILTI-related FTCs attributable to the underlying CFC(s). The GILTI deduction and the GILTI-related FTCs may be limited if an NOL carryforward partially offsets US taxable income.

In these situations, the utilization of the NOL carryforwards may result in either reduced or no additional cash tax savings to the US shareholder from the GILTI deduction or the GILTI-related FTCs. Absent any NOL carryforwards, the US shareholder would have reduced its tax liability by using the GILTI deduction and foreign tax credits permitted under GILTI to achieve the same cash tax savings as a US shareholder that has available NOL carryforwards. For example, consider a US shareholder that has no US-based pretax earnings, and its US taxable income is solely due to GILTI. If the expected GILTI-related FTCs were significant enough, the US shareholder would have the same cash tax savings from applying the GILTI deduction and FTCs as it would from using NOL carryforwards to offset the current year's US taxable income. That is, the GILTI deduction and the GILTI-related FTCs would reduce the US shareholder's federal income tax payable to zero. This could also be the case for companies that have existing DTAs that, upon reversal, are expected to result in future NOLs. Refer to section 5.7, *Global intangible low-taxed income*, for further discussion on GILTI provisions.

If a company elects to account for GILTI as a period cost

Because of the US tax law ordering rules for using NOL carryforwards, questions have arisen about how GILTI affects a US shareholder's assessment of the realizability of its US federal NOL carryforwards and DTAs when it has elected to account for GILTI as a period cost.[23] We understand that two views have developed in practice, as follows:

View A

A company should follow the tax-law NOL carryforward ordering rules to determine whether any existing DTAs are expected to be realized. The TCJA requires a US shareholder to first use available NOL carryforwards to reduce GILTI before considering the effects of the GILTI deduction and GILTI-related FTCs. Based on the tax-law ordering requirements, a company that expects to generate taxable income (including GILTI) in the future and expects NOL carryforwards to reduce its tax liability related to that income may conclude that the NOL carryforwards are realizable and should not record a valuation allowance related to the NOLs that will be used in the future. Under this view, the fact that a company is unable to benefit from future GILTI deductions or GILTI-related FTCs that will be generated in the future is not relevant for this assessment.

View B

A US shareholder should assess the realizability of its NOL carryforwards and DTAs that upon their reversal are expected to result in future NOL carryforwards on the basis of the incremental economic benefit expected to be realized. Under this view, the US shareholder would determine the benefit of NOL carryforwards and DTAs based on the incremental cash tax savings on a with-and-without basis. An entity using a with-and-without approach may measure the expected benefit from its NOLs and DTAs as the difference between (1) the expected cash taxes considering the use of the NOL carryforwards and other DTAs, and (2) the expected cash taxes without considering the use of the NOL carryforwards and other DTAs. If the expected benefit from NOLs and DTAs is less than their carrying amounts, the entity may conclude a valuation allowance is necessary.

In our discussions with the FASB staff, the staff said both views have merit under ASC 740, and a company could elect an accounting policy to apply either view. The accounting policy would have to be applied consistently and, if the effect of the policy is material to the financial statements, it should be disclosed as a significant accounting policy. Any change to a company's initial policy election would be considered a voluntary accounting change subject to the guidance in ASC 250-10-45-2 (i.e., the entity would need to justify that the use of the allowable alternative accounting principle is preferable).

If a company elects to provide deferred taxes for GILTI

We also believe that a company that elects an accounting policy to provide deferred taxes related to GILTI could make similar policy elections when evaluating the realizability of federal NOL carryforwards and DTAs. However, a company that elects to account for deferred taxes related to GILTI will need to make sure that its accounting policy for evaluating the realizability of federal NOLs and DTAs is consistent with its conclusions for measuring GILTI-related deferred taxes.

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[23] Final US federal regulations under Section 250 did not adopt specific ordering rules for determining the Section 250 deduction taxable income limitation that was provided in proposed regulations. The preamble to the final Section 250 regulations indicates that, until further guidance is issued, companies may choose any reasonable method to take into account other deductions subject to a taxable income limitation when determining the allowable Section 250 deduction.

See section 14.3.6.2, *Accounting for GILTI in deferred taxes*, for additional discussion when accounting for GILTI in deferred taxes.

6.5 Source three — tax-planning strategies

Source one	Source two	Source three	Source four
Taxable income in prior carryback years, if carryback is permitted under the tax law	Future reversals of existing taxable temporary differences	Tax-planning strategies	Future taxable income exclusive of reversing temporary differences and carryforwards

ASC 740-10-30-17 requires consideration of all possible sources of taxable income and other available evidence when assessing the need for and amount of a valuation allowance. A tax-planning strategy represents a possible source of positive evidence that must be considered when assessing the need for a valuation allowance. Various actions, elections and strategies are implicit in estimates of expected future taxable income. In that regard, not all tax-planning actions that a company may ordinarily take would be considered tax-planning strategies under ASC 740-10-30-19. However, a qualified tax-planning strategy is an action (including an election for tax purposes) that:

- **Is prudent and feasible.** Implementation of the strategy must be primarily within the control of management. Management must have the ability to implement the strategy and expect to do so unless the need is eliminated in future years. If an action is not considered prudent, management probably would not undertake it, and if the action is considered not feasible, management would not have the ability to do it.
- **A company ordinarily might not take but would take to prevent an operating loss or tax credit carryforward from expiring unused.** Actions management undertakes in the normal course of business (i.e., for business or tax purposes other than utilization of carryforwards that would otherwise expire unused) are not tax-planning strategies under ASC 740.
- **Would result in the realization of deferred tax assets**. As noted in section 19.6, *Tax-planning strategies*, a strategy must meet the recognition and measurement criteria (i.e., more likely than not) of the guidance for accounting for income tax uncertainty in ASC 740-10-30 to be considered a tax-planning strategy.

In evaluating whether possible strategies qualify under ASC 740-10-30-19, companies need to consider all possible consequences of the strategies to determine whether the strategies meet the requirements discussed above. For example, if certain assets are pledged as collateral, management may not have the ability to securitize those assets. Likewise, underwriting and documentation standards may affect the feasibility of certain asset securitizations. In addition, as discussed in section 6.5.2, *Consideration of significant expenses*, significant costs or losses incurred in connection with implementing a tax-planning strategy must be considered in determining the required amount of a valuation allowance. A company would also be required to make sure that any tax-planning strategy would be consistent with accounting determinations in other areas (see section 6.6.2, *Consistency of assumptions and projections*, for further discussion).

In some cases what appear to be tax-planning strategies also represent forecasts of future income. For example, while the decision to sell an appreciated non-core asset may represent a tax-planning strategy to the extent it results in the reversal of a temporary difference in an earlier period than currently expected, any pretax gain on sale would represent a projection of future income that would be subject to the same limitations as any other projections of future income. See section 6.6, *Source four — future taxable income (exclusive of reversing temporary differences and carryforwards)*, for additional discussion of projections of future income.

6.5.1 Tax-planning strategies — optionality

Qualifying tax-planning strategies must be considered before a conclusion can be reached about the amount of a valuation allowance.

Tax-planning strategies are actions that could accomplish one of the following goals:

- Accelerate taxable amounts so a company may use expiring carryforwards (i.e., shift estimated future taxable income between future years or shift the estimated pattern and timing of future reversals of temporary differences)
- Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
- Change the nature of the income (e.g., from tax-exempt income to taxable income)

Consideration of tax-planning strategies is not optional. The effects of all strategies that meet the ASC 740 criteria must be considered when determining the amount of valuation allowance required for deferred tax assets. Companies cannot recognize the effect of only certain tax-planning strategies and postpone recognizing the effect of other qualifying tax-planning strategies until later years if the valuation allowance still has a balance. Tax-planning strategies, however, may not be used to minimize the recognition of deferred tax liabilities.

Because consideration of tax-planning strategies is required, management must make a reasonable effort to identify significant qualifying tax-planning strategies when determining the need for and amount of a valuation allowance, unless taxable income from other sources (i.e., future reversals of existing taxable temporary differences, taxable income in prior carryback years or future taxable income) is deemed adequate to eliminate the need for a valuation allowance before considering tax-planning strategies.

The following example illustrates the use of a tax-planning strategy to shift the estimated pattern and timing of future reversals of temporary differences.

Illustration 6-10: Tax-planning strategy to accelerate taxable amounts

Facts

- Assume a company's only temporary difference relates to $1.5 million of gross profit on a sale that qualifies as an installment sale for US federal tax purposes that will reverse at $500,000 per year over the next three years.
- The company also has an $800,000 tax NOL carryforward that expires next year.
- Assuming taxable income, other than the reversal of the installment sale, is not expected for the next year and, ignoring tax-planning strategies, the company would have to recognize an allowance for some portion of the deferred tax asset relating to the NOL carryforward, because only $500,000 of taxable temporary differences reverse next year.
- Assume, however, that the company could (if necessary) collect the installment receivables the following year in a transaction that would be accounted for as a sale for tax purposes. The transaction would accelerate for income tax purposes the reversal of the total $1.5 million temporary difference.

Analysis

Given that the strategy is prudent and feasible (and it would qualify for recognition and measurement in accordance with ASC 740-10), the entire benefit of the NOL carryforward could be recognized and a valuation allowance would not be required. Any costs associated with the acceleration, such as a factoring discount or an inducement for early repayment, would have to be considered in determining the total benefit available.

6.5.2 Consideration of significant expenses

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-44

A significant expense might need to be incurred to implement a particular tax-planning strategy, or a significant loss might need to be recognized as a result of implementing a particular tax-planning strategy. In either case, that expense or loss (net of any future tax benefit that would result from that expense or loss) reduces the amount of tax benefit that is recognized for the expected effect of a qualifying tax-planning strategy. For that purpose, the future effect of a differential in interest rates (for example, between the rate that would be earned on installment sale receivables and the rate that could be earned on an alternative investment if the tax-planning strategy is to sell those receivables to accelerate the future reversal of related taxable temporary differences) is not considered.

ASC 740-10-30-19 requires the consideration of tax-planning strategies that are expected to result in significant costs (subject to a "prudent and feasible" evaluation, including the accounting for uncertainty in income taxes). The tax benefit recognized as a result of a tax-planning strategy would, however, be reduced by any significant expenses that would be incurred to implement that strategy or any significant losses that would be recognized if the particular strategy was implemented (net of any recognizable tax benefits associated with those expenses or losses). The reduction would be included as part of the valuation allowance. This is consistent with the requirements in ASC 740-10-30-17 to assess all available evidence to determine whether a valuation allowance is needed.

Illustration 6-11: Consideration of significant expenses in a tax-planning strategy

Facts

- At the end of 2018 a US company has a $100 million net operating loss carryforward that arose in a taxable year ending before 31 December 2017 (i.e., it is not subject to the 80% of taxable income limitation) and is scheduled to expire in 2019.
- The company does not expect to have taxable income in 2019.
- The company owns a manufacturing plant with a carrying amount of $100 million for financial statement purposes and a tax basis of zero. For financial reporting purposes, the remaining depreciable life of the plant at the end of 2018 is 10 years and the plant is depreciated using the straight-line method.
- The tax rate is 25%.

Analysis

Absent a tax-planning strategy, the company would compute deferred income taxes at 31 December 2018 as follows:

	Expected reversal year		Total (DTA/DTL
	2019	2020 to 2028	at 2018)
		(amounts in millions)	
Depreciation	$ 10	$ 90	$ 100
Net operating loss	(100)	–	(100)
Taxable income (loss)	$ (90)	$ 90	$ –
Deferred tax liability			$ 25
Deferred tax asset			$ 25
Valuation allowance			(23)
Deferred tax asset (net of valuation allowance)			$ 2

The company would realize only $10 million of the net operating loss carryforward by offsetting $10 million of differences relating to the basis differences in the manufacturing plant scheduled to reverse in 2019.

However, assume that the manufacturing plant has a market value of $100 million at the end of 2018 and that management would enter into a sale-leaseback rather than let the NOL expire unused. The company could assume a sale of the plant in 2019 at $100 million coupled with a leaseback of the plant. Also assume that estimated commissions and legal fees related to the sale of the plant are $12 million.

The sale-leaseback in 2019 would accelerate reversal of the entire $100 million of taxable temporary difference to 2019. As a result, the entire $100 million operating loss carryforward could be applied against the $100 million of taxable income resulting from the sale; however, the total tax benefit of $25 million would be reduced by the expenses (net of tax) necessary to implement the strategy. A valuation allowance would be recognized for $9 million ($12 million commission and legal fees less the future tax benefit of those expenses at 25%) resulting in the recognition of a net deferred tax asset of $16 million ($25 million less $9 million).

It is noteworthy, however, that the sale-leaseback transaction would not result in the realization of the NOL for financial reporting purposes. Instead, this transaction would result in a substitution (or freshening) of the tax benefit because the company would receive future deductions attributable to the leaseback costs. The remaining deferred tax asset must still be evaluated for realizability. See section 6.4.2, *Tax benefit substitution versus realization*, for further discussion.

6.5.2.1 Classification of expenses to implement tax-planning strategies

Questions have arisen regarding the appropriateness of including fees incurred to implement tax strategies, resolve tax contingencies, or defend tax structures as a component of income tax expense. Typically, such fees include amounts paid to attorneys, accountants and underwriters.

The ASC Master Glossary defines income tax expense (benefit) as the sum of current tax expense (benefit) (i.e., the amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year) and deferred tax expense (benefit) (i.e., the change during the year (or since the acquisition date for acquired temporary differences) in an entity's deferred tax liabilities and assets). In addition, Regulation S-X, Rule 5-03(b)(11) requires financial statements included in SEC filings to include only taxes based on income under the caption income tax expense.

Although ASC 740 does not provide specific guidance on the classification of fees and costs incurred related to complying with income tax reporting, implementing tax strategies or defending positions taken in income tax returns as filed, we believe professional fees and any other costs incurred that do not represent amounts that will be payable to, or refundable from, a taxing authority based solely on income should not be included as a component of income tax expense based on the definition of income tax expense in the ASC Master Glossary.

If a tax-planning strategy that was assumed would be implemented to preserve a deferred tax asset is ultimately implemented, an entry will be required to reflect the expenses in an income statement line item other than income taxes. Failure to make this adjustment when the tax-planning strategy is implemented would result in expenses inappropriately reported when incurred in the tax expense line item in the income statement.

6.5.3 Tax elections

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-40

Paragraph 740-10-30-19 indicates that tax-planning strategies include elections for tax purposes. The following are some examples of elections under current U.S. federal tax law that, if they meet the criteria for tax-planning strategies, should be considered in determining the amount, if any, of valuation allowance required for deferred tax assets:

a. The election to file a consolidated tax return

b. The election to claim either a deduction or a tax credit for foreign taxes paid

c. The election to forgo carryback and only carry forward a net operating loss.

In addition to applying strategies to alter temporary difference reversal periods, companies also must consider tax elections available under the law. Possible strategies under US tax law include elections to (1) carry forward a loss in lieu of a carryback (under US federal tax law, net operating losses created in taxable years beginning after 31 December 2020 are not eligible for carryback),[24] (2) claim a deduction for foreign taxes paid in lieu of the foreign tax credit and (3) consolidate subsidiary operations for tax purposes.

Companies should consider if the benefit from a carryforward of an operating loss would further reduce the amount of a valuation allowance for deferred tax assets compared with the benefit provided by the carryback of the loss (if carrybacks are permitted in the tax jurisdiction). Companies might forgo carryback provisions if a carryback would result in a loss of foreign or other tax credits. Alternatively, if, for tax provision purposes, maximum deferred tax benefits would result from assuming a deduction for foreign taxes, in lieu of claiming a credit, that election should be assumed.

[24] The CARES Act provides corporate taxpayers a five-year carryback period for net operating losses arising in tax years beginning after 31 December 2017 and before 1 January 2021. That is, calendar-year companies can carryback operating losses arising in 2018, 2019 and 2020 to offset taxable income in each of the five tax years preceding the tax year when the loss was generated. For example, 2018 losses can be carried back to offset taxable income in 2013 through 2017. This change amended the provisions in the TCJA that had generally repealed all carrybacks of losses generated in taxable years ending after 31 December 2017.

Companies also should consider electing to include subsidiaries in a consolidated return, assuming such an election is feasible (i.e., within management's control). Generally, net operating losses of subsidiaries may not be used to offset taxable income of other profitable operations, unless the profit and loss operations are included in a consolidated return. By applying a tax-planning strategy to elect to file a consolidated return, a company might be able to recognize the benefit of one subsidiary's deductible temporary differences by offsetting taxable temporary differences of another subsidiary.

6.5.4 Tax-planning strategies — examples

Examples of tax-planning strategies include:

- Selling and leasing back operating assets to accelerate the reversal of taxable temporary difference to offset an operating loss carryforward that would otherwise expire in the next few years — (see sections 6.4.2, *Tax benefit substitution versus realization*, and 6.5.2, *Consideration of significant expenses*, for illustrations).
- Selling debt securities classified as available-for-sale or trading, to accelerate taxable capital gains for appreciated securities — A tax-planning strategy that includes selling a security at a loss may trigger an impairment loss under ASC 320 (or under ASC 326 for debt securities after the adoption of ASU 2016-13).
- Selling appreciated assets that are not key to future operations to accelerate taxable or deductible temporary difference reversals — Selling essential assets or a business is not a valid tax-planning strategy because it generally fails the two criteria noted in ASC 740-10-30-19 and section 6.5, *Source three — tax-planning strategies*. In addition, any pretax gain would be considered a projection of future income to be evaluated under section 6.6, *Source four — future taxable income (exclusive of reversing temporary differences and carryforwards)*.
- Prefunding pensions and other obligations to accelerate deductible temporary difference reversals.
- Disposing obsolete inventory that is reported below cost for financial reporting purposes — This would accelerate a deduction for the amount by which the tax basis of the inventory exceeds the book basis.
- Selling loans at their reported value (assuming reported at historical cost), which includes an allowance for bad debts — This would accelerate a tax deduction to the extent of the allowance for bad debts.
- Timing the maturity of a deferred tax liability to obtain the maximum benefit from tax credits (e.g., general business tax credits).
- Changing filing methods for tax purposes — an example would be electing to file a consolidated tax return when it is solely within the control of the taxpayer.

Certain strategies will not qualify under ASC 740-10-30-19 because they are not prudent. For example, a company generally could not assume outright sale of a trademark or significant operating assets that are key to future operations. It also might not be prudent to prefund executive deferred compensation because funding may create taxable income for the company's executives. In addition, a company generally cannot assume prompt resolution of a contingency in order to accelerate reversals of deductible temporary differences if resolution is not within management's control.

The following are examples of actions that do not qualify as tax-planning strategies:

- Selling a money-losing subsidiary
- Launching a cost-reduction initiative (or any similar attempt to affect future profitability)

- Anticipating a change from taxable C corporation status to nontaxable S corporation status, even though under current US federal tax law approval of such a change is automatic if the statutory criteria are met, because changes in tax status[25] are discrete events and are recognized at the date the change is approved by taxing authorities (or on the filing date if regulatory approval is not required)

6.5.5 Considering tax-planning strategies when an entity has deferred tax assets that do not expire

As discussed in section 6.1.2, *Carryforwards and other tax attributes that do not expire*, it is not appropriate to assume that deferred tax assets that do not expire will ultimately be realized simply because they do not expire. A company with deferred tax assets that do not expire is still required to evaluate whether it is more likely than not that the deferred tax asset will be realized based on the four possible sources of taxable income described in section 6.2, *Sources of taxable income*.

If there isn't enough taxable income from a single source of taxable income to support a conclusion that a valuation allowance is not necessary, companies are required to consider all available sources of taxable income, including available tax-planning strategies. That is, available tax-planning strategies in this situation should be considered, even when evaluating the realizability of a deferred tax asset that does not expire or a deferred tax asset that, upon reversal, will result in a deferred tax asset that does not expire. For example, a company may determine that it has an available tax-planning strategy to change tax filing methods and elect to file a consolidated tax return (assuming such an election is within management's control). Applying this tax-planning strategy might enable the company to realize the benefit of one subsidiary's deferred tax asset that does not expire or that, upon reversal, will result in a deferred tax asset (e.g., a NOL carryforward) that does not expire based on the expected reversal of taxable temporary differences of another subsidiary.

While companies are required to evaluate available tax-planning strategies that would result in the realization of deferred tax assets, careful consideration is necessary when those actions result in projections of future taxable income (e.g., a projected gain on the sale of an appreciated noncore asset). In those situations, a company is still required to assess whether it's able to rely on those projections, based on the weight of positive and negative evidence.

6.6 Source four — future taxable income (exclusive of reversing temporary differences and carryforwards)

Source one	Source two	Source three	Source four
Taxable income in prior carryback years, if carryback is permitted under the tax law	Future reversals of existing taxable temporary differences	Tax-planning strategies	Future taxable income exclusive of reversing temporary differences and carryforwards

By its very nature, future taxable income (exclusive of the reversal of existing temporary differences and carryforwards) requires estimates and judgments about future events that may be predictable but are far less certain than past events that can be objectively measured. It is this judgment about future taxable income that poses the greatest challenge for management in determining the necessary amount of any required deferred tax asset valuation allowance.

As discussed in section 6.2.1, *Appropriate character of taxable income*, both positive and negative evidence should be considered in determining whether a valuation allowance is needed. The more negative evidence that exists, the more difficult it is to support a conclusion that a valuation allowance is

[25] See chapter 9, *Change in the tax status of an entity*, for a discussion of the accounting ramifications of a change in tax status.

not needed. Because estimates of future taxable income require significant judgment, the more negative evidence that exists, the less reliance can be placed on projections of future taxable income (refer to section 6.1.1, *Evaluation of positive and negative evidence*, for additional discussion of the evaluation of positive and negative evidence). In this regard, as discussed in section 6.1.1.1, *Cumulative losses*, expectations about future taxable income would rarely be sufficient to overcome the negative evidence of recent cumulative losses (see section 6.1.1.1 for further discussion).

6.6.1 Period covered by the projections of future income

Questions often arise regarding how many years of future taxable income may be included in the evaluation of the need for a valuation allowance, particularly when a company has experienced significant fluctuations in earnings or has recently emerged from a cumulative loss position (refer to section 6.1.1.1, *Cumulative losses*, for discussion of cumulative losses). As discussed in section 6.1.1, *Evaluation of positive and negative evidence*, companies should use judgment in considering the effect of negative and positive evidence, and the weight given to the potential effect of the evidence should be commensurate with the extent to which it can be objectively verified.

In general, we believe companies should include projected future income in their evaluation of the need for a valuation allowance to the extent the projections can be supported at a more-likely-than-not level. When a company determines that positive evidence (e.g., a history of accurately projecting income) outweighs any negative evidence (e.g., historic operating losses) to support that projected future taxable income should be included in the evaluation of the need for a valuation allowance, it may be difficult to support including only a limited number of years (e.g., three years) in the evaluation. We would generally not expect companies to arbitrarily cut off projected income unless there is a valid reason for limiting the number of years included in the evaluation.

However, because of the imprecision inherent in any forward-looking data, the further in the future estimates go, the less objectively verifiable they become. Therefore, if it is necessary for a company to include projected future income for an extended period of time (e.g., 10 years) to support the future realization of the tax benefit of an existing deductible temporary difference or carryforward, the company should question whether there is sufficient evidence to support the projections at a more-likely-than-not level for this period of time.

If a company determines that it is appropriate to limit the period of projected future taxable income used in the evaluation of the need for a valuation allowance and the limitation results in the company recording a partial valuation allowance, it would not be appropriate for the company to offset income from subsequent periods against the valuation allowance, which effectively results in a rolling projection of future taxable income.

For example, at the end of 20X5 a company has a valuation allowance for all deferred tax assets in excess of projected future taxable income for the next three years (the company has limited the number of years used in the projections). Because only a limited number of years was used in the projections of future taxable income, it would not be appropriate for the company to offset the first-quarter income tax expense by reducing its valuation allowance based on forecasting an additional quarter of profitability. This inappropriate application effectively rolls one additional quarter into projected future income each quarter so that there is a rolling three-year projection of future taxable income included in the analysis that results in the company reducing its valuation allowance each quarter. Instead, the valuation allowance should only be adjusted when changes in circumstances cause a change in judgment about the realization of deferred tax assets in future years because of a change in estimated taxable income in future annual periods that is more likely than not to occur (refer to section 15.2.2.2, *Changes in the valuation allowance*) and should not be reduced because a company simply met projections of future income they had already relied on.

6.6.2 Consistency of assumptions and projections

Generally, the assumptions and projections used to analyze the realizability of assets under US GAAP should not change based on the nature of the asset being analyzed. In other words, companies should not have one set of projections for evaluating the need for a valuation allowance under ASC 740 and another set of projections for evaluations of impairment under ASC 350, ASC 360, or other ASC topics. In addition, the SEC staff has questioned companies that have used projections for accounting purposes that differ from those shared with analysts and investors. Noteworthy is that in some instances ASC 740 may be more restrictive than other standards about when it is appropriate to rely on projections of future taxable income. That is, ASC 740 requires that the weight of all available evidence, both positive and negative, be considered when evaluating the realizability of deferred tax assets. That means that while a company's projections have not changed, negative evidence may be substantive enough such that projections cannot be relied on as a source of future taxable income.

In addition, disclosures in Management's Discussion and Analysis (MD&A) and other sections of documents containing audited financial statements should be consistent with the projections used in the realization analysis required by US GAAP. For example, disclosures in MD&A should be consistent with the disclosures regarding the establishment of a 100% valuation allowance of a material deferred tax asset.

6.6.2.1 Recovery of investments in subsidiaries

Companies that have not provided deferred taxes on the outside basis differences of domestic subsidiaries under the theory that such basis differences could be recovered in a tax-free manner[26] should not contradict that assumption in computing other deferred tax effects. That is, if the company determines that its outside basis difference is not a taxable temporary difference pursuant to the provisions of ASC 740-30-25-7 (i.e., its investment in the domestic subsidiary can be recovered in a tax-free manner), the company cannot also assert that it would cause the domestic subsidiary to make a distribution, liquidate or be sold in a taxable transaction to eliminate, or reduce, the need for a valuation allowance on deferred tax assets. Instead, deferred taxes and the evaluation of the need for, and amount of, a valuation allowance on deferred tax assets should be computed in a manner consistent with management's plans regarding the recovery of the company's investment in the subsidiary.

See section 6.6.2.2, *Undistributed earnings of a foreign subsidiary*, for a discussion of similar principles related to the outside basis differences and unremitted earnings of foreign subsidiaries.

6.6.2.2 Undistributed earnings of a foreign subsidiary

Companies that have not provided deferred taxes on the unremitted earnings of foreign subsidiaries under the exception in ASC 740-30-25-18(a) for earnings that would not be remitted for the foreseeable future[27] should not contradict that assumption in computing other deferred tax effects. The guidance in ASC 740 does not permit a company to consider future reversals of basis differences for which a deferred tax liability has not been recognized based on permitted exceptions to comprehensive recognition of deferred taxes (e.g., basis differences relating to investments in foreign subsidiaries that are essentially permanent in nature). Likewise, future distributions of past or future earnings of subsidiaries may not be considered in determining the need for, or amount of, a valuation allowance except to the extent that (1) a deferred tax liability has been recognized for existing undistributed earnings or (2) a company has a policy of remitting earnings that is expected to be continued in the future (e.g., 50% of a foreign subsidiary's earnings each year are remitted and 50% are permanently reinvested).

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[26] See section 14.4, *Investments in domestic subsidiaries, corporate joint ventures and domestic investees*, for further discussion.

[27] See section 14.3.1, *Investments that are essentially permanent in duration*, for further discussion.

Thus, when determining the need for, or amount of, a valuation allowance, a company could not consider future earnings that might result from the payment of dividends, liquidation or sale of a foreign subsidiary for which earnings were presumed to be indefinitely reinvested.

Income of a US company's foreign subsidiaries may be subject to tax on GILTI (see section 5.7, *Global intangible low-taxed income*, for further discussion). A US company subject to GILTI is required to include that income in the determination of its current year US income tax payable and cannot assert indefinite reinvestment of those earnings for US federal income tax purposes. Accordingly, a US company subject to GILTI should include that income in its projections of future taxable income, and, if it has elected an accounting policy to provide deferred taxes related to GILTI, should compute that amount exclusive of existing reversing taxable temporary differences related to GILTI.

Illustration 6-12: Reversal of basis differences when foreign earnings are permanently reinvested

Facts

- LFS Corporation has a deductible temporary difference of $1,000 relating to its investment in its domestic subsidiary, Company MLS, that is expected to reverse in the foreseeable future.
- Company LNS, a foreign subsidiary for which earnings historically have not been remitted to the domestic parent company, is the only one of LFS Corporation's foreign subsidiaries that is more likely than not to have future income.
- LFS Corporation has not recognized a deferred tax liability for the undistributed earnings of Company LNS because of the exception permitted under ASC 740-30-25-18(a) for investments in foreign subsidiaries that are essentially permanent in duration.

Analysis

Because LFS Corporation has not recognized a deferred tax liability for the undistributed earnings of Company LNS, it would not be appropriate to consider future distributions of future (or past) earnings of Company LNS as a basis for realization of the deferred tax asset relating to the deductible temporary differences attributable to LFS Corporation's investment in Company MLS.

6.6.3 Originating and reversing temporary differences

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-14

For some assets or liabilities, temporary differences may accumulate over several years and then reverse over several years. That pattern is common for depreciable assets. Future originating differences for existing depreciable assets and their subsequent reversals are a factor to be considered when assessing the likelihood of future taxable income (see paragraph 740-10-30-18(b)) for realization of a tax benefit for existing deductible temporary differences and carryforwards.

Future taxable income for purposes of assessing the realizability of deductible temporary differences excludes the reversal of existing taxable temporary differences and consists solely of:

Projected book income
+ (-) Permanent differences
+ (-) Future originating temporary differences

The reversal of existing taxable temporary differences is identified as a separate source of taxable income[28] and, therefore, must be excluded from future taxable income to avoid double-counting the effects of this source of taxable income. However, future originating temporary differences (including those related to existing depreciable assets) and their subsequent reversals should be considered when assessing the likelihood of future taxable income in determining whether a valuation allowance is necessary for existing deductible temporary differences and carryforwards (ASC 740-10-55-14).

Illustration 6-13: Excluding the reversal of existing taxable temporary differences and the calculation of future taxable income

Facts

- A company is evaluating projected taxable income as a source of future taxable income to support the realizability of its deferred tax assets and carryforwards.
- At 31 December 20X0, the company has existing taxable temporary differences of $40 related to depreciable assets that will reverse in future periods.
- The company is forecasting $15 of future originating taxable temporary differences that will arise, but not reverse, during the period used in the projection.
- At 31 December 20X0, the company has deductible temporary differences of $160.
- The company has determined that there are no available carrybacks or tax planning strategies available.

Analysis

The following tables illustrate how the reversal of existing taxable temporary differences and the calculation of future taxable income should be considered when assessing the realizability of existing temporary differences.

Incorrect

Projected book income	$ 100
Permanent differences	20
Future originating temporary differences	(15)
Reversal of existing taxable temporary differences	40
Projected taxable income	$ 145

Correct

Projected book income	$ 100
Permanent differences	20
Future originating temporary differences	(15)
Reversal of existing taxable temporary differences	Not Included
Projected taxable income for use in realizability analysis (i.e., Source Four income)	$ 105

Incorrect

Gross deductible temporary differences	$ 160
Sources of taxable income:	
Source One – Available carrybacks	0
Source Two – Reversals of existing taxable temporary differences	40
Source Three – Tax planning strategies	0
Source Four – Projected future taxable income	145
Total sources of taxable income	$ 185
Valuation allowance required? [$185>$160]	No $ 0

Correct

Gross deductible temporary differences	$ 160
Sources of taxable income:	
Source One – Available carrybacks	0
Source Two – Reversals of existing taxable temporary differences	40
Source Three – Tax planning strategies	0
Source Four – Projected future taxable income	105
Total sources of taxable income	$ 145
Valuation allowance required? [$160-$145=$15 x 25% tax rate]	Yes $ 4

[28] ASC 740-10-30-18(a).

Estimating future originating temporary differences and determining the reversal patterns of future originating temporary differences can be a very complicated process and will require the use of estimates and judgments. However, the extent of scheduling required, if any, will depend on each company's circumstances — mainly, its tax position, its expectations of future profitability, the nature of its temporary differences and carryforwards, reversal patterns, and the availability of appropriate tax-planning strategies.

Most consistently profitable operating companies will often be able to avoid extensive scheduling efforts. If sufficient taxable income to offset deductible temporary differences and carryforwards is expected in the future, further consideration of the pattern and timing of the reversals of future originating temporary differences may not be necessary. However, it is important to make certain that future taxable income identified is of the appropriate character (refer to section 6.2.1, *Appropriate character of taxable income*) and does not result in a substitution (or freshening) of the tax benefit (refer to section 6.4.2, *Tax benefit substitution versus realization*).

6.6.4 Weighing evidence when evaluating operating loss and tax credit carryforwards

Because a deferred tax asset is recognized for all deductible temporary differences and operating loss and tax credit carryforwards, the benefit of a net operating loss for tax purposes and tax credit carryforwards could be recognized before it is realized if a conclusion is reached that a valuation allowance is not necessary. When an entity assesses the need for a valuation allowance, any limitations imposed by the tax law for operating loss or tax credit carryforwards must be considered in determining whether it is more likely than not that some portion or all of the deferred tax asset will be realized. See section 6.4.1, *Considerations when NOL carryforwards do not expire or when tax law limits the use of NOL carryforwards*, for further discussion of limitations on net operating loss carryforwards.

ASC 740 provides that a deferred tax asset relating to a loss carryforward would not have to be reduced by a valuation allowance if sufficient positive evidence exists to support its recognition.

Illustration 6-14: Evaluating operating loss and tax credit carryforwards

Assume that a historically profitable company settles a significant lawsuit such that it is in a net operating loss carryforward position for tax purposes. The realization of a tax benefit associated with the net operating loss carryforward would depend on whether future income of a sufficient amount was considered more likely than not.

If objective evidence indicates that such income was considered more likely than not to occur in the carryforward period and there is no evidence to the contrary, recognition of the deferred tax asset without a valuation allowance would be appropriate.

However, reaching a conclusion that a valuation allowance is not required would often be difficult when there is negative evidence, such as cumulative losses in recent (i.e., the current and two preceding) years.

ASC 740-10-30-23 requires that the weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which the evidence can be objectively verified. The requirement to weigh positive evidence based on "the extent to which it can be objectively verified" has the effect of severely limiting those situations where deferred tax assets can be realized when a company has incurred recurring pretax losses from operations. The following example illustrates realization of a deferred tax asset relating to a loss carryforward (supported by source four) and recognition of the related valuation allowance.

Illustration 6-15: Realization of a DTA related to a loss carryforward and recognition of a VA

Assume a company has the following operating results and temporary differences. Also, assume the company's effective tax rate is 40% for all years presented.

	20X0 to 20X2	20X3	20X4	20X5	20X6
Pretax financial income (loss)	$ 3,000	$ (4,000)	$(1,000)	$ 1,000	$4,000
Depreciation temporary difference	(400)	(100)	(100)	200	200
Taxable income (loss)	$ 2,600	$ (4,100)	$(1,100)	$ 1,200	$4,200
Statutory tax rate	40%	40%	40%	40%	40%
Taxes currently payable (refundable)	$ 1,040	$ (1,040)[(a)]	$ –	$ –[(b)]	$1,120[(c)]

(a) In 20X3, $2,600 of the operating loss is carried back to 20X0—20X2 to reduce taxes paid in those years and a receivable of $1,040 ($2,600 x 40%) is recorded for the refund. The remaining $1,500 gross NOL ($600 tax effected) is carried forward to future years.

(b) No tax is due because $1,200 of the $2,600 NOL carryforward ($1,500 carryforward from 20X3 plus $1,100 from 20X4) is used to offset the $1,200 taxable income in 20X5.

(c) In 20X6, taxable income of $4,200 is offset by remaining 20X3 loss carryforwards of $1,400 ($300 from 20X3 and $1,100 from 20X4). Tax payable is $1,120 (or [$4,200-$1,400] x 40%).

Depreciation temporary difference:

	20X2	20X3	20X4	20X5	20X6
Book basis	$ 1,000	$ 800	$ 600	$ 400	$ 200
Tax basis	(600)	(300)	–	–	–
Taxable temporary difference	$ 400	$ 500	$ 600	$ 400	$ 200

Consider carryback and carryforward periods as sources of taxable income.

Operating loss carryforwards generated in 20X3 and 20X4 would be used as follows:

	20X3	20X4	20X5	20X6
Beginning-of-year operating loss carryforward	$ –	$(1,500)	$(2,600)	$(1,400)
Current year loss	(4,100)	(1,100)	–	–
Operating loss carryback	2,600	–	–	–
Utilization of operating loss carryforward	–	–	1,200	1,400
End-of-year operating loss carryforward	$(1,500)	$(2,600)	$(1,400)	$ –

Assuming at the end of 20X3, 20X4 and 20X5 available positive evidence is not sufficient to overcome the negative evidence of the recent cumulative losses, deferred taxes would be determined as follows:

	20X0 to 20X2	20X3	20X4	20X5	20X6
Deferred tax liability	$ (160)	$ (200)	$ (240)	$(160)	$ (80)
Deferred tax asset	–	600(d)	1,040(e)	560(f)	–
Allowance for deferred tax asset	–	(400)(g)	(800)(g)	(400)(g)	–
Net deferred tax liability	$ (160)	$ –	$ –	$ –	$ (80)

(d) NOL carryforward as of 31 December 20X3 ($1,500) at 40%.

(e) NOL carryforward as of 31 December 20X4 ($2,600) at 40%.

(f) NOL carryforward as of 31 December 20X3 ($1,400) at 40%.

(g) A valuation allowance would be recognized for the amount by which the deferred tax asset exceeds the deferred tax liability (the depreciation temporary difference reverses within the carryforward period). Under certain circumstances, the profitable results in 20X5 combined with other positive evidence might be sufficient to offset the negative evidence of the recent cumulative losses and result in the reduction or elimination of the need for a valuation allowance at 31 December 20X6.

Income tax provision:

	20X0 to 20X2	20X3	20X4	20X5	20X6
Current expense (benefit)	$1,040	$(1,040)	$ –	$ –	$ 1,120
Deferred expense (benefit)	160	(160)	–	–	80
Total	$1,200	$(1,200)	$ –	$ –	$ 1,200

Note: The illustration above contemplates tax laws that permit carrybacks. A company will need to understand whether taxable income can be carried back to prior years based on each tax jurisdiction's rules.

6.7 Considerations for the release of a valuation allowance

The assessment of the realizability of deferred tax assets and the need for a valuation allowance is often one of the more challenging aspects of accounting for income taxes. Part of this challenge is that the evaluation of the realizability of deferred tax assets requires judgment to apply the more-likely-than-not framework in ASC 740 to real-life situations.

We have received numerous inquiries about whether ASC 740 requires a different model or criteria to be applied when evaluating whether an existing valuation allowance continues to be required than the model used when assessing whether a valuation allowance is needed for the first time. The answer is no. That is, the model for evaluating whether a valuation allowance is required is the same despite whether a valuation allowance already exists. ASC 740 simply established a framework for evaluating the realizability of deferred tax assets and that framework is required to be applied in assessing whether a valuation allowance is needed for the first time or whether an existing valuation allowance should be maintained or reversed.

That being said, the key difference in applying the model in these situations is often the extent of positive and negative evidence that exists and the effect that evidence has on an entity's ability to rely on projections of future taxable income as the sole source to realize a deferred tax asset. In the case of an existing valuation allowance, an entity has likely experienced significant negative evidence that prevented it from relying on projections of future taxable income sufficient to realize the deferred tax asset. That negative evidence may have included a period of past losses. In that case, the negative evidence was so significant that it previously prevented the entity from relying on projections of future taxable income. In order to determine that a valuation allowance is no longer required (i.e., the deferred tax asset is realizable) based solely on projections of future taxable income, the entity would have to weigh all negative evidence (including past operating losses) against positive evidence to determine whether it is appropriate to rely on projections of future taxable income at this time.

Just as with the initial recording of a valuation allowance, there are no bright lines or formulas for purposes of evaluating whether a valuation allowance is still required, and the exercise of professional judgment is necessary. For instance, the existence of cumulative losses is not a bright-line, "on/off switch" related to the ability to rely on projections of future taxable income and the corresponding need for or elimination of a valuation allowance (see section 6.1.1, *Evaluation of positive and negative evidence*). As a result, the determination of whether a company is or is not in a cumulative loss position does not, in and of itself, result in a conclusion with respect to the realizability of deferred tax assets.

If an entity has recently returned to profitability after a period of loss, the entity would need to evaluate whether the return to profitability is sufficient positive evidence to overcome the negative evidence of past losses. This is a facts-and-circumstances-based evaluation that would consider the severity and duration of past losses, the degree and duration of the return to profitability, the contributing factors leading to both losses and income, the stability of the current economic environment and whether the pattern of profitability is sufficient to overcome the historical pattern of losses. The longer and more severe the history of losses, the more positive evidence that would be needed to determine that projections of future taxable income can be relied on. For example, when an entity has experienced an uncertain operating environment characterized by a period of recurring losses, it will not be unusual that a demonstrated ability to operate profitably for a recurring annual period as well as evidence of a more stable operating environment will generally be needed to overcome such evidence.

6.8 Foreign tax credit carryforwards

ASC 740 does not limit the recognition of deferred tax assets for foreign tax credit carryforwards to the amount of deferred tax liabilities recognized for undistributed foreign earnings. In this regard, deferred tax assets for foreign tax credits could be recognized (that is, recorded without a valuation allowance) under ASC 740 in a manner similar to other deferred tax assets if (1) deferred taxes are provided for the unremitted earnings of foreign subsidiaries or (2) there are other sources of foreign income (other than the unremitted earnings for which deferred taxes have not been provided) that could be used to realize the benefit in the current period.

US federal tax law disallows foreign tax credits or deductions for taxes (including withholding taxes) paid or accrued with respect to any dividend to which the 100% exemption for the foreign source portion of dividends received from certain foreign subsidiaries applies. However, foreign tax credits may offset tax on foreign income taxed to the US shareholder subject to limitations. Because foreign tax credits generally are limited to the US tax that would have been paid on the amount of the foreign source income, the recognition of foreign tax credit carryforwards should be challenged if it is expected that the foreign source income will continue to be generated in the future.

For example, if foreign source income is expected to continue, the payment of foreign taxes at a 25% tax rate in certain circumstances could result in a foreign tax credit carryforward of 4% (foreign tax rate of 25% less US tax rate of 21%). As long as the foreign tax rate exceeds the US tax rate and other foreign source income taxed at less than the US tax rate is not available, the recoverability of the excess foreign tax credit remains questionable. In situations such as these, it generally will be appropriate to recognize a valuation allowance for all or some portion of the excess foreign tax credit carryforward.

6.9 Effect of AMT on deferred tax assets (updated June 2023)

In August 2022, the US enacted the IRA, implementing a new corporate alternative minimum tax (CAMT). The enactment of this law generated questions about whether a company should consider the effects of being subject to the new CAMT in the future in assessing the realizability of tax benefits from all deductible temporary differences, carryforwards and tax credits available for regular tax purposes. In response to a technical inquiry, the FASB staff stated that because ASC 740 does not specifically address this issue, a company could make an accounting policy election to either consider the effect of the CAMT system when evaluating the need for, and the amount of, a valuation allowance or account for the effects on deferred taxes, including carryforwards and tax credits, in the period they arise. The policy elected should be consistently applied. The FASB staff said the application of this view is limited to the accounting for the new US CAMT, and a company should have transparent disclosures about its policy election. See section 5.5.3.1, *Valuation allowance considerations when subject to the CAMT*, for additional discussion on the CAMT and valuation allowance accounting considerations related to tax credits generated under the CAMT rules.

We believe that an entity that is subject to alternative tax regimes in other jurisdictions that are similar to the AMT regime discussed in ASC 740-10-25-42 and 43 and ASC 740-10-30-10 and 11 or the CAMT can make a similar accounting policy election for the effects of being subject to the tax regime on its evaluation of the realizability of deferred tax assets, including those for income tax credits (except for AMT tax credit carryforwards, which are evaluated based on the guidance in ASC 740-10-55-33). That is, a company should consistently apply its policy to all AMT tax regimes that are similar to the AMT regime discussed in ASC 740-10-25-42 and 43.

6.10 Future tax benefits deemed worthless or expired

In certain cases, the tax benefits associated with deductible temporary differences and tax loss carryforwards are not realized because sufficient taxable income was not generated in the carryforward period, and such carryforward amounts expire unused. When the expired deferred tax assets have been fully offset by a valuation allowance, the deferred tax asset and valuation allowance are reduced by the same amount. Recognizing the reduction in the tax asset and corresponding valuation allowance generally should occur when the carryforward period expires. That is, deferred tax assets should not remain on a company's books after their expiration date even if such deferred tax assets are fully offset by a valuation allowance.

Additionally, a change in ownership may limit an entity's ability to use net operating loss carryforwards and other losses for purposes of determining taxable income before these items expire. Section 382 of the Internal Revenue Code limits the availability of US net operating loss carryforwards and certain built-in losses when there is an ownership change. The determination of whether such a limitation exists may be uncertain (see chapter 19, *Accounting for uncertainty in income taxes*).

Under Section 382, an entity is limited to the amount of US net operating loss carryforwards used to offset current and future year income. When an entity determines that loss carryforwards are limited and mathematically determines that these credits will expire unused, questions arise as to whether the related deferred tax assets should no longer be recognized or whether a valuation allowance should be established for the amount of the deferred tax assets that will expire unused. We believe that either approach is acceptable. See section 15.3.6, *Tax effects of transactions among or with shareholders*, for discussion of the intraperiod tax allocation of transactions among or with shareholders that affect tax attributes of the company.

6.11 A change in valuation allowance

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Other Presentation Matters

740-10-45-20

The effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related **deferred tax asset** in future years ordinarily shall be included in income from continuing operations. The only exceptions are changes to valuation allowances of certain tax benefits that are adjusted within the measurement period as required by paragraph 805-740-45-2 related to business combinations and the initial recognition (that is, by elimination of the valuation allowances) of tax benefits related to the items specified in paragraph 740-20-45-11(c) through (f). The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations as required by paragraphs 740-20-45-2 and 740-20-45-8.

Income Taxes — Intraperiod Tax Allocation

Other Presentation

740-20-45-4

Paragraph 740-10-45-20 requires that changes in the beginning of the year balance of a **valuation allowance** caused by changes in judgment about the realization of deferred tax assets in future years are ordinarily allocated to continuing operations. That paragraph also identifies certain exceptions to that allocation guidance related to business combinations and the items specified in paragraph 740-20-45-11(c) through (f). The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations using the general allocation methodology presented in this Section.

6.11.1 General

The general rule for changes in valuation allowances is the offsetting charge (benefit) is recognized as a component of income tax expense from continuing operations. However, there are certain exceptions to that rule, such as the elimination of a valuation allowance initially recognized in a purchase business combination and certain transactions that are recognized in equity as discussed in chapter 15, *Intraperiod tax allocation*. Refer to section 20.6.3, *Gain from the disposal of a component of an entity*, for presentation considerations when there is a change in the realizability of a valuation allowance resulting from a gain from the disposal of a component of an entity.

6.11.2 Changes in valuation allowances — business combinations

See chapters 11, *Business combinations*, 12, *Noncontrolling interests*, and 13, *Asset acquisitions*, for further discussion.

6.11.3 Valuation allowances for temporary differences related to undistributed earnings of a foreign subsidiary

See section 6.6.2.2, *Undistributed earnings of a foreign subsidiary*, for discussion of special considerations of deferred tax assets and liabilities related to temporary differences related to undistributed earnings of a foreign subsidiary when evaluating the need for, and amount of, a valuation allowance on deferred tax assets.

6.11.4 Intraperiod tax allocations

The initial recognition of valuation allowances when items of income or loss from other than continuing operations are recognized in a company's financial statements requires careful consideration due to the intraperiod allocation requirements of ASC 740. Those requirements are discussed in detail in chapter 15, *Intraperiod tax allocation*. In addition to section 6.11.4.1, *Valuation allowance for certain debt and equity securities*, and section 6.11.4.2, *Valuation allowances for amounts recorded in other comprehensive income related to postretirement benefit plans*, the following sections of chapter 15, *Intraperiod tax allocation*, should be considered when evaluating the need for, and the amount of, a valuation allowance:

- Section 15.2, *Income tax expense (benefit) allocated to continuing operations — the incremental approach*, addresses special provisions of the intraperiod tax allocation requirements that, in some cases, override the general allocation methodology (prior to the adoption of ASU 2019-12).
- Section 15.2.2.2, *Changes in the valuation allowance*, addresses certain circumstances (e.g., initial recognition of tax benefits from a business combination or certain items recognized directly in equity) in which the effect of a change in the valuation allowance is not reported in income. See section 11.11, *Valuation allowance in a business combination*, for further discussion of accounting for changes in valuation allowances established in a business combination under ASC 805, including valuation allowances related to business combinations accounted for pursuant to accounting standards issued before ASC 805.

The primary sections in chapter 15, *Intraperiod tax allocation*, that address valuation allowances are listed below.

6.11.4.1 Valuation allowances for certain debt and equity securities

See section 15.3.1, *Income taxes for debt securities classified as available for sale*, and the related sub-sections in chapter 15, *Intraperiod tax allocation*, for a discussion of valuation allowances recognized for available-for-sale debt securities. An entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with an entity's other deferred tax assets. While the expected reversal of unrealized losses during the holding period may be included in projections of future taxable income, it would not be appropriate to forecast future appreciation in available-for-sale debt securities due to other factors such as anticipating future interest rate reductions or favorable changes to the debtor's credit worthiness.

Companies are generally required to measure equity investments (except those that result in consolidation of the investee, are accounted for under the equity method and certain other investments) at fair value and recognize any changes in fair value in net income. The related tax effects from recognizing changes in fair value that were recognized in net income are also recorded in net income.

Companies must assess the realizability of the deferred tax assets arising from unrealized losses using the same four sources of taxable income that are used to assess other deferred tax assets. In performing this assessment companies need to consider whether there is sufficient taxable income of the appropriate character under the tax law; however, it would not be appropriate to forecast future appreciation of the fair values of equity securities to conclude a valuation allowance is not necessary. See section 6.2.1, *Appropriate character of taxable income*, for additional discussion.

6.11.4.2 Valuation allowances for amounts recorded in other comprehensive income related to postretirement benefit plans

See the following sections in chapter 15, *Intraperiod tax allocation*:

- 15.3.4.2, *Valuation allowances*, for a discussion of valuation allowance recognized concurrent with the initial recognition of amounts related to postretirement benefit plans in other comprehensive income
- 15.3.4.2.1, *Subsequent recognition of valuation allowance*, for a discussion of valuation allowance recognized after the initial recognition of amounts related to postretirement benefit plans in other comprehensive income
- 15.3.4.2.2, *Valuation allowance changes due to changes in amounts in other comprehensive income related to postretirement benefit plans*, for a discussion of the effect of changes in the valuation allowance attributable to a deferred tax asset created by the recognition of amounts related to postretirement benefit plans in other comprehensive income
- 15.3.4.2.3, *Change in judgment resulting in decreased valuation allowance*, for a discussion of the effect of reductions in the valuation allowance due to changes in judgment regarding the need for, or amount of, a valuation allowance on the deferred tax asset created by amounts related to postretirement benefit plans recognized in other comprehensive income
- 15.3.4.2.4, *Change in judgment resulting in increased valuation allowance*, for a discussion of the effect of increases in the valuation allowance due to changes in judgment regarding the need for, or amount of, a valuation allowance on a deferred tax asset created by amounts recorded in other comprehensive income related to postretirement benefit plans

7 A change in the valuation allowance

The content in chapter 7 has been moved to section 6.11, *A change in valuation allowance*. There were no significant changes in the content.

8 An enacted change in tax laws or rates

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-47

The effect of a change in tax laws or rates shall be recognized at the date of enactment.

Subsequent Measurement

740-10-35-4

Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. A change in tax laws or rates may also require a reevaluation of a **valuation allowance** for deferred tax assets.

Other Presentation Matters

740-10-45-15

When deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date.

8.1 Changes in tax laws and rates

Under ASC 740-10-45-15, the effects of changes in tax rates and laws on deferred tax balances are recognized in the period in which the new legislation is enacted. In the case of US federal income taxes, the enactment date is the date the bill becomes law (i.e., upon presidential signature). The total effect of tax law changes on deferred tax balances is recorded as a component of tax expense related to continuing operations for the period in which the law is enacted even if the assets and liabilities relate to discontinued operations, a prior business combination or items of accumulated other comprehensive income. Noteworthy is that tax court rulings and IRS private letter rulings are not changes in tax law. Instead, they are interpretations of existing law.

For interim reporting purposes, the effect of new legislation must be recognized in the interim period in which the legislation is enacted even if the change in the tax rates is retroactive.

When deferred tax accounts are adjusted as required by ASC 740-10-35-4 for the effect of a change in tax laws or rates, the effect is included in income from continuing operations for the period that includes the enactment date. Companies cannot allocate the effects of rate changes to interim periods prior to the enactment date. Furthermore, ASC 740-270-30-11 prohibits including the impact of tax law changes on deferred tax assets or liabilities and taxes payable or refundable for prior years in the computation of the estimated effective tax rate for the year, effectively prohibiting spreading the effects of the change over interim periods following enactment. The FASB believes (as discussed in paragraph 112 of Statement 109, which is nonauthoritative) that a change in tax laws or rates is an event that has an economic consequence in the period that the change occurs. The effects of new tax legislation on taxes currently payable or refundable for a prior year is also recognized in the period that includes the enactment date (ASC 740-270-25-6).

Before the adoption of ASU 2019-12, the effect of a change in tax laws or rates on taxes currently payable or refundable for the current year is recorded after the effective date and reflected in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date (ASC 740-270-25-5). After the adoption of ASU 2019-12, entities are required to reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the first interim period that includes the enactment date. This is the case even if the rate change is effective in a later interim period of the annual period that includes the enactment date (ASC 740-270-25-5). Refer to section 20.3, *Effect of new tax legislation (before the adoption of ASU 2019-12)*, and 20.3A, *Effect of new tax legislation (after the adoption of ASU 2019-12)*, for more information on the interim effects of changes in tax laws or rates on taxes currently payable or refundable.

These rules apply to tax legislation in all tax jurisdictions. Thus, multi-locational and multinational companies will have to be alert to tax law changes in jurisdictions where they have significant operations to ensure that the income tax effects of such changes are reported in the appropriate interim period. In addition, they will need an understanding of the legislative process in those locations to determine the requirements for enactment (see section 8.2, *Enactment date*). The following examples illustrate the application of the above provisions.

Illustration 8-1: Accounting for the effect of a change in tax rates when the tax benefit may be realized by offsetting future taxable income or by a loss carryback

Assume at 31 December 20X0 a company's only temporary difference is a $2 million reserve for expenses related to a litigation accrual (deductible temporary difference), which is expected to result in tax deductions of $1 million in 20X1 and 20X2. Assume a change in the enacted tax rate occurs on 1 January 20X1 that decreases the tax rate to 21% for periods beginning on or after 1 January 20X1 versus the prior 35%.

If the company expects to realize the tax benefit by offsetting taxable income in the future, the applicable enacted tax rate on 1 January 20X1 and future periods would be 21% (resulting in a deferred tax asset of $420,000). However, if the company expects to realize the tax benefit by loss carryback (assuming a loss carryback is permitted under the tax law), the applicable enacted tax rate would be 35% (resulting in a deferred tax asset of $700,000). Determinations of whether to carryforward or carryback tax benefits are often dictated by the tax law.

Note: *The change in tax rate would be accounted for in the period of enactment (i.e., the interim reporting period that includes the 1 January 20X1 enactment date). Accordingly, the deferred tax asset should not be adjusted for the change in tax rate as of 31 December 20X0.*

Illustration 8-2: Timing of recognition of newly enacted tax rates on deferred taxes

Assume at the end of 20X0 a company's only temporary difference is a $1 million taxable temporary difference that arose in the prior year and is expected to reverse in 20X1 and 20X2. The deferred tax liability at the beginning of the year (20X0) is $350,000, based on the 35% tax rate in effect at December 31 of the prior year. Also, assume that, on 20 December 20X0, legislation was enacted that reduced the tax rate from 35% to 21% for all future years and that taxable income is expected in 20X1 and 20X2.

The deferred tax liability at 31 December 20X0 would be $210,000 (or $1 million at 21%). As a result of applying the newly enacted tax rates, the deferred tax liability would be reduced by $140,000 ($350,000 deferred taxes at the old tax rate, less $210,000 liability based on the new tax rates) as of the enactment date (20 December 20X0). The entire $140,000 adjustment would be recorded in the fourth quarter (i.e., the interim period in which the rate change was enacted) as a reduction of that quarter's tax expense. In this example, it is assumed there were no substantive differences in temporary differences between 20 December 20X0 and 31 December 20X0. If there were substantive differences in temporary differences between these two dates, a computation on 20 December 20X0 temporary differences would be required.

In situations where the newly enacted tax rates are phased in over two or more years, the reversal pattern of the temporary differences should be considered in determining the applicable tax rates to use in calculating deferred taxes. The impact of a phased-in tax is illustrated with the following example.

Illustration 8-3: Measurement of deferred taxes when newly enacted tax rates are phased in over multiple years

Facts

At the end of 20X0, a company's only temporary difference is $1 million related to deferred income for financial reporting purposes for a subscription received in advance (a deductible temporary difference).

- The related subscription will be recognized equally in 20X1 and 20X2 for financial reporting purposes. Enacted tax rates are 35% in 20X0 and the prior two years, 40% for 20X1 and 20X2 and 45% for 20X3 and all future years. The appropriate rate at which to measure the deferred tax asset is dependent on when the tax effect of the future reversals of the temporary differences is expected to affect taxes payable.
- The company is located in a tax jurisdiction that permits losses to be carried back.

Analysis

If taxable income is expected in 20X1 and 20X2, the applicable tax rate would be 40%.

If company breaks even and the company is expecting tax losses from the reversal of the temporary difference in 20X1 and 20X2, the applicable tax rate would be:

- 35%, if realization of the tax benefits for the losses in 20X1 and 20X2 will result from a loss carryback to 20X0 or prior years. That is, the tax effect of the future reversals of the temporary differences would affect taxes payable in 20X0 or prior years.
- 45%, if realization of the tax benefits for the losses in 20X1 and 20X2 will result from a loss carryforward to 20X3 and later. That is, the tax effect of the future reversals of the temporary differences would affect taxes payable in 20X3 and later years.

8.2 Enactment date

ASC 740 does not specifically address how to determine the enactment date in jurisdictions outside the United States. Simply stated, the enactment date is when all steps in the process for legislation to become law have been completed. For example, in Australia and Canada, the enactment date would be when Royal Assent is given to the bill, not when a bill is passed by Parliament. This conclusion is equally applicable to foreign subsidiaries of US companies. Noteworthy, ASC 740's definition of "enacted date" does not include the concept of "substantially enacted." That is, even if final steps for enactment are relatively assured, they must be completed before enactment.

8.2.1 Enactment date (United States)

ASC 740-10-25-47 requires deferred tax assets and liabilities to be adjusted for the effects of a change in tax law or rates in the period that includes the enactment date. In the US, the enactment date is considered to be the date that the President of the United States signs the legislation (or 10 days after presentation to the President of the United States (except Sundays), if unsigned and not vetoed) and it becomes law (regardless of prior announced support). However, if the President of the United States vetoes the legislation, the US Congress could override the presidential veto by a two-thirds vote in each house. In that scenario, the enactment date would be the date the second congressional body overrode the presidential veto. Many states have a similar process.

8.2.2 Enactment date (outside of the United States)

The AICPA International Practices Task Force addressed how to determine the enactment date in foreign jurisdictions with a specific question relating to a change in tax rates in Australia. Most Australian companies have a 30 June year-end. Prior to 30 June 1995, the Australian Parliament passed a bill changing the tax rates for corporations; however, the bill did not receive Royal Assent by the Governor-General until after 30 June 1995. The Australian constitution stipulates Royal Assent by the Governor-General, appointed by Queen Elizabeth II, must be received before legislation passed by the Australian Parliament can become law. The constitution gives the Governor-General discretion to withhold assent. In practice, however, the Governor-General does not withhold Royal Assent unless, in the unusual circumstance, the Prime Minister requests it.

The conclusion reached by the AICPA International Practices Task Force (i.e., when Royal Assent is given) is pragmatic and can be applied to any jurisdiction regardless of the form of government. Simply stated, the enactment date is when all steps in the process for legislation to become law have been completed, even if certain steps are virtually assured or viewed as ceremonial. In Australia, enactment date is the date Royal Assent is given to the bill. This conclusion is equally applicable to foreign subsidiaries of US companies.

8.2.3 Provisional measures

In some tax jurisdictions, the tax law is sometimes significantly altered by provisional measures that remain in force for three months and expire automatically if they are not extended for an additional three-month period. These provisional measures generally are not enacted by the legislature and should not be used as the enacted tax rate for the purpose of recognizing the tax effect of temporary differences under ASC 740.

8.3 Effects of rate changes on deferred taxes

The effect of a change in tax rates on deferred tax assets and liabilities is recognized as a component of income tax expense from continuing operations in the period in which the change is enacted (ASC 740-10-45-15 — see discussion above). The following illustration demonstrates the effect of the change when a deferred tax asset has been recognized for operating loss carryforwards and includes the effect of graduated tax rates on the calculation.

Illustration 8-4: A change in tax law from a flat rate to graduated rates

Assume Company A has only one temporary difference, represented by a net operating loss carryforward for tax purposes of $20 million at 31 December 20X0. Management expects to fully realize this benefit in future periods and, based on the weight of all available evidence, adequately supported this assertion by scheduling the expected future reversal pattern as of 31 December 20X0 as follows:

	20X1	20X2	20X3	Total
	(in thousands)			
Estimated taxable income	$ 9,000	$10,000	$15,000	
Carryforward expected to be applied	(9,000)	(10,000)	(1,000)	
Expected statutory tax rate	35%	35%	35%	
Deferred tax asset at 31 December 20X0	$ 3,150	$ 3,500	$ 350	$ 7,000

Based on the above calculation, Company A concluded no valuation allowance was needed as of 31 December 20X0 and the full $7 million deferred tax asset was recognized at 31 December 20X0.

Assume a tax law was enacted on 15 August 20X1 that changed the tax rates from a flat 35% to a graduated rate of 35% for entities with taxable income equal to or less than $10 million and 40% for entities with taxable income greater than $10 million. Thus, in 20X3 Company A's tax rate is expected to be 40% rather than 36.7% (or $10 million at 35% plus $5 million at 40%).

Assume Company A's estimates of future taxable income remained unchanged in 20X1 and that one-half of the estimated taxable income ($4.5 million) and the related deferred tax benefit ($1.575 million) for 20X1 was utilized through 30 June 20X1. Thus, Company A's deferred tax asset balance would be $5.425 million ($7 million less $1.575 million) as of 30 June 20X1. Further, assume there were no transactions from 30 June 20X1 through the enactment date (15 August 20X1) that would materially impact the deferred tax asset.

As of 1 July 20X1 (rather than the enactment date, for practical purposes), the deferred tax asset would be recomputed during the third quarter as follows:

	1 July through 31 December 20X1	**20X2**	**20X3**	**Total**
		(in thousands)		
Estimated taxable income	$ 4,500	$ 10,000	$ 15,000	
Carryforward applied to income:				
Over $10 million at 40%	–	–	(1,000)	
Up to $10 million at 35%	(4,500)	(10,000)	–	
Estimated taxable income	$ –	$ –	$ 14,000	
Carryforward utilized	$ 4,500	$ 10,000	$ 1,000	
Applicable tax rate	35%	35%	40%	
Deferred tax asset at 1 July 20X1	$ 1,575	$ 3,500	$ 400	$ 5,475
Estimated deferred tax balance at 30 June 20X1				(5,425)
Increase (decrease) in earnings due to change in tax law at 1 July 20X1				$ 50

Thus, Company A would recognize an increase in its deferred tax asset balance of $50 and a corresponding reduction in its income tax provision in the quarter ended 30 September 20X1 (that is, the quarter that included the 15 August 20X1 enactment date) related to the change in tax rates.

Many companies will not be able to estimate their taxable income in future years as precisely as in this example; therefore, ASC 740 permits the use of an average graduated tax rate[29] to calculate the effects of the change. A company's average graduated tax rate, as discussed in ASC 740-10-30-9, is estimated based on anticipated average annual taxable income in future years, resulting in a composite tax rate.

In this example, if the company estimated that its taxable income over the next few years would fluctuate between $9 million and $15 million, the company may have simply estimated its average tax rate at 37.5%, in which case the revised deferred tax benefit of the NOL would have been approximately $5.8 million ($15.5 million carryforward balance at 1 July 20X1 x 37.5% estimated rate). However, if a company's estimated average graduated tax rate is expected to change from year to year, this short-cut approximation method would not be appropriate. Instead, the company should schedule its expected utilization of deferred tax assets and apply its best estimate of its future average graduated tax rate (based on currently enacted tax rates and laws) in the period in which the deferred tax asset is expected to be used.

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[29] See section 5.1.1, *Average graduated tax rates*, for discussion of considerations of statutory graduated tax rates when computing deferred tax amounts.

8.4 Retroactive change in enacted tax rates

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-48

The tax effect of a retroactive change in enacted tax rates on current and deferred tax assets and liabilities shall be determined at the date of enactment using temporary differences and currently taxable income existing as of the date of enactment.

Initial Measurement

740-10-30-26

The reported tax effect of items not included in income from continuing operations (for example, discontinued operations, cumulative effects of changes in accounting principles, and items charged or credited directly to shareholders' equity) that arose during the current fiscal year and before the date of enactment of tax legislation shall be measured based on the enacted rate at the time the transaction was recognized for financial reporting purposes.

Other Presentation Matters

740-10-45-16

Paragraph 740-10-25-48 provides the recognition guidance when a tax law retroactively changes tax rates. In such cases, the cumulative tax effect is included in income from continuing operations.

740-10-45-17

Paragraph 740-10-30-26 provides the measurement guidance for a change in tax rates on items not included in income from continuing operations that arose during the current fiscal year and prior to the date of enactment. In such cases, the tax effect of a retroactive change in enacted tax rates on current or deferred tax assets and liabilities related to those items is included in income from continuing operations in the period of enactment.

ASC 740-10-45-15 requires deferred tax liabilities and assets be adjusted for the effect of a change in tax laws or rates when enacted and that the effect be included in income from continuing operations. In addition, ASC 740-10-25-48 requires that the tax effect of a retroactive change in enacted tax rates on current and deferred tax assets and liabilities should be determined at the date of enactment using temporary differences and currently taxable income existing as of the date of enactment. The cumulative tax effect is included in income from continuing operations (ASC 740-10-45-16). See chapter 5, *Recognition and measurement*, for further discussion.

ASC 740-10-30-26 requires that the reported tax effect of items not included in income from continuing operations (e.g., discontinued operations, cumulative effects of changes in accounting principles, items charged or credited directly to shareholders' equity) arising during the current fiscal year and prior to the enactment date should be measured based on the enacted rate at the time the transaction was recognized for financial reporting purposes. As discussed above, the tax effect of a retroactive change in enacted tax rates on current or deferred tax assets and liabilities related to those items is included in income from continuing operations in the period of enactment (ASC 740-10-45-17). That is, the effect of a tax rate change is not backward traced.

Companies must consider two principal factors in determining the effects of a tax rate change on income from continuing operations. The first is the effect of the retroactive rate change, if applicable, on estimated taxable income through the enactment date. The second is the effect of the rate change on deferred tax balances existing at the enactment date, effectively requiring companies to estimate their temporary differences as of the enactment date. For public companies and others subject to periodic reporting requirements, estimating temporary differences as of the most recent quarter often will be adequate, with appropriate adjustments for material unusual or infrequent transactions between the enactment date and quarter end. For companies that do not prepare interim financial statements, calculating the effect of the change will require additional effort. For such companies, the effect of reversals of beginning deferred tax balances for the period through the enactment date will have to be considered, as well as the deferred tax effects of originating temporary differences. Calculating the effects of a retroactive rate change is illustrated in the following example.

Illustration 8-5: Retroactive tax rate during an interim period

Assume at 31 December 20X0 a calendar-year company has only one temporary difference, which related to the use of accelerated depreciation of fixed assets for tax purposes and straight-line depreciation for financial reporting purposes. At 31 December 20X0, the $15 million taxable temporary difference and related deferred tax liability of $5.25 million (assuming a 35% effective tax rate) were scheduled to reverse as follows (in thousands):

	20X1	**20X2**	**20X3**	**Total**
Reversal of taxable temporary difference	$ 4,000	$ 5,000	$ 6,000	$15,000
Expected tax rate	35%	35%	35%	35%
Deferred tax liability at 31 December	$ 1,400	$ 1,750	$ 2,100	$ 5,250

Further, assume the company calculated its income tax expense, as reported in its interim 20X1 financial statements, using an effective tax rate of 35%. Based on this rate, the company recorded tax expense for the six months ended 30 June 20X1 as follows:

Application of effective tax rate to six-month results:

Year-to-date pretax income	$ 18,000
Estimated annual effective tax rate	35%
Income tax provision for six months ended 30 June 20X1	$ 6,300

Assuming the taxable temporary difference reverses ratably during each year (i.e., at 30 June 20X1, $2 million of the taxable temporary difference for 20X1 had reversed), the income tax provision for the first six months of $6.3 million represents the net effect of current income tax expense of $7 million less the deferred tax benefit of $0.7 million (or $2 million x 35%) representing the reversal of the previously recognized deferred tax liability relating to the use of accelerated depreciation for tax purposes.

These amounts are calculated as follows (in thousands):

Year-to-date pretax income for financial reporting	$ 18,000
Add: reversal of the excess book over tax depreciation for first six months	2,000
Taxable income through 30 June 20X1	20,000
Statutory federal income tax rate	35%
Current income tax expense	$ 7,000
Reduction in temporary difference — depreciation	$ (2,000)
Statutory federal income tax rate	35%
Reversal of deferred tax liability	$ (700)

In the quarter ended 30 September 20X1, new tax legislation was enacted on 10 August 20X1, which increased the tax rate from 35% to 40%, retroactive to 1 January 20X1. Accordingly, the company recalculated its estimated effective tax rate and determined that it had increased from 35% to 40%. The company also estimated its temporary differences as of 30 June 20X1 and determined no significant transactions occurred from that date through 10 August 20X1 that would materially affect its temporary differences. The effect of the rate change on previously reported income tax expense is calculated as follows (in thousands):

Effect of the rate change on taxable income for the first six months:	
$18 million pretax income @ 5% effective tax rate change	$ 900
$2 million excess book over tax depreciation	100
$2 million reversal of taxable temporary differences	(100)
Effect of rate change on deferred tax liabilities at 30 June 20X1:	
($15 million − $2 million = $13 million @ 5%)	650
	$ 1,550

Therefore, third-quarter income tax expense is increased by $1.55 million. This illustration assumes that third-quarter income and changes in deferred taxes recorded through the date of the enacted change in tax law were not significant. If such changes were significant, there would be an additional effect from the change in tax law. See section 20.8.1.2, *Calculation of second-quarter income tax expense when a change in tax rates occurs*, for an example calculation where such interim effect is calculated. In addition, the estimated effective tax rate used for the remainder of the year will be 40%.

When considering the use of an interim date other than the enactment date for determining the impact of a change in tax rates, companies should consider whether any transactions occurred between the date used to estimate the deferred tax balances and the enactment date, which would materially affect the calculation. For example, significant equity transactions, business combinations and discontinued operations should be considered. Transactions of this nature occurring between the balance sheet date used to estimate temporary differences and the enactment date should reflect the tax effects determined at the rate in existence at the transaction date. Further, for assets or liabilities that are measured at fair value on a recurring basis (e.g., available-for-sale debt securities), companies should consider whether the change in fair value between the date used to estimate the deferred tax balances and enactment date would materially affect the calculation. The effect of the rate change on these items should be reflected as part of income tax expense in income from continuing operations. If a company changes the amount of a previously recorded valuation allowance as a result of remeasuring existing temporary differences and loss carryforwards, the amount of the change in the valuation allowance is also reflected in continuing operations.

Also noteworthy is that a retroactive rate change could affect the results of operations even if a company has no deferred taxes, see section 8.6, *Change in tax law or rates related to items not recognized in continuing operations*, for further details.

In addition to the effects of the change in tax rates, consideration should be given to other changes in the law that affect a company's effective tax rate. For example, a significant provision of the 1986 Tax Reform Act was the extension of the research and development (R&D) credit, which originally expired as of 30 June 1992. The Act retained the eligibility requirements of the prior law, but extended the credit to 30 June 1995, and was retroactive to 1 July 1992. Because tax calculations from 1 July 1992 through 30 June 1993 did not include the effect of the R&D credit extension, a catch-up adjustment was required in the third quarter of 1993 (for calendar-year companies) for the benefit of this change in the law, which was reported as a reduction of income tax expense from continuing operations. In addition, the estimated annual effective tax rate for the remainder of the year was required to be adjusted to reflect the availability of the credit.

8.5 Changes in tax rates after adopting new accounting standards

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Other Presentation Matters

740-10-45-18

Paragraph 740-10-25-47 requires that the effect of a change in tax laws or rates be recognized at the date of enactment. Accordingly, if an entity were adopting a new accounting standard as of a date prior to the enactment date, the effect of the change in tax laws or rates would not be recognized in the cumulative effect of adopting the standard, but would be recognized in income from continuing operations for the period that includes the enactment date. This would be true regardless of whether the change was retroactive to the earlier date.

ASC 740-10-45-15 states "when deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date." Accordingly, if an entity were adopting a new accounting standard as of a date prior to the enactment date, the effect of the change in tax laws or rates would not be recognized in the cumulative effect of adopting the standard but would be recognized in income from continuing operations for the period that includes the enactment date. This would be true, regardless of whether the change in tax law or rate was retroactive to the earlier date (ASC 740-10-45-18).

Further, after accounting for the enactment date effects of a change in tax law, a company may adopt a new accounting standard retroactively (by revising earlier period financial statements or through a cumulative catch-up adjustment). Companies that account for the adoption of a new accounting standard after accounting for the effects of changes in the tax law will likely need to calculate the enactment-date effects of the change in tax law for a second time if the new accounting standard changes the financial results for transactions that occurred before the enactment date. The first calculation would be for the reporting period that included the enactment date. The company would then need to account for the income tax effects of adopting the new standard, which could change the previously reported financial results (i.e., a change to the previously issued financial statements that included the period of enactment or a change reflected in the cumulative catch-up effect of adoption).

For example, if a change in tax law occurred on 1 October 20X5 and if a company adopts the new accounting standard on 1 January 20X6 using a full retrospective method, it will first recast its 20X4 and 20X5 financial results for the period before enactment based on the tax law in effect during those periods. The effects of the 1 October 20X5 tax law change will then be recalculated based on the revised financial results reflecting the effects of the new accounting standard. This means that the enactment-date effects of the change in tax law in a company's recast financial results may differ from the amounts originally reported in the 20X5 financial statements that a company issues.

8.6 Change in tax law or rates related to items not recognized in continuing operations

In some situations, deferred tax assets and liabilities will relate to transactions that initially were accounted for as direct entries to shareholders' equity or comprehensive income for which the offsetting tax effects also were accounted for as equity or comprehensive income adjustments (ASC 740-20-45-11). Examples of such transactions include deferred taxes on foreign currency translation adjustments and the tax effects relating to unrealized holding gains and losses for available-for-sale debt securities that are excluded from earnings and reported in other comprehensive income.

ASC 740-10-45-15 requires that the effects of tax law and tax rate changes be reflected as a component of tax expense from continuing operations. Thus, the effects of tax law and tax rate changes on deferred taxes initially charged or credited directly to shareholders' equity or other comprehensive income would be recognized as an adjustment to income tax expense or benefit and not as an adjustment to shareholders' equity or other comprehensive income. Similarly, the effects of tax rate changes on deferred taxes related to prior period items reported as discontinued operations would be reflected in continuing operations in the period of change. ASC 740-20-45-3 has a general prohibition regarding backward tracing.

Illustration 8-6: Retroactive change in tax rates reflected in income from continuing operations when discontinued operations are reported

Assume a company had no temporary differences but recognized a $100 million gain on discontinued operations in the second quarter of 20X1. The effect of a retroactive increase in the enacted tax rate from 35% to 40% in the third quarter of 20X1 would be reflected in income before discontinued operations in the third quarter. If we assume breakeven operating results, the income statement would be presented as follows (in thousands):

	Three months ended		Year-to-date
	30 June 20X1	**30 September 20X1**	**30 September 20X1**
Income before taxes and discontinued operations	$ –	$ –	$ –
Tax expense ($100 million at 5%)	–	5,000	5,000
(Loss) before discontinued operations	–	(5,000)	(5,000)
Gain on discontinued operations, net of tax expense of $35 million	65,000	–	65,000
Net income (loss)	$ 65,000	$ (5,000)	$ 60,000

Similarly, if the $100 million credit represented a transaction that was credited directly to other comprehensive income, net of the 35% tax effect, the company would report a net loss from continuing operations of $5 million in the third quarter representing the 5% increase in the tax rate. ASC 740-10-45-15 requires that the effect of the rate change be reflected in income from continuing operations, regardless of the original accounting for the item.

8.7 Changes in tax accounting methods

When a company determines its taxable income each year and prepares its tax returns, it is required by tax law in many jurisdictions (including the US) to use consistent tax accounting methods for similar transactions, just as it is required to consistently apply accounting policies when preparing its financial statements in accordance with US GAAP. US federal tax accounting methods only affect *when* an item is treated as taxable income or a deductible expense and not *whether* an item is treated as taxable income or a deductible expense. That is, the determination of whether a transaction is taxable or deductible in any period is not the establishment of a tax accounting method. If there is uncertainty as to whether a transaction is taxable or deductible, see chapter 19, *Accounting for uncertainty in income taxes*.

The remaining discussion and sections below provide guidance for changes in federal tax accounting methods in the US. Similar considerations may be applicable in other jurisdictions.

Initial adoption of a tax accounting method

As noted above, a tax accounting method must be used consistently when preparing each year's tax return. Determining when a tax method has been established is dependent on whether the tax accounting method is proper or improper.

- A proper tax accounting method is adopted with the first use of that method for a particular transaction on a US federal tax return.
- An improper tax accounting method is adopted with the second use of that method for a particular transaction on a US federal tax return. That is, the improper tax accounting method is adopted when it is used consistently on at least two consecutive US federal tax returns.[30]

For example, a company uses an improper tax accounting method in year 1 and discovers the improper method prior to filing its tax return in year 2. The company uses a proper tax accounting method in its year 2 tax return. With the filing of the year 2 tax return, the company has adopted a proper tax accounting method. If, however, the company did not discover the improper method prior to filing its year 2 tax return and filed its year 2 tax return using the same improper method, the company has now adopted a tax accounting method despite the method being improper.

Once a company adopts a tax accounting method, whether proper or improper, the company must continue to use that method until the company files a request to change the tax accounting method with the IRS National Office. A company evaluates its use of an improper tax accounting method in accordance with the ASC 740 guidance on uncertain tax positions. This evaluation will likely result in a company recording a liability for an uncertain tax position, as well as accrued interest and penalties. See chapter 19, *Accounting for uncertainty in income taxes*, for additional discussion.

Changes in tax accounting methods

Common tax accounting method changes include changes in inventory valuation methods, revenue recognition methods and the timing of deduction of certain expenses. These changes can be discretionary (i.e., made at the company's election) or nondiscretionary (i.e., required by the taxing authority as a result of an examination of part or all of the company's income tax return, changes in administrative procedures, interpretations or tax regulations, or otherwise). Refer to section 8.7.1, *Discretionary change in tax accounting methods*, and section 8.7.2, *Nondiscretionary change in tax accounting methods*, below for additional discussion.

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[30] Additionally, the IRS may consider an improper tax accounting method as adopted if the method is used consistently on at least two nonconsecutive US federal tax returns for a transaction that does not occur annually.

8.7.1 Discretionary change in tax accounting methods

In the US, a company seeking to change a tax accounting method is required to file the change with the IRS National Office on Form 3115, *Application for Change in Accounting Method*. There are two types of tax discretionary accounting method changes — automatic tax accounting method changes (automatic changes) and nonautomatic tax accounting method changes (nonautomatic changes). Both types include changes from a proper method to another proper method and changes from an improper method to a proper method.

- Automatic changes — An automatic change does not require approval from the IRS National Office. Eligible changes are listed in the applicable IRS guidance.[31]
- Nonautomatic changes — A nonautomatic change requires approval from the IRS National Office as the method change is not listed in the applicable IRS guidance.

It is important to note that a company under IRS audit may be required to obtain the consent of the IRS director (or his or her delegate) prior to filing a Form 3115 with the IRS National Office. A company's need to obtain consent from the IRS director potentially limits the company's ability to change its tax accounting methods (i.e., the company's ability to file Form 3115 is limited) despite a change being considered an "automatic change."

Changing from one proper tax accounting method to another proper tax accounting method — discretionary automatic changes

When a company determines that it is eligible for an automatic change, Form 3115 is attached to the company's tax return for the year of change. A copy of the Form 3115 is required to be filed with the IRS National Office prior to the Form 3115 being filed with the tax return. Once the Form 3115 is filed with the IRS National Office, the company is deemed to have the consent of the IRS when the Form 3115 is attached to its tax return (i.e., IRS consent is perfunctory after the Form 3115 is filed with the IRS National Office). A company should carefully consider any requirements that may be associated with filing a Form 3115 with the IRS National Office to ensure that they are met (e.g., obtaining the consent of the IRS director if under audit (see above), attaching certain information).

For an automatic change from one proper tax accounting method to another proper tax accounting method, we believe the financial statement effect of that change should generally be recognized when the Form 3115 is filed with the IRS National Office. We generally expect that a company would file the Form 3115 in the same accounting period it concludes that it has the intent and ability to file the form. In certain cases, however, a company may conclude that, based on the facts and circumstances, it should recognize the income tax accounting effects of a tax accounting method change in the financial statements prior to filing Form 3115 (i.e., a company may conclude that it has the intent and ability to file an automatic change on Form 3115, but it may not have done so as of the balance sheet date). We would not expect that a company under IRS audit proposing to change its tax accounting method from one proper method to another proper method would account for a tax accounting method change prior to receiving the consent of the IRS director to file Form 3115, if such consent is, or will be, required.

If a change in tax accounting method results in the recognition of a deferred tax asset, that asset is evaluated for realizability under ASC 740's more-likely-than-not criteria.

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[31] Every year, the IRS issues a list of automatic method changes companies can voluntarily make with the filing of their annual income tax returns.

Changing from one proper tax accounting method to another proper tax accounting method — discretionary nonautomatic changes

For nonautomatic changes, a company files a Form 3115 with the IRS National Office during the tax year in which the company would like to change its tax accounting method and must receive written consent from the IRS National Office before changing its tax accounting method for the year. For a nonautomatic change from one proper tax accounting method to another, we believe the financial statement effect of that change should be recognized in the period in which the company receives notification of the IRS National Office's approval of the change (i.e., when all procedures necessary to effect the change have been completed). Between filing of the Form 3115 and potential approval, it may be prudent for a company to provide transparent disclosures in its notes to the financial statements discussing the possible change in tax accounting method.

Changing from an improper tax accounting method to a proper tax accounting method — automatic and nonautomatic changes

A company evaluates its use of an improper tax accounting method in accordance with the ASC 740 guidance on uncertain tax positions. This evaluation may result in a company recording a liability for an uncertain tax position, as well as accrued interest and penalties. While a change from an improper to proper tax accounting method is referred to as a discretionary change, because the method was improper, the use of the improper method results in a tax uncertainty that must be accounted for. See chapter 19, *Accounting for uncertainty in income taxes*, for additional discussion.

A company may change from an improper tax accounting method to a proper tax accounting method. When a company files the Form 3115 with the IRS National Office, the IRS is generally precluded from challenging the company's use of the improper method in earlier tax years (i.e., the company generally is provided audit protection for the prior improper method and is not assessed interest and penalties). This audit protection for the improper method is triggered on the date that the company files the Form 3115 with the IRS National Office. Audit protection is provided as the IRS' tax accounting method change procedures provide for resolution of the use of the improper method and any related adjustment to a company's tax obligation (refer to section 8.7.4, *Implementing a change in tax accounting method*). Audit protection also serves as an incentive for a company to change from its improper method. However, prior to filing the Form 3115, the company has audit risk associated with its improper method. Noteworthy is that audit protection may not be provided for a tax accounting method change if a company's improper method was the result of improper books and records, negligence or intentional disregard of tax rules. Therefore, a company should assess whether it will be provided audit protection based on the specific facts and circumstances of its use of an improper method.

For automatic changes from an improper tax accounting method to a proper tax accounting method, we believe that the financial statement effect of that change generally should be recognized when the Form 3115 is filed with the IRS National Office as this generally triggers audit protection, and thus generally resolves the uncertain tax position based on the change in facts. Upon filing a Form 3115 to change from an improper method to a proper method and assuming the company is afforded audit protection, we believe that a company generally should reclassify any recorded liability for unrecognized tax benefits to a deferred tax liability (or taxes payable depending on the circumstances) to reflect the tax consequences of the change in accounting method. Additionally, a company generally should reverse any accrued interest and penalties recorded for the improper method in the period in which the Form 3115 is filed and it has been determined that audit protection will be afforded.

For nonautomatic changes, the IRS National Office must approve the change. However, because a company is generally afforded audit protection (see discussion above) with the filing of the Form 3115 with the IRS National Office, a company also should generally reflect in its financial statements the tax accounting consequences of nonautomatic changes from an improper to a proper tax accounting method in the period in which the Form 3115 is filed with the IRS National Office. The company should assess the likelihood that the nonautomatic change will be approved by the IRS National Office and that the company will change from an improper method before recognizing the effects of a change in tax accounting method (e.g., before reclassifying the liability for unrecognized tax benefits and possibly reversing accrued interest and penalties).

8.7.2 Nondiscretionary change in tax accounting methods

In some cases, a taxing authority requires a company to change its tax accounting methods based on an examination of part or all of the company's income tax return, changes in the administrative procedures, interpretations or tax regulations. These changes are often the subject of significant negotiations and/or litigation, depending on the level of ambiguity in the underlying tax law or aggressiveness of the tax positions taken by the company. These types of changes in tax accounting methods tend to be specific to the facts and circumstances of each company, and those matters should be considered in determining the ultimate financial statement recognition of the change in tax accounting methods. However, we believe the financial statement effect of nondiscretionary changes in tax accounting methods should generally be recognized in accordance with the guidance on uncertainty in income taxes in ASC 740 (see chapter 19, *Accounting for uncertainty in income taxes*, for additional discussion).

8.7.3 Presentation of a change in tax accounting method

A change in tax accounting methods due to a change in tax law is required to be recognized in the period in which the change in tax law is enacted as a component of income tax expense from continuing operations (ASC 740-10-45-15). Similarly, if a company elects to make a tax method change (e.g., a change from one permissible tax accounting method to another), we also generally would expect the financial statement consequences of the tax method change to be recognized as a component of income tax expense from continuing operations.

8.7.4 Implementing a change in tax accounting method

When a company changes a tax accounting method, generally it is required to make a cumulative catch-up adjustment under Internal Revenue Code Section 481(a) (Section 481(a) adjustment) to ensure that there are no duplications or omissions of taxable income or deductible expense in its tax returns. As a result, the Section 481(a) adjustment treats the new tax accounting method as if it were always used.

For Section 481(a) adjustments that increase taxable income (i.e., positive Section 481(a) adjustments), the company generally is required to reflect the adjustment ratably over four years. That is, the company includes 25% of the adjustment in the current and each of the subsequent three years' tax returns. Therefore, taxable income in each of those four years is higher than it otherwise would have been. As the Section 481(a) adjustment increases future taxable income, it is considered a taxable temporary difference, with the measurement of the deferred tax liability subject to future changes in tax laws or rates. This differs from a long-term payable to a taxing authority that is not subject to changes in tax laws or rates, which we believe is not a taxable temporary difference.

Tax accounting method changes that give rise to positive Section 481(a) adjustments and do not conform to the book treatment of the related item generally result in two temporary differences. The following guidance illustrates this concept.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-59

A change in tax law may require a change in accounting method for tax purposes, for example, the uniform cost capitalization rules required by the Tax Reform Act of 1986. For calendar-year taxpayers, inventories on hand at the beginning of 1987 are revalued as though the new rules had been in effect in prior years. That initial catch-up adjustment is deferred and taken into taxable income over not more than four years. This deferral of the initial catch-up adjustment for a change in accounting method for tax purposes gives rise to two temporary differences.

740-10-55-60

One temporary difference is related to the additional amounts initially capitalized into inventory for tax purposes. As a result of those additional amounts, the tax basis of the inventory exceeds the amount of the inventory for financial reporting. That temporary difference is considered to result in a deductible amount when the inventory is expected to be sold. Therefore, the excess of the tax basis of the inventory over the amount of the inventory for financial reporting as of December 31, 1986, is considered to result in a deductible amount in 1987 when the inventory turns over. As of subsequent year-ends, the **deductible temporary difference** to be considered would be the amount capitalized for tax purposes and not for financial reporting as of those year-ends. The expected timing of the deduction for the additional amounts capitalized in this example assumes that the inventory is not measured on a LIFO basis; temporary differences related to LIFO inventories reverse when the inventory is sold and not replaced as provided in paragraph 740-10-55-13.

740-10-55-61

The other temporary difference is related to the deferred income for tax purposes that results from the initial catch-up adjustment. As stated above, that deferred income likely will be included in taxable income over four years. Ordinarily, the reversal pattern for this temporary difference should be considered to follow the tax pattern and would also be four years. This assumes that it is expected that inventory sold will be replaced. However, under the tax law, if there is a one-third reduction in the amount of inventory for two years running, any remaining balance of that deferred income is included in taxable income for the second year. If such inventory reductions are expected, then the reversal pattern will be less than four years.

740-10-55-62

Paragraph 740-10-35-4 requires recognition of the effect of a change in tax law or rate in the period that includes the enactment date. For example, the Tax Reform Act of 1986 was enacted in 1986. Therefore, the effects are recognized in a calendar-year entity's 1986 financial statements.

For Section 481(a) adjustments that reduce taxable income (i.e., negative Section 481(a) adjustments), the company is required to reflect the full adjustment in the tax year of change. As a negative Section 481(a) adjustment only affects current taxes payable, this adjustment does not result in any temporary difference.

Some tax accounting method changes are made on a prospective basis in the year of change (i.e., the "cut-off method"). Transactions prior to the year of change are accounted for using the prior tax accounting method. Tax accounting method changes subject to a cut-off are specifically identified in IRS guidance.

8.8 Other discussions of the impact of changes in tax rates

See section 11.10, *Effects of change in tax laws or rates subsequent to a business combination*, for further discussion of accounting pursuant to ASC 805 for the remeasurement of deferred tax assets and liabilities established in a business combination as a result of a change in tax regulations.

See section 15.2.2.1, *Changes in tax laws, rates or tax status*, for a discussion of changes in tax rates and the impact on intraperiod tax allocation.

See section 15.3.1.3, *Income tax rate changes*, for a discussion of changes in tax rates and the impact on unrealized gains and losses recognized in other comprehensive income attributable to securities accounted for under ASC 320 and classified as available for sale.

See section 15.3.4.4, *Income tax rate changes,* for a discussion of the impact of changes in tax laws and rates on deferred taxes initially recognized in other comprehensive income attributable to postretirement benefit plans.

See section 19.7.1.3, *Changes in tax rates*, for further discussion on the effects of changes in tax rates on uncertainties in tax positions.

See section 20.3, *Effect of new tax legislation (before the adoption of ASU 2019-12)*, and section 20.3A, *Effect of new tax legislation (after the adoption of ASU 2019-12)*, for a discussion of changes in tax rates and the effect on interim financial statements.

9 Change in the tax status of an entity

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-32

An entity's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset shall be recognized for temporary differences in accordance with the requirements of this Subtopic at the date that a nontaxable entity becomes a taxable entity. A decision to classify an entity as tax exempt is a tax position.

740-10-25-33

The effect of an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and a change in tax status that results from a change in tax law is recognized on the enactment date.

Derecognition

740-10-40-6

A **deferred tax liability** or **asset** shall be eliminated at the date an entity ceases to be a taxable entity. As indicated in paragraph 740-10-25-33, the effect of an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and a change in tax status that results from a change in tax law is recognized on the enactment date.

Other Presentation Matters

740-10-45-19

When deferred tax accounts are recognized or derecognized as required by paragraphs 740-10-25-32 and 740-10-40-6 due to a change in tax status, the effect of recognizing or derecognizing the deferred tax liability or asset shall be included in income from continuing operations.

9.1 General

Some forms of businesses, such as partnerships, certain limited-liability companies and S corporations, generally are not subject to income taxes. However, as a result of changes in tax law or changes in elections, an entity may change from nontaxable to taxable status or vice-versa. Noteworthy is that a change to a real estate investment trust (REIT) is not considered a change in tax status. That is, a REIT is taxed as a C corporation at normal corporate rates; however, in computing its taxable income, a REIT can deduct dividends paid.

ASC 740-10-45-19 requires that the deferred tax effects of a change in tax status be included in income from continuing operations. When an entity changes its tax status and becomes subject to income taxes, deferred tax assets and liabilities should be recognized for existing temporary differences (ASC 740-10-25-32). Likewise, when a taxable entity ceases to be taxable, deferred tax assets and liabilities should be eliminated (ASC 740-10-40-6).

An election for a voluntary change in tax status is recognized at the time the change is effective in accordance with the applicable tax laws, which is the date the approval for the change is granted by the taxing authorities, if required, or on the filing date, if approval is not necessary (ASC 740-10-25-33). An adjustment should not be made merely because a change in the status is planned. For example, a taxable corporation should not eliminate deferred taxes because it plans to change to S corporation status. A change in tax status that results from a change in tax law is recognized on the enactment date, similar to other tax law changes.

9.2 Conversion of a partnership to a corporation

A partnership is a nontaxable entity, and income tax consequences of transactions within the partnership flow through to the partners (i.e., investors). Deferred tax assets and liabilities are recognized for the difference between the financial reporting basis and tax basis of the investment in the partnership (referred to as outside basis differences) at the investor level (see section 2.3, *Partnerships and other pass-through entities*, and section 14.6*, Investments in partnerships and other pass-through entities*).

In the US, a conversion of a partnership to a taxable corporation is a change in tax status that generally does not require approval by the taxing authority. While the tax basis in the assets and liabilities generally does not change when a partnership is taxed as a corporation, the corporation is now a taxable entity, and the temporary differences on existing assets and liabilities within the corporate entity (referred to as inside basis differences) are subject to tax. When a partnership converts to a corporation, the entity recognizes in continuing operations the effects of recording deferred taxes related to any inside basis differences. The outside basis of the corporation would also be a taxable or deductible basis difference subject to the exceptions and limitations noted in chapter 14, *Foreign and domestic subsidiaries.* A taxable corporation's conversion to a partnership or other pass-through entity also is considered a change in tax status for which the related changes in temporary differences are recognized in continuing operations.

A change in status may also change the tax basis related to existing assets and liabilities. For example, in the US, a partnership may have net liabilities for tax purposes before a change to a taxable corporation. A gain that is taxable to the partners arises on conversion to a corporation. The succeeding corporation also receives a step up in tax basis as a result of the taxable gain attributable to its former partners.

A question may arise as to whether a change in tax basis for the corporation is considered a change in tax status or a transaction among shareholders. ASC 740-10-45-19 requires that the deferred tax effects of a change in tax status be included in income from continuing operations, whereas the tax effects of changes in the tax bases of assets and liabilities caused by transactions among or with shareholders is included in equity (ASC 740-20-45-11(g)). ASC 740-20-45-11(g) was previously included in EITF 94-10, "Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109." While not codified in ASC 740, EITF 94-10 noted specifically that it did not address shareholder transactions that involve a change in the tax status of a company (such as a change from nontaxable S corporation status or partnership status to taxable C corporation status).

Regardless of whether the reporting entity is the consolidated entity (i.e., parent and the previous partnership that is now a corporation) or the standalone now-taxable corporation (previously a nontaxable partnership), the income tax benefits related to the increase in tax basis are recognized in income from continuing operations as the increase in tax basis resulted from the change in tax status of a subsidiary and not a transaction with a shareholder.

See section 9.6 for additional SEC guidance when preparing pro forma financial information or historical financial statements when an entity changes its tax status from a partnership to a corporation.

9.2.1 Outside basis considerations related to a conversion of a partnership to a corporation

Before the conversion to a corporation, the partners in a partnership recognized deferred tax assets and liabilities for the difference between the financial reporting basis and tax basis of the investment in the partnership (referred to as outside basis differences) at the investor level. The outside basis differences of an investment in a partnership are generally recognized by the investor versus the partnership (see sections 2.3, *Partnerships and other pass-through entities*, and 14.6*, Investments in partnerships and other pass-through entities*). The partnership itself is nontaxable and therefore does not record deferred taxes assets and liabilities.

For the investor in a partnership, a conversion from a partnership to a corporation may result in the application of an exception to recognizing the outside basis difference for the investment in the corporation. Changes to deferred tax assets and liabilities related to a change in the expected manner of recovery of the investment are recorded to income from continuing operations in the period in which the change occurs (which can be no earlier than when the change in status occurs). See chapter 14, *Foreign and domestic subsidiaries*, for further discussion.

9.3 Change in tax status as a result of acquisition

An S corporation's nontaxable status may change as a result of its acquisition by a C corporation. For example, an S corporation will become taxable at the date of the business combination when its status as an S corporation is terminated. Deferred taxes generally are recognized at the acquisition date related to temporary differences of the S corporation as those temporary differences are taxable at the business combination date. We often receive questions whether the deferred taxes are considered part of the business combination or a change in tax status of the S corporation. In the consolidated financial statements, we believe it is appropriate to consider the recognition of the deferred taxes as part of the business combination. The S corporation had its nontaxable status terminated solely as a result of the acquisition by a C corporation. That is, the S corporation's nontaxable status would not have changed but for the acquisition. The acquisition accounting will reflect the deferred tax assets and liabilities recognized for the tax effects of differences between assigned book values and tax bases of assets acquired and liabilities assumed (see section 11.2, *Tax effects of basis differences*).

However, if after the business combination the previous S corporation issues separate financial statements and the effects of the business combination are not "pushed down" and recorded directly onto the acquired entity's books, the loss of nontaxable status is not directly related to the acquisition. That is, in the separate financial statements of the subsidiary, a business combination has not occurred as new book basis is not established. Instead, a change in tax status of the acquired entity has occurred. In these circumstances, the recognition of deferred tax assets and liabilities are recorded at the acquisition date to income from continuing operations in the acquired entity's separate financial statements.

9.4 Change in tax status — subsequent event

If an election to change a company's tax status is approved by the tax authority (or filed, if approval is not necessary) after the balance sheet date but before the financial statements are issued, the change in tax status would be reflected in the period in which the change is approved by the tax authority (or filed, if approval is not necessary) as noted in section 9.1, *General*, (in this case, the subsequent year). In these circumstances, disclosure of the pending change and the effects of the change should be included in the notes to the financial statements as a subsequent event. Pro forma disclosure requirements should also be considered. For an entity that converts to a C corporation as part of an IPO, see section 9.6, *Upon consummation of initial public offering*, for further discussion.

Illustration 9-1: When the change in tax status should be accounted for as a subsequent event
An S corporation with net taxable temporary differences files an election on 28 February 20X1 to become a taxable corporation effective 1 January 20X1. The company has not issued financial statements for the year ended 31 December 20X0. ASC 740-10-25-32 requires an entity to recognize a deferred tax liability or asset for a temporary difference at the date that a nontaxable entity becomes a taxable entity. Because ASC 740-10-25-33 requires a change in tax status to be reflected in the period an election is approved by the tax authority (or filed, if approval is not necessary), the company should not record deferred taxes as of 31 December 20X0 because the election was not approved (or filed, if approval is not necessary) until 20X1. The change in status is a subsequent event that should not affect reported amounts in the 31 December 20X0 financial statements (i.e., a non-recognized subsequent event). However, the company should disclose in the notes to its 20X0 financial statements the change in the tax status and the effects of that change, if material.

If a change in the tax law that causes a change in an entity's tax status is enacted after the balance sheet date but before the issuance of the financial statements, the effect of that change is reflected in the period in which the tax law is enacted under the provisions of ASC 740-10-45-15. (See section 8.1, *Changes in tax laws and rates*, in this publication for a discussion of the requirements of ASC 740-10-45-15.) However, disclosure of the change in tax status and the effect thereof should be included in the notes to the financial statements, if material.

9.4.1 Change in tax status — effective date versus financial reporting date

The effective date for tax purposes of an entity's change in tax status depends on the applicable tax laws of the jurisdiction. In the US, the tax effective date for a change in tax status is dependent on when the election is filed. If the change in tax status is filed with the IRS no later than two months and 15 days after the beginning of the tax year, the election is retroactively effective to the beginning of the current tax year. Alternatively, if the change in tax status is not filed within that period, the election is effective as of the beginning of the next tax year. However, an entity can request a prospective revocation date (i.e., a revocation that is effective on the date specified, which may be on or after the date the election is filed) for tax purposes.

Deferred tax assets and liabilities generally are measured using the enacted tax rates expected to apply to taxable income in the periods in which the deductible or taxable temporary difference is expected to be realized or settled. A change in tax status may affect an entity's deferred tax balances. The effect of a change in tax status on deferred tax balances is recognized on the approval date (or on the filing date if approval is not required). As a result, if the change in tax status becomes effective in a period after the approval date (or filing date if approval is not required), an entity would need to consider scheduling the reversal of existing temporary differences between the taxable and nontaxable periods to understand the enacted tax rate that is applicable to those temporary differences. For example, formerly taxable entities that file a voluntary election to be treated as nontaxable entities would be required to maintain deferred taxes for temporary differences expected to reverse before the effective date of the conversion as well as corporate-level taxes related to net unrecognized built-in gains (see section 9.5, *Built-in gains*).

Illustration 9-2: Measuring temporary differences when a company converts to an S corporation and approval is not required

Company A with a calendar year-end files an election on 15 August 2011 to convert to an S corporation with a 1 January 2012 effective date. Approval from the Internal Revenue Service is not required for this tax status change. Company A has a net deferred tax liability of $1,000 at 15 August 2011 and expects $700 will reverse in periods after the 1 January 2012 effective date. $300 of the net deferred tax liability is expected to reverse before 31 December 2011. Assume Company A does not expect any future tax consequences (such as tax on built-in gains) after changing to nontaxable S corporation status.

In preparing its annual tax provision, Company A will recognize the tax effects for the change in tax status in the quarterly period ended 30 September 2011. Company A will recognize a $700 deferred tax benefit in income from continuing operations for the portion of the net deferred tax liability scheduled to reverse after 1 January 2012 that will not be taxable under the provisions of the tax law. The remaining $300 deferred tax liability expected to reverse before 31 December 2011 is unchanged as a result of the change in tax status.

In addition, there are implications to the estimated annual effective tax rate for originating temporary differences between the recognition and the effective date of the tax status change. See chapter 20, *Interim reporting*, for further details.

9.5 Built-in gains

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-64

An entity may change from taxable C corporation status to nontaxable S corporation status. An entity that makes that status change shall continue to recognize a deferred tax liability to the extent that the entity would be subject to a corporate-level tax on net unrecognized built-in gains.

740-10-55-65

A C corporation that has temporary differences as of the date of change to S corporation status shall determine its deferred tax liability in accordance with the tax law. Since the timing of realization of a built-in gain can determine whether it is taxable, and therefore significantly affect the deferred tax liability to be recognized, actions and elections that are expected to be implemented shall be considered. For purposes of determining that deferred tax liability, the lesser of an unrecognized built-in gain (as defined by the tax law) or an existing temporary difference is used in the computations described in the tax law to determine the amount of the tax on built-in gains. Example 24 (see paragraph 740-10-55-168) illustrates this guidance.

For US companies converting from a taxable C corporation to an S corporation, a corporate income tax may be imposed if certain assets are disposed of. The tax is based on the net built-in gain that is recognized during the five-year period beginning on the first day the corporation is an S corporation (the recognition period). However, for assets disposed of after the five-year period (the recognition period), the corporation is not subject to corporate taxes on the related built-in gains.

The total amount of gain that may be subject to the built-in gains tax is generally limited to the excess of the aggregate fair market value of the corporation’s assets over their aggregate tax bases on the effective date of the S corporation election (the net unrealized built-in gain). However, the amount subject to tax in the recognition period (net recognized built-in gain) may be less than the gain on sale. Calculating the amount of net recognized built-in gain is complex and includes consideration of the current year taxable income, recognized built-in gains and losses and net unrealized built-in gains (reduced by recognized built-in gains from prior years).

The FASB has stated that a company converting from a C corporation to an S corporation (after 1986) must retain an existing deferred tax liability to the extent that the company would be subject to the built-in gains tax (ASC 740-10-55-64). In determining the deferred tax liability to be retained at the date of conversion, actions and elections expected to be implemented should be considered (for example, the expectation that depreciable assets will continue to be used in operations and, thus, not subject to the built-in gains tax). In addition, for purposes of calculating the net built-in gain temporary difference, the lesser of the unrecognized built-in gain (loss) or the existing temporary difference for each asset is used (ASC 740-10-55-65). In other words, the unrecognized built-in gain (loss) applicable to each asset for financial reporting purposes is limited to the amount of the temporary difference for that asset existing at the conversion date. The deferred tax liability would continue to be remeasured at each financial statement date until the end of the recognition period. Any change in that liability should be recorded in income tax expense (benefit) in the period of change.

Illustration 9-3: Calculation of a built-in gain deferred tax liability when a C corporation elects S corporation status

Assume a C corporation electing S corporation status effective 1 January 20X1 has the following built-in gains and temporary differences at 31 December 20X0:

	Equity securities	Inventory	Fixed assets
(1) Fair value	$ 800	$ 1,500	$ 1,000
(2) Tax basis	600	1,520	800
(3) Book value	700	1,490	900
(4) Built-in gain (loss) (1 − 2)	200	(20)	200
(5) Temporary difference (3 − 2)*	100	(30)	100

* For simplicity purposes, the deferred tax assets or liabilities for the temporary differences are not included in this example. This example solely reflects the tax effects of the built-in gain.

Assuming that (1) the equity securities and inventory will be disposed in the following year, (2) the fixed assets are expected to be used in operations and not sold within five years, (3) the company had no operating or capital loss carryforwards at 31 December 20X0 and (4) the applicable corporate tax rate is 21%, the calculation of the ASC 740 "built-in gain" deferred tax liability at 1 January 20X1 would be as follows:

Equity securities	$ 100
Inventory	(20)
Fixed assets	–
Net unrecognized built-in gain under ASC 740	80
Corporate tax rate	x 21%
Deferred tax liability	$ 17

In this illustration, the ASC 740 unrecognized built-in gain for equity securities was limited to the existing taxable temporary difference of $100. No deferred tax liability is recognized for the unrecognized built-in gain relating to fixed assets because those assets are not expected to be disposed within the five-year recognition period. If some of the fixed assets are subsequently disposed of in the recognition period, the tax liability would be reflected as a period expense.

As discussed above, net recognized built-in gain is subject to limitations, including taxable income. Thus, a company that incurs net operating losses may not be subject to the built-in gains tax. Although a company may not expect to pay taxes on built-gains due to the expectation of future tax losses, the anticipation of the tax consequences of future tax losses is prohibited under ASC 740-10-25-38. Therefore, at the time of conversion to an S corporation, a company records a deferred tax liability on any built-in gains even if it expects future tax losses, unless management plans to hold the asset beyond the five-year recognition period (and not be subject to the tax in any future period).

9.6 Upon consummation of initial public offering

Many private companies are organized as nontaxable entities (e.g., S corporations, limited liability corporations or partnerships) to minimize the tax burden on the equity owners. However, prior to consummation of an IPO, these companies often convert to C corporations, which are taxable entities. In these cases, the SEC staff expects IPO registrants to present pro forma income tax information and pro forma earnings per share (EPS).[32]

Prior to an amendment[33] of the SEC Rules, the SEC staff required companies to present such additional pro forma disclosures in or alongside the historical financial statements in their IPO registration statements. However, amended Rule 11-02(a)(12) of Regulation S-X states that registrants cannot present pro forma financial information on the face of their historical financial statements or in the accompanying notes, except when such presentation is required by US GAAP or IFRS, as applicable.

As a result, we believe registrants should continue to determine whether additional pro forma information described in this section is material in an IPO registration statement and evaluate the appropriate location for such disclosures (e.g., narrative description of the pro forma effects of a transaction, notes to unaudited pro forma financial information, selected financial data table in a registration statement).

Pro forma income tax should be calculated using statutory tax rates that were in effect in prior periods. Presentation is generally limited to the most recent annual and interim period included in the IPO registration statement. However, if the pro forma adjustments relate to only income taxes (i.e., the IPO registration statement does not include any other pro forma information for other events or transactions), the SEC staff encourages registrants to present pro forma income tax and pro forma EPS for all periods included in the historical financial statements. If a registrant elects to present pro forma information for all periods, pro forma income tax and EPS measures should continue to be presented in SEC filings made after the IPO.

Registrants should also consider the requirement in ASC 740-10-45-19 that the effect of recognizing or eliminating a deferred tax liability or asset related to a change in tax status (e.g., S corporation to C corporation) shall be included in income from continuing operations in its historical results.

Illustration 9-4: Example of disclosures when an entity changes tax status upon consummation of an IPO

[Under amended Article 11 of Regulation S-X, a company should determine whether the additional pro forma information in this example is material in its IPO registration statement and evaluate the appropriate location for such disclosures. The illustrative disclosure below assumes the company provides unaudited pro forma condensed combined financial information in its registration statement. A company's actual disclosures would be based on the facts and circumstances that will likely require modification from the disclosures in this illustration.]

Assume LML, a limited liability company, will convert to a C corporation (LMLC) through the exchange of LML limited liability company units for LMLC common stock immediately prior to the consummation of an initial public offering of LMLC common stock.

LML may provide the following pro forma disclosures to reflect the change in tax status in connection with the IPO.

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[32] SEC staff's Financial Reporting Manual Section 3410

[33] In May 2020, the SEC amended its requirements for registrants to provide information about significant business acquisitions and disposals. Among other things, the new rules changed the form and content of the pro forma financial information required by Article 11 of Regulation S-X. See SEC Release 33-10786, ***Amendments to Financial Disclosures about Acquired and Disposed Businesses (Final Rule)***.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

Note X1: Description of the Exchange Transaction

LML will complete certain transactions prior to the consummation of the IPO by LMLC, its wholly owned subsidiary, at 31 December 20X1. Immediately prior to the IPO, the LML unit holders will contribute their membership interest in LML to LMLC in exchange for common stock of LMLC (the "Exchange Transaction"). As a result of the Exchange Transaction, LML will become a wholly owned subsidiary of LMLC. LMLC will account for the reorganization as an exchange of shares between entities under common control at historical cost in a manner similar to a pooling of interests. After the reorganization, the ownership percentage of each LMLC common stockholder will be the same as its ownership percentage in the LML units.

In connection with the Exchange Transaction, LML will make a special cash distribution to certain members of the Company totaling approximately $12 million comprised of approximately:

- $7.8 million attributable to previously recognized and undistributed income of the Company at 31 December 20X1
- $1.2 million of income expected to be recognized and not distributed in 20X1 through the expected payment date on which the members have paid, or will pay, income tax
- Approximately $3 million attributable to a return of capital at 31 December 20X1

The actual distribution is subject to change based on the actual income of the Company during 20X1 through the date of the Exchange Transaction. In addition, a deferred income tax liability, estimated to be approximately $5.6 million at 31 December 20X1, will be recognized as a component of continuing operations as a result of the conversion from a limited-liability company to a C corporation.

LML's equity has not been retroactively restated for the proposed reorganization.

The net proceeds from the proposed IPO are planned to be used primarily to reduce outstanding indebtedness, fund a portion of the distributions to the LML unit holders, extinguish certain outstanding long-term debt, and provide funds for expansion of operations, working capital needs and other general corporate purposes.

Note X2: Adjustments to Unaudited Pro Forma Condensed Combined Financial Information

The tax-related adjustments to unaudited pro forma condensed combined financial information include:

(a) The pro forma net income taxes and pro forma net income reflect federal and state income taxes (assuming a 25% combined effective tax rate) as if LML had been taxed as a corporation in accordance with Subchapter C of the Internal Revenue Code (a "C corporation") for the year ended 31 December 20X1. Pro forma weighted average shares outstanding reflect 1 million shares outstanding, which assumes the shares resulting from the reorganization were outstanding for the year ended 31 December 20X1 (see Note X1).

(b) The pro forma balance sheet at 31 December 20X1 reflects a deferred tax liability estimated to be $5.6 million that will be recognized as a component of continuing operations as a result of the conversion from a limited liability company to a C corporation and a $12 million distribution of undistributed taxable earnings and a return of capital to LML unit holders (see Note X1).

Entities need to consider the SEC guidance in SAB Topic 4.B when preparing pro forma financial information or historical financial statements. This guidance requires entities converting from an S corporation or partnership to a C corporation to reclassify undistributed earnings to paid-in capital. This presentation assumes a constructive distribution to (contribution by) the owners followed by a capital contribution (distribution).

9.7 Loss of nontaxable status

Certain entities, such as S corporations and not-for-profit organizations, can lose their nontaxable status if statutory requirements are not maintained. If an entity takes an action (or fails to take an action) that results in a change in its tax status, the effect of that change in status should be recognized in the period in which the change occurs. However, if the company has initiated steps to cure its violation(s), careful consideration is required in determining whether a change in tax status has occurred.

9.8 REIT conversion

Under the US Internal Revenue Code, a REIT is taxed as a C corporation. However, in computing its taxable income, a REIT can deduct dividends paid (see section 9.1, *General*). That is, the entity's earnings are taxable, but the amount subject to income taxes is reduced by a deduction for the amount of REIT income distributed to shareholders.

A C corporation that seeks to be treated as a REIT for tax purposes first reports the conversion to the IRS by filing a specific tax form (1120-REIT). This form does not require IRS approval and is often filed in a period after the end of the entity's initial tax year as a REIT, generally with the first tax return filed after the REIT conversion.

To initially be treated as a REIT for tax purposes:

- The legal entity structure must be that of a REIT
- Accumulated earnings and profits from its operations as a C corporation must be purged through a distribution to shareholders (Accumulated E&P Purge)
- The initial tax return as a REIT on Form 1120-REIT is filed

On an ongoing basis, the entity must continue to qualify and file as a REIT for tax purposes in order to qualify for the dividends paid deduction.

We often receive questions regarding in which period and under which guidance an entity's conversion to a REIT should be considered. Questions include:

- In what period is it appropriate to recognize the tax effects of a C corporation's conversion to a REIT?
- Is this conversion a discretionary change in tax status subject to ASC 740-10-25-33 (i.e., account for the conversion to REIT in the period in which the change in status occurs (the period in which the Form 1120-REIT is filed as no approval by the IRS is necessary))?
- If the conversion to a REIT is not a change in tax status, in which period is it appropriate to recognize the tax effects of the conversion?

As a REIT continues to be taxed as a C corporation, we do not consider a REIT conversion to be a change in tax status.

Because we do not view the REIT conversion to be a change in tax status, the income tax effects of the REIT conversion are reflected in the period when all significant actions necessary to qualify as a REIT are completed and the entity has committed to becoming a REIT ("REIT compliant and committed").

The following are some key considerations for determining whether a C corporation has completed all significant actions necessary to qualify as a REIT:

- The company has obtained approval from the appropriate parties (e.g., board of directors or shareholders) to make the conversion.
- The company has obtained financing (as applicable) for the Accumulated E&P Purge.
- The remaining actions for the company to achieve REIT status are only of a legal and administrative nature (i.e., any remaining steps are considered perfunctory).
- The company has completed the Accumulated E&P Purge. If the Accumulated E&P Purge has not been completed, the reasons for the delay are perfunctory (e.g., the related funds are on hand, but as distribution is not required until a certain date under the tax law, the company is choosing to wait and make the cash distribution on that date). Obtaining financing for the Accumulated E&P Purge would not be considered perfunctory.

We generally would not consider a C corporation to be REIT compliant and committed until all of the significant actions necessary to qualify as a REIT (as listed above) have been completed. Upon completion of all significant actions necessary to achieve a REIT conversion (assuming the C corporation remains committed to that course of action), deferred tax assets or liabilities should be adjusted to reflect the enacted tax rate(s) (after consideration of the deduction received for distributing REIT income) expected to apply to taxable income in the period in which the deferred tax assets or liabilities are expected to be realized. In addition, the estimated annual effective tax rate is adjusted in that same interim period.

Income tax effects before REIT conversion

In order to become "REIT ready" many companies will need to undergo certain legal entity restructurings. Such restructuring may include intercompany transfers of assets and liabilities. The tax effects of those transactions may be unfavorable without also considering a REIT conversion. For example, a company may transfer certain real estate assets to a jurisdiction with a higher state tax rate. The tax effects of that transaction would be recognized in the period when the transaction occurs and may be subject to intercompany transaction guidance (section 3.2.2*, Intercompany transactions*).

To the extent the intercompany transaction exception is not applicable,[34] the temporary differences related to the transferred assets or liabilities are measured using the applicable enacted tax rate. We do not believe it is appropriate to consider the rate that will apply when the entity is a REIT until the entity is REIT-compliant and committed. As a result, a tax provision may be recognized in one period for the change in tax rates applicable due to an intercompany transaction and reversed in a later period when the entity is REIT-compliant and committed.

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[34] Companies are required to recognize the income tax effects of intercompany sales or transfers of assets, other than inventory, in the income statement as income tax expense (or benefit) in the period the sale or transfer occurs. There is an exception to recognizing the income tax effects of intercompany sales or transfers of assets for intercompany inventory sales and transfers. Companies transferring assets in anticipation of moving them into a REIT will need to determine whether the assets being transferred meet the definition of inventory before applying the exception to recognizing the income tax effects of an intra-entity transfer.

10 Regulated entities

Excerpt from Accounting Standards Codification

Regulated Operations — Income Taxes

Recognition

980-740-25-1

For regulated entities that meet the criteria for application of paragraph 980-10-15-2, this Subtopic specifically:

a. Prohibits net-of-tax accounting and reporting

b. Requires recognition of a deferred tax liability for tax benefits that are flowed through to customers when temporary differences originate and for the equity component of the **allowance for funds used during construction**

c. Requires adjustment of a deferred tax liability or asset for an enacted change in tax laws or rates.

980-740-25-2

If, as a result of an action by a regulator, it is probable that the future increase or decrease in taxes payable for (b) and (c) in the preceding paragraph will be recovered from or returned to customers through future rates, an asset or liability shall be recognized for that probable future revenue or reduction in future revenue pursuant to paragraphs 980-340-25-1 and 980-405-25-1. That asset or liability also shall be a temporary difference for which a deferred tax liability or asset shall be recognized.

980-740-25-3

Example 1 (see paragraph 980-740-55-8) illustrates recognition of an asset for the probable revenue to recover future income taxes.

980-740-25-4

Example 2 (see paragraph 980-740-55-13) illustrates adjustment of a deferred tax liability when the liability represents amounts already collected from customers.

10.1 General

ASC 740 is applicable to regulated entities that apply the provisions of ASC 980. Thus, if, as a result of an action by a regulator, it is probable the future increase or decrease in taxes payable for the items addressed in ASC 980-740-25-1(b) or (c) will be recovered from or returned to customers through future rates, an asset or liability should be recognized for that probable future revenue increase or reduction. That asset or liability, in turn, is also a temporary difference, and a deferred tax liability or asset should be recognized for the deferred tax consequence of that temporary difference. For general-purpose financial reporting, that asset or liability and the deferred tax liability or asset are not offset but are reported separately.

Two of the key objectives of ASC 740, reduced complexity and relaxed criteria for recognition of deferred tax assets, can prove elusive for some regulated entities. The following areas generally require judgment and careful consideration for regulated entities:

1. The evaluation and measurement of valuation allowances needed for deferred tax assets associated with future deductible amounts is often very complex and extremely subjective. In addition, regulatory acceptance of the more-likely-than-not criteria for recognition of deferred tax assets is important.

   See chapter 6, *Valuation allowances*, for additional discussion of the criterion in ASC 740 regarding the need for, and amount of, a valuation allowance for deferred tax assets.

2. Although the guidance for income taxes in ASC 740 does not mandate a particular method of allocating current and deferred tax expense between members of a consolidated group, certain types of allocation methods are prohibited. In addition, compliance with regulatory policies regarding intercompany tax allocation methods must be considered. An allocation determined as if each member were a separate taxpayer is acceptable, even though the sum of the amounts allocated to separate members may not equal the consolidated amount.

   See chapter 17, *Separate financial statements of a subsidiary*, for additional discussion of this issue.

10.2 Regulatory-assisted acquisitions of financial institutions

A financial institution can be acquired pursuant to an assistance agreement (Agreement) between the acquirer and the governmental regulator (the Regulator). Under the Agreement, the acquirer may receive a note receivable from the Regulator, which typically equals the amount by which the fair value of the acquired institution's liabilities exceeds the fair value of its assets. In addition, the acquirer may infuse additional capital into the acquired institution that, with the Regulator's assistance, is expected to make the financial institution a viable entity.

The assistance provided by the Regulator under the Agreement may include:

(1) yield maintenance assistance (which guarantees additional interest on specified interest-bearing assets, a level of return on specified non-interest-bearing assets, reimbursement if covered assets are ultimately collected or sold for amounts that are less than a specified amount, or any combination thereof),

(2) indemnification against certain loss contingencies, and

(3) the purchase by the Regulator of equity securities issued by the financial institution for cash or a note receivable from the Regulator.

Under the terms of the Agreement, the Regulator may be entitled to share in certain tax benefits subsequently realized by the financial institution.

Financial services companies acquiring financial institutions pursuant to an assistance agreement are subject to the business combination guidance in ASC 805, as applicable, as well as the provisions in ASC 740 regarding the recognition and measurement of deferred taxes. See chapter 11, *Business combinations*, for a discussion of the requirements of ASC 740.

10.3 Business combinations

See chapter 11, *Business combinations*, for a detailed discussion regarding the impact of ASC 740 on the accounting for business combinations under ASC 805.

In addition, regulated entities must consider the implications of the guidance on deposit-based intangible assets as discussed in section 11.6, *Deposit-based intangibles*, as applicable.

11 Business combinations

This chapter provides guidance on accounting for income taxes related to a business combination, including the recognition of deferred taxes. Deferred taxes are recognized for the differences between the tax bases and the amounts recognized for financial reporting purposes of the assets acquired and liabilities assumed in a business combination.

Excerpt from Accounting Standards Codification

Business Combinations — Income Taxes

Recognition

805-740-25-2

An **acquirer** shall recognize a **deferred tax asset** or **deferred tax liability** arising from the assets acquired and liabilities assumed in a business combination and shall account for the potential tax effects of **temporary differences**, **carryforwards**, and any income tax uncertainties of an **acquiree** that exist at the **acquisition date**, or that arise as a result of the acquisition, in accordance with the guidance in Subtopic 740-10 together with the incremental guidance provided in this Subtopic.

805-740-25-3

As of the acquisition date, a deferred tax liability or asset shall be recognized for an acquired entity's taxable or **deductible temporary differences** or operating loss or tax credit carryforwards except for differences relating to the portion of goodwill for which amortization is not deductible for tax purposes, leveraged leases, and the specific acquired temporary differences identified in paragraph 740-10-25-3(a). Taxable or deductible temporary differences arise from differences between the tax bases and the recognized values of assets acquired and liabilities assumed in a business combination. Example 1 (see paragraph 805-740-55-2) illustrates this guidance. An acquirer shall assess the need for a **valuation allowance** as of the acquisition date for an acquired entity's deferred tax asset in accordance with Subtopic 740-10.

805-740-25-4

Guidance on tax-related matters related to the portion of goodwill for which amortization is not deductible for tax purposes is in paragraphs 805-740-25-8 through 25-9; guidance on accounting for the acquisition of leveraged leases in a business combination is in paragraph 840-30-30-15; and guidance on the specific acquired temporary differences identified in paragraph 740-10-25-3(a) is referred to in that paragraph.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

Guidance on tax-related matters related to the portion of goodwill for which amortization is not deductible for tax purposes is in paragraphs 805-740-25-8 through 25-9; guidance on accounting for the acquisition of **leveraged leases** in a business combination is in Subtopic 842-50; and guidance on the specific acquired temporary differences identified in paragraph 740-10-25-3(a) is referred to in that paragraph.

Other Presentation Matters

805-740-45-2

The effect of a change in a valuation allowance for an acquired entity's **deferred tax asset** shall be recognized as follows:

a. Changes within the measurement period that result from new information about facts and circumstances that existed at the **acquisition date** shall be recognized through a corresponding adjustment to **goodwill**. However, once goodwill is reduced to zero, an acquirer shall recognize any additional decrease in the valuation allowance as a bargain purchase in accordance with paragraphs 805-30-25-2 through 25-4. See paragraphs 805-10-25-13 through 25-19 and 805-10-30-2 through 30-3 for a discussion of the measurement period in the context of a **business combination**.

b. All other changes shall be reported as a reduction or increase to income tax expense (or a direct adjustment to contributed capital as required by paragraphs 740-10-45-20 through 45-21).

11.1 General

ASC 805, *Business Combinations*, provides guidance on the accounting and reporting for transactions that represent a business combination. An entity determines whether a transaction is a business combination by applying the definition of a business included in ASC 805. Determining whether a transaction represents a business combination or an asset acquisition is important as it determines how certain elements such as income taxes, transaction costs, contingent consideration and acquired in-process research and development costs are accounted for by the acquirer (see chapter 13, *Asset Acquisitions*, for additional discussion of accounting for the tax consequences of an asset acquisition).

From a tax law perspective, a business combination may be taxable or nontaxable. This determination is important as the tax nature of the business combination will have differing effects on the deferred tax balances to be recorded as of the acquisition date:

- In a taxable business combination, the acquirer's tax bases in the assets acquired and the liabilities assumed are generally stepped up to the respective fair values at the acquisition date.
- In a nontaxable (or tax-free) business combination, the acquirer's tax bases in the assets acquired and the liabilities assumed are generally the acquiree's tax bases immediately before the acquisition date.

ASC 805-740 provides business combination income tax accounting guidance for:

(1) changes in an acquirer's valuation allowance resulting from a business combination,

(2) changes after the acquisition date in a valuation allowance,

(3) changes to uncertain tax positions that exist at the time of or arise as a result of a business combination, and

(4) tax benefits arising from the excess of tax-deductible goodwill over goodwill for financial reporting.

ASC 805-740 requires all subsequent changes to a valuation allowance or uncertain tax position that relate to the acquired company and existed at the acquisition date that occur both within the measurement period and as a result of facts and circumstances that existed at the acquisition date are recognized as an adjustment to goodwill. All other changes in a valuation allowance are recognized as a reduction or increase to income tax expense (or a direct adjustment to additional paid-in capital (APIC) as required by ASC 740-10-45-20).

The measurement period is the time after the acquisition during which the acquirer obtains information necessary to identify and measure all aspects of the business combination in accordance with the guidance in ASC 805. The measurement period is not a fixed period for all business combinations, or even for all aspects of a particular business combination. The measurement period ends once the acquirer is able to determine that it has obtained all necessary information that existed as of the acquisition date or has determined that such information is not available. However, in no circumstances may the measurement period exceed one year from the acquisition date. See section 7.3, *Measurement period*, of our FRD, ***Business combinations***, for further discussion.

11.2 Tax effects of basis differences

ASC 805-740-25-3 requires the recognition of deferred tax assets and liabilities for the tax effects of differences between assigned book values and tax bases of assets acquired and liabilities assumed in a business combination. The tax bases of assets acquired and liabilities assumed are based on the relevant tax law and may be the seller's carryover tax basis, or the tax basis may be adjusted as a result of the business combination or other transaction. See section 11.2.1, *Changes in tax basis*, for further discussion.

As of the acquisition date, a deferred tax liability or asset should be recognized for an acquired entity's taxable or deductible temporary differences or operating loss or tax credit carryforwards except for the portion of goodwill that is not deductible for tax purposes, leveraged leases, and the specific acquired temporary differences identified in paragraph 740-10-25-3(a) (see section 11.13.4, *Assertion regarding indefinite reinvestment*, for a further discussion). The specific acquired temporary differences are accounted for in accordance with ASC 740-10-25. The provisions of ASC 805-740 apply to basis differences that arise in both taxable and nontaxable business combinations. Refer to section 3.2.2.6, *Business combinations*, for discussion of applicability of the income taxes guidance to intercompany transactions (ASC 740-10-25-3(e) and ASC 810-10-45-8) in a business combination.

Illustration 11-1: Recognition of deferred taxes as of the acquisition date

Assume that at the beginning of 20X0, a company acquires another company for $60 million in a tax-free business combination. The only book/tax basis difference relates to depreciable property and equipment with a fair value of $50 million and a zero tax basis. The fair values of other identifiable assets acquired and liabilities assumed net to zero. The tax rate is 25%, no future tax rate changes have been enacted, and the amortization of goodwill is not deductible for tax purposes. The consideration transferred would be assigned under ASC 805 and ASC 740 as follows (in millions):

Property and equipment	$ 50	
Deferred tax liability	(13)	(Basis difference of $50 million x 25%)
Goodwill	23	(Derived)
Consideration transferred	$ 60	

Assume for 20X0 the company has consolidated pretax income of $10 million exclusive of charges for depreciation related to the acquired company. Assuming no other book-taxable income differences, taxes currently payable would be $2.5 million ($10 million x 25%). Property and equipment acquired in the business combination are depreciated over 10 years. Goodwill, which is not tax-deductible, is not amortized for book purposes (and not impaired) in this example. Income statement reporting under ASC 740 (in millions) would be as follows:

Pretax income before adjustments	$ 10.0
Acquired-company charges:	
Depreciation	(5.0)
Pretax income	5.0

Income taxes:	
Current tax expense	(2.5)
Deferred tax benefit ($5 change in book basis of PPE ($5*25%))	1.3
Total income tax expense	(1.2)
Net income	$ 3.8

11.2.1 Changes in tax basis

Subsequent to a business combination, the acquiring entity may make tax elections adjusting the tax bases of assets acquired and liabilities assumed or may transfer acquired assets or liabilities among subsidiaries. We often receive questions as to whether these post-combination elections or transfers would be considered part of the business combination or would be accounted for outside of the business combination.

ASC 805 provides the framework for determining whether a transaction is part of a business combination or should be accounted for separately.

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-21

A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

a. A transaction that in effect settles preexisting relationships between the acquirer and acquiree (see paragraphs 805-10-55-20 through 55-23)

b. A transaction that compensates employees or former owners of the acquiree for future services (see paragraphs 805-10-55-24 through 55-26)

c. A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs (see paragraph 805-10-25-23).

805-10-25-22

Paragraphs 805-10-55-18 through 55-26, 805-30-55-6 through 55-13, 805-740-25-10 through 25-11, 805-740-45-5 through 45-6, and Example 2 (see paragraph 805-10-55-30) provide additional guidance for determining whether a transaction is separate from the business combination transaction.

Implementation Guidance and Illustrations

805-10-55-18

Paragraphs 805-10-25-20 through 25-22 establish the requirements to identify amounts that are not part of the business combination. The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction is part of the exchange for the acquiree or whether the transaction is separate from the business combination:

a. The reasons for the transaction. Understanding the reasons why the parties to the combination (the acquirer, the acquiree, and their owners, directors, managers, and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

b. Who initiated the transaction. Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.

c. The timing of the transaction. The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

See section 3.4.1.2, *Meaning of 'part of the business combination,'* of our FRD, ***Business combinations***, for further discussion of the ASC 805 considerations described above.

11.2.1.1 Tax effects of obtaining a step-up in tax basis of acquired net assets

Excerpt from Accounting Standards Codification

Income Taxes-Overall

Recognition

Transactions Directly between a Taxpayer and a Government

740-10-25-53

Transactions directly between a taxpayer and a government (in its capacity as a taxing authority) shall be recorded directly in income (in a manner similar to the way in which an entity accounts for changes in tax laws, rates, or other tax elections under this Subtopic). (See Example 26 [paragraph 740-10-55-202] for an illustration of a transaction directly with a governmental taxing authority.)

In some jurisdictions, an acquirer may make a payment to the taxing authority to obtain a step-up in the tax basis of acquired net assets. The payment may be made by the buyer or the seller and may or may not have been negotiated as part of the business combination. Understanding the facts and circumstances that give rise to the step-up in tax basis is an important consideration. Consider the following scenarios:

- **Scenario one:** The seller, prior to the business combination, enters into a transaction with the taxing authority to make a payment to the taxing authority in exchange for a step-up in tax basis.

  We believe that accounting for the step-up in tax basis, as a result of the seller's transaction with the taxing authority, would be reflected in the business combination.

- **Scenario two:** The buyer, subsequent to the business combination, enters into a transaction with the taxing authority to make a payment to the taxing authority in exchange for a step-up in tax basis. A tax basis step-up may be a transaction between the buyer and the taxing authority (a third party) and not part of the business combination. ASC 740-10-25-53 provides that transactions directly between a taxpayer and a government (in its capacity as a taxing authority) should be recognized in income in a manner similar to a change in tax laws or rates. The tax payment and the deferred tax effect of stepping-up the inside-tax bases of the acquired net assets should be recognized in income in the period in which the election is made and not included in the business combination. See section 13.1.7, *Transaction directly with a governmental taxing authority*, for further discussion, including discussion related to a step up in the tax basis of goodwill.[35]

11.2.1.1.1 Tax effects of a post-acquisition merger

In determining the tax bases of assets acquired and liabilities assumed in a business combination, an entity determines the available tax elections. Some tax elections are available without approval of a taxing authority and are wholly within the control of the reporting entity, while other tax elections require approval of the taxing authority. See section 9.1, *General*, in chapter 9 on change in the tax status of an entity for further discussion.

Certain tax benefits are available only if the tax return includes both the existing entity and the acquired entity. Consider the following example.

Illustration 11-2: Tax return that includes both the existing entity and the acquired entity
Company A currently operates ProfitCo in Jurisdiction X. ProfitCo operates at a profit and creates taxable income in Jurisdiction X. Company A acquires LossCo in Jurisdiction X. LossCo operates at a loss and generates taxable losses each year in Jurisdiction X. Company A elects to file a consolidated return in Jurisdiction X upon the acquisition of LossCo. Subsequent to the acquisition, ProfitCo's ongoing profits will be included with LossCo's ongoing losses in a consolidated return. See section 11.13.1, *Valuation allowance for acquired deferred tax assets*, for discussion of valuation allowance considerations in a business combination.

However, some jurisdictions require each entity to file its own tax return. As a result, an entity may merge legal entities in such a jurisdiction post-acquisition. In other jurisdictions, an entity can elect to file a consolidated tax return without the need to merge legal entities.

In jurisdictions that do not permit entities to file consolidated returns, a decision to undertake a merger may be contemplated as part of a business combination, but the merger cannot be completed until after the acquisition date. For example, certain documents (including a third-party valuation report) may be required to be filed with the taxing authorities as part of the merger notification process and may not be available to file with the taxing authorities until after the acquisition date. Questions arise as to whether the tax effects of the post-acquisition merger should be accounted for as part of the business combination.

Careful consideration of the facts and circumstances is necessary to determine whether a merger of legal entities is a post-combination intercompany, or similar, transaction (generally not accounted for as part of a business combination) or a tax election (generally accounted for as part of the business combination). Most post-combination reorganizations are not reflected in the business combination. However, in limited circumstances, a post-combination merger may be considered similar to a tax election to file a consolidated tax return post-combination when the post-combination merger is contemplated at the time of the acquisition, is a perfunctory process and is completed shortly after the merger. A merger is generally considered perfunctory when formal approval from the taxing authority is not required.

[35] ASU 2019-12 clarifies the existing guidance and requires an entity to determine whether a step-up in the tax basis of goodwill relates to the business combination in which the book goodwill was originally recognized or a separate transaction. The guidance lists factors that may indicate that the step-up in tax basis relates to a separate transaction (see section 13.1.7, *Transaction directly with a governmental taxing authority*, for further discussion).

11.2.1.2 Post-combination intercompany transactions

Subsequent to a business combination, the acquirer may enter into intercompany transactions as part of its overall tax structure (e.g., an intercompany transfer of acquired intellectual property). Such transactions may be contemplated at the time of the business combination or occur during the measurement period. Questions often arise as to whether such transactions should be considered part of the business combination.

Post-combination intercompany transactions are typically entered into at the sole discretion of the acquirer and the tax effects of such transactions are accounted for outside of the business combination (in accordance with ASC 805-10-25-21). See section 3.2.2, *Intercompany transactions*, for guidance specific to the accounting for the income tax effects of intercompany transactions.

11.2.1.3 Post-combination intercompany transfers of acquired intellectual property

Intercompany transfers of acquired IP can take a variety of forms. In one form, a US entity transferring acquired IP to a foreign corporation is treated under Internal Revenue Code Section 367(d) (Section 367(d)), as having sold the acquired IP in exchange for payments for each tax year which are contingent on the productivity, use or disposition of the acquired IP. In Section 367(d) transactions, the transfer of the acquired IP generally does not result in a current tax obligation of the US entity because income or gain is not otherwise recognized for tax purposes. Rather, over the acquired IP's tax-determined useful life, the US entity will recognize in taxable income amounts that are commensurate with the income generated by the transferred IP for each taxable year.

There is often a difference between the book basis and the tax basis of IP acquired in a nontaxable business combination. This difference is generally a deferred tax liability because the book basis represents the fair value of the IP at the acquisition date (less any amortization since acquisition) and, in a nontaxable business combination, the acquired IP's tax basis is generally lower than its book basis. If, subsequent to the business combination, the acquired IP is transferred by a US acquirer to a foreign subsidiary and the transfer is subject to Section 367(d) (i.e., no current tax due on the transfer but over the useful life of the acquired IP the US entity will recognize in taxable income for each taxable year amounts that are commensurate with the income generated by the transferred IP), a question arises as to the disposition of the deferred tax liability that exists at the time of the transfer.

In a Section 367(d) transaction, we believe the US entity transferring the acquired IP should retain the deferred tax liability. Although the acquired IP was transferred to a foreign corporation, the US entity will still be taxed on the current transfer in future periods. That is, the transfer of the acquired IP triggers a liability in the US that will be based on the IP-related income generated in the foreign jurisdiction. We believe it would be inconsistent to reverse the existing deferred tax liability to income when it has been effectively exchanged for another tax liability, albeit a tax liability that will be quantified over time. Instead, we believe the deferred tax liability should be reversed to current taxes payable as the current tax becomes due.

In periods subsequent to the transfer, a company should monitor the remaining deferred tax liability. To the extent the ultimate US tax obligation is expected to exceed, or be lower than, the deferred tax liability associated with the transferred IP, we believe a company should account for the difference on a systematic and rational basis. See section 3.2.2.8, *Intercompany sale or transfer of assets other than inventory*, for additional discussion.

11.3 Identifiable intangible assets and goodwill

ASC 805-20-30-1 requires all assets acquired, liabilities assumed and any noncontrolling interests to be recorded at their acquisition-date fair values, with the limited exceptions discussed in ASC 805-20-25-16. Individual assets include tangible assets (e.g., inventories, property), financial assets (e.g., accounts and notes receivable, marketable and nonmarketable securities, derivative contracts) and identifiable intangible assets (e.g., patents, franchises, trademarks).

For income tax purposes, amounts assigned to particular assets acquired and liabilities assumed may be different from amounts used for financial reporting. The differences in assigned values for financial reporting and tax purposes result in temporary differences. In applying ASC 740, companies are required to recognize the tax effects of temporary differences related to all assets and liabilities, including identifiable intangible assets, except goodwill that is not tax-deductible, leveraged leases and the specific acquired temporary differences identified in ASC 740-10-25-3(a).

Goodwill amortization accounting alternative

Private companies and not-for-profit entities (NFPs) may elect to amortize goodwill acquired in a business combination or in an acquisition by an NFP on a straight-line basis over 10 years (or potentially less) and to use a simplified impairment test at either the entity or reporting unit level (goodwill amortization accounting alternative). An impairment loss is measured as the excess of the carrying amount (including goodwill) of the entity (or reporting unit) over its fair value and is allocated to individual amortizable units of goodwill on a pro rata basis using their relative carrying amounts or another reasonable and rational basis.[36]

While the goodwill amortization accounting alternative guidance doesn't address income tax accounting, companies that elect to use it must continue to apply the unique and complicated income tax accounting requirements related to goodwill. An election to apply the goodwill amortization accounting alternative may also have an effect on preexisting valuation allowances on deferred tax assets if deferred tax liabilities related to component 1 goodwill (see section 11.3.4, *Tax-deductible goodwill*, below) had not previously been considered by the company as a source of future taxable income. This is because the reversal of taxable temporary differences associated with non-amortizing book goodwill generally would not have been considered a source of taxable income under the previous accounting, unless the company's accounting policy was to consider these deferred tax liabilities when evaluating NOLs that do not expire or deferred tax assets that upon reversal would give rise to NOLs that do not expire were being assessed for realizability. However, the reversal of taxable temporary differences related to amortizing goodwill would qualify as such a source of taxable income and may reduce a valuation allowance. See section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*.

11.3.1 Nondeductible goodwill

Goodwill arises in business combinations when the aggregate of the following exceeds the amount of acquisition-date identifiable assets acquired net of the liabilities assumed:

- The acquisition-date fair value of the consideration transferred
- The acquisition-date fair value of any noncontrolling interest in the acquiree
- In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree

Conceptually, the difference between the book basis and tax basis of goodwill constitutes a temporary difference and deferred taxes should be recognized. However, the requirements of ASC 740 differ depending on whether goodwill can be amortized as a deduction for tax purposes. ASC 740-10-25-3(d) prohibits recognition of a deferred tax liability relating to temporary differences for goodwill whose amortization is not deductible for tax purposes.

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[36] Refer to our FRD, ***Intangibles — Goodwill and other***, for additional information about the accounting and financial reporting of goodwill.

When the amortization of goodwill is not deductible for tax purposes, recognition of deferred taxes for the future tax effects of recovering goodwill would result in a deferred tax liability that would further increase both goodwill *and* deferred tax liabilities because goodwill and the related deferred tax liability are mutually dependent on each other in the mechanics of recording the purchase transaction. The FASB concluded that adjusting goodwill by an amount equal to the deferred tax liability to reflect the future tax effects of recovering goodwill would not provide information that was particularly relevant and the computation of that adjustment would often be complex. Thus, the FASB concluded deferred tax liabilities should not be recognized for goodwill temporary differences if goodwill is not tax-deductible.

11.3.1.1 Amortization of nondeductible goodwill

As noted in section 11.3.1, *Nondeductible goodwill*, recognizing a deferred tax liability related to nondeductible goodwill is prohibited. Amortizing (or impairing; see section 11.8.3, *Impairment of nondeductible goodwill*) nondeductible goodwill under the goodwill amortization accounting alternative does not result in a change to previously recorded deferred taxes or a new temporary difference. The amortization (or impairment) of goodwill results in a basis difference without future tax consequences (commonly referred to as a permanent difference). Therefore, no income tax benefit is recorded for amortization (or impairment) associated with nondeductible goodwill.

11.3.2 Nondeductible identified intangible assets

All basis differences related to identified intangible assets are temporary differences for which deferred tax assets and liabilities should be recognized. Although some believe identified intangible assets that are not deductible for tax purposes are essentially the same as goodwill and the accounting for the income tax effects of those intangible assets should be the same as nondeductible goodwill, the FASB disagreed with that approach because it believes goodwill is different from other types of intangible assets. The FASB believes goodwill is a residual amount — it is the excess of the purchase price over the assigned values of the net assets acquired. In the FASB's view, other types of intangible assets are not residual amounts and the computation of the required deferred tax adjustment would not be complex.

11.3.3 Purchase price allocation differences

In a taxable business combination, the consideration paid is assigned to the assets acquired and the liabilities assumed for tax purposes as well as for financial reporting purposes (805-740-25-6). However, the amounts assigned to particular assets and liabilities may differ for financial reporting and tax purposes. ASC 740 requires deferred tax liabilities and assets to be recognized for the deferred tax consequences of those temporary differences. For example, a portion of the amount of goodwill recorded for financial reporting purposes may be allocated to other assets for income tax purposes, and amortization of that other asset may be deductible for tax purposes.

Illustration 11-3: Recognition and measurement differences

Facts

Assume that a company recognized $1 million of goodwill for financial reporting purposes in a business combination; however, for tax purposes the $1 million was allocated to an intangible asset, the amortization of which is deductible for tax purposes. Also, assume that the tax rate is 25%.

Analysis

The company would recognize a deferred tax asset of $250,000 ($1,000,000 x 25%) related to the amortizable intangible asset recognized for tax purposes.

11.3.4 Tax-deductible goodwill

Excerpt from Accounting Standards Codification

Business Combinations — Income Taxes

Recognition

805-740-25-8

Guidance on the financial accounting for goodwill is provided in Subtopic 350-20. For tax purposes, amortization of goodwill is deductible in some tax jurisdictions. In those tax jurisdictions, the reported amount of goodwill and the tax basis of goodwill are each separated into two components as of the acquisition date for purposes of deferred tax calculations. The first component of each equals the lesser of goodwill for financial reporting or tax-deductible goodwill. The second component of each equals the remainder of each, that is, the remainder, if any, of goodwill for financial reporting or the remainder, if any, of tax-deductible goodwill.

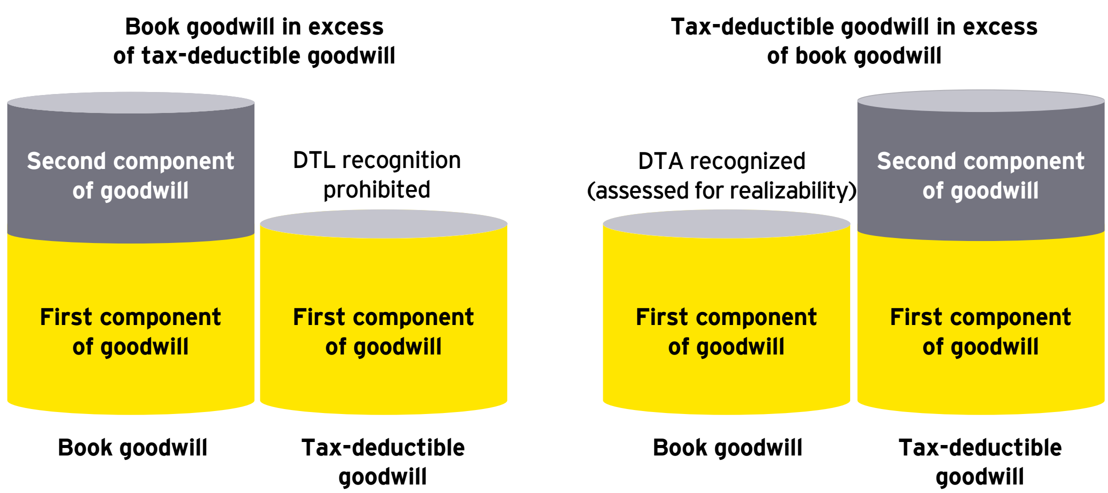
805-740-25-9

Any difference that arises between the book and tax basis of that first component of goodwill in future years is a temporary difference for which a deferred tax liability or asset is recognized based on the requirements of Subtopic 740-10. If that second component is an excess of tax-deductible goodwill over the reported amount of goodwill, the tax benefit for that excess is a temporary difference for which a deferred tax asset is recognized based on the requirements of that Subtopic (see Example 4 [paragraph 805-740-55-9]). However, if that second component is an excess of goodwill for financial reporting over the tax-deductible amount of goodwill, no deferred taxes are recognized either at the acquisition date or in future years.

In tax jurisdictions where amortization of goodwill is deductible for tax purposes, ASC 805-740-25-8 requires that the amount of goodwill recognized for financial reporting and the tax basis of goodwill each be separated into two components as of the acquisition date for purposes of computing deferred taxes. This analysis should include all goodwill recognized as a result of the business combination, including any tax-deductible goodwill of the acquired company that continues after the acquisition.

The first component of goodwill equals the lesser of goodwill for financial reporting or tax-deductible goodwill. The second component of goodwill equals the remainder, if any, of (1) goodwill for financial reporting over tax-deductible goodwill or (2) tax-deductible goodwill over goodwill reported for financial reporting. Deferred taxes are recognized for any differences that arise in the future between the financial reporting basis and tax basis of the first component of goodwill.

The following graphic illustrates the first component and second component of goodwill.



ASC 805-740-25-9 requires that the tax benefits arising from the excess of tax-deductible goodwill over goodwill for financial reporting purposes (i.e., the second component) be recognized at the acquisition date as a deferred tax asset similar to other temporary differences. The FASB concluded that the excess of tax-deductible goodwill over goodwill for financial reporting purposes meets the definition of a temporary difference. As such, recognizing the tax benefit of that temporary difference at the date of the business combination is appropriate and consistent with the deferred tax accounting principles of ASC 740. However, ASC 805-740-25-9 prohibits recognizing a deferred tax liability for financial reporting goodwill in excess of tax-deductible goodwill.

Measuring the deferred tax asset associated with an excess of tax-deductible goodwill over goodwill for financial reporting purposes is an iterative process because both goodwill for financial reporting purposes and the deferred tax asset are established in the same allocation of the fair value of the acquired entity. That is, allocating part of the fair value of the entity to the deferred tax asset has the effect of reducing the residual allocated to goodwill for financial reporting, which, in turn, has the effect of increasing the temporary difference and the related deferred tax asset. This iterative effect is measured by solving the following equations:

Deferred tax asset (DTA) = (tax rate/(1 − tax rate)) x preliminary temporary difference, where
Preliminary temporary difference = tax basis in goodwill − preliminary financial reporting goodwill, and where
Preliminary financial reporting goodwill = excess of fair value of the acquired entity over its net identifiable assets before recognizing the DTA associated with the excess tax-deductible goodwill
Final financial reporting goodwill = preliminary financial reporting goodwill − DTA

The following example illustrates the accounting for the tax consequences of goodwill when tax-deductible goodwill exceeds goodwill for financial reporting at the acquisition date.

Illustration 11-4: Accounting for the tax consequences of goodwill when tax-deductible goodwill exceeds goodwill for financial reporting

Facts

- Company A paid $1,000 to acquire all of the outstanding shares of Company B in a business combination.
- The preliminary measurement of all the acquired assets and assumed liabilities (prior to taking into account the tax benefit associated with tax-deductible goodwill) resulted in net assets (acquired assets and liabilities including their related tax effects) of $400 and preliminary financial reporting goodwill of $600.
- The tax basis of goodwill is $900.
- The tax rate is 25%.

Analysis

The preliminary temporary difference is $300 ($900 tax-basis goodwill − $600 preliminary financial reporting goodwill).

The DTA is calculated as follows (based on the formula discussed above):

(.25/ (1 − .25)) x $300 = $100

Goodwill for financial reporting purposes at the acquisition date is $500 ($600 preliminary financial reporting goodwill — $100 DTA).

The final allocation of the $1,000 fair value of the acquired company is as follows:

Net assets acquired (excluding goodwill and its related tax effects)	$	400
Goodwill		500
Deferred tax asset related to goodwill		100

Allocation of goodwill to tax-paying components

In accordance with ASC 740-10-30-5, deferred taxes are determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. ASC 350 generally requires goodwill for financial reporting to be assigned to reporting units. Neither ASC 740 nor ASC 350 requires goodwill to be allocated to separate tax-paying components. Thus, the reporting units to which goodwill is assigned under ASC 350 may not align with the tax-paying components that goodwill is associated with for tax purposes (e.g., a reporting unit might consist of more than one tax-paying component having tax-deductible goodwill).

We believe that goodwill for financial reporting should be allocated to tax-paying components on a systematic and rational basis that is consistently applied. After goodwill for financial reporting has been allocated to tax-paying components (in conjunction with a business combination), the acquirer should identify the first and second components of goodwill by separating goodwill for financial reporting and the tax basis of goodwill at each tax-paying component. The following example illustrates the differing effect of identifying the first and second components of goodwill by tax-paying components.

Illustration 11-5: Identifying the first and second components of goodwill by tax-paying components

Facts

In a business combination, Company A paid $1,000 to acquire all of the outstanding shares of Company B, which operates in two tax jurisdictions and has two tax-paying components (X and Y). In the business combination accounting, Company A records $120 of goodwill for financial reporting. Company B represents a new reporting unit and Company A allocates $80 of goodwill for financial reporting to X and $40 to Y on a systematic and rational basis (e.g., using an approach consistent with the principles of ASC 350). Tax-deductible goodwill acquired in the business combination equals $100, of which $35 is associated with X and $65 is associated with Y.

Analysis

The first and second components of goodwill for X and Y are as follows:

	X		Y	
	Book	**Tax**	**Book**	**Tax**
First component	$ 35	$ 35	$ 40	$ 40
Second component	45	0	0	25
Total	$ 80	$ 35	$ 40	$ 65

At the acquisition date, Company A would not record a deferred tax liability at X because goodwill for financial reporting exceeds tax-deductible goodwill. However, Company A would record a deferred tax asset at Y because tax-deductible goodwill exceeds goodwill for financial reporting.

See section 11.3.5, *Goodwill amortization and impairment allocation policies*, for discussion of tax-deductible goodwill subsequent to the acquisition date.

11.3.5 Goodwill amortization and impairment allocation policies

As discussed in section 11.3.4, *Tax-deductible goodwill*, in tax jurisdictions where amortization of goodwill is deductible for tax purposes, ASC 805-740-25-8 requires that the amount of goodwill reported for financial reporting basis and the tax basis of goodwill each be separated into two components as of the acquisition date for purposes of computing deferred taxes.

The first component of goodwill equals the lesser of goodwill for financial reporting or tax-deductible goodwill. Deferred taxes are recognized for any difference that arises in the future between the financial reporting and tax basis of the first component of goodwill. The second component of goodwill equals the remainder, if any, of:

- **Goodwill for financial reporting over tax-deductible goodwill** — a deferred tax liability is prohibited from being recorded for this difference

  or

- **Tax-deductible goodwill over goodwill for financial reporting** — a deferred tax asset is recognized at the acquisition date

As a result of the distinct accounting for the first component and second component of goodwill, companies are faced with a variety of accounting policies related to the allocation of tax amortization and impairment and amortization (if the entity qualifies for and elects to amortize goodwill for financial reporting purposes) of goodwill for financial reporting to the first component and second component of goodwill.

The accounting policies a company considers are as follows:

	Tax goodwill amortization policy	Financial reporting goodwill policy	Section
Financial reporting goodwill not amortized			
Tax-deductible goodwill exceeds financial reporting goodwill	Ordering policy for allocation of tax amortization between first component and second component of goodwill	Not applicable — impairment would only affect first component of goodwill	Amortization: 11.3.5.1 Impairment: 11.8; 11.8.1
Financial reporting goodwill exceeds tax-deductible goodwill	Not applicable — amortization only affects first component of goodwill	Ordering policy for allocation of impairment between first component and second component of goodwill	Amortization: 11.3.5.1 Impairment: 11.8; 11.8.1
Financial reporting goodwill is amortized*			
Tax-deductible goodwill exceeds financial reporting goodwill	Ordering policy for allocation of tax amortization between first component and second component of goodwill	Not applicable — amortization* or impairment only affects first component of goodwill	Amortization: 11.3.5.2 Impairment: 11.8; 11.8.1
Financial reporting goodwill exceeds tax-deductible goodwill	Not applicable — amortization only affects first component of goodwill	Ordering policy for allocation of amortization* or impairment to first component and second component of goodwill	Amortization: 11.3.5.2 Impairment: 11.8; 11.8.1

* Goodwill is amortized for financial reporting purposes only if the entity is a private company or an NFP and elects the goodwill amortization accounting alternative. See section 11.3, *Identifiable intangible assets and goodwill*, for additional discussion.

11.3.5.1 Financial reporting goodwill not amortized

Tax-deductible goodwill exceeds financial reporting goodwill

When tax-deductible goodwill exceeds goodwill for financial reporting purposes, we believe there are two acceptable methods for allocating amortization for tax purposes:

(1) allocate tax amortization first to the second component of goodwill (i.e., tax-deductible goodwill in excess of goodwill for financial reporting) and then allocate the remainder to the first component of goodwill (i.e., tax-deductible goodwill that was equal to financial reporting goodwill on the acquisition date), or

(2) allocate tax amortization on a pro rata basis between both components of goodwill.

If tax amortization is first allocated to the second component of goodwill and goodwill is not amortized for financial reporting purposes, a company will first reduce any deferred tax asset related to the second component of goodwill reported in acquisition accounting before reporting a deferred tax liability related to the first component of goodwill. If amortization is allocated on a pro rata basis between both components of goodwill, the deferred tax asset will be reduced for the portion allocated to the second component of goodwill and a deferred tax liability will be reported for the portion allocated to the first component of goodwill.

Illustration 11-6: Allocating tax goodwill amortization when tax-deductible goodwill exceeds goodwill for financial reporting purposes and financial reporting goodwill is not amortized

Facts

- At the acquisition date goodwill for financial reporting is $400 and tax-deductible goodwill is $900.
- The tax rate is 25%.
- A deferred tax asset for the second component of goodwill (i.e., the tax-deductible goodwill over goodwill for financial reporting) of $125 is reported at the acquisition date ($500 X 25%).
- Goodwill is amortized for tax purposes over 10 years.
- Goodwill for financial reporting is not amortized.
- There is no impairment of goodwill in the first year after the acquisition.

Analysis

In year 1, deferred taxes related to goodwill would be reported as follows using the two methods described above:

Method 1 (allocate tax amortization first to the second component of goodwill)

Tax amortization of $90 ($900/10 years) would all be allocated to the second component of goodwill ($500). This component of tax-deductible goodwill would be reduced to $410 ($500 — $90) and the deferred tax asset would be reduced by $23 ($90 x 25%).

Method 2 (allocate tax amortization on a pro rata basis between the two components of goodwill)

Tax amortization of $90 ($900/10 years) would all be allocated pro rata between the second component of goodwill (i.e., the portion of tax-deductible goodwill in excess of goodwill for financial reporting) ($500) and the first component of goodwill (i.e., the portion that was equal for financial reporting and tax purposes on the acquisition date) ($400). The second component of goodwill would be reduced to $450 ($500 — ($500/$900 x $90)) and the deferred tax asset would be reduced by $13 ($50 x 25%). For the first component of goodwill, tax goodwill would be reduced to $360 ($400 — ($400/$900 x $90)) while goodwill for financial reporting would continue to be $400, which would create a deferred tax liability of $10 ($40 x 25%).

Noteworthy is that under both method 1 and method 2, the direct net effect on the income tax provision is zero.

The following is a comparison of the effect on deferred income taxes of these two methods from the acquisition date through the 10-year tax amortization period of the goodwill:

	Method 1			Method 2		
Period	**DTA**	**DTL**	**Net DTA (DTL)**	**DTA**	**DTL**	**Net DTA (DTL)**
At acquisition	$ 125	$ –	$ 125	$ 125	$ –	$ 125
Year 1	103	–	103	113	10	103
Year 2	80	–	80	100	20	80
Year 3	58	–	58	88	30	58
Year 4	35	–	35	75	40	35
Year 5	13	–	13	63	50	13
Year 6	–	10	(10)	50	60	(10)
Year 7	–	33	(33)	38	70	(33)
Year 8	–	55	(55)	25	80	(55)
Year 9	–	78	(78)	13	90	(78)
Year 10	–	100	(100)	–	100	(100)

Because goodwill for financial reporting is allocated only to the first component of goodwill, impairment of goodwill for financial reporting will only affect the deferred taxes associated with the first component of goodwill. See discussion in section 11.8.2, *Allocation of impairment of tax-deductible goodwill*.

Financial reporting goodwill exceeds tax-deductible goodwill

Goodwill for financial reporting purposes may exceed tax-deductible goodwill. As a result, the second component of goodwill is only associated with goodwill for financial reporting purposes and no deferred taxes are recognized for the second component of goodwill at the acquisition date or in the future. While tax-deductible goodwill is amortized, goodwill for financial reporting is not (see section 11.3.5.2, *Financial reporting goodwill is amortized*, for discussion of considerations when a private company or NFP elects the goodwill amortization accounting alternative). Goodwill for financial reporting may, however, become impaired. See discussion in section 11.8.2, *Allocation of impairment of tax-deductible goodwill*, for considerations when tax-deductible goodwill exists and goodwill for financial reporting is impaired.

11.3.5.2 Financial reporting goodwill is amortized

As discussed in section 11.3, *Identifiable intangible assets and goodwill*, a private company or NFP can elect to amortize goodwill acquired in a business combination or in an acquisition by an NFP on a straight-line basis over 10 years (or potentially less) and use a simplified impairment test at either the entity or reporting unit level.[37] A company that is a PBE (e.g., a publicly traded company) cannot amortize goodwill.

Tax-deductible goodwill exceeds financial reporting goodwill

Tax-deductible goodwill may exceed goodwill for financial reporting. The deferred tax effects will depend on the policy a company has elected for allocating the amortization of tax-deductible goodwill. Presuming tax amortization is first allocated to the second component of goodwill and goodwill is amortized for financial reporting, a company will first reduce any deferred tax asset related to the second component of goodwill reported in acquisition accounting as a result of the amortization of the tax-deductible goodwill. The

[37] Refer to our FRD, ***Intangibles — Goodwill and other***, for additional information about the accounting and financial reporting of goodwill.

amortization of goodwill for financial reporting will initially result in a deferred tax asset associated with the first component of goodwill. After the deferred tax asset associated with the second component of goodwill is reduced to zero, the deferred taxes associated with the first component of goodwill will be affected by both the amortization of tax-deductible goodwill and goodwill for financial reporting purposes.

Alternatively, if tax amortization is allocated on a pro rata basis between the two components of goodwill, the tax amortization will result in the deferred tax asset being reduced for the portion allocated to the second component of goodwill. However, the deferred taxes associated with the first component of goodwill are affected by both the amortization of tax-deductible goodwill and goodwill for financial reporting purposes.

The following example illustrates these concepts.

Illustration 11-7: Allocating tax goodwill amortization when tax-deductible goodwill exceeds goodwill for financial reporting purposes and financial reporting goodwill is amortized

Facts

- At the acquisition date goodwill for financial reporting purposes is $400 and tax-deductible goodwill is $900.
- The tax rate is 25%.
- A deferred tax asset for tax-deductible goodwill over goodwill for financial reporting of $125 is reported at the acquisition date ($500 X 25%).
- Goodwill is amortized for tax purposes over 15 years.
- Goodwill for financial reporting purposes is amortized over 10 years.
- There is no impairment of goodwill in the first year after the acquisition.

Analysis

In year 1, deferred taxes related to goodwill would be reported as follows using the two methods for tax-deductible goodwill described above:

Method 1

Tax amortization of $60 ($900/15 years) would all be allocated to the second component of goodwill (i.e., the portion of tax-deductible goodwill in excess of goodwill for financial reporting ($500)). This component of tax-deductible goodwill would be reduced to $440 ($500 — $60) and the deferred tax asset would be reduced by $15 ($60 x 25%). Amortization of goodwill for financial reporting of $40 ($400/10 years) is only related to the first component of goodwill (i.e., the portion related to tax-deductible goodwill that equals goodwill for financial reporting at the acquisition date ($400)). The first component of goodwill for financial reporting would be reduced to $360 ($400 — $40). The tax-deductible goodwill associated with the first component of goodwill remains unchanged. The deductible temporary difference associated with the first component of goodwill is $40 ($400 tax-deductible goodwill — $360 of goodwill for financial reporting), which would create a deferred tax asset of $10 ($40 x 25%).

Method 2

Tax amortization of $60 ($900/15 years) would all be allocated pro rata between the second component of goodwill (i.e., the portion of tax-deductible goodwill in excess of goodwill for financial reporting ($500)) and the first component of goodwill (i.e., the portion that was equal for financial reporting and tax purposes on the acquisition date ($400)). The tax-deductible goodwill associated with the second component of goodwill would be reduced to $467 ($500 – ($500/$900 x $60)) and the deferred tax asset would be reduced by $8 ($33 x 25%). For the first component of goodwill, tax goodwill would be reduced to $373 ($400 – ($400/$900 x $60)) while goodwill for financial reporting would be reduced to $360 ($400 – $40). The deductible temporary difference associated with the first component of goodwill is $13 ($373 tax-deductible goodwill – $360 of goodwill for financial reporting purposes), which would create a deferred tax asset of $3 ($13 x 25%).

The following is a comparison of the effect on deferred income taxes of these two methods from the acquisition date through the 15-year tax amortization period of the tax-deductible goodwill:

	Method 1			Method 2		
Period	**C2 DTA**	**C1 DTA**	**Total DTA**	**C2 DTA**	**C1 DTA**	**Total DTA**
At acquisition	$ 125	$ –	$ 125	$ 125	$ –	$ 125
Year 1	110	10	120	117	3	120
Year 2	95	20	115	108	7	115
Year 3	80	30	110	100	10	110
Year 4	65	40	105	92	13	105
Year 5	50	50	100	83	17	100
Year 6	35	60	95	75	20	95
Year 7	20	70	90	67	23	90
Year 8	5	80	85	58	27	85
Year 9	–	80	80	50	30	80
Year 10	–	75	75	42	33	75
Year 11[a]	–	60	60	33	27	60
Year 12	–	45	45	25	20	45
Year 13	–	30	30	17	13	30
Year 14	–	15	15	8	7	15
Year 15	–	–	–	–	–	–

[a] Beginning in year 11 under method 2, the DTA for the C1 goodwill changes by larger amounts compared to years 1 through 10 because the financial reporting goodwill is fully amortized by the end of year 10.

Goodwill for financial reporting purposes exceeds tax-deductible goodwill

Goodwill for financial reporting purposes may exceed tax-deductible goodwill. As a result, the second component of goodwill is only associated with goodwill for financial reporting purposes and no deferred taxes are recognized for the second component of goodwill at the acquisition date or in the future. When goodwill for financial reporting exceeds tax-deductible goodwill and goodwill for financial reporting is amortized, we believe there are two acceptable methods for allocating financial reporting amortization:

(1) allocate amortization of goodwill for financial reporting first to the second component of goodwill (i.e., goodwill for financial reporting in excess of tax-deductible goodwill) and then allocate the remainder to the first component of goodwill (i.e., goodwill for financial reporting equal to tax-deductible goodwill on the acquisition date), or

(2) allocate amortization for financial reporting on a pro rata basis between the two components of goodwill.

If the company elects to first allocate the amortization of goodwill for financial reporting purposes to the second component of goodwill and the company also has tax-deductible goodwill, only deferred taxes related to the first component of goodwill will be affected. Initially, the amortization of tax-deductible goodwill and goodwill for financial reporting purposes will likely result in the recognition of a deferred tax liability related to the first component of goodwill because only the amortization of tax-deductible goodwill will affect the first component of goodwill. However, after the second component of goodwill is fully amortized, the deferred tax effect related to the first component of goodwill will be dependent on the amount of tax-deductible goodwill amortized and the amount of goodwill amortized for financial reporting purposes.

Similarly, if the company allocates the amortization of goodwill for financial reporting on a pro rata basis, the deferred tax effect related to the first component of goodwill is dependent on the amount of tax-deductible goodwill amortized and the amortization of the goodwill for financial reporting purposes allocated to the first component of goodwill. There will be no deferred tax consequences associated with the amortization of goodwill for financial reporting purposes allocated to the second component of goodwill.

See section 11.8.2, *Allocation of impairment of tax-deductible goodwill*, for discussion of allocating an impairment of goodwill for financial reporting.

Illustration 11-8: Allocating goodwill amortization for financial reporting purposes when goodwill for financial reporting purposes exceeds tax-deductible goodwill and financial reporting goodwill is amortized

Facts

- At the acquisition date goodwill for financial reporting purposes is $900 and tax-deductible goodwill is $400.
- The tax rate is 25%.
- No deferred tax balances are recognized at the acquisition date as goodwill for financial reporting purposes is in excess of tax-deductible goodwill.
- Goodwill is amortized for tax purposes over 15 years.
- Goodwill for financial reporting purposes is amortized over 10 years.
- There is no impairment of goodwill in the first year after the acquisition.

Analysis

In year 1, deferred taxes related to goodwill would be reported as follows using the two methods for goodwill for financial reporting purposes described above:

Method 1

Amortization of goodwill for financial reporting purposes of $90 ($900/10 years) would all be allocated to the second component of goodwill (i.e., the portion of goodwill for financial reporting purposes that is in excess of tax-deductible goodwill) ($500). This component of goodwill for financial reporting purposes would be reduced to $410 ($500 — $90) and there would be no associated deferred tax. Amortization of tax-deductible goodwill of $27 ($400/15 years) is only related to the first component of goodwill ($400). The first component of tax-deductible goodwill would be reduced to $373 ($400 — $27). The goodwill for financial reporting purposes associated with the first component of goodwill remains unchanged. The taxable temporary difference associated with the first component of goodwill is $27 ($400 of goodwill for financial reporting purposes — $373 tax-deductible goodwill), which would create a deferred tax liability of $7 ($27 x 25%).

Method 2

Amortization of goodwill for financial reporting purposes of $90 ($900/10 years) would all be allocated on a pro rata basis between the second component of goodwill (i.e., the portion of goodwill for financial reporting purposes in excess of tax-deductible goodwill) ($500) and the first component of goodwill (i.e., the portion that was equal for financial reporting and tax purposes on the acquisition date) ($400). The goodwill for financial reporting purposes associated with the second component of goodwill would be reduced to $450 ($500 – ($500/900 x $90)) and there would be no associated deferred tax. For the first component of goodwill, goodwill for financial reporting would be reduced to $360 ($400 – ($400/900 x $90)) while tax-deductible goodwill would be reduced to $373 ($400 – $27). The deductible temporary difference associated with the first component of goodwill is $13 ($373 tax-deductible goodwill – $360 of goodwill for financial reporting purposes), which would create a deferred tax asset of $3 ($13 x 25%).

The following is a comparison of the effect on deferred income taxes of these two methods from the acquisition date through the fifteen-year tax amortization period of the tax-deductible goodwill:

	Method 1			Method 2		
Period	**C2**	**C1 DTA (DTL)**	**Net DTA (DTL)**	**C2**	**C1 DTA**	**Total DTA**
At acquisition	$ –	$ –	$ –	$ –	$ –	$ –
Year 1	–	(7)	(7)	–	3	3
Year 2	–	(13)	(13)	–	7	7
Year 3	–	(20)	(20)	–	10	10
Year 4	–	(27)	(27)	–	13	13
Year 5	–	(33)	(33)	–	17	17
Year 6	–	(30)	(30)	–	20	20
Year 7	–	(14)	(14)	–	23	23
Year 8	–	2	2	–	27	27
Year 9	–	18	18	–	30	30
Year 10	–	33	33	–	33	33
Year 11	–	27	27	–	27	27
Year 12	–	20	20	–	20	20
Year 13	–	13	13	–	13	13
Year 14	–	7	7	–	7	7
Year 15	–	–	–	–	–	–

11.3.6 Excess tax-deductible goodwill in pre-ASC 805 transactions

Because ASC 805 requires that the tax benefit associated with the excess of tax-deductible goodwill over goodwill for financial reporting purposes be recognized at the acquisition date, Statement 109.262 (non-authoritative) was amended to eliminate the guidance on where to recognize the benefit once it is realized on the tax return (i.e., first to reduce goodwill, then to other noncurrent intangible assets related to the acquisition, and finally to reduce income tax expense). However, because ASC 805 does not provide for a cumulative effect adjustment to recognize deferred taxes on previous acquisitions, guidance is still necessary for previous business combinations accounted for in accordance with Statement 141 (non-authoritative).

Although the guidance previously included in Statement 109.262 (non-authoritative) has been superseded, we believe that guidance should continue to apply to business combinations accounted for under Statement 141 (non-authoritative). For example, assume in 2005 Company A acquired Company B and that tax goodwill was $1,000 and goodwill for financial reporting was $200. Assume tax goodwill is amortized over 10 years. As of 1 January 2009, tax goodwill is $600 and goodwill for financial reporting remains at $200.

Because ASC 805 does not change the accounting for prior business combinations, a deferred tax asset related to the existing $400 basis difference is not recognized on adoption of ASC 805. Instead, we believe an entity should continue to apply their existing accounting policy for the recognition of the tax benefits of this goodwill. That policy, which previously was detailed in Statement 109.262 (non-authoritative), requires that the tax benefit of tax-basis goodwill in excess of goodwill for financial reporting (i.e., component two goodwill) be recognized when realized and applied first to reduce goodwill reported for financial reporting related to the acquisition to zero, then to reduce other noncurrent intangible assets related to the acquisition to zero, with any remaining benefit recognized as a reduction of income tax expense.

11.3.7 Changes in acquirer's valuation allowance as a result of a business combination

Excerpt from Accounting Standards Codification

Business Combinations — Income Taxes

Initial Measurement

805-740-30-3

The tax law in some tax jurisdictions may permit the future use of either of the combining entities' deductible temporary differences or **carryforwards** to reduce **taxable income** or taxes payable attributable to the other entity after the business combination. If the combined entity expects to file a consolidated tax return, an acquirer may determine that as a result of the **business combination** its valuation for its deferred tax assets should be changed. For example, the acquirer may be able to utilize the benefit of its tax operating loss carryforwards against the future taxable profit of the **acquiree**. In such cases, the acquirer reduces its valuation allowance based on the weight of available evidence. However, that reduction does not enter into the accounting for the business combination but is recognized as an income tax benefit (or credited directly to contributed capital [see paragraph 740-10-45-20]).

In a period prior to a business combination, the acquirer, after considering all available positive and negative evidence, concluded that a valuation allowance was required on its deferred tax assets (including net operating losses). This valuation allowance is still necessary immediately prior to the acquisition. The deferred tax liabilities assumed in the business combination are available to offset the reversal of the acquirer's preexisting deferred tax assets. As a result of the business combination, the acquiring company determines their preexisting deferred tax assets are more likely than not to be realized by the combined entity and the valuation allowance should be reduced or eliminated.

Under ASC 805-740, a change in an acquirer's valuation allowance for a deferred tax asset that results from a change in the acquirer's circumstances caused by a business combination should be accounted for as an event separate from the business combination. As a result, changes in an acquirer's valuation allowances that stem from a business combination should be recognized as an element of the acquirer's deferred income tax expense (benefit) in the reporting period that includes the business combination. (Note that, although rare, increases in an acquiring entity's valuation allowance that results from a business combination should continue to be reported as adjustments to income tax expense pursuant to ASC 805-740.)

For example, assume that an acquirer that had previously recognized a valuation allowance against its NOL carryforwards determines that it should be able to utilize the benefit of those NOLs against deferred tax liabilities of the acquired company. Therefore, the acquirer should reduce its preexisting valuation allowance. In accounting for that reduction under ASC 805-740, the acquirer would credit deferred income tax expense.

An additional complication arises when the acquirer and acquiree will file a consolidated tax return (without limitation on increased deductions between the entities) and both have deferred tax assets and deferred tax liabilities, and a valuation allowance is necessary for the combined company. It can be challenging to determine whether the valuation allowance is included in the accounting for the business combination or in continuing operations. In these situations, the combined company should determine how to order the taxable income that results from the future reversals of the existing taxable temporary differences. We believe that the company should use a systematic and rational approach to ordering the taxable income when determining which deferred tax assets are realizable. In practice we have observed the following approaches when ordering the available taxable income to determine which deferred tax assets are realizable:

- Follow the tax law
- Allocate the available taxable income pro rata to the acquirer and acquiree deferred tax assets
- Allocate the available taxable income first to the existing deferred tax assets of the acquirer
- Allocate the available taxable income first to the deferred tax assets of the acquiree

The combined entity should consistently apply a policy to all business combinations when determining the order of the deferred tax assets that may benefit from future taxable income of the combined entity. We believe it is most appropriate to consider the application of the tax law. The tax law generally determines the sequence in which tax benefits (e.g., NOLs) and reversals of deferred tax liabilities of the combined entity are utilized for tax purposes. For example, assume both the acquirer and acquiree had preexisting NOLs and all NOLs can be used by the combined entity without limitations. If the tax law in a particular jurisdiction requires the combined entity to offset taxable income with NOLs generated from the earliest period, the combined company orders the realizability of the deferred tax assets based on the age of the deferred tax asset. That is, presume the oldest NOLs relate to the acquirer and the acquiree has deferred tax liabilities that are expected to reverse in the next year. Since the acquirer's existing deferred tax assets are considered under the tax law to benefit first from the deferred tax liability of the acquiree, any release of a related valuation allowance is not part of the business combination and should be accounted for outside of acquisition accounting in continuing operations.

While an acquirer may reduce its preexisting valuation allowance as a result of a business combination, it also may determine a valuation allowance is necessary on acquired deferred tax assets. The effect of recording a valuation allowance related to the acquired deferred tax assets is included in the accounting for the business combination. See section 11.11, *Valuation allowance in a business combination*, for further discussion on recording a valuation allowance in a business combination.

The following illustration demonstrates the application of a "follow the tax law" ordering policy when determining which deferred tax assets of the combined company are more likely than not to be realized.

Illustration 11-9: Application of a "follow the tax law" ordering policy when determining which deferred tax assets of the combined company are more likely than not to be realized

Assume Company A had $1,000 deferred tax assets related to NOL carryforwards at the beginning of 20X4. No other temporary differences exist. Company A previously considered the weight of all available positive and negative evidence from all four sources of taxable income and concluded a valuation allowance was required on the $1,000 of deferred tax assets. $600 of the deferred tax assets were related to NOLs arising in 20X0 with the $400 remainder related to NOLs arising in 20X1.

In the first quarter of 20X4, Company A acquired the stock of Company B in a business combination accounted for under ASC 805. At the beginning of 20X4 and at the acquisition date, Company B reflected a $700 deferred tax asset relating to NOLs for the tax year ended 20X3. Prior to the business combination, Company B determined that the deferred tax assets are more likely than not to be realized as Company B had $700 of deferred tax liabilities that are of the appropriate character and are expected to be reversed in the appropriate period to allow for the realization of the deferred tax assets.

Deferred tax balances of each company prior to business combination:

Tax year	Deferred tax assets (i.e., NOLs)	Deferred tax liabilities	Existing valuation allowance prior to business combination
20X0	$ 600	$ -	$ (600)
20X1	400	-	(400)
Total Company A	$ 1,000	$ -	$ (1,000)
20X3	$ 700	$ (700)	$ -
Total Company B	$ 700	$ (700)	$ -

For simplicity purposes, assume the $700 DTL and $700 DTA are unchanged in purchase accounting and no other temporary differences are recorded. Subsequent to the business combination, the combined company expects to file a consolidated tax return and tax law in the combined entity's jurisdiction permits use of either company's NOL carryforward to reduce taxes payable attributable to the combined company subsequent to the business combination. The $700 deferred tax liability assumed in the business combination is a source of taxable income[a] available to offset the reversal of a portion, but not all, of the combined entity's $1,700 deferred tax asset. No additional DTLs are recognized by the combined company and the combined company identifies no other sources of taxable income. The combined company determines that a valuation of $1,000 is necessary. Tax law in the combined entity's jurisdiction requires usage of NOLs from the earliest periods to offset taxable income.

[a] For simplicity, the illustration assumes that there are no limitations on the use of the NOLs.

Tax year of NOL	Combined company DTAs (i.e., NOLs)	Combined company taxable income from reversal of DTLs	DTAs expected to be realized	DTAs for which valuation allowance necessary
20X0	$ 600	$ 600	$ (600)	$ -
20X1	400	100	(100)	300
20X3	700	-	-	700
Total	$ 1,700	$ 700	$ (700)	$ 1,000

Since the tax law in the combined entity's jurisdiction requires usage of NOLs from the earliest period first, the combined entity can benefit $700 of Company A's existing deferred tax assets ($600 from 20X0 and $100 from 20X1) with the $700 deferred tax liability assumed in the business combination. As a result, the combined company will release $700 of the valuation allowance that previously existed for Company A's deferred tax assets. The $700 tax benefit is included in income from continuing operations in the period of the business combination. Additionally, the combined company will record a valuation allowance in the business combination of $700 as the acquired net operating losses of Company B are not more likely than not to be realized. The combined company will maintain a valuation allowance of $1,000 at the acquisition date.

11.3.8 Disposal of tax-deductible goodwill

In a business combination, all acquired goodwill should be assigned to one or more reporting units as of the acquisition date. A reporting unit is the level of reporting at which goodwill is tested for impairment and is an operating segment or a component of an operating segment. A reporting unit can consist of one or more legal entities or constitute a part of a legal entity. Refer to section 3.11 (before the adoption of ASU 2017-04) or section 3A.11 (after the adoption of ASU 2017-04), *Assigning goodwill to reporting units*, in our FRD, ***Intangibles — Goodwill and other***, for further discussion on assigning goodwill to reporting units.

In tax jurisdictions where amortization of goodwill is deductible for tax purposes, ASC 805-740-25-8 requires that the amount of goodwill recognized for financial reporting and the tax basis of goodwill each be separated into two components as of the acquisition date for purposes of computing deferred taxes. These components are not further evaluated at a later date despite a disposition or changes in operating segments.

When a company decides to dispose of a business, it is important to understand what is included in the disposition. For financial reporting, the goodwill of a reporting unit that is disposed of in its entirety is included as part of the carrying amount of the net assets disposed of in determining the gain or loss on the disposal. When a portion of a reporting unit is disposed of and that portion constitutes a business, a portion of the goodwill of the reporting unit should be included in the disposal. The assignment of goodwill is based on the relative fair values of the portion of the reporting unit being disposed of (assuming the portion is a business) and the portion of the reporting unit remaining. This allocation requires a determination of the fair value of both the business to be disposed of and the business (or businesses) within the reporting unit that will be retained. See section 3.14 (before the adoption of ASU 2017-04) or section 3A.14 (after the adoption of ASU 2017-04), *Disposal of all or a portion of a reporting unit*, in our FRD, ***Intangibles — Goodwill and other***.

A company may sell shares of a legal entity or assets and liabilities within a legal entity that has tax-deductible goodwill. Careful consideration of the tax law is necessary to determine if the tax-deductible goodwill remains in the seller's consolidated group for financial reporting purposes following the disposition. In certain jurisdictions, tax-deductible goodwill attaches to the legal entity rather than to the assets and liabilities within the legal entity. For example, in those jurisdictions, if the legal entity is sold to a buyer, and thus deconsolidated for financial reporting purposes, the tax-deductible goodwill no longer remains in the seller's consolidated group. However, in those same jurisdictions if assets and liabilities of that entity are sold out of the legal entity, the tax-deductible goodwill remains with the entity, and thus with the seller assuming that the legal entity continues to be consolidated for financial reporting purposes.

While ASC 350-20-40-3 requires the reporting unit to allocate goodwill for financial reporting based on the relative fair values of the portion of the reporting unit being disposed of (assuming the portion is a business) and the portion of the reporting unit remaining, the tax basis of the goodwill may be treated differently. That is, the allocation of the tax basis of goodwill will be based on the relevant tax law. For example, assume a company has one reporting unit with several legal entities and goodwill is allocated to the reporting unit for financial reporting and tax purposes. Assume that the company disposes of all of the shares of one legal entity constituting a business within the reporting unit. Also, assume that all of the tax-deductible goodwill of the reporting unit is attached to the legal entity that is disposed. In this case, the reporting unit may continue to have goodwill for financial reporting after the disposition because the goodwill for financial reporting is allocated among the disposed business and the remaining business(es). However, the company no longer has tax-deductible goodwill as a result of the disposition of the legal entity that had tax-deductible goodwill. The disposition of the shares of the legal entity does not change the previous income tax accounting for the goodwill recognized in the business combination. That is, the company continues to utilize the first and second component of goodwill that was previously determined at the acquisition date for purposes of computing deferred taxes.

The following illustrations reflect the deferred tax accounting related to the disposal of a business involving tax-deductible goodwill.

Illustration 11-10: Disposal of all of the shares of the previously acquired company with tax-deductible goodwill

Facts

- Company A acquired Company B on 31 December 20X2 in a taxable business combination (i.e., a business combination in which Company A steps up the tax bases of Company B's acquired assets to fair value as of the acquisition date) resulting in $1,500 of tax-deductible goodwill (amortizable over 10 years) equal to the goodwill amount for financial reporting as of the acquisition date (i.e., first component of goodwill is $1,500 for financial reporting and tax purposes).
- No other temporary differences existed as of the acquisition date.
- Company B's business was not considered a separate reporting unit; rather, Company B's business was integrated with other businesses of Company A and included in existing Reporting Unit C.
- Reporting Unit C has no other tax or financial reporting goodwill. Company A's tax rate is 25%.
- At 31 December 20X5, Company A decided to dispose its entire investment (i.e., all of the shares) in Company B.
- The unamortized tax-deductible goodwill of $1,050 at 20X5 ($1,500 tax basis as of the acquisition date less $450 of tax amortization in 20X3 through 20X5) that is attached to Company B is included in the disposal.

Analysis

Since Company B is not a separate reporting unit, Reporting Unit C's goodwill for financial reporting is allocated based on the relative fair value of Company B and the portion of Reporting Unit C remaining. The amount of goodwill for financial reporting purposes allocated to the disposed business, Company B, is $800. Consequently, $700 of the original $1,500 goodwill for financial reporting purposes is allocated to the remaining business of Reporting Unit C ($1,500 less $800 allocated to the disposed business). Because goodwill for financial reporting was all assigned to the first component of goodwill, the company continues to compute deferred taxes on the taxable temporary difference related to goodwill for financial reporting despite the reporting unit having no remaining tax-deductible goodwill. A deferred tax liability of $175 is recognized related to the goodwill taxable temporary difference.

Goodwill for financial reporting of Reporting Unit C remaining	$ 700
Tax basis goodwill retained	$ 0
Taxable temporary difference	$ 700
Tax rate	25%
Deferred tax liability	$ 175

Illustration 11-11: Disposal of a significant portion of the previously acquired company's assets and liabiliites with tax-deductible goodwill

Facts

- Company A acquired Company B on 31 December 20X2 in a taxable business combination (i.e., a business combination in which Company A steps up the tax bases of Company B's acquired assets to fair value as of the acquisition date) resulting in $1,500 of tax-deductible goodwill (amortizable over 10 years) equal to the goodwill amount for financial reporting as of the acquisition date (i.e., first component of goodwill is $1,500 for financial reporting and tax purposes).
- No other temporary differences existed as of the acquisition date.
- Company B's business was not considered a separate reporting unit; rather, Company B's business was integrated with other businesses of Company A and included in existing Reporting Unit C.
- Reporting Unit C has no other goodwill.
- Company A's tax rate is 25%.
- At 31 December 20X5, Company A disposed of a significant portion of Company B's assets and liabilities but did not sell any of the shares of Company B.
- The unamortized tax-deductible goodwill that is attached to Company B is $1,050 at 31 December 20X5 ($1,500 tax basis as of the acquisition date less $450 of tax amortization in 20X3 through 20X5).
- The disposition of the assets and liabilities qualifies as a disposition of a business.

Analysis

Because Company A did not dispose of Company B, the tax-deductible goodwill remains within Company A's consolidated group. For financial reporting purposes, $600 of the goodwill for financial reporting is allocated to the disposed business and $900 of the goodwill for financial reporting is retained with the remaining business of Reporting Unit C based on a relative fair value of the reporting unit's businesses that are being retained and disposed. Because the goodwill for financial reporting was all assigned to the first component of goodwill, the company continues to compute deferred taxes on the temporary difference related to goodwill. A deferred tax asset of $38 is recognized related to the deductible temporary difference and is evaluated for realizability.

Goodwill for financial reporting of Reporting Unit C remaining	$ 900
Tax basis goodwill retained	$ 1,050
Deductible temporary difference	$ 150
Tax rate	25%
Deferred tax asset	$ 38

11.4 Tax consequences of contingent consideration

An acquirer may be obligated to deliver cash, additional equity interests, or other assets to former owners of an acquired business after the acquisition date if certain specified events occur or conditions are met (i.e., "contingent consideration"). In other instances, the seller may be obligated to return previously transferred consideration (commonly referred to as "contingently returnable consideration") to the buyer if specified future events occur or fail to occur. These arrangements are commonly used by buyers and sellers when there are differences of opinion as to the fair value of the acquired business.

Under ASC 805, contingent payment arrangements that are an element of consideration transferred (as opposed to a compensatory arrangement with employees) are recognized as of the acquisition date as part of the fair value transferred in exchange for the acquired business. The FASB concluded that subsequent changes in the fair value of a contingent consideration obligation (or contingently returnable consideration) does not affect the acquisition-date fair value of the consideration transferred to the acquiree. Instead, subsequent changes in the fair value of a contingent consideration arrangement (or contingently returnable consideration) are considered to relate to post-combination events and changes in circumstances of the combined entity. Thus, ASC 805 requires that changes in the value of such contingent payment arrangements should not affect the measurement of the consideration transferred on the acquisition date.

After initially measuring the fair value of a contingent payment arrangement, an acquirer accounts for changes in fair value as follows:

- Contingent consideration obligations that are classified as equity should not subsequently be remeasured, consistent with the accounting for other obligations that require an entity to deliver its equity shares.
- Contingent consideration obligations classified as liabilities and contingently returnable consideration classified as assets that are not within the scope of ASC 815, should be remeasured at fair value each reporting period with changes in fair value recognized in earnings.
- Contingent consideration obligations classified as liabilities and contingently returnable consideration classified as assets that are financial instruments within the scope of ASC 815 are accounted for in accordance with that ASC. Thus, assets and liabilities for contingent consideration that are subject to ASC 815 should be subsequently remeasured at fair value with changes in fair value reported through earnings in accordance with ASC 815.

For tax purposes, contingent payment arrangements are generally not recognized until they become fixed and determinable, which results in a difference in the total consideration recognized for financial reporting and tax purposes on the date of acquisition as well as the measurement in subsequent periods. The balance of this section discusses the accounting for contingent payment arrangements that are reflected at fair value as part of the consideration transferred in a business combination.

When a business combination includes a contingent payment arrangement, we believe the acquirer should evaluate the ultimate tax consequences that will result if the contingency is settled at its carrying amount (i.e., fair value) to determine whether a deferred tax asset or liability should be recognized (i.e., hypothetically evaluate the tax consequences as if the contingency were settled at its carrying amount (fair value) as of the acquisition date).

11.4.1 At acquisition — taxable

If a transaction is a taxable business combination (i.e., a business combination in which the buyer receives a step-up in the tax bases of the acquired net assets), the settlement of a contingent payment arrangement will generally affect the tax basis of goodwill. That settlement will result in an increase to the tax basis of goodwill for contingent consideration obligations and a decrease to the tax basis goodwill for contingently returnable consideration. Therefore, an acquirer should include the additional tax-basis goodwill that would result from the settlement of a contingent consideration obligation at its carrying amount as of the acquisition date in determining whether it is appropriate to report a deferred tax asset for tax-deductible goodwill in excess of goodwill for financial reporting purposes (see section 11.3.4, *Tax-deductible goodwill*, for additional discussion of this analysis).

Similarly, the fair value asset at the acquisition date for contingently returnable consideration would be assumed to reduce the tax basis of goodwill in determining whether it is appropriate to report a deferred tax asset for tax-deductible goodwill in excess of goodwill for financial reporting purposes. If the settlement of the contingent payment arrangement would give rise to (or decrease) tax basis other than tax goodwill, a corresponding deferred tax asset would also be established; however, it would not be subject to the computations associated with taxable goodwill. The concepts discussed above are illustrated in the example in the section below.

11.4.2 Post-acquisition — taxable

At each reporting date when the contingent consideration obligation or contingently returnable consideration is remeasured at fair value (i.e., because it is classified as an asset or a liability), the deferred tax consequences of any adjustments should be reported outside of acquisition accounting (i.e., in income tax expense), consistent with the accounting for the change in the fair value of the contingent consideration. Therefore, the analysis of tax-deductible goodwill versus goodwill for financial reporting purposes should not be revisited subsequent to the acquisition date.

If the fair value of a contingent consideration obligation increases (or the fair value of contingently returnable consideration decreases), the acquirer would report a deferred tax asset even if tax goodwill is not in excess of financial reporting goodwill. Additionally, if the fair value of a contingent consideration obligation decreases (or the fair value of contingently returnable consideration increases), it would be necessary to either report a deferred tax liability (if a deferred tax asset was not previously reported, i.e., goodwill for financial reporting was equal to or in excess of tax-deductible goodwill) or reduce the previously reported deferred tax asset (with any excess reflected as a deferred tax liability).

The following illustration reflects these concepts in a taxable business combination.

Illustration 11-12: Tax consequences of contingent consideration at acquisition and post-acquisition in a taxable business combination

Facts

- At the acquisition date, the amount of goodwill reported for financial reporting (before taking into consideration the tax benefit associated with goodwill) and tax basis of goodwill are $600 and $400, respectively.
- The tax rate is 25%.
- If certain conditions are met after two years, the acquirer will be required to pay the seller of the acquired business an additional amount, which has been valued at $275 as of the acquisition date.
- After one year, during the normal remeasurement performed each reporting period (other than adjustments reflecting facts that existed on the acquisition date and that became known during the measurement period) the acquirer determines that the fair value of the obligation is $125 and a $150 adjustment is recognized in the current period income statement.

Analysis

At acquisition

Because financial reporting goodwill exceeds tax goodwill, if there was no contingent consideration obligation, the acquirer would not report deferred taxes on goodwill. However, the $275 contingent consideration obligation (fair value as of the date of acquisition) should be included in the tax basis of goodwill in evaluating the need to report a deferred tax asset. Because the adjusted tax basis of goodwill is $675, a deferred tax asset should be recognized as of the acquisition date calculated as follows:

The preliminary temporary difference is $75 ($675 tax basis goodwill — $600 preliminary goodwill for financial reporting).

The DTA is calculated as follows:

$$(.25 /(1 - .25)) \times \$75 = \$25$$

Goodwill for financial reporting purposes at the acquisition date is $575 ($600 preliminary goodwill for financial reporting — $25 DTA).

> **Post-acquisition**
>
> When the fair value of the liability is reduced to $125 one year later, the deferred tax consequences of the adjustment would be recognized outside of acquisition accounting (i.e., goodwill for financial reporting purposes is not adjusted). The acquirer would report deferred tax expense of $38 ($150 decrease in liability x 25%) resulting in a net deferred tax liability of $13 (the $50 difference between financial reporting goodwill at the acquisition date of $575 and adjusted tax goodwill of $525 ($675 hypothetical goodwill as of the acquisition date — $150 subsequent adjustment) x 25%).
>
> At the end of the second year, the liability was ultimately settled by the acquirer paying consideration of $200 (i.e., $75 more than the estimated fair value of the liability at the end of the first year, which would be reported in the income statement in the second year). Similar to the adjustment reported in the first year, the deferred tax effects of the settlement of the liability would be recognized outside of acquisition accounting. The acquirer would report deferred tax benefit of $19 ($75 increase in amount required to ultimately settle the liability x 25%) resulting in a net deferred tax asset of $6, for the difference between financial reporting goodwill at the acquisition date of $575 and adjusted tax goodwill of $600 ($675 hypothetical goodwill as of the acquisition date — $75 subsequent adjustment).

11.4.3 At acquisition — nontaxable

If the transaction is a nontaxable business combination (i.e., a stock purchase), the settlement of a contingent payment arrangement will generally affect the acquirer's tax basis in the stock acquired (i.e., an increase to the acquirer's tax basis in the investment for contingent consideration obligations and a decrease to the acquirer's tax basis in the investment for contingently returnable consideration). If a contingent payment arrangement would result in a net deferred tax asset or deferred tax liability as of the acquisition date, the provisions of ASC 740 should be considered to determine whether it is appropriate to recognize such a deferred tax asset or liability as of the acquisition date.

11.4.3.1 Deferred tax asset — outside basis difference

As discussed further in section 14.5, *Limitations on deferred tax assets for outside basis differences of foreign and domestic subsidiaries, corporate joint ventures and investees*, ASC 740-30-25-9 restricts recognition of a deferred tax asset for the excess of the tax basis over the financial reporting basis of an investment (outside basis difference) in either a foreign or domestic subsidiary or corporate joint venture. Therefore, an acquirer would only recognize a deferred tax asset for a contingent payment arrangement that would result in a net deferred tax asset on the investment as of the acquisition date if it is apparent that the outside basis difference will reverse in the foreseeable future (which is expected to be rare for a newly acquired entity). If an arrangement includes contingently returnable consideration that would decrease the acquirer's tax basis in the stock, but the decrease would result in the tax basis of the investment still exceeding the financial reporting basis, the reduced deferred tax asset would still be subject to the limitation of ASC 740-30-25-9.

11.4.3.2 Deferred tax liability — outside basis difference

As discussed in sections 14.3, *Investments in foreign subsidiaries, corporate joint ventures and foreign investees*, and 14.4, *Investments in domestic subsidiaries, corporate joint ventures and domestic investees*, ASC 740 provides certain exceptions related to the need to report a deferred tax liability related to the excess of the financial reporting basis of an investment in a domestic or foreign subsidiary or corporate joint venture over its tax basis:

- ASC 740-30-25-18 provides an exception to reporting a deferred tax liability for the excess of the financial reporting basis over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration.

- ASC 740-30-25-7 provides an exception to reporting a deferred tax liability if the tax law provides a means by which the reported amount of an investment in the stock of a domestic subsidiary could be recovered in a tax-free transaction (e.g., a tax-free liquidation or a statutory merger) and the company expects that it ultimately will use that tax-free transaction.

An acquirer is required to recognize a deferred tax liability for a contingent payment arrangement that would result in a net deferred tax liability on the investment as of the acquisition date unless one of these exceptions is met.

11.4.4 Post-acquisition — nontaxable

11.4.4.1 Deferred tax asset — outside basis difference

At each reporting date, when the contingent consideration obligation or contingently returnable consideration is remeasured at fair value, the deferred tax consequences of any adjustments should be reported outside of acquisition accounting (i.e., in income tax expense), consistent with the accounting for the change in the fair value of the contingent consideration. However, any such deferred tax asset and liability is subject to ASC 740, including the limitations related to the establishment of a deferred tax asset on the outside basis difference of an investment in a subsidiary or corporate joint venture. As a result, to the extent there is a subsequent change in the fair value of the contingent payment arrangement post-acquisition (up to and including settlement) that results in a deferred tax asset (e.g., an increase in the contingent consideration obligation or a decrease in the contingently returnable consideration where the investment's tax basis continues to exceed its financial reporting basis) related to the investment, the tax consequences of such adjustment are limited by whether a corresponding deferred tax asset was or can be reported in accordance with ASC 740-30-25-9.

11.4.4.2 Deferred tax liability — outside basis difference

To the extent there is a subsequent change in the fair value of a contingent payment arrangement post-acquisition (up to and including settlement) that results in a deferred tax liability (e.g., a decrease in the contingent consideration obligation when the investment's financial reporting basis continues to exceed its tax basis or an increase in the contingently returnable consideration) related to the investment, the tax consequences of such adjustment should be reflected in income unless one of the exceptions to reporting deferred tax liabilities in ASC 740-30-25-7 or ASC 740-30-25-18 has been met.

11.5 Deferred taxes for acquisition-related costs

An acquirer generally incurs various acquisition-related costs in connection with a business combination, including:

- Direct costs of the transaction, such as costs for services of lawyers, investment bankers, accountants, valuation experts and other third parties
- Indirect costs of the transaction, such as recurring internal costs (e.g., the cost of maintaining an acquisition department)
- Financing costs, such as costs to issue debt or equity instruments used to effect the business combination (e.g., issuance costs)

Because the FASB reasoned that acquisition-related costs are not part of the fair value of the exchange between the buyer and seller for the acquired business, ASC 805 precludes direct and indirect acquisition-related costs from being accounted for as part of consideration transferred. Instead, acquisition costs are to be accounted for separately as transactions in which the buyer makes payments in exchange for the services received. The FASB noted that direct and indirect acquisition-related costs generally do not represent assets of the acquirer at the acquisition date since they are consumed as the services are rendered. Thus, direct and indirect acquisition-related costs generally would be charged to expense in the period that the related services are received. The requirement that acquisition-related costs be expensed does not extend to financing costs (i.e., debt issuance and equity issuance costs) incurred related to a business combination. Debt issuance costs generally are deferred and amortized over the term of the related debt. The costs of registering and issuing equity securities generally are treated as a reduction of the proceeds of issuing the securities.

Although ASC 805 requires that direct and indirect acquisition-related costs be charged to expense in the period in which the related services are rendered, these costs may not be immediately deductible for tax purposes. Tax rules may require that the costs be included in tax-deductible goodwill, capitalized as a separate intangible asset, or added to the tax basis of the stock acquired. Because acquisition-related costs are incurred prior to the closing of the transaction, the tax consequences of the costs may not be known at the time the costs are incurred (e.g., the costs may be immediately deductible if the transaction is never consummated but may be required to be included in the tax basis of the stock acquired if the transaction is consummated).

We believe the most appropriate method of accounting for the tax effects of acquisition-related costs is to assess the tax consequences based on the circumstances that exist as of the date the costs are incurred, without assuming the business combination will ultimately occur. This is consistent with the ASC 805 principle that such costs are accounted for separately from the business combination. Therefore, if the acquisition-related cost will result in a future deduction if the business combination does not occur, the acquirer would report a deferred tax asset when the related cost is charged to expense. Conversely, if the acquisition-related costs will result in a tax benefit only if the business combination is consummated, a deferred tax asset should not be recognized.

If a deferred tax asset is reported for acquisition-related costs, once the business combination is consummated, the acquirer must assess whether the deferred tax asset continues to exist or whether it must be written off. If the transaction is a taxable business combination, the costs incurred generally would be included in the purchase consideration for tax purposes (i.e., included in taxable goodwill). In these situations, the acquirer should continue to carry the deferred tax asset, even if financial reporting goodwill exceeds tax goodwill (i.e., the portion of taxable goodwill related to acquisition-related costs should be excluded from the analysis of tax-deductible goodwill versus goodwill for financial reporting purposes (see section 11.3.4, *Tax-deductible goodwill*, for additional discussion of this analysis)).

If the transaction is a nontaxable business combination, the costs incurred generally would be included in the tax basis of the stock acquired (i.e., increase the deferred tax asset or decrease the deferred tax liability related to the acquirer's investment in the stock, if the tax basis of the stock acquired is affected).

11.5.1 Excess tax basis over financial reporting basis

As discussed previously, ASC 740-30-25-9 restricts recognition of a deferred tax asset for the excess of the tax basis over the financial reporting basis of an investment (outside basis difference) in either a foreign or domestic subsidiary or corporate joint venture. For those outside basis differences, a deferred tax asset is recognized "only if it is apparent that the temporary difference will reverse in the foreseeable future," which is expected to be rare for a newly acquired entity. Therefore, when the income tax accounting for an acquisition results in a deferred tax asset for the excess of the tax basis over the financial reporting basis of an investment that is not recognized as a result of the limitations in ASC 740-30-25-9, the deferred tax asset previously reported for acquisition-related costs would be charged to expense on the acquisition date.

11.5.2 Excess financial reporting basis over tax basis

Similarly, if the acquisition would have resulted in a deferred tax liability on the outside basis difference absent the acquisition-related costs, and the deferred tax asset for the acquisition-related costs is greater than the deferred tax liability, the excess deferred tax asset related to the acquisition-related costs would be charged to expense on the acquisition date. If an acquisition results in a net deferred tax liability for the excess of the financial reporting basis over the tax basis of an investment, the deferred tax asset reported for the acquisition-related costs is offset against the deferred tax liability on the outside basis difference in the investment.

However, as discussed previously, ASC 740 provides certain exceptions related to the need to report a deferred tax liability related to the excess of the financial reporting basis of an investment in a domestic or foreign subsidiary or corporate joint venture over its tax basis. Therefore, when the income tax accounting for an acquisition results in a net deferred tax liability for the excess of the financial reporting basis over the tax basis of an investment that is not recognized as a result of one of the exceptions in ASC 740, the deferred tax asset previously reported for acquisition-related costs must be charged to expense on the acquisition date.

In certain situations, acquisition-related costs are not included in the tax basis of the shares acquired, but are separately recognized as a non-amortizing intangible asset for tax purposes. These amounts are generally only deductible on liquidation or sale of the acquiree. Accordingly, careful consideration of the need for a valuation allowance is required.

11.6 Deposit-based intangibles

Acquired deposit-based intangibles, or core deposits, often are valued separately from goodwill for financial statement and tax purposes. ASC 740 distinguishes between nondeductible goodwill and other types of intangible assets. No deferred tax liability is recognized for goodwill temporary differences if the goodwill amortization is not deductible for tax purposes. This exclusion from the comprehensive recognition of deferred taxes does not extend, however, to other types of intangible assets, whether deductible for tax purposes or not. Accordingly, temporary differences associated with deposit-based intangibles result in recognition of a deferred tax liability or asset.

Tax amortization of deposit-based intangibles continues to be a major source of controversy between financial institutions and taxing authorities. The Internal Revenue Service continues to challenge the deductibility of amortization of deposit-based intangibles, even though a number of court decisions have allowed the deductions. It may be necessary to consider potential challenges from taxing authorities in determining the amount of deductible temporary differences associated with controversial items such as deposit-based intangibles in accordance with the guidance on uncertainties in income taxes in ASC 740-10 (see chapter 19, *Accounting for uncertainty in income taxes*, for additional discussion).

11.7 Acquired research and development deferred tax liabilities (updated August 2022)

ASC 805 requires an acquirer to recognize all tangible and intangible assets to be used in research and development that are acquired in a business combination (acquired R&D) as assets for financial reporting purposes (i.e., the amounts allocated to these assets are no longer expensed on the acquisition date). Deferred taxes should be provided for any differences between the financial reporting basis and tax basis of acquired R&D. As the book basis of acquired R&D assets typically exceeds the tax basis, a deferred tax liability generally will be reported related to this temporary difference.

Subsequent to the acquisition date, acquired intangible in-process research and development (IPR&D) capitalized as a result of a business combination is accounted for pursuant to the provisions of ASC 350, which specifies that all intangible assets acquired in a business combination that are used in research and development activities be capitalized as indefinite-lived intangible assets, regardless of whether they have an alternative future use. These acquired assets remain indefinite-lived assets until the completion or abandonment (i.e., the time at which the company determines it will not pursue further development of the intangible IPR&D assets, will not derive defensive value from them and will not sell, license or rent them) of the associated research and development efforts. Because acquired IPR&D is considered indefinite-lived, prior to successful completion or abandonment of the project, the reversal of the related taxable temporary differences for which the deferred tax liabilities are reported is often not able to be predicted. In order to be a source of future taxable income to support the realizability of a deferred tax asset, a taxable temporary difference must reverse in a period such that it would result in the realization of the deferred tax asset (i.e., before a loss carryforward expires) — a particularly problematic requirement for this item to be used as a source of future taxable income. See section 4.3.2, *Examples of temporary difference reversal patterns*, for a further discussion on assessing the reversal patterns of temporary differences related to indefinite-lived intangible assets. See section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income,* for additional discussion on acquired R&D as a source of future taxable income.

11.8 Impairment of identifiable intangible assets and goodwill

Identifiable intangible assets and goodwill often are amortized at a faster rate for tax purposes than for financial reporting purposes or are not subject to amortization at all for financial reporting purposes under ASC 350 (e.g., indefinite-lived intangible assets and goodwill unless the goodwill amortization accounting alternative is elected). In these situations, the excess tax amortization over financial reporting amortization generally results in a lower tax basis than financial reporting basis in those assets. The difference in the basis for financial reporting versus tax reporting creates a taxable temporary difference and a resulting deferred tax liability. However, the recognition of a book impairment loss attributable to identifiable intangible assets or tax-deductible goodwill results in (1) the reversal of an existing taxable temporary difference, (2) the creation of a deductible temporary difference after reversal of the existing taxable temporary difference, or (3) an increase to an existing deductible temporary difference.

11.8.1 Impairment of goodwill (after the adoption of ASU 2017-04)

After an entity adopts ASU 2017-04[38], a goodwill impairment loss is measured as the amount by which the carrying amount of an entity (or a reporting unit) including goodwill exceeds its fair value, limited to the total amount of goodwill of the entity (or allocated to the reporting unit). Recognizing the goodwill impairment loss affects the amount of the basis difference between book goodwill and tax-deductible goodwill. The impairment loss would increase a deferred tax asset or decrease a deferred tax liability related to tax-deductible goodwill. Adjusting the deferred tax balance related to goodwill to reflect the change in the book and tax basis difference after a book impairment charge immediately results in the carrying amount of the reporting unit (or entity) exceeding its fair value again, which would require another goodwill impairment charge.

To address this issue, ASU 2017-04 (ASC 350-20-35-73) requires an entity to calculate the impairment charge and the deferred tax effect using a simultaneous equations method that is similar to how an entity measures goodwill and related deferred tax assets in a business combination (or an asset acquisition when the book basis and tax basis differ on the date of acquisition).

[38] ASU 2017-04, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, eliminates the requirement to calculate the implied fair value of goodwill (i.e., Step 2 of today's goodwill impairment test) to measure a goodwill impairment charge. Instead, entities will record an impairment charge based on the excess of a reporting unit's carrying amount over its fair value (i.e., measure the charge based on today's Step 1). The standard is effective for annual and any interim impairment tests performed for (1) periods beginning after 15 December 2019 for PBEs that are US SEC filers, excluding smaller reporting companies and (2) for periods beginning after 15 December 2022 for all other entities. Early adoption is permitted for interim and annual goodwill impairment testing dates on or after 1 January 2017.

Excerpt from Accounting Standards Codification

Intangibles — Goodwill and Other - Goodwill

Overall Accounting for Goodwill

Pending Content:

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* | **Transition Guidance:** 350-20-65-3

Step 1

350-20-35-8B

If a reporting unit has tax deductible goodwill, recognizing a goodwill impairment loss may cause a change in deferred taxes that results in the carrying amount of the reporting unit immediately exceeding its fair value upon recognition of the loss. In those circumstances, the entity shall calculate the impairment loss and associated deferred tax effect in a manner similar to that used in a business combination in accordance with the guidance in paragraphs 805-740-55-9 through 55-13. The total loss recognized shall not exceed the total amount of goodwill allocated to the reporting unit. See Example 2A in paragraphs 350-20-55-23A through 55-23C for an illustration of the calculation.

Recognition and Measurement of a Goodwill Impairment Loss

Pending Content:

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* | **Transition Guidance:** 350-20-65-3

The Goodwill Impairment Test

350-20-35-73

A goodwill impairment loss, if any, shall be measured as the amount by which the carrying amount of an entity (or a reporting unit) including goodwill exceeds its fair value, limited to the total amount of goodwill of the entity (or allocated to the reporting unit). Additionally, an entity shall consider the income tax effect from any tax deductible goodwill on the carrying amount of the entity (or the reporting unit), if applicable, in accordance with paragraph 350-20-35-8B when measuring the goodwill impairment loss. See Example 2A in paragraph 350-20-55-23A for an illustration.

Implementation Guidance and Illustrations

Pending Content:

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* | **Transition Guidance:** 350-20-65-3

Example 2A: Impairment Test When Goodwill Is Tax Deductible

350-20-55-23A

Goodwill is deductible for tax purposes for some business combinations in certain jurisdictions. In those jurisdictions, a deferred tax asset or deferred tax liability is recorded upon acquisition on the basis of the difference between the book basis and the tax basis of goodwill. When goodwill of a reporting unit is tax deductible, the impairment of goodwill creates a cycle of impairment because the decrease in the book value of goodwill increases the deferred tax asset (or decreases the deferred tax liability) such that the carrying amount of the reporting unit increases. However, there is no corresponding increase in the fair value of the reporting unit and this could trigger another impairment test.

350-20-55-23B

This Example illustrates the use of a simultaneous equation when tax deductible goodwill is present to account for the increase in the carrying amount from the deferred tax benefit.

Beta Entity has goodwill from an acquisition in Reporting Unit X. All of the goodwill allocated to Reporting Unit X is tax deductible. On October 1, 20X6 (the date of the annual impairment test for the reporting unit), Reporting Unit X had a book value of goodwill of $400, which is all tax deductible, deferred tax assets of $200 relating to the tax-deductible goodwill, and book value of other net assets of $400. Reporting Unit X is subject to a 40 percent income tax rate. Beta Entity estimated the fair value of Reporting Unit X at $900.

	Carrying Amount	Fair Value	Preliminary Impairment	Preliminary Deferred Tax Adjustment	Carrying Amount After Preliminary Impairment
Goodwill	$ 400	$ -	$ (100)	$ -	$ 300
Deferred taxes	200	-	-	40	240
Other net assets	400	-	-		400
Total	$ 1,000	$ 900	$ (100)	$ 40	$ 940

350-20-55-23C

In the Example above, the carrying amount of Reporting Unit X immediately after the impairment charge exceeds its fair value by the amount of the increase in the deferred tax asset calculated as 40 percent of the impairment charge. To address the circular nature of the carrying amount exceeding the fair value, instead of continuing to calculate impairment on the excess of carrying amount over fair value until those amounts are equal, Beta Entity would apply the simultaneous equation demonstrated in paragraphs 805-740-55-9 through 55-13 to Reporting Unit X, as follows.

Simultaneous equation: [tax rate/(1 − tax rate)] × (preliminary temporary difference) = deferred tax asset

Equation for this example: 40%/(1 − 40%) × 100 = 67

	Carrying Amount	Fair Value	Preliminary Impairment	Adjustment for Equation	Carrying Amount After Impairment
Goodwill	$ 400	$ -	$ (100)	$ (67)	$ 233
Deferred taxes	200	-	-	67	267
Other net assets	400	-	-		400
Total	$ 1,000	$ 900	$ (100)	$ 0	$ 900

350-20-55-23D

The company would report a $167 goodwill impairment charge partially offset by a $67 deferred tax benefit recognized in the income tax line. If the impairment charge calculated using the equation exceeds the total goodwill allocated to a reporting unit, the total impairment charge would be limited to the goodwill amount.

Illustration 11-13: Calculating the goodwill impairment charge and related tax effects using a simultaneous equation method

Facts

- The following information is as of the date CP Company tested goodwill of one of its reporting units for impairment:
  - The tax rate is 25%.
  - Goodwill for financial reporting is $1,000 and tax-deductible goodwill is $1,200.
  - Deferred tax asset (all related to tax-deductible goodwill) of $50.
  - Carrying value of the identifiable other net assets is $450.
  - Total carrying value of the reporting unit is $1,500 and the current fair value is $1,100.

Analysis

At the impairment testing date, CP Company records a goodwill impairment loss of $400 which represents the amount the carrying value of its reporting unit ($1,500) exceeds the current fair value of its reporting unit ($1,100). Since the impairment loss will result in the financial reporting basis in goodwill being reduced by $400 to $600, the deferred tax asset related to the tax-deductible goodwill must be adjusted.

If the guidance didn't require the simultaneous equations method, the deferred tax effect of the goodwill impairment would be $100 ($400 x 25%) with a corresponding increase in the deferred tax asset. The subsequent carrying value of the reporting unit would be $1,200 ($1,500 − $400 + $100). Because there would be no corresponding increase in the fair value of the reporting unit, the reporting unit would have another impairment of $100 ($1,200 − $1,100). Thus, the deferred tax effect would result in a continuous cycle of impairment.

Therefore, the required simultaneous equations method is used. To do this, the entity calculates a goodwill impairment charge of $533 as follows: $400 + [(25% / (1 − 25%)) x $400]. This effectively grosses up the goodwill impairment charge to account for the increase of $133 in the deferred tax asset related to the tax-deductible goodwill. After CP Company records the goodwill impairment charge and the deferred tax effect, the carrying value ($1,100 = $1,500 − $533 + $133) and the fair value ($1,100) of the reporting unit are equal. After recording the goodwill impairment charge, the deferred tax asset related to tax-deductible goodwill is increased by $133 from $50 to $183. CP Company should consider if the increase in its DTA requires it to reassess its prior valuation allowance conclusions.

The following graphic presents the carrying value immediately before and after recording the impairment loss.

	Carrying value	Goodwill impairment	Deferred tax	After impairment
Identifiable other net assets	$450			$ 450
Goodwill	1,000	(400)	(133)	467
Deferred tax assets (all related to tax-deductible goodwill)	50	–	133	183
Total carrying value of reporting unit	$1,500	(400)	–	$1,100[(a)]

Impairment calculation	
Carrying value of reporting unit	$ 1,500
Fair value of reporting unit	1,100[(a)]
Goodwill impairment (before simultaneous equation) (*Carrying value – fair value of reporting unit*)	400
Simultaneous equation (*Tax rate/(1-tax) x impairment*) (.25 / (1 - .25) x $400)	133
Goodwill impairment (after simultaneous equation)	$533

(a) Note that by using the simultaneous equations method, after CP Company records the goodwill impairment charge and the deferred tax effect, the carrying value ($1,100) and the fair value ($1,100) of the reporting unit are equal.

Total net income effect of impairment	
Pretax impairment loss	$533
Plus: Deferred tax benefit	(133)
Total net income effect of impairment	$400

An entity should evaluate if a valuation allowance is required when an impairment charge results in an increase or the initial recognition of a deferred tax asset. Because ASC 350-20-35-8B requires the impairment loss and the associated deferred tax effect to be measured using a simultaneous equation, questions have arisen if the recording of a valuation allowance should be considered when initially measuring the impairment charge (and factored into the simultaneous equation calculation) or should the recording of the valuation allowance be treated as a separate event from recognizing the impairment loss. We do not believe that the guidance in ASC 350-20 requires the use of the simultaneous equation subsequent to the initial measurement of the goodwill impairment loss and related deferred tax effects. The realizability assessment of the associated deferred tax asset would be a separate evaluation performed in accordance with ASC 740. That is, we do not believe an entity would be required to measure the effects of recognizing a valuation allowance by performing a second calculation of the simultaneous equation. However, we are aware of diversity in practice.

See section 11.3.1, *Nondeductible goodwill*, and 11.3.1.1, *Amortization of nondeductible goodwill*, for additional discussion of the income tax accounting considerations of nondeductible goodwill.

11.8.2 Allocation of impairment of tax-deductible goodwill

When tax-deductible goodwill is impaired for financial reporting purposes under ASC 350 (including those entities who have elected the goodwill amortization accounting alternative), deferred tax amounts should be adjusted to reflect the changes in the temporary differences. Unless a private company or NFP elects the goodwill amortization accounting alternative, goodwill is generally not amortized for financial reporting purposes while amortization is recognized for tax purposes. As a result, the goodwill for financial reporting prior to an impairment write-down will often exceed the tax-deductible goodwill. That is, a company that has tax-deductible goodwill separates goodwill into two components as of the acquisition date (see section 11.3.4, *Tax-deductible goodwill*, for discussion of allocating goodwill to the first component and second component of goodwill). When goodwill for financial reporting exceeds tax-deductible goodwill, deferred taxes are recognized only for the first component of goodwill. As a result, when goodwill for financial reporting is impaired and goodwill for financial reporting exceeds tax-deductible goodwill, we believe a company should allocate impairment of goodwill for financial reporting using one of two methods: (1) allocate impairment of goodwill for financial reporting first to the second component of goodwill (i.e., goodwill for financial reporting in excess of tax-deductible goodwill) and then allocate the remainder to the first component of goodwill (i.e., goodwill for financial reporting equal to tax-deductible goodwill on the acquisition date), or (2) allocate impairment for financial reporting on a pro rata basis between the two components of goodwill.

When tax-deductible goodwill exceeds goodwill for financial reporting, deferred taxes are recognized for both the first component and second component of goodwill. However, goodwill for financial reporting is only associated with the first component of goodwill. As a result, impairment of goodwill for financial reporting is only allocated to the first component of goodwill.

11.8.3 Impairment of nondeductible goodwill

As discussed in section 11.3.1, *Nondeductible goodwill*, ASC 740-10-25-3(d) and ASC 805-740-25-3 prohibit recognition of deferred tax liability for nondeductible goodwill. Therefore, when nondeductible goodwill is impaired under the provisions of ASC 350 (including when the goodwill amortization accounting alternative has been elected), that impairment does not result in a change to the previously recorded deferred taxes. Thus, the impairment is treated as a basis difference without future tax consequences (commonly referred to as a "permanent difference"); therefore, no tax benefit is recorded.

11.8.3.1 Allocation of subsequent impairments to deductible and nondeductible goodwill

As discussed in section 11.3.4, *Tax-deductible goodwill*, a reporting unit to which goodwill is assigned under ASC 350 may not align with tax-paying components that have tax-deductible goodwill. We believe that goodwill for financial reporting should be allocated to tax-paying components on a systematic and rational basis that is consistently applied. A tax-paying component (or reporting unit) may include goodwill from more than one acquisition and the acquisitions may have tax-deductible goodwill and nondeductible goodwill. As discussed in section 11.3, *Identifiable intangible assets and goodwill*, deferred taxes may be recognized for deductible goodwill.

If the acquirer subsequently recognizes an impairment of a portion, but not all, of its goodwill associated with a tax-paying component and the goodwill in the tax-paying component is from more than one acquisition, the impairment needs to be allocated between the deductible and nondeductible portions of goodwill. If the acquirer has maintained sufficient records to specifically identify the portions of goodwill that are subsequently impaired, the impairment loss should reduce the deductible and nondeductible portions of goodwill accordingly. However, practice has indicated that most acquirers do not have such records and thus must allocate the impairment in a systematic and rational method (e.g., pro rata, first reduce deductible goodwill, or first reduce nondeductible goodwill) between the two portions of goodwill. We believe the preferable method is to allocate the impairment on a pro rata basis as the other methods would generally not be supportable in the absence of sufficient records to directly attribute the impairment to either or both portions of goodwill.

11.9 Foreign currency temporary differences from 'pushdown' adjustments

Under ASC 830, following a business combination, the acquisition date fair values of the identifiable assets acquired, liabilities assumed and any noncontrolling interest in the acquiree should be translated as if the measurement adjustments were recorded directly on the books of the foreign subsidiary (i.e., pushdown accounting is required under ASC 830). This also would be the case for foreign investees accounted for by the equity method.

Purchase price adjustments, other than nondeductible goodwill, attributable to the assets and liabilities of a foreign entity generally create temporary differences under ASC 740 because such allocations generally do not result in adjustments to the foreign tax bases of those assets and liabilities. These temporary differences result whether the foreign entity uses the US dollar or the foreign currency as its functional currency (although ASC 740-10-25-3(f) provides an exception for nonmonetary assets for a foreign entity when the parent's currency is its functional currency — see section 3.2.3, *Foreign currency differences*, for a discussion of this exception).

Illustration 11-14: Foreign currency temporary differences from pushdown adjustments

Facts

- At 31 December 20X0, a US multinational company purchased a foreign entity in a business combination for an amount that is $100,000 in excess of the foreign entity's book value and tax basis.
- At the acquisition date, the exchange rate was FC2 = $1.00 and the fair value of the foreign subsidiary's land and buildings exceeded their respective book values by $75,000.
- The excess of the purchase price over the fair value of the assets acquired ($25,000) was allocated to goodwill.
- The foreign currency is the functional currency.
- Foreign earnings are permanently reinvested.
- Amortization and depreciation charges are immaterial.
- Purchase adjustments are reflected for US consolidation purposes only and are not pushed down to the foreign entity's local statutory accounting records.

Analysis

The $100,000 of purchase price adjustments are converted into FC amounts and allocated to the foreign subsidiary at the acquisition date as follows:

	US dollar amount	Exchange rate	Foreign currency equivalent
Land and buildings (no amortization)	$ 75,000	FC2 = $1.00	FC 150,000
Goodwill	25,000	FC2 = $1.00	50,000
Translation component of other comprehensive income	N/A		N/A
Total	$ 100,000		FC 200,000

Deferred taxes are provided on the FC150,000 taxable temporary difference related to land and buildings at the foreign entity's effective tax rate of 40% = FC60,000. This amount is added to goodwill and then translated into dollars at the current exchange rate as follows:

	Foreign currency equivalent	Exchange rate	US dollar amount
Deferred tax liability	FC (60,000)	FC2 = $1.00	$ (30,000)
Goodwill	60,000	FC2 = $1.00	30,000

Translated amounts at the end of 20X1 when the foreign currency strengthens in value from FC2 = $1.00 to FC1.6 = $1.00 are as follows:

	Foreign currency equivalent	Exchange rate	US dollar amount
Land and buildings	FC 150,000	FC1.6 = $1.00	$ 93,750
Goodwill	110,000	FC1.6 = $1.00	68,750
Deferred tax liability	(60,000)	FC1.6 = $1.00	(37,500)
Translation adjustment component of other comprehensive income	N/A		N/A
Total	FC 200,000		$ 125,000

Deferred taxes of FC60,000 continue to be provided on the temporary difference related to land and buildings. Note: the offsetting CTA adjustments have not been shown for purposes of simplicity. See our FRD, ***Foreign currency matters***.

11.10 Effects of change in tax laws or rates subsequent to a business combination

Deferred tax assets and liabilities related to a business combination should be measured at rates enacted as of the acquisition date. Tax rate changes, or any deferred tax adjustments for new tax legislation, following a business combination should be reflected in income from continuing operations in the period in which the change in tax laws or rate is enacted. This treatment would be applied regardless of how soon after an acquisition the new law is enacted, whether the negotiating parties contemplated the effects of the new tax law, or if the change in tax laws or rates was retroactive. ASC 740-10-35-4 specifically requires that deferred taxes be adjusted for the effect of a change in *tax laws or rates* and ASC 740-10-45-15 requires the effect to be included in income from continuing operations in the period that includes the enactment date.

New information about the facts and circumstances that existed at the acquisition date for tax positions acquired in or that arose from a business combination may result in an adjustment to goodwill during the business combination measurement period. However, a change in tax rate after the business combination occurred would not result in a business combination measurement period adjustment. That is, a change in income tax position attributable to a change in tax law, including the remeasurement of deferred tax balances or a change in the assessment of realizability of acquired deferred tax assets, should be recognized in income tax expense attributable to continuing operations.

The following example illustrates applying the provisions of ASC 740 to the accounting for the effects of rate changes following a business combination.

Illustration 11-15: Accounting for the effects of a tax rate change following a business combination

Facts

- A calendar-year company acquired another company for $200,000 in a nontaxable business combination on 30 June 20X0, when the tax rate was 40%.
- Acquired fixed assets have a tax basis of zero and are appraised at $100,000.
- There are no other temporary differences and all other identifiable assets and liabilities net to zero.
- In November 20X0, a new tax law was enacted that reduced the tax rate to 25%.
- For simplicity, no amortization of fixed assets or impairment of goodwill was recorded in 20X0 subsequent to the acquisition.

Analysis

The consideration received would be assigned as follows as of the acquisition date:

Fixed assets — fair values	$ 100,000
Tax basis	–
Temporary difference — taxable	100,000
Enacted tax rate at acquisition date	40%
Deferred tax liability	$ 40,000
Fixed assets	$ 100,000
Deferred tax liability	(40,000)
Goodwill (derived)	140,000
Consideration transferred	$ 200,000

Note: For simplicity purposes, this example ignores depreciation that would occur in 20X0. Deferred taxes at the end of 20X0 and the deferred tax provision for 20X0 would be computed as follows:

Fixed assets — book values	$ 100,000
Tax basis	–
Temporary difference — taxable	100,000
Enacted tax rate at year-end	25%
Deferred tax liability	$ 25,000
Deferred tax liability, 31 December 20X0	$ 25,000
Deferred tax liability, 30 June 20X0	40,000
Deferred tax benefit, income statement	$ 15,000

In this example, the benefit of $15,000 from the reduction of deferred tax liabilities would be reflected as a reduction of income tax expense in the continuing operations portion of the income statement.

11.10.1 Effect of enactment of new tax law on post-acquisition measurement period adjustments

Additional consideration is necessary when accounting for the tax effects of measurement period adjustments when a change in tax law is enacted in a period subsequent to a business combination but during the ASC 805 measurement period. We believe that ASC 805 measurement period adjustments should consider the tax effects based on the law in place at the acquisition date. That is, the deferred tax effects from ASC 805 measurement period adjustments would first be measured using the tax rate as of the acquisition date. A second adjustment would be recorded to adjust those deferred tax balances to the new tax rate. The second adjustment would be recorded as a component of income tax expense attributable to continuing operations.

The following example illustrates the accounting for a business combination that occurred before the enactment date:

Illustration 11-16: Accounting for the tax effects of measurement period adjustments when a change in tax law is enacted during the measurement period

Facts

- Company CMM entered into a business combination on 1 September 20X7.
- At the business combination date, Company CMM did not finalize its accounting for indefinite-lived intangible assets and expects to finalize its accounting during the ASC 805 measurement period.
- On the date of the acquisition, Company CMM recorded a provisional amount of $1 million for the fair value of its intangible assets. The tax basis is zero.
- At the date of the acquisition, the enacted tax rate is 35% and Company CMM recorded a $350,000 deferred tax liability for the book and tax basis difference, with an offsetting adjustment to goodwill (based on the tax law in effect on that date).

Analysis

Company CMM records the following journal entries on 1 September 20X7 to recognize the intangible asset and related tax effects:

Intangible assets	$ 1,000,000	
Goodwill		$ 1,000,000
Goodwill	350,000	
Deferred tax liabilities		350,000

During December 20X7, the new tax law was enacted and it reduced the tax rate to 21%. Company CMM reduces the deferred tax liability associated with the acquired intangible asset by $140,000 ($1,000,000 x (35% — 21%)), with the offsetting adjustment to income tax expense. For simplicity, assume no impairment of the intangible subsequent to the acquisition.

Company CMM records the following journal entry on the enactment date of the new tax law:

Deferred tax liabilities	$ 140,000	
Income tax expense		$ 140,000

On 1 May 20X8, Company CMM finalizes its accounting under ASC 805 for the intangible assets and increases the business combination provisional amount by $100,000. Company CMM records the following entries to record the ASC 805 measurement period adjustment and related deferred tax effects based on the tax law that was in place at the acquisition date:

Intangible assets	$ 100,000	
Goodwill		$ 100,000
Goodwill	35,000	
Deferred tax liabilities		35,000

Also, on 1 May 20X8, Company CMM would adjust the deferred tax liability to reflect the effects of the new tax rate on the final adjustment:

Deferred tax liability	$ 14,000	
Income tax expense		$ 14,000

11.11 Valuation allowance in a business combination

When deferred tax assets resulting from a business combination are *not* more likely than not to be realized, based on all available evidence as of the acquisition date, ASC 740 requires the acquiring company to recognize a valuation allowance to reduce the carrying amount of the deferred tax assets to an amount that is more likely than not to be realized. The effect of recording a valuation allowance in business combination accounting is to increase the amount of goodwill recorded (or reduce the amount of bargain purchase recognized under ASC 805).

11.11.1 Changes in a valuation allowance established at the acquisition date

Excerpt from Accounting Standards Codification

Business Combinations — Income Taxes

Recognition

805-740-45-2

The effect of a change in a valuation allowance for an acquired entity's **deferred tax asset** shall be recognized as follows:

a. Changes within the measurement period that result from new information about facts and circumstances that existed at the **acquisition date** shall be recognized through a corresponding adjustment to **goodwill**. However, once goodwill is reduced to zero, an acquirer shall recognize any additional decrease in the valuation allowance as a bargain purchase in accordance with paragraphs 805-30-25-2 through 25-4. See paragraphs 805-10-25-13 through 25-19 and 805-10-30-2 through 30-3 for a discussion of the measurement period in the context of a **business combination**.

b. All other changes shall be reported as a reduction or increase to income tax expense (or a direct adjustment to contributed capital as required by paragraphs 740-10-45-20 through 45-21).

The FASB concluded that business combination accounting should not be affected by changes to deferred tax asset valuation allowances that occur after the acquisition date. Essentially, the FASB decided that the integrity of asset bases established in business combination accounting should be maintained and not adjusted as a result of the subsequent realization of acquired tax benefits. Thus, under ASC 805, the effects of changes outside of the measurement period (or within the measurement period if the changes result from new information about facts that arose after the acquisition date) to deferred tax asset valuation allowances established in acquisition accounting are reported directly as a reduction of income tax expense.

Changes to valuation allowances established in acquisition accounting that occur within the measurement period that result from new information about the facts and circumstances that existed at the acquisition date are recognized through a corresponding adjustment to goodwill. Once goodwill is reduced to zero, any additional decrease in the valuation allowance should be reported as a bargain purchase gain (i.e., as a gain attributable to the acquirer). The measurement period ends as soon as the acquirer receives the necessary information about facts and circumstances that existed as of the acquisition date or learns that the information is not obtainable. However, in no circumstances may the measurement period exceed one year from the acquisition date.

11.11.1.1 Pre-statement 141(R) business combinations

The accounting for subsequent changes in valuation allowances established at the acquisition date in accordance with ASC 805 is effective prospectively from the date of adoption of ASC 805. Thus, after ASC 805 is adopted, all changes to valuation allowances established in acquisition accounting (whether the combination was accounted for under APB 16 (non-authoritative), Statement 141 (non-authoritative), or ASC 805) should be recognized in accordance with the amended requirements of ASC 740.

Illustration 11-17: Accounting for subsequent changes in valuation allowances established at the acquisition date

Facts

Assume that a company with a calendar year-end recognized a valuation allowance against acquired deferred tax assets as part of a business combination completed in 2006 (i.e., the acquisition was accounted for under Statement 141 (non-authoritative)). In March 2009, after the adoption of ASC 805, the company determined that the valuation allowance was no longer necessary.

Analysis

The reversal of the valuation allowance (i.e., the initial recognition of an acquired benefit) is recognized as a reduction of income tax expense in the period that the valuation allowance was no longer deemed to be necessary and not as a reduction of goodwill because this adjustment was recognized outside of the measurement period.

11.12 Changes in a tax uncertainty established at the acquisition date

Excerpt from Accounting Standards Codification

Business Combinations — Income Taxes

Recognition

805-740-25-5

The tax bases used in the calculation of deferred tax assets and liabilities as well as amounts due to or receivable from taxing authorities related to prior **tax positions** at the date of a business combination shall be calculated in accordance with Subtopic 740-10.

Other Presentation Matters

805-740-45-4

The effect of a change to an acquired **tax position**, or those that arise as a result of the acquisition, shall be recognized as follows:

a. Changes within the measurement period that result from new information about facts and circumstances that existed as of the acquisition date shall be recognized through a corresponding adjustment to goodwill. However, once goodwill is reduced to zero, the remaining portion of that adjustment shall be recognized as a gain on a bargain purchase in accordance with paragraphs 805-30-25-2 through 25-4.

b. All other changes in acquired income tax positions shall be accounted for in accordance with the accounting requirements for tax positions established in Subtopic 740-10.

Income tax uncertainties that may arise in a business combination include: the allocation of the purchase price to individual assets and liabilities for tax purposes in a taxable business combination; the carryover bases of assets, liabilities and carryforwards in a nontaxable combination; or the filing and tax return positions for periods prior to the acquisition. The guidance regarding the accounting for income tax uncertainties recognized in a business combination is included in ASC 740-10. Refer to chapter 19, *Accounting for uncertainty in income taxes*, for further information.

ASC 805-740 provides guidance regarding the recognition of subsequent adjustments to tax positions acquired in a business combination. In accordance with ASC 805-740-45-4, the effect of a change to an acquired tax position, or those that arise as a result of the acquisition, that occurs within the measurement period and results from new information about the facts and circumstances that existed at the acquisition date should be recognized through a corresponding adjustment to goodwill. Once goodwill is reduced to zero, any additional decrease related to the tax uncertainty should be reported as a bargain purchase gain (i.e., as a gain attributable to the acquirer).

All other changes in acquired income tax positions are recognized the same as any other changes in income tax positions, within income tax expense as discrete items in the period in which the changes occur.

11.12.1 Pre-statement 141(R) business combinations

The accounting for changes in acquired income tax positions in accordance with ASC 805 is effective prospectively from the date of adoption of ASC 805. Thus, after ASC 805 is adopted, all changes to tax uncertainties established in acquisition accounting (whether the combination was accounted for under APB 16 (non-authoritative), Statement 141 (non-authoritative) or ASC 805) should be recognized in accordance the amended requirements of ASC 805-740-45-4.

Illustration 11-18: Accounting for subsequent changes in acquired uncertain tax positions

Facts

Assume that a company with a calendar year-end recognized a liability for an acquired uncertain tax position as part of a business combination completed in October 2008 (i.e., the acquisition was accounted for under Statement 141 (non-authoritative)). In January 2009, after the adoption of ASC 805, the company received information about facts and circumstances that existed as of the acquisition date. The measurement period for tax uncertainties is still open as of January 2009.

Analysis

Based on this information, the company determined that the liability recorded for the acquired uncertain tax position was understated. As a result, the increase in the liability for the uncertain tax position should be recognized as an increase to goodwill.

11.13 Effect of acquirer-specific attributes on measurement of acquired deferred taxes

11.13.1 Valuation allowance for acquired deferred tax assets

When deferred tax assets resulting from a business combination are *not* more likely than not to be realized based on all available evidence as of the acquisition date, ASC 740 requires the acquiring company to recognize a valuation allowance to reduce the carrying amount of the deferred tax assets to an amount that is more likely than not to be realized.

If subsequent to a business combination, the combined company expects to file a consolidated tax return and the tax law permits the use of either of the combining companies' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other company subsequent to the business combination, an assessment of the need for, and amount of, a valuation allowance would be based on the combined company's past and expected future results of operations as of the acquisition date. For example, preexisting deferred tax liabilities of the acquirer may be available to offset acquired deferred tax assets.

Section 11.3.7, *Changes in acquirer's valuation allowance as a result of a business combination*, discusses the accounting for a change in an acquirer's existing valuation allowance caused by a business combination. Additionally, section 11.3.7 discusses considerations when a valuation allowance is necessary for the combined company. Under ASC 805-740 (and ASC 740), a change in an acquirer's existing valuation allowance caused by a business combination should be accounted for outside of acquisition accounting. There is no similar requirement to recognize the effect of acquirer-specific attributes on the measurement of acquired deferred taxes separately from the measurement of acquired assets and assumed liabilities in a business combination. For example, a valuation allowance or lack thereof reported on deferred tax assets acquired in a business combination relates to assets and liabilities acquired in the business combination even when the tax attributes of the acquirer (e.g., projected future profitability of the acquirer and the reversal of the acquirer's preexisting taxable temporary differences) are the determining factor in the analysis of whether a valuation allowance is required. The following example further illustrates this point.

Illustration 11-19: Valuation allowance for acquired deferred tax assets

Facts

- Company X acquired Company Y in a business combination at the beginning of 20X0 for $60 million in a nontaxable business combination.
- Company X's only acquired financial reporting-tax basis difference relates to depreciable property and equipment with a fair value of $50 million and no tax basis.
- The fair values of other identified assets acquired and liabilities assumed net to zero.
- The tax rate is 25% and no future rate changes have been enacted.
- Company Y has a $55 million NOL carryforward that, under the tax law, can be used by Company X post-acquisition.
- Company X has a deferred tax liability of $3 million on temporary differences of $10 million that is in an entity that is able to use the acquiree's NOL carryforward.
- All temporary differences are reviewed for timing and it is determined they will reverse within the acquired company's NOL carryforward period.

Analysis

In assessing the need for a valuation allowance for the $14 million deferred tax asset related to the $55 million NOL carryforward ($55 million x 25%), future taxable income would not need to be considered because the $55 million NOL carryforward would be offset by $50 million of taxable temporary differences of the acquired company and $10 million of taxable temporary differences of the acquiring company. The total consideration would be assigned as follows as of the acquisition date (in millions):

Property and equipment	$ 50
Deferred tax liability recognized for the acquired company's taxable temporary differences ($50 million at 25%)	(13)
Deferred tax asset recognized for the acquired company's loss carryforward (realizable against the acquired company's taxable temporary differences ($50 million at 25%) and half of the acquiring company's taxable temporary differences ($5 million at 25%))	14[a]
Goodwill (derived)	9
Consideration received	$ 60

[a] See section 11.3.7, *Changes in acquirer's valuation allowance as a result of a business combination*, for further discussion on determining the order usage of net operating losses consistent with the application of tax law.

In the above example, under the tax law, the acquired company's operating loss carryforward is offset by the taxable temporary differences of both the acquired company and the acquiring company. In this regard, estimates of the acquiring company's temporary differences may be necessary at the acquisition date to determine whether deductible temporary differences and operating loss carryforwards are offset by taxable temporary differences.

An assessment of the need for, and amount of, a valuation allowance should consider any provisions in the tax law that restrict the future use of either of the combining companies' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other company subsequent to the business combination.

11.13.2 Apportioned tax rates

Deferred tax assets and liabilities related to a business combination should be measured at rates enacted as of the acquisition date. If in periods subsequent to a business combination, the combined company expects to file a consolidated tax return, the enacted tax rates for the combined entity should be used in measuring deferred tax assets and liabilities. Many states require apportionment of taxable income to the states in which companies operate based on various factors. As a result of a business combination and apportionment tax rules, the overall tax rate applied to acquired deferred tax assets and liabilities is often different from the rate that was applicable when the acquiree was not part of the combined entity.

As discussed above, deferred taxes acquired in a business combination should be measured based on the expected tax consequences to the combined entity, even if such measurement is affected by acquirer specific attributes (i.e., the acquirer should not separately calculate deferred taxes using the acquiree's historical rate and only include that portion in acquisition accounting and the remainder in the acquirer's current income statement). In addition, if the tax rate (including consideration of income apportionment) applicable to existing deductible or taxable temporary differences of the acquirer changes as a result of a business combination, the effect of the change should be reported in current operating results and not in acquisition accounting.

11.13.3 Unborn foreign tax credits

Companies may have foreign subsidiaries that are taxed at a local tax rate that is higher than the parent's tax rate (e.g., a company with a 25% tax rate may have a foreign subsidiary that is taxed at a 30% rate). When earnings from these subsidiaries are remitted to the parent, they generate tax credits that may be available for use against taxes due for other foreign subsidiaries that pay taxes at a lower rate (e.g., if a company with a 25% tax rate has a foreign subsidiary with a 10% local tax rate, the company may be required to pay taxes of 15% on repatriated earnings unless the company has offsetting foreign tax credits). Foreign tax credits that exist on unremitted earnings of foreign subsidiaries are often referred to as unborn tax credits. Unborn tax credits generally are not reported as deferred tax assets but are considered in measuring deferred tax liabilities on outside basis differences in foreign subsidiaries. Refer to section 14.3.10, *Consideration of unborn foreign tax credits*, for additional discussion of the measurement of deferred tax liabilities in jurisdictions with unborn foreign tax credits.

In a business combination, an acquirer may determine that its existing unborn tax credits may be used to offset a tax liability associated with unremitted earnings of an acquiree when the acquirer plans to repatriate earnings. As discussed above, deferred taxes acquired or assumed in a business combination should be measured based on the expected tax consequences to the combined entity. Therefore, it is appropriate to take into account the effect of the acquirer's unborn tax credits when measuring acquired deferred tax liabilities (i.e., the effect of the acquirer's unborn tax credits on deferred tax liabilities assumed in the business combination would be included in acquisition accounting). However, if the acquiree is in a tax jurisdiction with a higher tax rate than the acquirer and will provide the acquirer with tax credits that may be used to reduce existing acquirer deferred tax liabilities, the effect of such unborn tax credits on the measurement of existing deferred tax liabilities should not be included in acquisition accounting but should be included in current operating results.

11.13.4 Assertion regarding indefinite reinvestment

In a business combination, the acquiring company must make its own determination as to the reinvestment strategy related to any acquired foreign operations. That is, upon consummation of the business combination, the purchaser's assertion regarding the indefinite reinvestment or repatriation of any current outside basis differences, as well as any future earnings of the foreign operations, is made without regard to any prior assertions made by the target (seller). To the extent the purchaser does not assert indefinite reinvestment of the outside basis difference related to acquired foreign operations, deferred tax liabilities associated with those basis differences would be recognized in acquisition accounting regardless of the pre-acquisition determination of the seller.

In anticipation of, or as a result of, a business combination, the acquiring company may change its indefinite reinvestment assertion related to its preexisting outside basis differences in foreign subsidiaries or foreign corporate joint ventures. Such changes are accounted for outside of the business combination in the period in which the change in assertion occurs. For example, an acquirer may need foreign earnings in order to fund an acquisition. We expect that the acquirer's change in assertion would generally occur in a period prior to the actual acquisition or repatriation. The tax effects of a change in assertion related to the acquirer's existing outside basis differences are recognized outside of the business combination.

Refer to section 11.16.1.2, *Deferred tax liabilities for foreign subsidiaries acquired in stages (before the adoption of ASU 2019-12)*, 11.16.1.2A, *Deferred tax liabilities for foreign subsidiaries acquired in stages (after the adoption of ASU 2019-12)*, and chapter 14, *Foreign and domestic subsidiaries*, for additional discussion of the accounting for the outside basis difference of foreign subsidiaries.

11.13.4.1 Deferred tax accounting on acquired outside basis differences in post-combination restructuring

As discussed in section 11.13.4, *Assertion regarding indefinite reinvestment*, an acquiring company in a business combination must make its own determination as to the reinvestment strategy related to any acquired foreign operations. To the extent an acquiring company does not assert indefinite reinvestment related to acquired foreign operations, deferred tax liabilities associated with the outside basis differences are recognized in acquisition accounting regardless of the pre-acquisition determination of the seller. In contrast, the tax effects of a change in indefinite reinvestment assertion related to an acquiring company's existing outside basis differences are recognized outside of the business combination in continuing operations in the period in which the change occurs.

Following a business combination, an acquiring company may choose to implement a restructuring plan to integrate the acquired foreign operations into its existing operating structure. The following example illustrates such a transaction.

Illustration 11-20: Implementing a restructuring plan following a business combination

Assume that both the acquiring and acquired companies are US corporations, and that each owns a foreign subsidiary located in the same foreign tax jurisdiction. The acquiring company previously asserted the existing outside basis difference related to its foreign subsidiary was indefinitely reinvested. Consequently, a deferred tax liability for the outside basis difference was not recorded.

The combined company is contemplating a tax restructuring. Based on the restructuring plan, after the business combination, the foreign subsidiary of the acquiring company will purchase the shares of the acquired company's foreign subsidiary.

For US federal tax purposes, certain dispositions of shares to related corporations are treated under Internal Revenue Code Section 304 (Section 304) as dividends to the entity which disposed of the shares. Careful consideration of the facts and circumstances of the acquiring and acquired foreign subsidiary is necessary to determine whether, for tax purposes, the transfer of the acquired subsidiary is considered a dividend for tax purposes and to determine to which subsidiary the dividend is attributed. In particular, under Section 304, the taxation of a dividend may vary based on the underlying tax earnings of a subsidiary (i.e., consideration of the current and accumulated earnings and profits of the acquiring subsidiary as well as the acquired subsidiaries may be necessary).

In this example, the restructuring plan includes a transfer of shares in the acquired company's foreign subsidiary to the acquiring company's foreign subsidiary that may result in a deemed distribution for tax purposes. The deemed distribution may result in a dividend, reduction in tax basis or capital gain being recognized by the combined transferor entity in the US. As a result, understanding which subsidiary the deemed distribution is attributed to is an important consideration.

In a business combination, the acquiring company must make its own determination as to the reinvestment strategy related to any acquired foreign operations. While post-combination restructuring plans are generally not considered part of a business combination, post-combination restructuring plans may affect whether the combined company can assert that an investment in a foreign subsidiary is indefinitely reinvested. That is, the combined entity may only be able to assert that a portion (or none) of the investment in the acquired foreign subsidiary is indefinitely reinvested because of the potential for a post-combination restructuring. As a reminder, day 2 changes in indefinite reinvestment assertions related to acquired entities are not reflected in the business combination.

In addition, in anticipation of a post-acquisition restructuring the combined company may change its indefinite reinvestment assertion related to preexisting investments in the acquirer's foreign subsidiaries. It is important to note that the tax effects of a change in assertion related to the acquirer's existing outside basis differences are recognized in continuing operations. Further, a post-combination restructuring may include intercompany transactions and the guidance related to intercompany transactions should be considered. See section 3.2.2, *Intercompany transactions*, for additional discussion.

11.14 Income tax effects of replacement awards classified as equity issued in a business combination

Acquirers often exchange acquiree share-based payment awards for their own share-based payment awards (i.e., replacement awards). Under ASC 805, if an acquirer is obligated to issue replacement awards in exchange for acquiree share-based payment awards, then all or a portion of the fair value of the acquirer's replacement awards should be included as part of the consideration transferred by the acquirer. Generally, the portion of the replacement award that is part of the consideration transferred is the amount that is attributable to pre-combination vesting whereas the portion attributable to future vesting is recognized as compensation cost as that service is rendered.

To the extent that the cost of such replacement awards is considered part of consideration transferred, related deferred taxes should be accounted for as an element of consideration transferred in the business combination if the replacement award is expected to result in a future tax deduction under existing tax law. To the extent that the cost of such replacement awards is recognized as post-combination compensation cost, a deferred tax asset would generally be established (through income tax expense) as that compensation cost is recognized. However, any ultimately realized tax benefit associated with the replacement share-based payment awards (i.e., the excess or deficiency) is accounted for without regard to whether the benefit is related to (sourced from) consideration transferred in the business combination or post-combination compensation cost. That is, any difference between the eventual tax benefit received and the amount of deferred tax asset associated with a replacement award should be recognized in accordance with the guidance on accounting for the tax effects of share-based payment awards in ASC 718. According to that guidance, any excess of the benefit of the ultimate tax deduction over the recognized deferred tax asset generally would be credited to income tax expense. Refer to chapter 21, *Share-based payments to employees*.

These requirements differ from accounting under Statement 141 (non-authoritative) for deferred taxes on replacement awards included in purchase price consideration. Practice under Statement 141 (non-authoritative) has followed the guidance in EITF 00-23, Issue 29(a) (non-authoritative), under which deferred taxes on replacement awards are not reported in business combination accounting and future deductions on those replacement awards are recognized when realized by adjusting the purchase price of the acquired business to the extent that the deduction reported for tax purposes does not exceed the fair value of awards recognized as part of the purchase price. Before the effective date of ASC 805, the tax benefit of any excess deduction should be recognized in paid-in capital.

Pursuant to ASC 805, accounting for differences between realized tax benefits and deferred tax assets associated with replacement awards will differ, depending on whether the replacement awards were exchanged in a business combination accounted for in accordance with ASC 805 or Statement 141 (non-authoritative) (or APB 16 (non-authoritative)). As mentioned in the preceding paragraph, for business combination transactions accounted for before the effective date of ASC 805, a deferred tax asset is not recognized to the extent that the cost of a replacement award is considered an element of consideration transferred. We understand that the FASB staff believes that any future tax deduction realized from any portion of share-based payments that were included in the purchase price of a business combination completed before the effective date of ASC 805 should be recognized consistent with prior practice as described in the preceding paragraph (i.e., in accordance with EITF 00-23 (non-authoritative)). Tax deductions realized from share-based payments that were included in the purchase price of a business combination completed after the effective date of ASC 805 should be recognized as provided in ASC 805.

11.14.1 Accounting for the tax effects of incentive stock options (ISOs)

Excerpt from Accounting Standards Codification

Business Combinations — Income Taxes

Recognition

805-740-25-11

For a replacement award classified as equity that ordinarily would not result in tax deductions under current tax law, an acquirer shall recognize no deferred tax asset for the portion of the fair-value-based measure attributed to precombination vesting and thus included in consideration transferred in the business combination. A future **event**, such as an employee's disqualifying disposition of shares under a tax law, may give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

As noted above under ASC 805, an acquirer should not recognize a deferred tax asset for the portion of a replacement award that is attributed to past service if the replacement award would not result in a future tax deduction under current tax law. However, a future event, such as a disqualifying disposition, may result in a tax deduction for an award that ordinarily does not qualify for a tax deduction. ASC 805-740-25-11 indicates that the tax effects of such an event would be recognized only when it occurs, but ASC 805 does not address where such tax effects should be reported in the financial statements (i.e., as an adjustment to APIC or as a current tax benefit). We believe that the tax effects of replacement awards for which a deferred tax asset was not recognized in acquisition accounting would be recognized as an income tax benefit from continuing operations in the income statement.

11.15 Differences in measurement of deferred taxes in separate financial statements of a subsidiary

ASC 740-10-30-27 specifies that the amount of current and deferred tax expense for a group of companies that files a consolidated income tax return must be allocated among the members of that group when those members issue separate financial statements. An allocation is required, for example, in call reports or separate financial statements of a bank that is a member of a consolidated income tax return group or when separate subsidiary financial statements are required for other regulatory filings.

ASU 2019-12 updates the guidance to clarify in ASC 740-10-30-27A that an entity is not required to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of legal entities that are not subject to tax. However, the guidance allows an entity to make an election to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of legal entities that are both not subject to tax and disregarded by the taxing authority (e.g., a single-member limited liability company). An entity that makes the election for one legal entity in the group is not required to make the election for all such members of a group that file a consolidated tax return. Therefore, an entity may elect to make the allocation in the separate legal entity financial statements on an entity-by-entity basis. An entity cannot make the election to allocate the consolidated amount of current and deferred tax expense for legal entities that are partnerships or other pass-through entities that are not wholly owned. ASU 2019-12 does not change the requirements in paragraph ASC 740-10-30-27 to allocate current and deferred taxes to the separate financial statements of members of the consolidated group that are subject to tax.

ASC 740 does not establish a specific method of allocation. The allocation method adopted must be systematic, rational and consistent with the broad principles of ASC 740. One such method, which is considered preferable by the SEC, is to allocate current and deferred taxes as if each member were a separate taxpayer. Under this method, ASC 740-10-30-27 notes that the sum of the amounts allocated to individual members of the income tax return group may not equal the consolidated amount.

When an acquirer expects to file a consolidated tax return that includes the acquiree, the assessment of the need for, and amount of, a valuation allowance is based on the combined company's past and expected future results of operations as of the acquisition date. Therefore, preexisting deferred tax liabilities of the acquirer that are available to offset acquired deferred tax assets may lead the acquirer to determine that a valuation allowance is not needed for acquired deferred tax assets. However, when the separate taxpayer method is used to allocate deferred taxes in the separate financial statements of the acquired subsidiary, it would not be appropriate to consider the combined company's past and expected future results in assessing the need for a valuation allowance. Instead, only the past and expected future results of the separate subsidiary would be considered. As a result, in certain situations, an acquirer may determine that it is not necessary to report a valuation allowance for deferred tax assets on a consolidated basis but it is necessary to report an allowance in the separate financials of the acquired subsidiary. This accounting leads to a question regarding how to account for the difference in valuation allowance in the separate financial statements of the acquired company.

We believe there are two acceptable methods that may be applied to account for the difference in valuation allowance in the separate financial statements of (or including) the acquired company. We believe the most appropriate method would be to report the valuation allowance in the subsidiary's separate financial statements by reporting an offsetting increase in the goodwill of the subsidiary. This method will result in the subsidiary reporting a larger goodwill balance than the goodwill included in the consolidated entity. In accordance with ASC 350-20-35-48, subsidiary goodwill must be tested for impairment at the subsidiary level using the subsidiary's reporting units. If an impairment is recognized at the subsidiary level, the parent company should consider whether the subsidiary's impairment indicates that it is more likely than not that the fair value of the affected reporting unit (or units) at the parent company level is below carrying amount and whether goodwill in that reporting unit (or units) should be tested for impairment. If goodwill of that higher-level consolidated reporting unit is impaired, a loss would be recognized at the consolidated level. This process for recognizing impairment could result in differences in goodwill at the consolidated and subsidiary levels regardless of whether the goodwill balances were equal on the acquisition date.

We believe an acceptable alternative to the above would be to report the valuation allowance in the subsidiary's separate financial statements by reporting a decrease to beginning equity. This accounting will result in the same goodwill balance for the subsidiary and the consolidated entity, with the subsidiary reporting a lower equity balance than the parent's investment in the subsidiary.

11.16 Tax effects of a business combination achieved in stages

11.16.1 Outside basis differences

An acquirer may obtain control of an acquiree through a series of acquisitions. Such a transaction is commonly referred to as a "step acquisition" transaction and in ASC 805 as a "business combination achieved in stages." If an acquirer owns a noncontrolling equity investment in an acquiree immediately before obtaining control, the acquirer should, under ASC 805, remeasure that prior investment to fair value as of the acquisition date and recognize any remeasurement gains or losses in earnings.

Before obtaining control through a step acquisition, the acquirer, unless it accounts for its investment using the equity method, recognizes changes in the value of a noncontrolling investment in the acquisition target in the income statement in accordance with ASC 321, *Investments — Equity Securities*.

The remeasurement of an equity investment to fair value is required because the FASB concluded that a change from holding a noncontrolling equity investment in an entity to controlling that entity is a significant change in the nature of and economic circumstances surrounding that investment. The acquirer exchanges its status as an owner of an investment in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity and the right to direct how the acquiree and its management use those assets in conducting its operations. In the FASB's view, that exchange warrants fair value recognition of all net assets over which control has been obtained and requires remeasurement through earnings of any previously held noncontrolling interest.

The remeasurement of an investment accounted for under the equity method to fair value will generally result in an increase or decrease in the financial reporting basis of the investment without a corresponding adjustment to the tax basis. The difference between the financial reporting basis and the tax basis of an investment is commonly referred to as an outside basis difference and deferred taxes are reported for outside basis differences related to noncontrolling equity investments. The deferred tax consequence of a change in outside basis difference due to the remeasurement of an equity method investment should be reflected in the acquirer's income statement outside of acquisition accounting, consistent with the pretax treatment discussed above.

Likewise, if the remeasurement were to trigger a current tax consequence, the current tax effect would be reflected in the acquirer's income statement. This accounting treatment will result in the same aggregate accounting, although in different periods, regardless of whether an investment is accounted for under the equity method or at fair value (e.g., under the fair value option). Had the equity method investment been accounted for using the fair value option and measured at fair value at each reporting date, the related deferred tax consequences would have been reported in the acquirer's income statement at each reporting date and there would be no difference to recognize on the date of acquisition.

The following example illustrates these concepts.

Illustration 11-21: Accounting for the tax effects of a business combination achieved in stages

Facts

- Company X has a 30% investment in Company Y, which meets the definition of a business under ASC 805, accounted for under the equity method.
- At the beginning of 20X9, Company X acquires the remaining 70% of Company Y for $70.
- On the date of the acquisition, the financial reporting basis and tax basis of the 30% investment is $20 and the fair value of the investment is $30.
- The tax basis in the 70% investment is $70 (i.e., there is no outside basis difference on the 70% investment).
- The tax rate is 25%.
- Company X will be required to provide deferred taxes for outside basis differences subsequent to the acquisition of Company Y (situations in which the acquirer is no longer required to provide deferred taxes for outside basis differences are discussed below in section 11.16.1.2, *Deferred tax liabilities for foreign subsidiaries achieved in stages (before the adoption of ASU 2019-12)*.

Analysis

On the date of acquisition, Company X would report a $10 gain on the remeasurement of its 30% investment in Company Y. Company X would also report deferred tax expense, and a corresponding increase in its deferred tax liability of $3 ($10 x 25%).

The following table summarizes the financial reporting (i.e., book) basis and tax basis of Company X's investment in Company Y:

	Book	Tax	DTA (DTL)
30% interest prior to acquisition of remaining interest	$ 20	$ 20	$ –
Remeasurement of 30% investment to FV on acquisition date	10	–	(3)
	30	20	(3)
Purchase of remaining 70% interest	70	70	–
Total investment in Company Y	$ 100	$ 90	$ (3)

Except for equity investments accounted for using the equity method, those that result in consolidation of the investee and certain other investments, equity investments are carried at fair value (or an alternative measurement if the fair value of the investee is not readily determinable) with changes in fair value recorded in net income. Therefore, the tax effects of changes in the acquirer's outside basis difference would already be recognized by the acquirer prior to obtaining control of the investee.

After achieving control of a target company, further acquisitions of ownership interests (i.e., acquisitions of noncontrolling ownership interests) are accounted for as transactions among shareholders pursuant to ASC 810. Accordingly, neither step acquisition nor business combination accounting principles will apply to accounting for such transactions. See section 12.2, *Changes in ownership interest in a subsidiary other than in a business combination*, for further detail.

11.16.1.1 Deferred tax liabilities for domestic subsidiaries acquired in stages

In a business combination achieved in stages, an acquirer may not be required to report deferred taxes on outside basis differences once the acquirer obtains control of the acquiree. ASC 740-30-25-7 requires a company to assess whether the excess of the reported amount of an investment (including undistributed earnings) in a domestic subsidiary for financial reporting purposes over the underlying tax basis is a taxable temporary difference. If the tax law provides a means by which the reported amount of an investment in the stock of a domestic subsidiary could be recovered in a tax-free transaction (e.g., a tax-free liquidation or a statutory merger) and the company expects that it ultimately will use that means to recover its investment, the outside basis difference would not be considered a taxable temporary difference because no taxes are expected to result when the temporary difference reverses.

We believe that if a deferred tax liability on the outside basis difference of an investment, including any deferred taxes associated with recognizing the holding gain described above, is no longer needed because the acquirer has the ability to recover the amount tax free once control is obtained, the deferred tax liability on the outside basis difference should be reversed in the acquirer's income statement in the reporting period that includes the business combination. This accounting is consistent with the accounting for a change in the acquirer's valuation allowance in accordance with ASC 805-740-30-3. A change in an acquirer's valuation allowance for a deferred tax asset that results from a change in the acquirer's circumstances caused by a business combination must be accounted for as an event separate from the business combination. Similar to a change in the acquirer's valuation allowance, although the deferred taxes on the outside basis difference are no longer needed because of the business combination, the deferred tax liability relates to the acquirer's preexisting interest, and therefore, changes in that liability should be accounted for outside of acquisition accounting. See section 14.4, *Investments in domestic subsidiaries, corporate joint ventures and domestic investees*, for further discussion and additional considerations.

The following example illustrates these concepts.

Illustration 11-22: Accounting for the tax effects of acquiring a domestic subsidiary in stages

Facts

- Company X has a 30% investment in Company Y, which meets the definition of a business under ASC 805, accounted for under the equity method.
- At the beginning of 20X9, Company X acquires the remaining 70% of Company Y for $70.
- On the date of the acquisition the financial reporting basis of the 30% investment is $25, the tax basis is $10, and the fair value is $30.
- A deferred tax liability of $4 relating to the equity investment exists immediately prior to the acquisition. The tax basis in the 70% investment is $70 (i.e., there is no outside basis difference in the 70% investment).
- The tax rate is 25%.
- The tax law provides a means by which the reported amount of the investment in the stock of Company Y, a domestic subsidiary, could be recovered in a tax-free transaction and Company X expects that it ultimately will use that means to recover its investment.

Analysis

Because the tax law provides a means by which the reported amount of the investment in the stock of Company Y could be recovered in a tax-free transaction and Company X expects that it ultimately will use that means to recover its investment, Company X's outside basis difference in Company Y, including the $1 difference related to the $5 gain on remeasurement of Company X's original 30% investment (($30 fair value − $25 financial reporting basis) x 25%), would not be considered a taxable temporary difference and no deferred tax liability would be required. Therefore, Company X would report a net deferred tax benefit of $4, which represents the reversal of the deferred taxes related to the original outside basis difference in the equity method investment (($25 financial reporting basis − $10 tax basis) x 25%).

11.16.1.2 Deferred tax liabilities for foreign subsidiaries acquired in stages (before the adoption of ASU 2019-12)

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12 that simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the legacy guidance to promote more consistency. The amendments eliminate the exceptions to the general requirements for recognizing and not recognizing a deferred tax liability related to the outside basis differences that predate changes in ownership of equity method investments and foreign subsidiaries. Instead, the guidance will require entities to account for the tax effects of the entire outside basis difference that relate to an investment in which there is an ownership change as if the entity had always accounted for the investment based on the new ownership structure.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Early adoption is permitted in interim or annual periods for which all other entities (i.e., entities that are not PBEs) have not made financial statements available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply these amendments on the treatment of outside basis differences relating to investments when there is a change in ownership using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.

ASC 740-30-25-17 provides an exception to comprehensive recognition of deferred taxes for temporary differences related to undistributed earnings of foreign subsidiaries and foreign corporate joint ventures that are, or will be, invested indefinitely. However, when an acquirer holds an equity investment in an acquiree prior to obtaining control, ASC 740-30-25-16 requires that the temporary difference for the acquirer's share of the undistributed earnings of the acquiree prior to the date it becomes a subsidiary continues to be treated as a temporary difference for which a deferred tax liability must be recognized to the extent dividends from the subsidiary do not exceed the parent company's share of the subsidiary's earnings subsequent to the date it became a subsidiary (i.e., a deferred tax liability related to an equity investment must be frozen until the temporary difference reverses).

As discussed above, under ASC 805, if an acquirer owns a noncontrolling equity investment in an acquiree immediately before obtaining control, the acquirer must remeasure that investment to fair value as of the acquisition date and recognize any remeasurement gains or losses in earnings. A question arises whether the deferred tax liability that must be frozen in accordance with ASC 740-30 should include the deferred tax consequences of remeasuring an equity investment to fair value when a foreign subsidiary is acquired in stages. This question arises because although ASC 740-30-25-16 specifies that deferred tax liabilities related to undistributed earnings should be frozen, it does not specify whether the outside basis difference resulting from remeasuring an acquirer's investment to fair value should be included in the amount frozen as this difference is not related to undistributed earnings.

However, ASC 740-30-25-18 extends the ASC 740-30 exception for recognizing a deferred tax liability for undistributed earnings indefinitely invested to include the entire amount of a temporary difference between the financial reporting basis and tax basis of an investment in a foreign subsidiary. Therefore, we believe the most appropriate treatment is to freeze the deferred tax liability on the outside basis difference in the equity investment after the investment has been remeasured to fair value (i.e., the amount frozen should include the deferred tax consequences of the remeasurement of the investment). As a result, the amount of the deferred tax liability frozen will equal the outside basis difference of the investment at fair value immediately prior to obtaining control.

The following example illustrates these concepts.

Illustration 11-23: Accounting for the tax effects of acquiring a foreign subsidiary in stages

Facts

- Company X has a 30% investment in a foreign corporation, Company Y, which meets the definition of a business under ASC 805, accounted for under the equity method.
- At the beginning of 20X9, Company X acquires the remaining 70% of Company Y for $700.
- On the date of the acquisition, the financial reporting basis of the 30% investment is $200, the tax basis is $100, and the fair value is $300.
- The tax basis in the 70% investment is $700 (i.e., there is no outside basis difference in the 70% investment).
- The tax rate is 25%.
- Upon acquisition of the remaining 70%, Company X is able to assert that the earnings of Company Y, a foreign subsidiary, will be indefinitely reinvested.

Analysis

On the date of acquisition, Company X would recognize a $100 gain on the remeasurement of its 30% investment in Company Y. Company X would also recognize deferred tax expense, and a corresponding increase in its deferred tax liability of $25 ($100 x 25%). Although Company X is able to assert that the earnings of Company Y will be indefinitely reinvested, the entire existing deferred tax liability of $50 (($300 adjusted financial reporting basis — $100 tax basis) x 25%) would be frozen until the temporary difference reverses. See section 14.3.3.1, *Change in status of foreign investees (before the adoption of ASU 2019-12)*.

11.16.1.2A Deferred tax liabilities for foreign subsidiaries acquired in stages (after the adoption of ASU 2019-12)

As discussed above, under ASC 805, if an acquirer owns a noncontrolling equity investment in an acquiree immediately before obtaining control, the acquirer must remeasure that investment to fair value as of the acquisition date and recognize any remeasurement gains or losses in earnings. After the acquirer gains control, ASC 740 requires the acquirer to account for the tax effects of the entire outside basis difference that relates to a foreign subsidiary as if the acquirer had always accounted for the investment as a foreign subsidiary. Therefore, when an acquirer gains control, it will need to determine whether it can apply the exceptions to recognizing deferred tax liabilities on its outside basis differences that predate the change in ownership (i.e., indefinitely reinvest the earnings of the acquiree or remit them in a tax-free manner).

In addition, if the acquirer determines that it can assert indefinite reinvestment for its taxable temporary differences related to the outside basis of the acquired entity, the tax effect of changing its indefinite reinvestment assertion related to the portion of its outside basis differences in foreign subsidiaries or foreign corporate joint ventures that existed before it gained control is not recognized in the accounting for the business combination (e.g., recognized as a component of income tax expense/benefit from continuing operations). Refer to section 11.13.4, *Assertion regarding indefinite reinvestment*, above and chapter 14, *Foreign and domestic subsidiaries*, for details on the accounting for outside basis differences in foreign subsidiaries.

The following example illustrates the accounting for deferred tax liabilities for a foreign subsidiary acquired in stages after the adoption of ASU 2019-12:

Illustration 11-23A: Accounting for the tax effects of acquiring a foreign subsidiary in stages

Facts

- Company X has a 30% investment in a foreign corporation, Company Y, which meets the definition of a business under ASC 805, and Company X accounts for the investment under the equity method.
- At the beginning of 20X9, Company X acquires the remaining 70% of Company Y for $700.
- On the date of the acquisition, the financial reporting basis of the 30% investment is $200, the tax basis is $100 and the fair value is $300.
- The tax rate is 25%.
- Before the acquisition, Company X had recorded a $25 deferred tax liability (($200 − $100) x 25%) attributable to the taxable temporary difference between the financial reporting basis and the tax basis of its 30% investment in Company Y.
- The tax basis in the 70% investment is $700 (i.e., there is no outside basis difference in the 70% investment).
- Upon acquisition of the remaining 70%, Company X is able to assert that the earnings of Company Y, a foreign subsidiary, will be indefinitely reinvested.

Analysis

On the date of acquisition, Company X recognized a $100 gain on the remeasurement of its 30% investment in Company Y. Company X also recognized deferred tax expense and a corresponding increase in its deferred tax liability of $25 ($100 x 25%). Therefore, immediately before gaining control, Company X has a deferred tax liability related to its outside basis difference of $50 (the $25 deferred tax liability that existed before it remeasured the investment to fair value plus the $25 increase recognized after it remeasured the 30% investment).

Because Company X is able to assert that the outside basis difference of its investment in Company Y will be indefinitely reinvested, the entire deferred tax liability of $50 (($300 adjusted financial reporting basis − $100 tax basis) x 25%) would be derecognized in the period when control is obtained. The tax effect resulting from the change in assertion would be recognized in Company X's income tax expense from continuing operations, not as part of the business combination.

11.16.1.3 Limitations on deferred tax assets for subsidiaries

ASC 740-30-25-9 restricts recognition of a deferred tax asset for the excess of the tax basis over the financial reporting basis of an investment (outside basis difference) in either a foreign or domestic subsidiary or corporate joint venture. For those outside basis differences, a deferred tax asset is recognized "only if it is apparent that the temporary difference will reverse in the foreseeable future." This restriction on the recognition of deferred tax assets on outside basis differences was included to bring some form of consistency with the exceptions provided for deferred tax liabilities, in ASC 740-30-25-7 and ASC 740-30-25-18.

In a business combination achieved in stages, unless the acquirer is able to assert that the outside basis difference will reverse in the foreseeable future, which is expected to be rare, the acquirer will be required to write off any deferred tax asset related to an equity investment once the acquirer obtains control. Similar to the treatment of deferred tax liabilities discussed above, although the recognition of a deferred tax asset on the outside basis difference is no longer permitted because of the business combination, the deferred tax relates to the acquirer's preexisting interest and, therefore, should be accounted for outside of acquisition accounting (i.e., accounted for in the income statement).

In many cases, the acquirer will have already reported a valuation allowance for a deferred tax asset related to an equity investment, and once control is obtained the acquirer will simply write off both the deferred tax asset and the related valuation allowance; as a result, there is no current period tax effect from the write-off.

The following example illustrates these concepts.

Illustration 11-24: Limitations on the recognition of deferred tax assets

Facts

- Company X has a 30% investment in Company Y, which meets the definition of a business under ASC 805, accounted for under the equity method.
- At the beginning of 20X9, Company X acquires the remaining 70% of Company Y for $350.
- On the date of the acquisition the financial reporting basis of the 30% investment is $100, the tax basis is $200 and the fair value is $150.
- The tax basis in the 70% investment is $350 (i.e., there is no outside basis difference in the 70% investment).
- The tax rate is 25%.
- Company X has not reported a valuation allowance against the deferred tax asset for the equity investment. The outside basis difference in the subsidiary is not expected to reverse in the foreseeable future.

Analysis

On the date of acquisition, Company X would recognize a $50 gain on the remeasurement of the 30% investment. Company X would also recognize tax expense of $12.5 ($50 x 25%). Because the outside basis difference in Company Y is not expected to reverse in the foreseeable future, the net deferred tax asset remaining of $12.5 (($200 tax basis — $150 adjusted financial reporting value) x 25%) should be charged off to expense outside of acquisition accounting in Company X's current period income statement.

Had Company X reported a valuation allowance against the deferred tax asset, the deferred tax asset remaining of $12.5 would be written off against the $25 valuation allowance (($200 tax basis — $100 initial financial reporting value) x 25%)). The remaining $12.5 valuation allowance would no longer be needed and would be reported as a tax benefit and the overall tax effect of this transaction would be zero ($12.5 tax expense on remeasurement — $12.5 tax benefit on elimination of valuation allowance).

11.16.2 Inside basis differences

In a nontaxable business combination, such as a stock acquisition, the historical tax bases of the assets acquired and liabilities assumed carry over from the acquired company which results in different financial reporting and tax bases of the assets acquired and liabilities assumed (referred to as inside basis difference). However, in certain circumstances, the tax bases in the assets acquired and liabilities assumed may be stepped up to fair value as a result of a negotiation among the buyer and seller in accordance with IRC Section 338, eliminating the inside basis difference. In a business combination achieved in stages, this election does not apply to the portion of the acquiree owned by the acquirer prior to obtaining control. Therefore, when such an election is made in a business combination achieved in stages, the assets acquired and liabilities assumed will not be stepped up to their full fair value for tax purposes and deferred taxes must be reported on the related inside basis difference. Had such a business combination been achieved in a single purchase with a 338 election, there would be less of a chance that an inside basis difference would exist at the date of acquisition.

A question arises whether the deferred tax consequences of an inside basis difference resulting from a previously held investment in an acquiree should be reflected in the acquirer's income statement outside of acquisition accounting or included in acquisition accounting, which will generally result in an increase in goodwill. ASC 805-740-25-2 requires that an acquirer recognize and measure deferred taxes arising from assets acquired and liabilities assumed, and the potential tax effects of temporary differences, carryforwards, and any income tax uncertainties of the acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with ASC 740.

As noted previously, the FASB believes that a change from holding a noncontrolling equity investment in an entity to obtaining control of that entity is a significant change in the nature of and economic circumstances surrounding that investment. The acquirer exchanges its status as an owner of an investment in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity. Because the assets and liabilities that create the inside basis differences are not acquired and recognized until the acquirer obtains control of the acquiree, we believe that any deferred taxes arising from inside basis differences of assets acquired and liabilities assumed should be recognized in acquisition accounting (i.e., the deferred tax consequences of the assets acquired and liabilities assumed should be recognized in the same manner as the assets and liabilities themselves — in acquisition accounting).

12 Noncontrolling interests

12.1 Reporting noncontrolling interests and income taxes in the consolidated income statement

ASC 810 requires that earnings attributed to noncontrolling interests be reported as part of consolidated earnings and not as a separate component of income or expense. However, since many users of consolidated financial statements are primarily interested in amounts that are attributable to the controlling interests, ASC 810 requires disclosure of the attribution of consolidated earnings to the controlling and noncontrolling interests on the face of the consolidated income statement.

Income taxes included in consolidated income tax expense (benefit) and attributed to noncontrolling interests on the face of the consolidated income statement will vary depending on whether a subsidiary is a partnership or a C corporation. Partnerships and other entities treated as partnerships for tax purposes (e.g., limited liability companies or S corporations) are not taxable entities. Instead, the tax consequences of a partnership's transactions flow through to the partners (i.e., investors). The partners then report their proportionate share of the partnership's income or loss in their individual financial statements. Therefore, an entity with a controlling interest in a partnership would only report taxes on its share of the partnership in consolidated income tax expense, including deferred income taxes related to its ownership interest in the partnership (i.e., outside basis difference). The taxes payable on the portion of the partnership owned by the noncontrolling interests are dependent on tax attributes of the noncontrolling interests and would not be included in consolidated income tax expense.

Conversely, a C corporation is a taxable entity and is responsible for the tax consequences of transactions by the corporation. Therefore, an entity that consolidates a C corporation would include the taxes of the corporation, in addition to the taxes related to its ownership interest in the corporation (i.e., outside basis difference) in its consolidated income statement, including income taxes attributed to the noncontrolling interests.

The following examples illustrate these concepts.

Illustration 12-1: Reporting noncontrolling interests in a partnership and income taxes in the consolidated income statement

Facts

- Company A has an 80% interest in Partnership B.
- Company A's pretax income before the earnings of Partnership B is $100.
- Partnership B's pretax income is $50.
- Company A's tax rate is 25%.
- Assume, for simplicity purposes, there are no temporary differences, including the outside basis difference related to Partnership B.

Analysis

Company A would report the following in its consolidated income statement:

Income before taxes ($100 + $50)	$	150
Income taxes (($100 + ($50 x 80%)) x 25%)		35
Consolidated net income		115
Less: net income attributable to the noncontrolling interests ($50 x 20%)		10
Net income attributable to the controlling interests	$	105

Illustration 12-2: Reporting noncontrolling interests in a C corporation and income taxes in the consolidated income statement

Facts

- Company A has an 80% interest in Company B, a C corporation.
- Company A's pretax income before the earnings of Company B is $100.
- Company B's pretax income is $50.
- Company A and Company B's tax rate is 25%.
- Assume, for simplicity purposes, there are no temporary differences including outside basis differences related to Company B.

Analysis

Company A would report the following in its consolidated income statement (as rounded):

Income before taxes ($100 + $50)	$	150
Income taxes (($100 + $50) x 25%)		38
Consolidated net income		112
Less: net income attributable to the noncontrolling interests (($50 − ($50 x 25%)) x 20%)		7
Net income attributable to the controlling interests	$	105

12.2 Changes in ownership interest in a subsidiary other than in a business combination

12.2.1 Decreases in a parent's ownership interest in a subsidiary without loss of control

A parent may decrease its ownership interest in a subsidiary by selling a portion of the subsidiary's shares it holds or by causing the subsidiary to issue shares to noncontrolling interests without losing control of the subsidiary. Under ASC 810, such transactions are accounted for as transactions among shareholders. The carrying amount of the noncontrolling interests is increased to reflect the change in the noncontrolling interests' ownership interests in the subsidiary's net assets (i.e., the amount attributed to the additional noncontrolling interests should reflect its proportionate ownership percentage in the subsidiary's net assets acquired). Any difference between consideration received (whether by the parent or the subsidiary) and the adjustment made to the carrying amount of the noncontrolling interest is recognized directly in equity attributable to the controlling interest (i.e., as an adjustment to paid-in capital).

Thus, decreases in a parent's ownership interest in a subsidiary that do not result in loss of control do not result in gain or loss recognition in the parent's consolidated financial statements. Therefore, the direct tax consequences of such transactions also should not result in expense or benefit recognition in the parent's consolidated financial statements and should be reported in equity. The accounting for indirect effects of such transactions is discussed in section 12.2.3, *Other tax effects of change in ownership of subsidiary*. This treatment is consistent with ASC 740-20-45-11(c), which requires that the tax effects of an increase or decrease in contributed capital be charged or credited directly to related components of shareholders' equity.

The following example illustrates these concepts.

Illustration 12-3: Decrease in a parent's ownership interest in a subsidiary without loss of control

Facts

- Parent owns 100% of Subsidiary, a foreign entity.
- The carrying amount and tax basis of Parent's investment in Subsidiary is $4,000.
- Subsidiary issues 1,000 previously unissued shares to a third party for $1,500 in cash, reducing Parent's ownership interest in Subsidiary from 100% to 80% and resulting in total equity of Subsidiary is $5,500.
- The transaction is not a taxable transaction to Parent (i.e., Parent's tax basis in its investment remains unchanged) and Parent's tax rate is 25%.
- Parent is not able to assert that earnings from Subsidiary will be indefinitely reinvested (i.e., the investment in Subsidiary does not qualify for the exception to recognition of a deferred tax liability under ASC 740-30).

Analysis

Even though the percentage of Parent's ownership interest in Subsidiary is reduced (i.e., decreased from 100% to 80%) when Subsidiary issues shares to the third party, Parent's investment in Subsidiary increases to $4,400 (80% of Subsidiary's equity of $5,500). The noncontrolling interest's share in Subsidiary's equity is $1,100 (20% of Subsidiary's equity of $5,500) and the difference between the cash received of $1,500 and the noncontrolling interest's share of Subsidiary's equity is reported in paid-in capital. The following entry would be reported:

Cash	$	1,500		
Paid-in capital			$	400
Stockholder's equity — noncontrolling interests				1,100

Because Parent's investment in Subsidiary has increased to $4,400 without a corresponding increase to the tax basis and Parent is unable to assert that earnings from Subsidiary will be indefinitely reinvested, a deferred tax liability of $100 would be reported (($4,400 carrying value — $4,000 tax basis) x 25%) in equity as follows:

Paid-in capital	$	100		
Deferred tax liability+			$	100

+ The deferred tax liability is based on the tax laws of the jurisdiction of the parent (in this example, 25%). See chapter 14, *Foreign and domestic subsidiaries*, for additional discussion regarding investments in foreign subsidiaries.

12.2.2 Increases in a parent's ownership interest in a subsidiary

A parent may increase its ownership interest in a subsidiary by accomplishing one of the following:

- Directly purchasing additional outstanding shares of the subsidiary
- Causing the subsidiary to reacquire a portion of its outstanding shares (a treasury stock buyback)
- Causing the subsidiary to issue its shares to the parent

Under ASC 810, accounting for an increase in ownership interest in a subsidiary is similar to accounting for a decrease in ownership interest without a loss of control. That is, the carrying amount of the noncontrolling interest(s) is adjusted (i.e., decreased in this case) to reflect the noncontrolling interests' reduced ownership interest in the subsidiary's net assets. Any difference between consideration paid (whether by the parent or the subsidiary) to noncontrolling interest(s) (or contributed by the parent to the net assets of the subsidiary) and the adjustment to the carrying amount of the noncontrolling ownership interest(s) in the subsidiary is recognized directly in equity attributable to the controlling interest (i.e., paid-in capital). Tax consequences of such transactions are also recognized directly in equity, except for certain indirect effects that are described below.

12.2.3 Other tax effects of change in ownership of subsidiary

A change in a parent's ownership interest in a subsidiary without a loss of control may have tax consequences that are not directly related to the transaction itself. For example, a decrease in ownership interest may result in a company no longer being able to file a consolidated tax return. If the parent previously relied on deferred tax liabilities of the subsidiary to offset deferred tax assets of the parent, it may be necessary for the parent to report a valuation allowance on its deferred tax assets. Alternatively, an increase in ownership interest may give the parent the ability to file a consolidated tax return and reduce or eliminate an existing valuation allowance.

Similarly, an increase or decrease in a parent's ownership interest may affect the parent's ability to take advantage of the exception in ASC 740-30-25-7 to reporting an outside basis difference as a taxable temporary difference. ASC 740-30-25-7 requires a company to assess whether the excess of the reported amount of an investment (including undistributed earnings) in a domestic subsidiary for financial reporting purposes over the underlying tax basis is a taxable temporary difference. If the tax law provides a means by which the reported amount of an investment in the stock of a domestic subsidiary could be recovered in a tax-free transaction (e.g., a tax-free liquidation or a statutory merger) and the company expects that it ultimately will use that means to recover its investment, the outside basis difference would not be considered a taxable temporary difference (see section 14.4, *Investments in domestic subsidiaries, corporate joint ventures and domestic investees*, for further discussion and additional considerations).

Some tax elections are available only if the parent company owns a specified percentage of the subsidiary's stock. Therefore, if a parent no longer has the ability to use a tax-free method of recovery as a result of a reduction in its ownership interest and determines it will not reacquire such an interest prior to liquidation, deferred taxes must be reported. Alternatively, if an increase in ownership gives a parent the ability to recover its outside basis difference in a tax-free manner (and it had previously determined it would not acquire such an interest), it may no longer be required to report a deferred tax liability on the basis difference.

Partnerships and other entities treated as partnerships for tax purposes are generally not taxable entities in the jurisdiction in which they qualify as a partnership. As discussed in section 2.3, *Partnerships and other pass-through entities*, a partner recognizes the future tax consequences of recovering the financial reporting basis of its investment in the partnership as deferred tax assets or liabilities. Deferred tax assets and liabilities are also recognized for the difference between the financial reporting basis and the tax basis of the investment in the partnership. Noteworthy is that the exception provided in ASC 740-30-25-7 on the recognition of an outside basis difference for a consolidated subsidiary is not applicable to investments in consolidated partnerships as the investor generally cannot recover its investment in the partnership in a tax-free manner.

In the above examples, although the parent's judgment about the realizability of its deferred tax assets or its ability to recover an outside basis difference in a tax-free manner are affected by an increase or decrease in the parent's ownership interest in the subsidiary, the change is not directly related to the increase or decrease in ownership percentage and should be recognized in income from continuing operations and not in equity. This treatment is consistent with ASC 740-10-45-20, which generally requires that the effect of a change in a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years be included in income from continuing operations.

12.2.4 Loss of control of a subsidiary

Control of a subsidiary might be lost (i.e., the subsidiary is required to be deconsolidated) as a result of a parent's decision to sell its controlling interest in the subsidiary to another party or as a result of a subsidiary's issuance of its shares to others. Control might also be lost, with or without a change in absolute or relative ownership levels, as a result of a contractual arrangement, or if the subsidiary becomes subject to the control of a government, court, administrator or regulator (e.g., through legal reorganization or bankruptcy). For transactions in the scope of ASC 810, loss of control of a subsidiary results in deconsolidation and constitutes a remeasurement event that results in gain or loss recognition as follows:

Fair value of any consideration received in the transaction that resulted in the loss of control	
+	Fair value of any retained noncontrolling interest in the former subsidiary at the date the former subsidiary is deconsolidated
+	Carrying amount of the noncontrolling interest in the former subsidiary (including accumulated other comprehensive income attributable to the noncontrolling interest) at the date the former subsidiary is deconsolidated
-	Carrying amount of the former subsidiary's assets and liabilities
=	**Gain or loss measured under ASC 810**

See chapter 19 of our FRD, ***Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests***, for further guidance on the scope of ASC 810 and the derecognition under ASC 810.

A transaction may result in the loss of control of a subsidiary that is not in the scope of ASC 810 but is accounted for under other GAAP (e.g., ASC 610-20, ASC 860). See our FRD, ***Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)***, for further guidance on accounting for derecognition under the scope of ASC 610-20.

When control of a subsidiary is lost, the parent derecognizes all of the assets and liabilities of the subsidiary, including any deferred taxes on inside basis differences. When the parent retains an equity investment in the former subsidiary, an adjustment to deferred taxes may be necessary to reflect appropriately the tax effects of any outside basis difference in the retained equity interest. For example, if the parent previously did not provide for deferred taxes on the outside basis difference because the subsidiary met one of the exceptions to recognizing deferred tax liabilities within ASC 740 (see sections 11.16.1.1, *Deferred tax liabilities for domestic subsidiaries acquired in stages*, 11.16.1.2, *Deferred tax liabilities for foreign subsidiaries acquired in stages (before the adoption of ASU 2019-12)*, and 11.16.1.2A, *Deferred tax liabilities for foreign subsidiaries acquired in stages (after the adoption of ASU 2019-12)*, and chapter 14, *Foreign and domestic subsidiaries*, for discussion of these exceptions), deferred taxes on any outside basis difference should be recognized at the time the parent decides to no longer retain control (but no later than when control is lost) since the entity generally would no longer be able to assert indefinite reinvestment of undistributed earnings (if the former subsidiary is a foreign entity) or investment can no longer be recovered in a tax-free manner (if the former subsidiary is a domestic subsidiary). Refer to section 14.3.3.1, *Change in ownership of investees and subsidiaries (before the adoption of ASU 2019-12)*, and section 14.3.3.1A, *Change in ownership of investees and subsidiaries (after the adoption of ASU 2019-12)*, for further discussion.

The following example illustrates these concepts.

Illustration 12-4: Deferred tax accounting with a loss of control of a subsidiary when retaining an equity investment

Facts

- Company A owns a 100% interest in Company B (a domestic subsidiary) which has net assets of $110.
- Company A sells 90% of its interest in Company B to a third party for cash proceeds of $125.
  - As a result of the sale, Company A loses control of Company B but retains a 10% noncontrolling interest in Company B.
  - The fair value of the retained interest on the date of sale is $13. Company A's tax basis in its investment in Company B is $100.
  - Prior to Company A's decision to sell 90% of its interest in Company B, Company A had determined that the reported amount of its investment in Company B, a domestic subsidiary, could be recovered in a tax-free transaction and expected that it ultimately would use that means to recover the investment (the offer to purchase a 90% interest in Company B was unsolicited). As a result, prior to Company A's decision to sell, Company A had not reported deferred taxes on the outside basis difference in its investment in Company B. The sale of the 90% interest is a taxable transaction. Company A's tax rate is 25%.

Analysis

At the time Company A decides to no longer retain 90% of its interest in Company B, Company A can no longer assert that the reported amount of its investment can be recovered in a tax-free manner. Therefore, a deferred tax liability of $3 (($110 financial reporting basis — $100 tax basis) x 25% — as rounded) would be recognized on the date Company A makes the decision to sell its investment in a taxable transaction (i.e., the date it can no longer represent it will liquidate its investment in a tax-free manner but no later than when control is lost).

Deferred tax expense	$ 3	
Deferred tax liability		$ 3

The gain on the sale of the 90% interest in Company B (and the related remeasurement of the retained interest) would be calculated in accordance with ASC 810 as follows:

Cash proceeds	$ 125
Fair value of retained interest in Company B	13
	138
Less carrying amount of Company B's net assets	(110)
Gain on sale	$ 28

Before taking into consideration deferred tax consequences, Company A would report current tax expense related to the $35 tax gain (excess of $125 cash proceeds over the tax basis ($100 tax basis in Company B x 90% interest sold)) on the sale of the 90% interest of $9 ($35 gain x 25% — as rounded) on the transaction. Company A's financial reporting basis in the retained interest in Company B would be $13 (fair value of retained interest at date of sale) and the tax basis would be $10 ($100 tax basis in Company B x 10% retained interest), resulting in an outside basis difference of $3. Therefore, Company A should have a deferred tax liability of $1 ($3 outside basis difference x 25% — as rounded) reported subsequent to the sale. The difference between the $3 deferred tax liability previously reported and the $1 remaining after the sale, relates to the 90% interest sold.

The journal entry to report Company A's loss of control would be as follows:

Cash	$ 125	
Investment in Company B	13	
Current tax expense	9	
Deferred tax liability	2	
Net assets of Company B		$ 110
Gain on sale and remeasurement		28
Taxes payable		9
Deferred tax benefit		2

13 Asset acquisitions

This chapter discusses matters addressed in ASC 740 related to the purchase of an asset or group of assets (including intangible and financial assets) not deemed to be a business, as well as the acquisition of future tax benefits, including net operating loss carryforwards, step-ups in tax basis resulting from transactions with a governmental authority and the purchase of company stock when the company consists solely of one or a few assets.

13.1 Asset acquisitions

Excerpt from Accounting Standards Codification

Income Taxes — General

Recognition

740-10-25-51

The tax effect of asset purchases that are not business combinations in which the amount paid differs from the tax basis of the asset shall not result in immediate income statement recognition. The simultaneous equations method shall be used to record the assigned value of the asset and the related deferred tax asset or liability. (See Example 25, Cases A and B [paragraphs 740-10-55-171 through 55-182] for illustrations of the simultaneous equations method.) For purposes of applying this requirement, the following applies:

a. An acquired financial asset shall be recorded at fair value, an acquired asset held for disposal shall be recorded at fair value less cost to sell, and deferred tax assets shall be recorded at the amount required by this Topic.

b. An excess of the amounts assigned to the acquired assets over the consideration paid shall be allocated pro rata to reduce the values assigned to noncurrent assets acquired (except financial assets, assets held for disposal, and deferred tax assets). If the allocation reduces the noncurrent assets to zero, the remainder shall be classified as a deferred credit. (See Example 25, Cases C and D [paragraphs 740-10-55-183 through 55-191] for illustrations of transactions that result in a deferred credit.) The deferred credit is not a temporary difference under this Subtopic.

c. A reduction in the valuation allowance of the acquiring entity that is directly attributable to the asset acquisition shall be accounted for in accordance with paragraph 805-740-30-3. Subsequent accounting for an acquired valuation allowance (for example, the subsequent recognition of an acquired deferred tax asset by elimination of a valuation allowance established at the date of acquisition of the asset) would be in accordance with paragraphs 805-740-25-3 and 805-740-45-2.

740-10-25-52

The net tax benefit (that is, the difference between the amount paid and the deferred tax asset recognized) resulting from the purchase of future tax benefits from a third party which is not a government acting in its capacity as a taxing authority shall be recorded using the same model described in the preceding paragraph. (See Example 25, Case F [paragraph 740-10-55-199] for an illustration of a purchase of future tax benefits.)

ASC 805-10-55 provides guidance for determining when the acquisition of an asset or a group of assets (and liabilities) is a business. If an acquired asset or asset group does not meet the definition of a business, as defined in ASC 805, the transaction is accounted for as an asset acquisition based on the principles described in ASC 805-50. Based on those principles, the cost of a group of assets acquired should be allocated to the assets acquired and liabilities assumed based on their relative fair values and goodwill is not recognized (ASC 805-50-30-3).

ASC 740 provides guidance and examples on accounting for asset purchases that are not business combinations when the amount paid for an asset differs from the tax basis of the asset. ASC 740-10-25-51 requires that the tax effect of asset purchases that are not business combinations in which the amount paid differs from the tax basis of the asset should not result in immediate income statement recognition. The same model should be used to record the net tax benefit resulting from a purchase of future tax benefits from a third party that is not a government acting in its capacity as a taxing authority (ASC 740-10-25-52). In addition, ASC 740-10-25-53 requires that transactions directly between a taxpayer and a government (acting in its capacity as a taxing authority) should be recorded directly in income (similar to a change in tax laws, rates or other tax elections under ASC 740-10).

ASC 740 requires the use of the simultaneous equations method to record the assigned value of the asset and the related deferred tax asset or liability. However, an acquired financial asset should be recorded at fair value, acquired assets held for disposal should be recorded at fair value less cost to sell and deferred tax assets should be recorded at the amount required by ASC 740.

An excess of the amounts assigned to the acquired assets over the consideration paid should be allocated pro rata to reduce the values assigned to noncurrent assets acquired (except financial assets, assets held for disposal and acquired deferred tax assets). If the allocation reduces the noncurrent assets to zero, the remainder should be classified as a deferred credit. The deferred credit is not a temporary difference under ASC 740. The deferred credit is amortized to income tax expense in proportion to the realization of the tax benefits that gave rise to the deferred credit. Additionally, if, subsequent to the acquisition, it becomes more likely than not that some or all of the acquired deferred tax asset will not be realized, the effect of such adjustment shall be recognized in continuing operations as part of income tax expense. A proportionate share of any remaining unamortized deferred credit balance shall be recognized as an offset to income tax expense. The deferred credit should not be classified as part of deferred tax liabilities or as an offset to deferred tax assets (ASC 740-10-45-22).

Reductions in the acquiring company's valuation allowance should be recognized as an income tax benefit in accordance with ASC 805-740-30-3. In addition, subsequent accounting for an acquired valuation allowance (for example, the subsequent recognition of an acquired deferred tax asset by elimination of a valuation allowance established at the date of acquisition of the asset) would be recognized in income from continuing operations in accordance with ASC 805-740-25-3 through 25-4 and ASC 805-740-45-2 (ASC 740-10-45-24).

Additionally, income tax uncertainties that exist at the date of acquisition of the asset should be accounted for in accordance with ASC 740-10 (ASC 740-10-45-23).

13.1.1 Asset acquired with tax basis greater than book basis

As an incentive for acquiring specific types of equipment in certain sectors, some foreign jurisdictions permit a tax deduction in excess of the acquired asset's cost. In addition, an asset acquired in a nontaxable transaction can result in a different book and tax basis of the asset because the asset's tax basis is the same as the seller's tax basis (i.e., carryover basis), while the asset is generally recorded at fair value for financial reporting purposes. If an asset is purchased in a transaction that is not a business combination and the amount paid is less than the tax basis of the asset, ASC 740-10-25-51 requires the future tax benefits be recognized at the asset's acquisition date, measured using the simultaneous equations method as shown below. Immediate income statement recognition is prohibited.

Illustration 13-1: Asset acquired with tax basis greater than book basis

Facts

Assume Company MLS purchases a machine for $100 and its tax basis is automatically increased to $150. Upon sale of the asset, there is no recapture of the "excess" tax deduction.[a] Further, assume the tax rate is 25%.

Analysis

In accordance with ASC 740, the amounts assigned to the equipment and the related deferred tax asset should be determined using the simultaneous equations method as follows (where FBB is final book basis; TB is the tax basis; CPP is cash purchase price; and DTA is deferred tax asset):

Equation A — computation of FBB of the machine is:	
CPP = FBB − (Tax rate × (FBB − TB))	
At a 25% tax rate, Equation A is:	CPP = FBB − 0.25FBB + 0.25TB
	0.75FBB = CPP − 0.25TB
	FBB = (CPP − 0.25TB) ÷ 0.75
Equation B — computation of amount assigned to the DTA is:	
DTA = (TB − FBB) × Tax rate	
At a 25% tax rate, Equation B is:	DTA = 0.25TB − 0.25FBB

In the above example, the following variables are known:

Tax basis	$	150
Tax rate		25%
Cash purchase price	$	100

The unknown variables (FBB and DTA) are solved as follows:

Equation A:	FBB = $ 83 = ($100 − $38) ÷ 0.75
Equation B:	DTA = $ 17 = $38 − $21

Accordingly, Company MLS records the purchase of the machine in the following journal entry:

Machine	$	83		
Deferred tax asset		17		
Cash			$	100

(a) This is a key assumption. Any recapture on sale would create a temporary difference.

13.1.2 Asset purchased for more than tax basis

Companies acquiring assets in nontaxable transactions record the assets at fair value for financial reporting purposes, which may be greater than the seller's tax basis in those assets (i.e., carryover basis) for tax purposes. ASC 740-10-25-51 requires the recognition of the deferred tax impact of acquiring an asset in a transaction that is not a business combination when the amount paid exceeds the tax basis of the asset on the acquisition date. A deferred tax liability is measured using the simultaneous equations method as shown below. Immediate income statement recognition is prohibited.

Illustration 13-2: Asset purchased for more than tax basis

Facts

- Company LNS pays $1 million for all of the outstanding stock of Company MEF in a nontaxable acquisition (that is, carryover basis for tax purposes).
- Company MEF's sole asset is an FCC license that has a tax basis of zero.
  - As a result, Company MEF does not meet the definition of a business under ASC 805 because substantially all of fair value of the gross assets acquired is concentrated in a single identifiable asset (i.e., FCC license).
  - Therefore, the purchase of MEF's outstanding stock is not considered to be a business combination and goodwill is not recognized.
- A deferred tax liability is recorded for the temporary difference related to the FCC license. In this case, the carrying amount of the FCC license and the deferred tax liability are calculated using the simultaneous equations method.
- Assume the tax rate is 25%.

Analysis

In accordance with ASC 740, the amounts assigned to the FCC license and the related deferred tax liability are determined using the simultaneous equations method as follows (where FBB is final book basis; TB is the tax basis; CPP is cash purchase price; and DTL is deferred tax liability):

Equation A — computation of FBB of the FCC license is:

CPP = FBB − (Tax rate × (FBB − TB))

At a 25% tax rate, Equation A is:	CPP = FBB − 0.25FBB + 0.25TB
	0.75FBB = CPP − 0.25TB
	FBB = (CPP − 0.25TB) ÷ 0.75

Equation B — computation of amount assigned to the DTL is:

DTL = (FBB − TB) × Tax rate

At a 25% tax rate, Equation B is:	DTL = 0.25FBB − 0.25TB

In the above example, the following variables are known:

Tax basis	$ –
Tax rate	25%
Cash purchase price	$ 1,000,000

The unknown variables (FBB and DTL) are solved as follows:

Equation A:	FBB = $ 1,333,333 = ($1,000,000 − $0) ÷ 0.75
Equation B:	DTL = $ 333,333 = $333,333 − $0

Accordingly, Company LNS records the acquisition of all outstanding shares of Company MEF which, for accounting purposes is treated as a purchase of the FCC license, using the following journal entry:

FCC license	$ 1,333,333	
Cash		$ 1,000,000
Deferred tax liability		333,333

13.1.3 Deferred credit from tangible asset acquisition

As noted in section 13.1.1, *Asset acquired with tax basis greater than book basis*, as an incentive for acquiring specific types of equipment in certain sectors, some foreign jurisdictions permit a tax deduction in excess of the acquired asset's cost. In addition, an asset acquired in a nontaxable transaction can result in a different book and tax basis of the asset since the asset's tax basis is the same as the seller's basis (i.e., carryover basis), while the asset is generally recorded at fair value for financial reporting purposes. If an asset is purchased in a transaction that is not a business combination and the amount paid is less than the tax basis of the asset, ASC 740-10-25-51 requires the future tax benefits be recognized at the asset's acquisition date, calculated using the simultaneous equations method. Immediate income statement recognition is prohibited.

An excess of the amounts assigned to the acquired assets over the consideration paid shall be allocated pro rata to reduce the values assigned to noncurrent assets acquired (except financial assets, assets held for disposal, and deferred tax assets). If the allocation reduces noncurrent assets to zero, the remainder should be classified as a deferred credit. Such deferred credit is amortized to income tax expense in proportion to the realization of the tax benefits that gave rise to the deferred credit (ASC 740-10-35-5). The deferred tax credit is not a temporary difference.

Illustration 13-3: Deferred credit from tangible asset acquisition

Facts

Assume Company LFS buys a machine for $50 with a tax basis of $320 and the tax rate is 25%.

Analysis

In accordance with ASC 740, the amounts assigned to the machine and the related deferred tax asset are determined using the simultaneous equations method as follows (where FBB is final book basis; TB is the tax basis; CPP is cash purchase price; and DTA is deferred tax asset):

Equation A — computation of FBB of the machine is	
CPP = FBB − (Tax rate × (FBB − TB))	
At a 25% tax rate, Equation A is:	FBB − 0.25FBB + 0.25TB = CPP
	0.75FBB = CPP − 0.25TB
	FBB = (CPP − 0.25TB) ÷ 0.75
Equation B — computation of amount assigned to the DTA is:	
DTA = (TB − FBB) × Tax rate	
At a 25% tax rate, Equation B is:	0.25TB − 0.25FBB = DTA

In the above example, the following variables are known:

Tax basis	$	320
Tax rate		25%
Cash purchase price	$	50

The unknown variables (FBB and DTA) are solved as follows:

Equation A:	FBB = $ – (a)	= ($50 − $80) ÷ 0.75
Equation B:	DTA = $80	= $80 − $0

(a) Although the computation yields a result of $(40), assets cannot be recorded below zero; therefore, the assigned value for the final book basis of the machine is zero.

The excess of the amount assigned to the deferred tax asset over the cash purchase price paid for the machine is recorded as a deferred credit. Accordingly, Company LFS records the purchase of the machine in the following journal entry:

Deferred tax asset	$	80		
Machine (a)		–		
Cash			$	50
Deferred credit				30

(a) Although the computation yields a result of $(40), assets cannot be recorded below zero; therefore, the assigned value for the final book basis of the machine is zero.

The deferred credit is amortized to earnings (as a component of income tax expense) on a proportionate basis with the reversal of the deferred tax asset. Thus, in this example, future earnings will only be impacted by the actual purchase price.

13.1.4 Deferred credit from the acquisition of assets recorded at fair value

Certain assets acquired in transactions that are not business combinations are required to be recorded at fair value (e.g., financial assets, assets held for disposal pursuant to ASC 360). If an acquired asset recorded at fair value has a different tax basis (i.e., carryover basis or the tax basis is other than fair value), ASC 740 requires a deferred tax asset or liability to be recognized for the income tax effect of the basis difference. To the extent generally accepted accounting principles dictate the initial recognition of acquired assets at fair value, ASC 740-10-25-51 requires the difference between (1) the sum of the fair value and deferred tax asset recognized and (2) the purchase price to be recognized as a deferred credit at the acquisition date. Such deferred credit is amortized to income tax expense in proportion to the realization of the tax benefits that gave rise to the deferred credit (ASC 740-10-35-5).

Illustration 13-4: Deferred credit from the acquisition of assets recorded at fair value

Facts

Assume Company LNS acquires the stock of Company CS for $250. The principal asset of Company CS is an equity security with a readily determinable fair value of $200 and a tax basis of $500. Further, assume the tax rate is 25% and Company CS does not meet the definition of a business under ASC 805; thus, the acquisition is accounted for as an asset purchase and not as a business combination.

Analysis

The acquired financial asset is recognized at fair value and a deferred tax asset is recognized (subject to a valuation allowance) pursuant to ASC 740. The excess of the sum of the fair value of the financial asset and the deferred tax asset over the purchase price is recorded as a deferred credit pursuant to ASC 740-10-25-51. Accordingly, Company LNS records the purchase of the equity security using the following journal entry:

Equity security (at fair value)[(a)]	$ 200	
Deferred tax asset ([$500 — $200] x 0.25)	75	
Cash		$ 250
Deferred credit (derived)		25

(a) Any adjustments to the deferred credit for subsequent changes in the fair value of the equity security should be recognized on a proportionate basis as an offset to the change in the related deferred tax balance.

13.1.5 Valuation allowance reduced due to acquired intangible and other assets

In some asset acquisitions, the purchaser has cumulative losses or other negative evidence, which resulted in a valuation allowance on its preexisting deferred tax assets (including net operating losses) immediately prior to the asset acquisition. In some asset acquisitions, the assets acquired will have a book basis greater than their tax basis that will result in the recognition of a deferred tax liability; for example, a nontaxable transaction where the only asset being acquired is an intangible asset that has little or no tax basis.

As a result of the asset acquisition, the acquiring company may determine that the deferred tax liability recorded as a result of the asset acquisition is a source of future taxable income and its preexisting deferred tax assets are more likely than not to be realized and the existing valuation allowance should be reduced or eliminated. ASC 740-10-25-51 states that a reduction in the acquiring company's valuation allowance that is directly attributable to the asset acquisition should be recognized as an income tax benefit in accordance with ASC 805-740-30-3 (see sections 11.3.7, *Changes in acquirer's valuation allowance as a result of a business combination*, and 11.13, *Effect of acquirer-specific attributes on measurement of acquired deferred taxes*, for further discussion).

13.1.6 Purchase of future tax benefits

ASC 740-10-25-52 requires that the tax benefit (that is, the difference between the amount paid and the deferred tax asset recognized) resulting from the purchase of future tax benefits from a non-governmental third party should be recognized as a deferred credit which is recorded in earnings as the deferred tax asset is realized.

Illustration 13-5: Purchase of future tax benefits

Facts

- A foreign entity that has nominal assets other than its net operating loss carryforwards (NOLs) is acquired by a foreign subsidiary of a US entity for the specific purpose of utilizing the NOLs (this type of transaction is often referred to as a "tax loss acquisition").
  - This transaction does not constitute a business combination, because the foreign entity does not meet the definition of a business under ASC 805.
- As a result of the time value of money and because the target company is in financial difficulty and has ceased operations, the foreign subsidiary is able to acquire the shell entity at a discount from the amount corresponding to the gross deferred tax asset for the NOLs.
  - $2 million is paid for NOLs having a deferred tax benefit of $5 million for which it is more likely than not that the full benefit will be realized.

Analysis

In accordance with ASC 740-10-25-52, the amount assigned to the deferred tax asset should be recorded at its gross amount and the excess of the amount assigned to the deferred tax asset over the purchase price should be recorded as a deferred credit (which will be amortized to income tax expense in proportion to the realization of tax benefits that give rise to it) as follows:

Deferred tax asset	$ 5,000,000	
Deferred credit		$ 3,000,000
Cash		2,000,000

As with the other deferred credits initially recognized pursuant to ASC 740-10-25-51, the $3,000,000 in this example would be recognized in earnings, on a proportionate basis, as the deferred tax asset is realized. In addition, as with any deferred tax asset, the company would evaluate the need for, and amount of, a valuation allowance for this deferred tax asset under the provisions of ASC 740-10-30-17.

13.1.7 Transaction directly with a governmental taxing authority

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12, which simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the legacy guidance to promote more consistency. One clarification says entities are required to determine whether the step-up in tax basis of goodwill relates to (1) the business combination in which the book goodwill was initially recognized, in which case no deferred tax asset would be recorded for the increase in tax basis (except for any amount of newly created tax deductible goodwill that exceeds the balance of book goodwill), or (2) a separate transaction, in which case a deferred tax asset would be recorded for the entire amount of the newly created tax deductible goodwill, subject to a valuation allowance.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021 and interim periods within fiscal years beginning after 15 December 2022.

Early adoption is permitted in interim or annual periods for which all other entities (i.e., entities that are not PBEs) have not made financial statements available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply this amendment prospectively.

Excerpt from Accounting Standards Codification

Income Taxes — General

Recognition

Transactions Directly between a Taxpayer and a Government

740-10-25-53

Transactions directly between a taxpayer and a government (in its capacity as a taxing authority) shall be recorded directly in income (in a manner similar to the way in which an entity accounts for changes in tax laws, rates, or other tax elections under this Subtopic). (See Example 26 [paragraph 740-10-55-202] for an illustration of a transaction directly with a governmental taxing authority.)

740-10-25-54

In situations in which the tax basis step up relates to goodwill that was previously not deductible, no deferred tax asset would be recorded for the increase in basis except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

An entity shall determine whether a step up in the tax basis of goodwill relates to the business combination in which the book goodwill was originally recognized or whether it relates to a separate transaction. In situations in which the tax basis step up relates to the business combination in which the book goodwill was originally recognized, no deferred tax asset would be recorded for the increase in basis except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill. In situations in which the tax basis step up relates to a separate transaction, a deferred tax asset would be recorded for the entire amount of the newly created tax goodwill in accordance with this Subtopic. Factors that may indicate that the step up in tax basis relates to a separate transaction include, but are not limited to, the following:

a. A significant lapse in time between the transactions has occurred.

b. The tax basis in the newly created goodwill is not the direct result of settlement of liabilities recorded in connection with the acquisition.

c. The step up in tax basis is based on a valuation of the goodwill or the business that was performed as of a date after the business combination.

d. The transaction resulting in the step up in tax basis requires more than a simple tax election.

e. The entity incurs a cash tax cost or sacrifices existing tax attributes to achieve the step up in tax basis.

f. The transaction resulting in the step up in tax basis was not contemplated at the time of the business combination.

Certain taxing authorities (primarily outside the US) allow corporate taxpayers to elect to step up the tax basis of certain assets (e.g., plant and equipment located within the taxing authority's jurisdiction) in exchange for a current payment to the taxing authority or in exchange for existing tax attributes (e.g., NOL carryforwards). These payments are generally a percentage of the step-up in tax basis (e.g., 3% of additional basis). ASC 740-10-25-53 requires transactions directly between a taxpayer and a government (in its capacity as a taxing authority) to be recorded directly in income in a manner similar to a change in tax laws or rates (assuming a taxable temporary difference is not created).

Illustration 13-6: Transaction directly with a governmental taxing authority

Facts

Assume the tax laws in a foreign country enable Company LNS to step up the tax basis for its manufacturing plant in that country from historical cost ($1 million) to fair value as of the date of the election ($2 million) in exchange for a current payment to the taxing authority of 3% of the step-up. Company LNS will make this election (and the up-front payment of $30,000) if it believes it is likely the additional deductions (at a 25% tax rate) created by the step-up will be utilized to reduce future taxable income and the timing and amount of the future tax savings justifies the current payment.

For purposes of this example, it is assumed the transaction that accomplishes this tax step up does not create a taxable temporary difference as described in ASC 740 (e.g., the tax benefit associated with the transaction with the governmental taxing authority becomes taxable in certain situations, such as those described in ASC 830-740-25-7).

Analysis

In accordance with ASC 740-10-25-53, the tax effects of transactions made directly with a taxing authority are recorded directly in earnings as follows:

Deferred tax asset (($2 million – $1 million) * 25%)	$ 250,000	
Deferred income tax benefit		$ 220,000
Cash		30,000

ASC 740-10–25-54 states that when the tax basis step-up relates to goodwill that was previously not deductible, no deferred tax asset would be recorded for the increase in basis except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill. The guidance in ASU 2019-12[39] clarifies the guidance in ASC 740-10-25-54 to say that entities are required to determine whether the step-up in tax basis relates to either of the following:

- The business combination in which the book goodwill was initially recognized, in which case no deferred tax asset would be recorded for the increase in basis (except for any amount of newly deductible goodwill that exceeds the balance of book goodwill)
- A separate transaction, in which case a deferred tax asset would be recorded for the entire amount of the newly created tax goodwill (subject to a valuation allowance)

The guidance lists the factors that may indicate that the step-up in tax basis relates to a separate transaction but also says other factors may need to be considered:

- A significant lapse in time between the transactions has occurred.
- The tax basis in the newly created goodwill is not the direct result of settlement of liabilities recorded in connection with the acquisition.
- The step-up in tax basis is based on a valuation of the goodwill or the business that was performed as of a date after the business combination.
- The transaction resulting in the step-up in tax basis requires more than a simple tax election.
- The entity incurs a cash tax cost or sacrifices existing tax attributes to achieve the step-up in tax basis.
- The transaction resulting in the step-up in tax basis was not contemplated at the time of the business combination.

An entity will need to evaluate its own facts and circumstance to determine whether the step-up of tax goodwill relates to a prior business combination in which the book goodwill was initially recognized or a separate transaction. The factors listed above are not all inclusive and other factors may need to be considered in reaching a conclusion. See section 11.2.1.1, *Tax effects of obtaining a step-up in tax basis of acquired net assets*, for further consideration.

If an entity concludes that the step-up in basis relates to a transaction that is a separate transaction, it will record a deferred tax asset for the entire amount of the newly created tax-deductible goodwill (subject to a valuation allowance assessment). The offsetting tax benefit would be recorded directly in income (in a manner similar to how an entity accounts for changes in tax laws, rates or other tax elections).

If an entity concludes that the transaction relates to a prior business combination in which the book goodwill was initially recognized, a company will need to consider the guidance in ASC 805-740-25-9 to determine whether a temporary difference can be recognized. In this situation, no amount would be recorded for the increase in basis of the tax goodwill except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill (i.e., the second component of tax-deductible goodwill exceeds the first component of book goodwill). See section 11.3.4, *Tax-deductible goodwill*, for more details.

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[39] ASU 2019-12 clarifies but does not change the guidance in ASC 740-10-25-54. ASU 2019-12 was effective for PBEs for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

14 Foreign and domestic subsidiaries

14.1 Introduction

This chapter provides guidance on the deferred tax accounting for the outside basis differences in investments in consolidated and certain unconsolidated entities. An outside basis difference is the difference between the financial reporting basis and the tax basis of the immediate parent or investor's investment in another entity. In contrast, the differences between book and tax bases of assets and liabilities held within each individual entity are referred to as inside basis differences. For example, if a foreign subsidiary owns equipment that is being depreciated under different methods for book and tax purposes, there is an inside basis difference that would be recognized and measured according to the guidance covered in chapter 5, *Recognition and measurement*.

There are numerous factors that can generate outside basis differences in a company's investments, including transactions with noncontrolling shareholders, business combinations or reorganizations and changes in a subsidiary's equity or other comprehensive income. Under ASC 740-30, a company may be required to record, or may be prohibited from recording, deferred taxes on outside basis differences in investments in (1) consolidated entities, despite the investments being eliminated in consolidation, and (2) other unconsolidated entities. Determining if a temporary difference should be recorded for an outside basis difference depends on several factors including the legal form of the subsidiary or investee (e.g., a corporation versus a partnership), the nature of the relationship with the subsidiary (foreign or domestic) and if the entity is consolidated or unconsolidated.

This chapter also provides guidance on several industry-specific exceptions to the requirements for recognition of deferred taxes on temporary differences. For example, this chapter provides guidance on industry-specific exceptions for US savings and loan associations and stock life insurance entities.

14.1.1 Six-step process for deferred tax accounting of outside basis differences

Given the complexities associated with deferred tax accounting for outside basis differences, we believe it is helpful to use the following six-step process to identify and account for those basis differences:

Step 1	**Start at the bottom of the organizational chart (bottom-up approach)**
Step 2	**Determine the legal form of the investee (e.g., C corporation, partnership) and investee type (e.g., consolidated, unconsolidated)**
Step 3	**Determine whether the investor/investee relationship is domestic or foreign**
Step 4	**Determine the book and tax basis of the investor's investment in the investee**
Step 5	**Determine whether the outside basis difference is a deductible temporary difference or a taxable temporary difference**
Step 6	**Determine whether the investor can apply an exception to the guidance for recognizing a deferred tax asset or deferred tax liability**

Step 1: *Start at the bottom of the organizational chart (bottom-up approach)*

Because a company is required to account for outside basis differences for investments at each level within its organization, we believe that it is necessary to start at the bottom of the company's organizational chart and complete the remaining five steps for each outside basis difference.

Step 2: *Determine the legal form of the investee (e.g., C corporation, partnership) and investee type (e.g., consolidated, unconsolidated)*

Determining the investee's legal form and type is imperative because that information is needed to determine whether a deferred tax recognition exception exists. For example, there are generally no deferred tax recognition exceptions (except for certain corporate joint ventures) for equity method investees, partnerships and other pass-through entities or investees accounted for at fair value (or an alternative measurement if the fair value of the investee is not readily determinable).

Step 3: *Determine whether the investor/investee relationship is domestic or foreign*

Whether an investment qualifies for certain deferred tax recognition exceptions depends on whether the immediate investor/investee relationship is domestic or foreign. Refer to section 14.2, *Determining foreign versus domestic subsidiaries*, for additional discussion.

Step 4: *Determine the book and tax basis of the investor's investment in the investee*

A parent's book basis in a consolidated investee is its investment balance prior to the investment balance being eliminated in consolidation. In the case of an unconsolidated investee, the book basis is the investment balance recorded in the consolidated financial statements. The tax basis is determined based on the applicable tax laws of the relevant tax jurisdiction.

Step 5: *Determine whether the outside basis difference is a deductible temporary difference or taxable temporary difference*

Refer to chapter 4, *Temporary differences*, for guidance on evaluating whether a temporary difference is deductible or taxable.

Step 6: *Determine whether an exception to recognizing a deferred tax asset or deferred tax liability exists and is applicable*

The last step of the process is evaluating whether the guidance in ASC 740 provides an exception to recognizing a deferred tax asset or deferred tax liability on the outside basis difference and the applicability of the exception given a company's facts and circumstances. See section 14.1.2, *Exceptions to deferred tax accounting for outside basis differences*, for additional discussion. If an exception does not apply, the entity then measures and recognizes a deferred tax asset or liability on the outside basis difference. See section 14.3.5, *Recognizing deferred tax liabilities when a company does not assert indefinite reinvestment*, and section 14.5, *Limitations on deferred tax assets for outside basis difference of foreign and domestic subsidiaries, corporate joint ventures and investees*, for additional discussion.

14.1.2 Exceptions to deferred tax accounting for outside basis differences

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-3

The only exceptions in applying those basic requirements are:

a. Certain exceptions to the requirements for recognition of deferred taxes whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

   1. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.

   2. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.

   3. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.

   4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. See paragraph 944-740-25-2 for the specific requirements related to this exception.

b. Subparagraph superseded by Accounting Standards Update No. 2017-15

c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Subtopic 840-30

d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3)

e. A prohibition on recognition of a deferred tax asset for the difference between the tax basis of **inventory** in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group. Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.

f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

The only exceptions in applying those basic requirements are:

a. Certain exceptions to the requirements for recognition of deferred taxes whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

   1. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign **corporate joint venture** that is essentially permanent in duration. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.

   2. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.

   3. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.

   4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. See paragraph 944-740-25-2 for the specific requirements related to this exception.

b. Subparagraph superseded by Accounting Standards Update No. 2017-15

c. The pattern of recognition of after-tax income for **leveraged leases** or the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Subtopic 842-50

d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3)

e. A prohibition on recognition of a deferred tax asset for the difference between the tax basis of **inventory** in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group. Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.

f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

Income Taxes — Other Considerations or Special Areas

Scope and Scope Exceptions

740-30-15-4

There are other exceptions to the comprehensive recognition of deferred income taxes on temporary differences specifically addressed in other Subtopics. However; the provisions of this Subtopic shall not be applied to analogous types of temporary differences.

Financial Services-Depository and Lending — Income Taxes

Recognition

942-740-25-1

As described in paragraph 740-10-25-3, a deferred tax liability shall not be recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base-year amount).

However, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction shall be accrued as tax expense of the current period.

942-740-25-2

Paragraph 740-30-25-5 requires that a deferred tax liability be recognized for the following types of taxable temporary differences:

a. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

942-740-25-3

The entity shall assess the need for a valuation allowance for deferred tax assets related to a savings and loan association's bad-debt reserve for financial reporting.

Financial Services-Insurance — Income Taxes

Recognition

944-740-25-3

As described in Topic 740, a **life insurance entity** shall not provide deferred taxes on taxable temporary differences related to policyholders' surplus that arose in fiscal years beginning on or before December 15, 1992. However, if circumstances indicate that the insurance entity is likely to pay income taxes, either currently or in later years, because of a known or expected reduction in policyholders' surplus, income taxes attributable to that reduction shall be accrued as a tax expense of the current period.

As noted above, recognition of deferred tax liabilities is not required for certain types of temporary differences, unless it becomes apparent they will reverse in the foreseeable future. Deferred tax assets on outside basis differences of subsidiaries and corporate joint ventures are subject to additional restrictions in ASC 740-30-25-9 through ASC 740-30-25-14.

The following table summarizes the application of exceptions to recognizing deferred tax liabilities and assets related to outside basis differences.

Relationship to immediate parent or investor	Nature of the outside basis difference	When to recognize DTL or DTA for an outside basis difference	Source of additional guidance	ASC 740 guidance
Subsidiary				
Domestic	Book basis exceeds tax basis of the investment (DTL)	A DTL is recognized unless the entity can recover the investment tax-free and expects to use that means.	Section 14.4	ASC 740-30-25-7
	Excess of tax basis over book basis (DTA)	A DTA is recognized only if it is apparent that the temporary difference will reverse in the foreseeable future.	Section 14.5	ASC 740-30-25-9
Foreign	Excess of book basis over tax basis (DTL)	A DTL is recognized unless the parent asserts and has the ability and intent to postpone remittance of all or part of its net investment (including earnings) indefinitely (i.e., essentially permanent in duration).	Section 14.3.1	ASC 740-30-25-17 ASC 740-30-25-18
	Excess of tax basis over book basis (DTA)	A DTA is recognized only if it is apparent that the temporary difference will reverse in the foreseeable future.	Section 14.5	ASC 740-30-25-9
Corporate joint venture				
Domestic	Excess of book basis over tax basis (DTL)	The investor recognizes the DTL. There are no recognition exceptions available when there is an excess of book basis over tax basis in a domestic corporate joint venture.	Section 14.4.2.1	ASC 740-30-25-5(b)
	Excess of tax basis over book basis (DTA)	A DTA is recognized only if it's apparent that the temporary difference will reverse in the foreseeable future.	Section 14.5	ASC 740-30-25-9
Foreign	Excess of book basis over tax basis (DTL)	A DTL is recognized unless the parent asserts and has the ability and intent to postpone remittance of all or part of its net investment (including earnings) indefinitely (i.e., essentially permanent in duration).	Section 14.3.4	ASC 740-30-25-17 ASC 740-30-25-18
	Excess of tax basis over book basis (DTA)	A DTA is recognized only if it's apparent that the temporary difference will reverse in the foreseeable future.	Section 14.5	ASC 740-30-25-9
Equity method investment excluding corporate joint ventures				
Domestic	Excess of book basis over tax basis (DTL)	Investor recognizes deferred tax liability. No recognition exceptions available.	Section 14.4.2.2	ASC 740-30-25-5(b)
	Excess of tax basis over book basis (DTA)	Investor recognizes deferred tax asset. No recognition exceptions available.	Section 14.5	N/A
Foreign	Excess of book basis over tax basis (DTL)	Investor recognizes deferred tax liability. No recognition exceptions available.	Section 14.3.4	ASC 740-30-25-5(b)
	Excess of tax basis over book basis (DTA)	Investor recognizes deferred tax asset. No recognition exceptions available.	Section 14.5	N/A
Partnerships and other pass-through entities				
Domestic	Excess of book basis over tax basis (DTL)	Investor recognizes deferred tax liability. No recognition exceptions available.	Section 14.6 Section 2.3	N/A
	Excess of tax basis over book basis (DTA)	Investor recognizes deferred tax asset. No recognition exceptions available.	Section 14.6 Section 2.3	N/A
Foreign	Excess of book basis over tax basis (DTL)	Investor recognizes deferred tax liability. No recognition exceptions available.	Section 14.6 Section 2.3	N/A
	Excess of tax basis over book basis (DTA)	Investor recognizes deferred tax asset. No recognition exceptions available.	Section 14.6 Section 2.3	N/A

14.2 Determining foreign versus domestic subsidiaries

The determination of whether an investee qualifies as a domestic or foreign subsidiary is made based on the relationship with the investee's immediate investor under a bottom-up approach. That is, a company cannot disregard income taxes payable upon remittance of earnings to an intermediate parent located in the same taxing jurisdiction under the ASC 740-30 foreign subsidiary exception because the subsidiary is not a foreign subsidiary of the intermediate parent. Likewise, if a company anticipates distributing earnings from one tax jurisdiction to another, without repatriation to its home country, the intermediate parent companies would not be able to support indefinite reinvestment of their investment in the lower-tier subsidiary even if the ultimate parent were able to support its assertion that the foreign earnings would not be repatriated to its domestic taxing jurisdiction.

Determining whether a subsidiary is a "foreign subsidiary" for purposes of the exceptions to providing deferred taxes requires an assessment of the facts and circumstances and income tax laws applicable to the parent.

Illustration 14-1: Determining whether a subsidiary is foreign or domestic

Facts

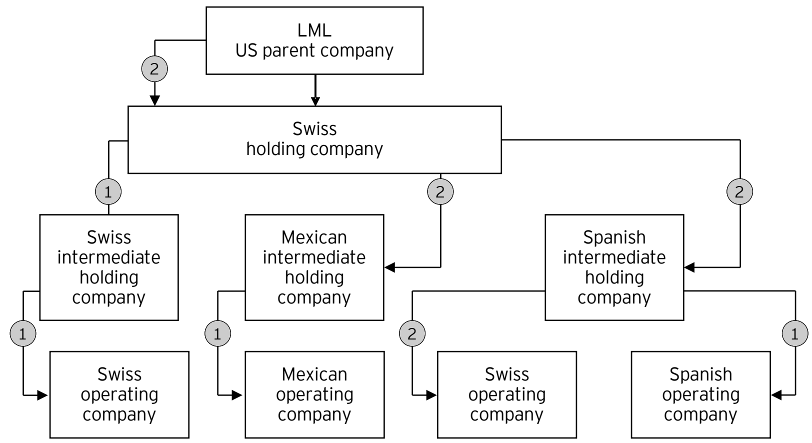
- Company LML, a US corporation, has a wholly owned holding company in Switzerland (Swiss holding company) that wholly owns three intermediate holding companies, one each in Switzerland, Mexico and Spain.
- Those intermediate holding companies own one or more operating companies (the operating companies) in their respective countries and the Spanish intermediate parent company subsidiary owns both Spanish and Swiss operating companies.

Analysis

The Swiss and Mexican intermediate holding companies would consider their operating companies to be domestic subsidiaries. The Spanish intermediate holding company would consider the Swiss operating subsidiary a foreign subsidiary and the Spanish operating subsidiary a domestic subsidiary. The domestic subsidiaries are not eligible for the foreign subsidiary exclusion from recognizing deferred taxes under ASC 740-10-25-3.

However, the intermediate holding companies may be able to recover their investments in domestic subsidiaries in a tax-free manner (as discussed in ASC 740-30-25-7) and thereby avoid recording deferred tax liabilities on the related outside basis difference. The Swiss holding company would consider the Swiss intermediate holding company as a domestic subsidiary but would consider two of its investees as foreign subsidiaries (the Mexican and Spanish intermediate holding companies). If the Swiss holding company could not support the indefinite reinvestment assertion, the Swiss holding company would provide for deferred taxes on the earnings of its foreign subsidiaries (the Spanish and Mexican intermediate holding companies). Company LML would likewise consider the Swiss holding company a foreign subsidiary and, if it could support the indefinite reinvestment assertion, would not provide for deferred taxes on repatriation to the US for overseas earnings indefinitely reinvested in that entity.

The following graphic illustrates which subsidiaries in this example are foreign subsidiaries that would make the immediate parent eligible for the ASC 740-30 exception.



1 Domestic subsidiary, so the immediate parent doesn't qualify for the ASC 740-30 foreign subsidiary exception

2 Foreign subsidiary, so the immediate parent qualifies for the ASC 740-30 foreign subsidiary exception

14.2.1 US domestic subsidiaries and US possessions

US income tax statutes identify domestic corporations as those companies organized under the laws of one of the 50 states or the District of Columbia. The tax code generally provides a foreign tax credit for taxes paid to a US possession such as Puerto Rico or the US Virgin Islands. Subsidiaries incorporated under the laws of Puerto Rico and the US Virgin Islands are generally considered "foreign" entities for purposes of determining if an investee qualifies as a domestic or foreign subsidiary and applying the exception to providing deferred taxes for basis differences and undistributed earnings that are or will be invested indefinitely (see section 14.3, *Investments in foreign subsidiaries, corporate joint ventures and foreign investees*, for additional discussion on the exception for recognizing deferred tax liabilities on outside basis differences of foreign subsidiaries). However, subsidiaries that are incorporated in the US but do business in Puerto Rico or the US Virgin Islands would be considered domestic subsidiaries. Determining whether a subsidiary is a "foreign subsidiary" for purposes of the exceptions to providing deferred taxes requires a facts-and-circumstances assessment considering income tax statutes applicable to the parent.

14.3 Investments in foreign subsidiaries, corporate joint ventures and foreign investees

ASC 740-10-25-3 provides an exception to comprehensive recognition of deferred taxes for temporary differences related to undistributed earnings of foreign subsidiaries and foreign corporate joint ventures (that are, or will be, invested indefinitely) because of the complexities involved in determining the amount to recognize in those situations. See section 14.3.4, *Foreign equity method investees and corporate joint ventures*, for a further discussion of corporate joint ventures.

Excerpt from Accounting Standards Codification

Income Taxes

Recognition

740-30-25-2

Including undistributed earnings of a subsidiary (which would include the undistributed earnings of a domestic international sales corporation eligible for tax deferral) in the pretax accounting income of a parent entity either through consolidation or accounting for the investment by the equity method results in a **temporary difference**.

740-30-25-3

It shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent entity. Accordingly, the undistributed earnings of a subsidiary included in consolidated income shall be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free.

740-30-25-5

A **deferred tax liability** shall be recognized for both of the following types of taxable temporary differences:

a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992

b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 740-30-25-18 for a corporate joint venture that is essentially permanent in duration.

Paragraphs 740-30-25-9 and 740-30-25-18 identify exceptions to the accounting that otherwise requires comprehensive recognition of deferred income taxes for temporary differences arising from investments in subsidiaries and corporate joint ventures.

740-30-25-6

Paragraph 740-30-25-18 provides that a deferred tax liability is not recognized for either of the following:

a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 740-30-25-17

b. Undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992, and that meet the criteria in paragraph 740-30-25-17. The criteria in that paragraph do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and as required by the preceding paragraph, a deferred tax liability shall be recognized if the undistributed earnings are a **taxable temporary difference**.

14.3.1 Investments that are essentially permanent in duration

Excerpt from Accounting Standards Codification

Income Taxes — Other Considerations or Special Areas

Undistributed Earnings of Subsidiaries and Corporate Joint Ventures

740-30-05-4

A domestic or foreign subsidiary remits earnings to a parent entity after the parties consider numerous factors, including the following:

a. Financial requirements of the parent entity

b. Financial requirements of the subsidiary

c. Operational and fiscal objectives of the parent entity, both long-term and short-term

d. Remittance restrictions imposed by governments

e. Remittance restrictions imposed by lease or financing agreements of the subsidiary

f. **Tax consequences** of the remittance.

Recognition

740-30-25-17

The presumption in paragraph 740-30-25-3 that all undistributed earnings will be transferred to the parent entity may be overcome, and no income taxes shall be accrued by the parent entity, for entities and periods identified in the following paragraph if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent entity shall have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. These criteria required to overcome the presumption are sometimes referred to as the indefinite reversal criteria. Experience of the entities and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent entity's representation of indefinite postponement of remittances from a subsidiary. The indefinite reversal criteria shall not be applied to the inside basis differences of foreign subsidiaries.

740-30-25-18

As indicated in paragraph 740-10-25-3, a deferred tax liability shall not be recognized for either of the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration

b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992.

740-30-25-19

If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity, it shall accrue as an expense of the current period income taxes attributable to that remittance. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent entity shall adjust income tax expense of the current period.

There is a presumption that all undistributed earnings will be remitted to the parent (ASC 740-30-25-3). To overcome this presumption, the company must maintain sufficient evidence of specific plans (e.g., past experience, working capital forecasts, long-term liquidity plans, capital improvement programs, merger and acquisition plans, investment plans) for reinvestment of the foreign operation's earnings such that the remittance of those earnings to the parent company will be postponed indefinitely.

The assertion that earnings from foreign operations will be indefinitely reinvested should be supported by projected working capital and long-term capital needs in the locations those earnings are generated (or other foreign locations), as well as an analysis of why those funds are not needed upstream. In addition, although companies have demonstrated their ability to indefinitely reinvest foreign earnings (e.g., positive cash flow from domestic operations, sufficient working capital and liquidity for both short-term and long-term domestic needs, the availability of debt or equity markets to provide funds for those domestic needs), declining market conditions may call into question a company's ability to continue to indefinitely reinvest foreign earnings.

We believe the evaluation of whether a company can initially assert indefinite reinvestment and whether it can maintain its assertion or no longer assert indefinite reinvestment involves the same considerations. The exception in ASC 740-30-25-17 related to the ability to remit earnings in a tax-free liquidation or on a tax-free basis requires a careful understanding of the specific facts and circumstances of the planned liquidation or remittance. In evaluating whether this exception is applicable, we believe that the ability must be within the company's control and presently available. That is, it is not contingent on some future action that is not completely under the company's unilateral control.

When a domestic parent company expects undistributed earnings of a foreign subsidiary to be partially or fully remitted in the foreseeable future, the domestic parent must provide deferred taxes on those earnings expected to be remitted in the foreseeable future in the period (annual or quarter) the determination changes. The initial recognition of deferred tax liabilities for accumulated and current earnings of foreign operations is reported as a component of income tax expense (benefit) from continuing operations.

ASC 740-30-50-2 requires additional disclosures if a deferred tax liability has not been recognized for temporary differences because of the indefinite reversal criteria of ASC 740-30. Refer to section 18.2.4, *Indefinite reversal and other exceptions*, for discussion of required disclosures.

14.3.1.1 Dividends received deduction (DRD) in the US

US companies are allowed to repatriate certain foreign source earnings without incurring additional US tax. Under US federal income tax laws, 100% of the foreign source portion of dividends paid by certain foreign corporations to a US corporate shareholder is exempt from US taxation. The dividend exemption does not apply to foreign income earned by a US corporation through foreign branches (including foreign corporations for which the company made check-the-box elections) or to gain on sales attributable to the appreciation of stock. However, the dividend exemption generally applies to gains on the sale of foreign stock attributable to the foreign subsidiary's earnings and profits (E&P).

A US company that has historically asserted indefinite reinvestment of its undistributed foreign earnings and expects not to incur US federal income tax liability after applying the 100% dividend received deduction upon repatriation of those earnings may decide to no longer continue to assert those earnings are indefinitely reinvested. However, a company should carefully consider the effects of other taxes, such as state and local income taxes, foreign withholding taxes or taxes associated with foreign exchange gains, that may be due upon distribution of those earnings (and would require deferred taxes to be provided) prior to changing its indefinite reinvestment assertion.

Questions and interpretative responses

Question 14-1 **What is indefinitely reinvested in a foreign subsidiary or foreign corporate joint venture?**

ASC 740-30-25-18 provides that a deferred tax liability is not recognized for an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. Further, ASC 740-30-25-19 notes that circumstances may change. As a result, it may become apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future.

Undistributed earnings often form a significant portion of the book-over-tax difference of an investment in a foreign subsidiary or foreign corporate joint venture (i.e., the outside basis difference). However, as noted in ASC 740-30-25-6(a), the exception can relate to "an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 740-30-25-17." As a result, companies need to consider the entire basis difference in the foreign subsidiary when evaluating this exception.

Question 14-2 **Do the terms "essentially permanent in duration" (ASC 740-30-25-18(a)), investment of "earnings indefinitely" (ASC 740-30-25-17), "indefinite postponement of remittances" (ASC 740-30-25-17) and "indefinite reversal criteria" (ASC 740-30-25-17) provide for similar application?**

Yes, ASC 740-30-25 uses different terms to describe the criteria required to overcome the presumption that the excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or foreign corporate joint venture will be transferred to the parent. However, ASC 740-30-25-17 generally describes these criteria as the indefinite reversal criteria, and we believe these terms (i.e., "essentially permanent in duration," "invest the undistributed earning indefinitely," "indefinite postponement of remittances") should be applied interchangeably.

Question 14-3 **If a company previously had a policy of indefinitely reinvesting foreign earnings, can it change its determination?**

Yes, the ASC 740-30 exception requires a company to continuously assert that those foreign undistributed earnings are indefinitely reinvested. We believe the evaluation of whether a company can initially assert indefinite reinvestment and whether it can maintain its assertion or no longer assert indefinite reinvestment involves the same considerations. If at any point a company is unable to make and support that assertion, those undistributed foreign earnings are no longer eligible for the indefinite reinvestment exception. While we do not expect a company to move in and out of indefinitely reinvested status (because doing so would call into question whether the company qualifies for the ASC 740-30 exception), we believe a significant event may represent a change in facts and circumstances that may trigger such a change in reinvestment assertion without calling into question past or future assertions regarding the company's intent and ability to reinvest indefinitely.

Question 14-4 **When and how should the income statement effect of a change in the indefinite reinvestment assertion be reflected?**

When a parent company no longer qualifies for the indefinite reinvestment exception in ASC 740-30, the parent must provide deferred taxes on those earnings in the period (annual or interim) the determination changes. If management changes its assertion as a result of identifiable events that occurred between the company's balance sheet date and the date the financial statements are issued, the change would represent a non-recognized subsequent event.

The initial recognition of deferred tax liabilities for accumulated and current earnings of foreign operations is reported as a component of income tax expense (benefit) from continuing operations. See section 20.2.1, *Income tax effects of a change in an indefinite reinvestment assertion*, for further details on reflecting changes in interim periods.

Question 14-5 **What if a company has not determined what portion of foreign earnings will be repatriated? Can the company default to a policy of indefinite reinvestment?**

No, ASC 740-30 includes a presumption that all undistributed earnings will be remitted to the parent in the foreseeable future. As a result, rather than defaulting to indefinitely reinvested, the company would default to repatriation of *all* foreign earnings and a related provision for income taxes attributable to those earnings. To overcome the presumption that *all* foreign earnings will be remitted in the foreseeable future, a company must maintain sufficient evidence of specific plans (e.g., past experience, working capital forecasts, long-term liquidity plans, capital improvement programs, merger and acquisition plans, investment plans) for reinvestment of the foreign operation's earnings such that the remittance of those earnings to the parent company will be postponed indefinitely.

The indefinite reinvestment plans should be consistent with actions a company is taking. For example, it would be inconsistent to assert a policy of indefinite reinvestment solely because a company had not yet calculated the amount of tax due on funds it plans to repatriate. Instead, in order to meet the requirements for indefinite reinvestment, a company would have to have specific plans and consistency in action supporting that reinvestment. The assertion that earnings from foreign operations will be indefinitely reinvested should be supported by projected working capital and long-term capital needs in the locations those earnings are generated (or other foreign locations), as well as an analysis of why those funds are not needed upstream. In addition, although companies have demonstrated their ability to indefinitely reinvest foreign earnings (e.g., positive cash flow from domestic operations, sufficient working capital and liquidity for both short-term and long-term domestic needs, and the availability of debt or equity markets to provide funds for those domestic needs), declining market conditions and favorable repatriation rates may call into question a company's ability and/or intent to continue to indefinitely reinvest foreign earnings.

Question 14-6 **Some companies have taken advantage of the ASC 740-30 exception but have not calculated the taxable temporary differences related to investments in foreign subsidiaries and corporate joint ventures (that are essentially permanent in duration) because calculating the amount was not practicable. What happens when the company is no longer indefinitely reinvesting all foreign earnings?**

There is no practicality exception available under ASC 740-30 if a company does not meet the criteria for indefinite reinvestment. As a result, a company must calculate and record any taxes that would be due upon repatriation.

See section 20.2.2, *Income tax effects of a change in an indefinite reinvestment assertion*, for further discussion of the income tax accounting effects when a company no longer asserts that an investment in a foreign subsidiary is indefinite.

On 21 December 2004, the FASB issued FSP FAS 109-2 (non-authoritative), which provided limited relief from the provisions of Statement 109 and APB 23 attributable to changes in a company's reinvestment decisions due solely to the American Jobs Creation Act of 2004. This was a limited exception that should not be applied by analogy to other situations.

The SEC issued Staff Accounting Bulletin (SAB) 118, *Income Tax Accounting Implications of the Tax Cuts and Jobs Act* (codified in ASC 740-10-S99-2A), which provided temporary relief to companies when their accounting for the enactment-date effects of TCJA was not complete in the period of enactment. SAB 118, among other things, provided temporary relief regarding the guidance in ASC 740-10-25-3 for providing deferred taxes on undistributed earnings of foreign subsidiaries and foreign corporate joint ventures, when a company changes its indefinite reinvestment assertion decision solely due to TCJA and could not finalize the tax liability on previously undistributed earnings. The FASB staff also issued a Staff Q&A that indicated that a private or not-for-profit entity applying SAB 118 would be in compliance with US GAAP. The guidance in SAB 118 or the FASB Staff Q&A should not be applied by analogy to other tax law changes.

Question 14-7 **Companies were required to pay taxes on previously undistributed earnings under the Tax Cuts and Jobs Act (TCJA) transition tax provisions. Does the transition tax create additional outside basis difference considerations regarding the indefinite reinvestment assertion?**

Generally, US corporations were required to include in income for each specified foreign subsidiary's last tax year beginning before 2018 their pro rata share of the net post-1986 historical earnings and profits (E&P) of each foreign subsidiary that had not been previously taxed. Under ASC 740-10-45-15, a company recognized the income tax accounting consequences of the one-time transition tax as a component of income tax expense from continuing operations in the period TCJA was enacted. Companies that recognized deferred taxes on undistributed foreign earnings prior to the enactment of the TCJA needed to adjust previously recognized deferred tax liabilities and consider the classification of the transition income tax payable. Companies that previously did not record deferred taxes related to undistributed earnings because they asserted those earnings were permanently reinvested can generally no longer assert indefinite reinvestment of those earnings for US federal income tax purposes.

After considering the effects of the transition tax on a foreign entity's outside basis difference, companies will still need to carefully evaluate each individual foreign investee to determine whether they can assert indefinite reinvestment of those earnings or whether they are required to recognize deferred tax liabilities related to outside basis differences.

The following are some of the matters related to outside basis differences that companies should consider when evaluating the need to provide deferred taxes on outside basis differences and whether the exceptions in ASC 740 apply:

Outside basis differences — The transition tax applies to post-1986 E&P. The outside basis difference related to post-1986 E&P may not equate to the entire outside basis difference related to an entity's investment in its foreign subsidiaries. The remaining outside basis difference will need to be examined to understand any federal, foreign or state taxes that could arise and whether the exceptions in ASC 740-30 related to indefinite reinvestment apply. In addition, companies will need to evaluate their intention for the reinvestment or continued reinvestment of E&P subject to the transition tax. There may be additional taxes (e.g., state, local, foreign, tax on foreign exchange gains) that would be due on these earnings, if they are remitted. Even in situations when future earnings of the foreign subsidiary may be subject to the 100% dividend exemption, companies will need to continue to evaluate their reinvestment intentions on future earnings and any other residual basis differences in order to determine whether they can continue to assert indefinite reinvestment or whether they will be required to provide for additional taxes that would be due on future earnings if they are remitted and/or the recognition of other basis differences.

Foreign taxes (e.g., withholding taxes) — Companies will still need to assess whether they can assert indefinite reinvestment of foreign earnings (including E&P subject to the one-time transition tax). Although a company will need to provide US taxes on E&P due to the one-time transition tax, it will need to evaluate whether it can continue to assert indefinite reinvestment of those earnings with respect to withholding taxes and other foreign income taxes that could potentially be assessed.

Gains on sale — Because gains from the sales of shares in a foreign investee are not eligible for the dividend exemption, companies need to separately track basis differences related to their investment balances and consider any intentions for disposal of a foreign investee.

State and local taxes — Companies will need to continue to assess their outside basis differences created by all book-to-tax differences and the state taxes that might apply. Companies should further understand the conformity rules in the states in which they operate so they can appropriately account for the effects on their state income taxes.

Question 14-8 **Does a going-concern uncertainty and/or bankruptcy filing affect a company's ability to assert indefinite reinvestment?**

When a going-concern uncertainty exists, or a company (or an entity's subsidiaries) has entered into bankruptcy, it may call into question the parent's ability to assert indefinite reinvestment of undistributed earnings in foreign subsidiaries or corporate joint ventures.

The level of uncertainty around a company's going concern (as defined by ASC 205, *Presentation of Financial Statements*) should be taken into consideration when determining whether management has the ability to assert indefinite reinvestment of foreign earnings. The higher the uncertainty, the less likely it will be that the company can settle its financial obligations without remitting undistributed foreign earnings. How a going-concern uncertainty affects management's assertion will depend on facts and circumstances.

Further when an entity enters bankruptcy, management may no longer have the ability to delay remittance of foreign earnings because the decision to remit these earning may be determined by the bankruptcy court or the trustee monitoring the company's bankruptcy proceeding.

14.3.1.2 Inside basis differences of foreign subsidiaries

While companies can have temporary differences within foreign subsidiaries (referred to as inside basis differences), as well as differences between the tax basis and the financial reporting basis of an investment in a foreign subsidiary (referred to as an outside basis difference), the ASC 740-30 exception only relates to outside basis differences.

Under ASC 740-30-25-17, the indefinite reversal criteria cannot be applied to inside basis differences of foreign subsidiaries and a deferred tax liability must be provided by the foreign subsidiary for the foreign subsidiaries' inside basis differences. It is important to note that ASC 740-10-25-24 acknowledges that although some temporary differences are deferred taxable income and have balances only on the income tax balance sheet (i.e., they don't relate to a particular financial reporting asset or liability), they are, nevertheless, temporary differences. Also, ASC 740-30-15-4 clearly limits the indefinite reversal criterion to the temporary differences described in ASC 740-30, and the guidance should not be applied by analogy to other types of temporary differences.

The following illustration reflects a company's inside basis difference resulted from a revaluation of its tax basis in fixed assets due to the effects of inflation.

Illustration 14-2: A foreign subsidiary's inside basis differences — Revaluation of tax basis due to inflation

Facts

- A US Parent company's Italian subsidiary, whose functional currency is the local currency, elects to restate its fixed assets for tax purposes to compensate for the effects of inflation.
  - The restatement increases the tax basis of fixed assets by $1 million with an offsetting credit to "revaluation surplus" under Italian tax law, which some view as a component of equity for tax purposes.
  - The $1 million credit to "revaluation surplus" in the income tax balance sheet is taxable in certain circumstances, such as in the event of a liquidation of the Italian subsidiary or if earnings associated with the revaluation surplus are distributed.
- There are no mechanisms available under Italian tax law to avoid eventual treatment of the revaluation surplus as taxable income.

Analysis

The $1 million inside basis difference related to the revaluation surplus results in taxable amounts in future years based on the provisions of the Italian tax law. Thus, it qualifies as a taxable temporary difference under ASC 740 even though it may be characterized as a component of equity for tax purposes. Accordingly, the ASC 740-30 exception cannot be used and a deferred tax liability is recognized in the period in which the restatement of fixed assets is recognized for tax purposes.

The reversal of the foreign subsidiary's inside basis difference, as discussed above, can result in additional taxation at the foreign subsidiary level and credits when the foreign subsidiary's accumulated earnings are remitted to the parent company. In the following illustration, temporary differences related to both inside and outside basis differences are considered. That is, the future tax consequences related to the reversal of the inside basis difference may be used as a partial offset to reduce the additional taxation that results from the parent's outside basis difference in its investment in the foreign subsidiary.

Illustration 14-3: Offsetting taxation from outside basis differences with inside basis differences

Assume that RST Corporation acquired all of the stock of AB Company, its only foreign subsidiary, in 20X0. Also, assume that (1) the parent's income tax rate is 30%, (2) the foreign income tax rate is 10%, (3) a foreign tax credit is provided against the parent's income taxes equal to 100% of the foreign tax liability, (4) there are no withholding taxes, (5) RST Corporation expects that all of AB Company's unremitted earnings will be remitted in the foreseeable future, and (6) the book and tax basis of RST Corporation's investment in AB Company were as follows at 31 December 20X2:

Book basis of investment in AB Company (i.e., book basis of stock), includes unremitted earnings of $2,000	$ 10,000	
Tax basis of the stock in AB Company	$ 8,000	
Book basis of net assets of AB Company	$ 10,000	
Tax basis of net assets of AB Company	$ 9,000	
Deferred tax liabilities would be recognized as follows:		
Inside basis difference of AB Company:		
Net assets book basis less tax basis ($10,000 – $9,000)	$ 1,000	
Foreign tax rate	10%	
Foreign deferred tax liability	$ 100	A
Outside basis difference:		
Stock book basis less tax basis ($10,000 – $8,000)	$ 2,000	
Parent's tax rate	30%	
	600	
Less: foreign tax credit (from above)	$ (100)	
Parent's deferred tax liability	500	B
Total consolidated deferred tax liability	$ 600	= A+B

This illustration includes many simplifying assumptions including the calculation of foreign tax credits. For example, this illustration does not consider a dividend received deduction or other aspects of a jurisdiction's tax law that may limit the benefit of foreign tax credits in the parent's tax jurisdiction. The calculation of foreign tax credits is extremely complex and will require the expertise of qualified tax professionals.

The illustration ignores the effects of foreign currency translation. See section 3.2.3, *Foreign currency differences*, for a discussion of the effects of foreign exchange rates.

14.3.2 Partial reinvestment

Management's decision to indefinitely reinvest foreign earnings is not an all-or-nothing determination. That is, a company can indefinitely reinvest a portion of accumulated foreign earnings and repatriate another portion of those earnings. If a company has both the intent and ability to indefinitely reinvest only a portion of the accumulated and future foreign earnings (i.e., repatriate only a portion the earnings of foreign operations), ASC 740-30-25-19 requires recognition of the deferred tax liabilities on the portion to be repatriated in the foreseeable future. In that case, the remaining undistributed foreign earnings (i.e., the indefinitely reinvested portion), would continue to be considered indefinitely reinvested and no deferred tax liabilities would be recognized.

14.3.2.1 Dividends

A company that asserts that earnings from foreign operations will be indefinitely reinvested may decide to pay dividends in the future from such operations. For example, a company decides to pay dividends in the future as a percentage (not to exceed 100%) of future earnings of the foreign operation. If there are no future earnings, there would be no dividends. We believe that a decision to pay (or actually paying) dividends based (and contingent) on future earnings of the foreign operation does not change the company's assertion related to previously undistributed earnings. Therefore, the company can continue to assert indefinite reinvestment of existing earnings that are not expected to be distributed in the future. However, taxes should be provided on future earnings that are not indefinitely reinvested.

If a company decides to pay future dividends regardless of future earnings (i.e., the company will pay dividends even if future earnings are not sufficient to fund the dividends), the company may no longer assert that existing earnings are indefinitely reinvested.

14.3.3 Other situations involving indefinite reinvestment

ASC 740-30-15-4 explicitly prohibits the application of the indefinite reinvestment exception to other temporary differences. That is, the criteria may not be applied to foreign partnerships, equity investments that are not corporate joint ventures (see section 14.3.4, *Foreign equity method investees and corporate joint ventures*), and inside basis differences or domestic subsidiaries (also see ASC 740-30-25-7).

For example, although reversal of a temporary difference related to LIFO inventories may be considered indefinite, within the control of management, and the present-value effect is negligible, companies nevertheless must provide deferred taxes on those differences, without any provision for discounting.

14.3.3.1 Change in ownership of investees and subsidiaries (before the adoption of ASU 2019-12)

Excerpt from Accounting Standards Codification

Income Taxes — Other Considerations and Special Areas

Recognition

740-30-25-15

An investment in common stock of a subsidiary may change so that it is no longer a subsidiary because the parent entity sells a portion of the investment, the subsidiary sells additional stock, or other transactions affect the investment. If the remaining investment in common stock shall be accounted for by the equity method, the investor shall recognize income taxes on its share of current earnings of the investee entity in accordance with the provisions of Subtopic 740-10. If a parent entity did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 740-30-25-17 (and the entity in which the investment is held ceases to be a subsidiary), it shall accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent that any of those undistributed earnings (prior to the change in status) will be remitted. The change in the status of an investment would not by itself mean that remittance of these undistributed earnings shall be considered apparent. If a parent entity recognizes a deferred tax liability for the temporary difference arising from its equity in undistributed earnings of a subsidiary and subsequently reduces its investment in the subsidiary through a taxable sale or other transaction, the amount of the temporary difference and the related deferred tax liability will change.

740-30-25-16

An investment in common stock of an investee (other than a subsidiary or corporate joint venture) may change so that the investee becomes a subsidiary because the investor acquires additional common stock, the investee acquires or retires common stock, or other transactions affect the investment. A temporary difference for the investor's share of the undistributed earnings of the investee prior to the date it becomes a subsidiary shall continue to be treated as a temporary difference for which a deferred tax liability shall continue to be recognized to the extent that dividends from the subsidiary do not exceed the parent entity's share of the subsidiary's earnings subsequent to the date it became a subsidiary.

Other Presentation Matters

Undistributed Earnings of Subsidiaries and Corporate Joint Ventures

740-30-45-3

If a parent entity did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 740-30-25-17 and the entity in which the investment is held ceases to be a subsidiary, paragraph 740-30-25-15 requires that it shall accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent that any of those undistributed earnings prior to the change in status will be remitted.

A company's investment in an investee may change from the equity method of accounting to consolidation and vice versa. As discussed in section 14.3.4, *Foreign equity method investees and corporate joint ventures*, the indefinite reinvestment exception under ASC 740-30 is only available to foreign subsidiaries (i.e., consolidated subsidiaries) and corporate joint ventures. As such, questions have arisen regarding the initial recognition of deferred taxes on the outside basis differences of consolidated investees that become equity method investees and the disposition of deferred taxes previously recognized on equity method investees that become consolidated subsidiaries. The table below summarizes the current guidance in ASC 740-30:

Change	Accounting considerations
Consolidated subsidiary → equity method investee	▸ *Foreign subsidiary's earnings previously asserted as indefinitely reinvested:* Accrue income tax expense in the period when it becomes apparent that they will be remitted. Note: The change in the status of an investment would not, by itself, mean that remittance of these undistributed earnings shall be considered apparent. ▸ *Domestic subsidiary's previous earnings*: Accrue income tax expense if the entity can no longer recover its investment tax-free. ▸ *Future earnings of both domestic and foreign investees*: Recognize income taxes on its share of earnings of the investee (e.g., the entity may no longer assert indefinite reinvestment on future earnings).
Domestic equity method investee → consolidated domestic subsidiary	▸ Eliminate previously recognized deferred tax liabilities if the entity can recover the investment tax-free and expects to use those means. See section 14.6.1.2, *Outside basis differences in equity method investees — applicable rate*, for additional discussion on domestic equity method investments.
Foreign equity method investee → consolidated foreign subsidiary	▸ Retain the deferred tax liabilities related to outside basis differences prior to gaining control even if the indefinite reversal criterion could apply to the unremitted earnings of the foreign subsidiary after the investee becomes a subsidiary.

It should be noted that the provisions of ASC 740-30-25-15 and ASC 740-30-25-16 only address the recognition and derecognition of deferred tax liabilities. See section 14.5, *Limitations on deferred tax assets for outside basis difference of foreign and domestic subsidiaries, corporate joint ventures and investees*, for further discussion of the recognition of deferred tax assets pursuant to ASC 740-30-25-9.

14.3.3.1A Change in ownership of investee and subsidiaries (after the adoption of ASU 2019-12)

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12, which simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the legacy guidance to promote more consistency. The amendments eliminate the exceptions to the general requirements for recognizing and not recognizing a deferred tax liability related to the outside basis differences that predate changes in ownership of equity method investments and foreign subsidiaries. Instead, the guidance will require entities to account for the tax effects of the entire outside basis difference that relate to an investment in which there is an ownership change as if the entity had always accounted for the investment based on the new ownership structure.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Early adoption is permitted in interim or annual periods for which all other entities (i.e., entities that are not PBEs) have not made financial statements available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply these amendments using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.

Excerpt from Accounting Standards Codification

Income Taxes — Other Considerations and Special Areas

Recognition

Ownership Changes in Investments

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

740-30-25-15

An investment in common stock of a subsidiary may change so that it is no longer a subsidiary because the parent entity sells a portion of the investment, the subsidiary sells additional stock, or other transactions affect the investment. If a parent entity did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 740-30-25-17 (and the entity in which the investment is held ceases to be a subsidiary), it shall accrue in the current period income taxes on the temporary difference related to its remaining investment in common stock in accordance with the guidance in Subtopic 740-10.

Other Presentation Matters

Undistributed Earnings of Subsidiaries and Corporate Joint Ventures

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

740-30-45-3

If a parent entity did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 740-30-25-17 and the entity in which the investment is held ceases to be a subsidiary, paragraph 740-30-25-15 requires that it shall accrue in the current period income taxes on the temporary difference related to its remaining investment in common stock in accordance with the guidance in Subtopic 740-10.

A change in a company's ownership interest in an investee may change the accounting for the investment from the equity method to consolidation or vice versa. ASC 740 requires the entity to account for the tax effects of the entire outside basis difference that relates to an investment in which there is an ownership change as if the entity had always accounted for the investment based on the new ownership structure.

As discussed in section 14.3.4, *Foreign equity method investees and corporate joint ventures*, the indefinite reinvestment exception under ASC 740-30 can only be applied to foreign subsidiaries (i.e., consolidated subsidiaries) and foreign corporate joint ventures. ASC 740-30-25-15 addresses the recognition of deferred taxes on the outside basis differences of consolidated subsidiaries that become equity method investees. That guidance requires that the entity recognize the income taxes on temporary differences related to its remaining investment in the current period. In addition, if an entity gains control of a foreign entity that it previously accounted for under the equity method, it should account for the tax effects of the outside basis difference as if the entity were always a consolidated subsidiary. That is, a company applies the guidance in ASC 740-30-25-17 and recognizes a deferred tax liability unless the parent asserts its intent and has the ability to postpone remittance of all or part of its net investment (including earnings) indefinitely (i.e., is essentially permanent in duration). The table below summarizes the current guidance in ASC 740-30:

Change	Accounting considerations
Consolidated subsidiary → equity method investee	▸ *Foreign subsidiary's earnings previously asserted as indefinitely reinvested:* Accrue income tax expense in the period when it becomes apparent that they will be remitted. ▸ *Domestic subsidiary's previous earnings:* Accrue income tax expense if the entity can no longer recover its investment tax-free. ▸ *Future earnings of both domestic and foreign investees*: Recognize income taxes on its share of earnings of the investee (e.g., the entity may no longer assert indefinite reinvestment on future earnings).
Domestic equity method investee → consolidated domestic subsidiary	▸ Eliminate previously recognized deferred tax liabilities if the entity can recover the investment tax-free and expects to use those means. See section 14.6.1.2, *Outside basis differences in equity method investees — applicable rate*, for additional discussion on domestic equity method investments.
Foreign equity method investee → consolidated foreign subsidiary	▸ Eliminate previously recognized deferred tax liabilities if available recognition exceptions (e.g., assert indefinite reinvestment) could apply to the outside basis difference.

It should be noted that the provisions of ASC 740-30-25-15 only address the recognition and derecognition of deferred tax liabilities. See section 14.5, *Limitations on deferred tax assets for outside basis difference of foreign and domestic subsidiaries, corporate joint ventures and investees*, for details on the recognition of deferred tax assets pursuant to ASC 740-30-25-9.

14.3.4 Foreign equity method investees and corporate joint ventures

Excerpt from Accounting Standards Codification

ASC Master Glossary

Corporate Joint Venture

A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

Other Considerations or Special Areas

Overview and Background

740-30-05-6

Corporate joint ventures are of two kinds: those essentially permanent in duration and those that have a life limited by the nature of the venture or other business activity.

740-30-05-7

Unless characteristics indicate a limited life, a corporate joint venture has many of the characteristics of a subsidiary. The investors usually participate in the management of the joint venture, consider the factors set forth in paragraph 740-30-05-4, and agree (frequently before forming the venture) as to plans for long-term investment, for utilizing the flexibility inherent in the U.S. Internal Revenue Code, and for planned remittances.

Recognition

Undistributed Earnings of Subsidiaries and Corporate Joint Ventures

740-30-25-4

The principles applicable to undistributed earnings of subsidiaries in this Section also apply to tax effects of differences between **taxable income** and pretax accounting income attributable to earnings of corporate joint ventures that are essentially permanent in duration and are accounted for by the equity method. Certain corporate joint ventures have a life limited by the nature of the venture, project, or other business activity. Therefore, a reasonable assumption is that a part or all of the undistributed earnings of the venture will be transferred to the investor in a taxable distribution. Deferred taxes shall be recorded, in accordance with the requirements of Subtopic 740-10 at the time the earnings (or losses) are included in the investor's income.

The ASC 740-30 exception for undistributed earnings of foreign subsidiaries and foreign corporate joint ventures does not apply to 50% or less owned investees that are not corporate joint ventures as defined in the ASC Master Glossary if the investor owns 50% or less of the investee. That is, the exception does not apply to jointly owned corporations that do not meet this definition (even if they can block dividends) or non-corporate joint ventures. The corporate joint venture exception is only intended to apply when the venture partners can control whether funds are indefinitely reinvested. In that regard, companies are required to provide deferred taxes for temporary differences related to all foreign investments accounted for using the equity method, other than foreign subsidiaries or foreign corporate joint ventures.

See discussion in section 15.2, *Income tax expense (benefit) allocated to continuing operations — the incremental approach*, for income statement presentation considerations related to equity method investments.

14.3.5 Recognizing deferred tax liabilities when a company does not assert indefinite reinvestment

When the exceptions to recognizing a deferred tax liability provided by ASC 740 are not applicable, a company must recognize a deferred tax liability for the identified outside basis differences. Following the measurement guidance in ASC 740-10, the deferred tax liability is measured using the enacted tax rates expected to apply to taxable income in the period in which the taxable temporary difference is expected to reverse (see section 5.1, *Applicable tax rates*, for further guidance).

All provisions of the enacted tax law are to be considered when a company has not asserted indefinite reinvestment. Certain foreign jurisdictions tax corporate income at different rates depending on whether that income is distributed to shareholders. The distributed income rate should be used by a foreign subsidiary to measure inside basis differences when the parent has not asserted the earnings of a foreign subsidiary are indefinitely reinvested (i.e., when an exception to recognizing the deferred tax liability does not apply). See section 5.3.1, *Rate differences between distributed and undistributed earnings (including subsidiary divided paid tax credits)*, for further information.

Additionally, deferred tax liabilities related to an investor's outside basis difference in the subsidiary are measured using enacted tax rates applicable to capital gains, ordinary income and so forth, based on the expected nature of taxable income upon reversal. Computation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related DRDs or foreign tax credits, as well as taxes that would be withheld from the dividend. Refer to section 5.3, *Dividends received deductions*, for further guidance.

14.3.6 Foreign operational structures

A company can make export sales, provide services, license technology or lease tangible property to unrelated dealers or customers outside its domestic market without establishing a branch or affiliated business entity in a foreign market. The principal advantage of exporting without establishing a local presence is that it is the simplest means of entering a foreign market. The principal disadvantage is that the company may be operating with a competitive handicap in developing the local market if its activities are restricted to export transactions without an established local presence. Thus, as a foreign market develops, a company will frequently seek to establish a local presence to better take advantage of business opportunities.

14.3.6.1 Branch offices

A foreign branch is part of the US corporate legal entity, even though it is physically located in the foreign country. From a business perspective, a "branch" can be described as anything from a sales office with just a few people to an immense manufacturing operation. From a tax perspective, a "foreign branch" describes an "integral business operation carried on by a US person outside of the United States." In addition, a wholly owned foreign subsidiary may elect to be treated as a disregarded entity for tax purposes and to be subject to tax like a branch. A branch will often be subject to tax in both the US and the foreign jurisdiction where the branch operations are located. While branch structures exist under US tax law, similar structures may exist under foreign jurisdictions' tax laws. The guidance and illustrations below focus on a US taxpayer but should be considered when evaluating similar structures that may exist in non-US jurisdictions.

Although the activities of branch operations are generally more substantial than simply exporting into the foreign market, the business advantage of operating in branch form is simplicity. That is, it gives an entity a local presence in the foreign market through an establishment that is likely less complex than forming a separate legal entity such as a corporation or partnership.

The US corporation's major tax concern in operating a foreign branch is avoiding double taxation. The branch's activities in the foreign country are often significant enough that, unless the branch qualifies for tax incentives under foreign law, the corporation's branch profits will be subject to foreign taxation. Because the legal entity doing business in the foreign market is still part of a US corporation, the branch profits will also be subject to US taxation. For most branches, two tax provisions will need to be computed. The first is a foreign tax provision with temporary differences based on the difference between the book basis and tax basis in the foreign jurisdiction. The second is a US tax provision with temporary differences based on the book and tax basis in the US.

The US entity (or parent) should also record deferred taxes for the US tax effects of the deferred tax assets and liabilities related to the foreign branch if they give rise to a temporary difference. For example, when there is a taxable temporary difference for a foreign branch that upon reversal will increase the taxes paid in the foreign jurisdiction it may give rise to foreign tax credits (or deductions) in the US that will be used to reduce its US taxes. In this case, the deferred tax liabilities related to the foreign branch will result in a deferred tax asset being recorded by the US parent (i.e., the deferred benefit of the future tax credits), and this deferred tax asset would need to be assessed for realizability. When a foreign branch has deductible temporary differences that upon reversal will reduce the foreign taxes paid, the reversal of that deductible difference may increase the US entity's tax payable due to foreign tax credits being displaced from the use of the deferred tax assets related to the foreign branch. This concept is similar to the treatment of state income taxes as discussed in ASC 740-10-55-20.

Because the branch is subject to taxation as a portion of a US corporation, the indefinite reinvestment exceptions in ASC 740-30 are generally not applicable to branches or wholly owned subsidiaries that elect to be treated as disregarded entities for US tax purposes. However, the exceptions under ASC 740-30 may still apply to other taxes due on distributions of earnings (e.g., foreign withholding taxes, possibly certain state taxes if the entity is treated differently for state income and federal income tax purposes).

A foreign branch may operate at a loss. For US tax purposes, while the foreign branch losses may be generating net operating loss carryforwards in the foreign tax jurisdiction, the foreign branch losses generally reduce taxable income in the US for the parent. When it is more likely than not that the deferred tax asset in the foreign tax jurisdiction will be realized, questions often arise about whether the entity is entitled to recognize a double tax benefit on the loss (i.e., current US tax deduction and the tax benefit from the foreign deferred tax asset).

To realize the benefit of the foreign branch loss, the foreign branch must have future taxable income. This future taxable income in the foreign jurisdiction also will be future taxable income for the US parent. However, the future taxable income in the foreign jurisdiction may be fully offset by using the existing foreign net operating losses. As a result, no foreign taxes will be paid, and no foreign tax credits are generated.

In general, it is not appropriate to recognize a double tax benefit. Thus, if the foreign branch loss is recognized in the US by the parent (either as a current reduction of US taxable income or as a branch deferred tax asset) *and* a foreign deferred tax asset is recognized for the foreign tax jurisdiction (for the NOL carryforward) because the foreign branch is relying on projections of future taxable income, a deferred tax liability (or reduction of the branch deferred tax asset) generally should be recognized in the US by the parent in an amount equal to the lesser of the tax benefit realized by the US parent from the foreign branch's losses or the deferred tax asset recorded for the foreign branch (i.e., the NOL carryforward). However, if there is a full valuation allowance recorded for the foreign branch's deferred tax assets, it would not be appropriate for the US entity to record a deferred tax liability (or reduction of the branch's deferred tax asset). See illustrations 14-6, 14-6A and 14-7 below.

Many branches have a different functional currency from the parent's reporting currency, which gives rise to a cumulative translation adjustment (CTA). Because a branch has attributes of both a foreign and domestic subsidiary, questions often arise about whether a company needs to account for taxes related to a CTA or whether an indefinite reinvestment assertion[40] can be made for a deferred tax liability associated with the CTA (if the indefinite reinvestment requirements can be met). We understand that both views may exist in practice.

The following illustrations reflect the deferred tax accounting related to branch temporary differences. The accounting for foreign tax credits is complex and requires a careful consideration of both the tax law and the realization of the tax credits that would be generated. These examples illustrate when a US entity (or parent) records deferred taxes for the US tax effects of the deferred tax assets and liabilities related to a foreign branch if they give rise to a temporary difference as discussed above and may not show alternative approaches used in practice.

Illustration 14-4: Branch with taxable income — US tax rate higher than branch's local tax rate

Facts

- Company JAC (US Parent) has a branch in Country Y, which has a lower local tax rate than Company JAC's US rate.
- The US income tax rate is 21%.
- The branch's statutory tax rate is 15%.
- Foreign taxes paid to Country Y will be fully creditable by Company JAC in the US.
- Company JAC operates a single foreign entity.
- In the current year, two temporary differences exist at the branch level for both jurisdictions:

  (1) a bad debt reserve of $400

  (2) a book in excess of tax basis in fixed assets of $600

To simplify this example, ignore the effect of state or local taxes on deferred amounts.

Analysis

Because the branch is subject to taxation in Country Y and in the US, the deferred tax provision related to each jurisdiction is computed separately. In Country Y, the net taxable temporary difference of $200 ($600 less $400) results in a foreign deferred tax liability (DTL) of $30 ($200 X 15%). Company JAC records a DTL of $42 ($200 X 21%) for the US deferred tax provision based on temporary differences between the book basis and US tax basis.

Additionally, when considering the net US DTL amount to be recorded, Company JAC will take into account the availability of foreign tax credits as result of the additional foreign taxes to be paid in Country Y when Country Y's DTL is settled. The US DTL will be reduced by $30 (equal to Country Y's DTL) to reflect the future US tax effects of the foreign tax credits that will arise when Country Y's DTL reverses.

[40] If the temporary difference associated with the CTA represents a deferred tax asset, the reporting entity would determine whether the deferred tax asset would reverse in the foreseeable future.

Country Y		
Nondeductible bad debt reserve	$ 400	
Book in excess of tax basis of fixed assets	(600)	
Net taxable temporary difference	(200)	
Statutory tax rate	15%	
Country Y net branch DTA/(DTL)		($ 30)
Company JAC (US parent)		
Nondeductible bad debt reserve	$ 400	
Book in excess of tax basis of fixed assets	(600)	
Net future taxable temporary difference	(200)	
Statutory tax rate	21%	
Company JAC net branch DTA/(DTL)		($ 42)
DTA on Country Y DTL (additional tax credits expected upon reversal of Country Y's DTL)		30
Net US DTA/(DTL)		($ 12)
Total DTA/(DTL)		($ 42)

Illustration 14-4A: Branch with taxable income: US tax rate lower than branch's tax rate

Company JAC (US Parent) has a branch in Country Y, which has a local tax rate greater than Company JAC's US rate. Assume the same facts as in Illustration 14-4 except that the branch's statutory tax rate is 30%.

Because the branch is subject to taxation in Country Y and the US, the deferred tax provision related to each jurisdiction is computed separately. In Country Y, the net taxable temporary difference of $200 ($600 less $400) results in a foreign net deferred tax liability (DTL) of $60 ($200 X 30%). Company JAC records a DTL of $42 ($200 X 21%) for the US deferred tax provision based on temporary differences between book basis and US tax basis. Additionally, Company JAC will need to record the deferred tax effects of deferred tax assets and liabilities in Country Y and take into account the availability of FTCs as result of the additional foreign taxes that arise when the net DTL in Country Y is settled.

In this example, because the branch in Country Y is the only foreign branch operated by Company JAC, Company JAC will likely only be able to benefit from the FTCs up to its US tax liability. Therefore, in this situation, it is appropriate to limit the deferred tax asset recognized by Company JAC on the DTL in Country Y to the amount of US taxes that can be offset by the FTC ($42 in this example).

Country Y		
Nondeductible bad debt reserve	$ 400	
Book in excess of tax basis of fixed assets	(600)	
Net taxable temporary difference	(200)	
Statutory tax rate	30%	
Country Y net branch DTA/(DTL)		($ 60)
Company JAC (US parent)		
Nondeductible bad debt reserve	$ 400	
Book in excess of tax basis of fixed assets	(600)	
Net future taxable temporary difference	(200)	
Statutory tax rate	21%	
Company JAC net branch DTA/(DTL)		($ 42)
DTA on Country Y DTL (additional tax credits expected upon reversal of Y's DTLs)		42
Net US DTA/(DTL)		$ -
Total DTA/(DTL)		($ 60)

It may be appropriate, in certain circumstances, to recognize additional US deferred tax assets for the future tax credits that may arise when the deferred tax liability in Country Y reverses. In this example, Company JAC may be able to increase its deferred asset on the deferred tax liability in Country Y up to an additional $18 to recognize the benefit of future tax credits (the deferred tax liability in Country Y of $60 less Company JAC's deferred tax liability of $42). This would be the case if, for example, Company JAC has other foreign branch operations/subsidiaries that have recorded deferred tax liabilities in jurisdictions with tax rates lower than the US that would allow it to use the additional FTCs that would be generated upon reversal of the DTL in Country Y.

However, the amount of additional deferred tax asset recorded by the US entity for the anticipated future FTCs should not exceed the total US tax that would arise from the reversal of the branches' taxable temporary differences. A company that records an additional branch DTA on the DTL in Country Y ($18 in this example) because it considers the reversal of taxable temporary differences in other branches located in lower tax jurisdictions should carefully evaluate the deferred tax asset for realizability.

We understand that another approach exists in practice when a US parent does not have the ability to fully use the FTCs that will arise when the deferred tax liabilities recorded for its branch's taxable temporary differences reverse. Under this approach, the US parent will record a deferred tax asset equal to the full amount of the FTCs that would arise from the deferred tax liabilities recorded for the branch's taxable temporary differences. In this case, the US parent would record a valuation allowance against its deferred tax asset when it is more likely than not that all or a portion of the deferred tax asset will not be realized. This alternative approach is applied in situations when the US parent operates only one branch or when it operates multiple branches. In the example above, if Company JAC applied the alternative approach it would record a deferred tax asset for $60 with an offsetting valuation allowance of $18 or a net deferred tax asset of $42. We believe this approach is also acceptable.

Illustration 14-5: Branch with taxable income and NOL carryforwards — US tax rate higher than branch's local tax rate

Assume the same facts as in Illustration 14-4 except the branch in Country Y has previously recognized net operating loss carryforwards that will be used to offset the future tax liability in Country Y when the foreign DTL is settled. Consequently, the branch does not expect to pay foreign taxes in Country Y to settle the foreign DTL. When measuring the US DTL, no adjustment is made for foreign tax credits or deductions that are not available due to use of net operating loss carryforwards.

A total DTL of $72 ($42 plus $30) is recognized. The lack of foreign tax credits or deductions affects the effective tax rate related to the deferred tax effect of current year originating temporary differences.

This would be the same as in Illustration 14-4A, but the total DTL would be $102 ($42 plus $60).

Illustration 14-6: Branch with losses — US tax rate higher than branch's local tax rate

Company JAC operates a branch in Country Z, which has a lower tax rate than Company JAC's US rate. The statutory tax rate in Country Z is 20%. Company JAC's statutory tax rate is 21%. During 20X2, the branch in Country Z incurred a taxable loss of $100, and Company JAC reported taxable profits of $500 (not including the branch taxable loss in Country Z). The branch taxable loss in Country Z resulted in a $20 deferred tax asset for an NOL carryforward. A valuation allowance is not required on the deferred tax asset in Country Z.

US taxable income before foreign branch loss	$ 500	
Country Z branch taxable loss	(100)	
Total taxable income	400	
US federal tax rate	21%	
US current tax before foreign tax credit		84
Foreign tax credit		-
US current tax after foreign tax credit		84
US deferred tax expense related to Country Z branch NOL (Note 1)		20
Total US tax expense		$ 104
Country Z branch taxable loss	($ 100)	
Country Z's tax rate	20%	
Country Z branch tax benefit		($ 20)
Consolidated tax expense		$ 84

Note 1

This amount represents the tax consequences of future taxable income reported in the US with no FTC to offset US tax due to branch utilization of net operating loss carryforwards. In this example, the branch in Country Z expects to have future taxable income of $100 in order to use the NOL carryforward. When the branch in Country Z uses its NOL, it displaces the FTCs that would have otherwise been available to reduce the US taxes due on that income ($100*21% = $21). Because the parent's tax rate is higher than the branch's tax rate, the DTL recorded by the parent would be limited to the DTA for the foreign branch, or $20 in this example (i.e., the displaced foreign tax credits would not be greater than the foreign tax on those earnings).

Illustration 14-6A: Branch with losses and a full VA required on the NOL carryforward — US tax rate higher than branch's local tax rate

Assume the same facts as in Illustration 14-6, except a full valuation allowance is required on the deferred tax asset in Country Z.

US taxable income before foreign branch loss	$ 500	
Country Z branch taxable loss	(100)	
Total taxable income	400	
US federal tax rate	21%	
US current tax before foreign tax credit		84
Foreign tax credit		-
US current tax after foreign tax credit		84
US deferred tax expense related to Country Z branch NOL		-
Total US tax expense		$ 84
Country Z branch taxable loss	($ 100)	
Country Z's tax rate	20%	
Country Z branch tax benefit		(20)
Valuation allowance on DTA NOL	20	
Net deferred tax expense/(benefit)	$ -	
Consolidated tax expense		$ 84

Illustration 14-7: Branch with losses — US tax rate lower than the branch's local tax rate

Company JAC operates a branch in Country Z. Assume the same facts as in Illustration 14-6 except the statutory tax rate in Country Z is 30%. The branch taxable loss in Country Z resulted in a $30 deferred tax asset. A valuation allowance is not required on the deferred tax asset for Country Z.

US taxable income before foreign branch loss	$ 500	
Country Z branch taxable loss	(100)	
Total taxable income	400	
US federal tax rate	21%	
US current tax before foreign tax credit		84
Foreign tax credit		-
US current tax after foreign tax credit		84
US deferred tax expense/DTL related to Country Z branch NOL (Note 1)		21
Total US tax expense		$ 105
Country Z branch taxable loss	($ 100)	
Country Z's tax rate	30%	
Country Z branch tax benefit		($ 30)
Consolidated tax expense		$ 75

Note 1

This amount represents the tax consequences of future taxable income reported in the US with no foreign tax credit to offset US tax due to the branch's use of its net operating loss carryforward. In this example, the branch in Country Z expects to have future taxable income of $100 in order to use the NOL carryforward. When the branch in Country Z uses its NOL, it displaces the foreign tax credits that would have otherwise been available to reduce the US taxes due on that income ($100*21% = $21). Therefore, since Company JAC's tax rate is lower than the tax rate in Country Z, the branch DTL recorded by Company JAC on the DTA in Country Z would be limited to Company JAC's tax rate ($100*21%). Companies would need to consider the interaction with foreign tax credits and earnings and losses in other jurisdictions to determine whether it is appropriate to establish a DTL at a rate other than 21% in this example.

If the branch in Country Z was not expected to benefit from an NOL carryforward and a full valuation allowance was recorded against the NOL, it would not be appropriate for Company JAC to record a deferred tax liability. See Illustration 14-6A.

14.3.6.2 Accounting for GILTI in deferred taxes

In the FASB staff Q&A on accounting for GILTI,[41] the staff noted that companies could either (1) account for taxes on GILTI as period costs, similar to special deductions, or (2) recognize deferred tax assets and liabilities when basis differences exist that are expected to affect the amount of the GILTI inclusion when the basis differences reverse. Questions have arisen about how companies that elect an accounting policy to recognize deferred taxes for GILTI-related temporary basis differences should measure those deferred taxes.

The GILTI inclusion[42] is based on the aggregate activities of all of a US shareholder's pro rata share of the tested items (e.g., tested income or tested loss) of each CFC, not just the activity of individual CFCs. Additionally, under the tax law, the GILTI inclusion is contingent on future events (e.g., future foreign

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[41] FASB staff Q&A, Topic 740, No. 5, *Accounting for Global Intangible Low-Taxed Income*.

[42] The discussion of the GILTI tax law considers final 951A regulations issued by the US Treasury on 14 June 2019. However, entities should continue to monitor related regulatory developments on laws enacted or amended with the TCJA.

income and the amount of the net deemed tangible income return on qualified business asset investments (QBAI)). Further, the GILTI inclusion may give rise to a deduction under Section 250(a)(1)(B) for up to 50% of the GILTI inclusion, referred to as the GILTI deduction.[43] As a result, questions have arisen about whether GILTI-related deferred taxes should be measured (1) based on looking through to the inside basis differences of each CFC, (2) only to the extent that a taxable outside basis difference exists on a particular CFC or (3) by using another approach.

The FASB staff and the SEC staff have indicated in discussions that the two-step model described below is consistent with the framework of ASC 740[44] and would be an acceptable approach when electing an accounting policy to account for GILTI in deferred taxes. However, because it's unclear how entities should apply the guidance in ASC 740 to account for GILTI in deferred tax accounting, other acceptable approaches for measuring deferred taxes for GILTI may exist. A company that applies the model described below or another acceptable model should apply that method consistently.

The approach discussed with the FASB staff and the SEC staff focuses on how a US shareholder would expect to recover its investment in the CFC.

Under ASC 740, a temporary difference arises when events have been recognized in the financial statements but will result in taxable or deductible amounts in future years based on provisions of the current tax law. Therefore, a company that elects a policy to recognize deferred tax assets and liabilities related to the future GILTI inclusion and applies the two-step model would only recognize deferred tax balances for GILTI when it expects a GILTI inclusion in its taxable income for the foreseeable future. In other words, a company applying this model would not record deferred tax balances for GILTI if, for example, it expects its CFCs to incur net losses or it expects to have enough net deemed tangible income return to reduce the GILTI inclusion to zero for the foreseeable future (see the discussion below on the calculation of GILTI income). As noted above, a company would need to make the determination as to whether it expects a GILTI inclusion for the foreseeable future for each US shareholder in its structure, taking into account necessary adjustments related to US shareholders that are members of the same consolidated group for US tax purposes.

A company that determined that it expects a GILTI inclusion in its taxable income for the foreseeable future could measure deferred taxes using the following two-step model.

Step 1	**Look through** each CFC to the underlying recorded assets and liabilities
Step 2	Determine whether a **residual outside basis** difference exists

The two-step model recognizes that part of the basis difference will reverse through ordinary operations (i.e., the look-through concept). It also recognizes that the residual outside basis difference, if any, may not result in a future GILTI inclusion (e.g., if income was earned prior to 1987) or may reverse in a sale, distribution or liquidation (i.e., the outside basis concept). In some cases, the entire reversal of the residual outside basis difference or a portion of it may not be subject to tax.

Step 1: Look through each CFC to the underlying recorded assets and liabilities

A US shareholder would first identify and measure the inside temporary basis differences by comparing the carrying amount with the tax basis (measured under US tax law) of the assets and liabilities held by each CFC. Once these items are identified, the US shareholder would assess which of those temporary

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[43] The Section 250 deduction for GILTI is reduced to 37.5% of the GILTI inclusion for taxable years beginning after 31 December 2025.

[44] This discussion focuses on US federal tax law. Similar considerations would apply for state tax law purposes in states that conform to the US federal tax GILTI provisions.

differences, when realized, would be expected to affect the GILTI inclusion.

For any inside temporary basis difference that is expected to affect the GILTI inclusion when realized, a US shareholder would measure the tax effects of those differences, considering the effects of a GILTI-related deduction or other adjustments (e.g., Section 250(a)(1)(B) or other adjustments such as QBAI return, both of which are discussed in further detail below).

A US shareholder will then recognize the deferred tax consequences of anticipated US FTCs for each CFC's local deferred tax balances (generally limited to 80% of the CFC's local deferred tax balances multiplied by the ratio of the GILTI inclusion over the aggregate income of related CFCs (excluding CFCs with losses) and subject to additional limitations under the tax law).

For any recognized deferred tax assets for GILTI, a realizability assessment would be required under ASC 740-10-30-17. Refer to section 6.4.5, *Accounting considerations for the effect of GILTI on the realizability of US federal DTAs*, for additional considerations related to GILTI and the realization of US deferred tax assets and NOL carryforwards.

Step 2: Determine whether a residual outside basis difference exists

After determining the temporary inside basis differences that upon their reversal will generate GILTI, a US shareholder will determine whether a residual outside basis difference exists. A residual outside basis difference for US federal purposes may exist when a portion of the outside basis will affect future US federal taxes but does not relate to the inside basis differences that upon reversal will affect the amount of GILTI inclusion in future periods. Any residual outside basis difference that does not relate to the underlying recorded assets and liabilities would be subject to the guidance and exceptions in ASC 740-30-25 for outside basis differences.

When using this approach, a company will not be able to look to the exceptions for recording deferred taxes in ASC 740-30-25 for the portion of the temporary difference that upon reversal affects the GILTI inclusion.

Additionally, under this approach, when a company is subject to GILTI, deferred taxes will be recognized for the future GILTI effect of the inside basis differences even if the outside book and tax basis are the same, and thus, the net outside basis difference is zero. This would be the same if the outside tax basis exceeds the outside book basis.

The following illustration shows an example of how this model would be applied in a simple situation.

Illustration 14-8: Two-step model when accounting for GILTI in deferred taxes

Facts

Assume that a US shareholder looks through each CFC to the underlying recorded assets and liabilities and identifies an inside taxable temporary difference of $500 that is expected to reverse into a $500 GILTI inclusion in the future. The company would record deferred taxes related to the $500 taxable temporary difference, regardless of whether an outside basis difference exists (i.e., even if the outside book and tax basis are the same or the outside basis difference is less than $500).

Also assume that after determining the $500 taxable temporary difference, no overall outside basis temporary difference exists (i.e., the outside basis difference is zero).

Analysis

The US shareholder would still need to determine whether a residual outside basis difference exists after determining the $500 taxable temporary difference. In this situation, the outside basis difference can be separated into the following two components:

- Taxable temporary inside basis difference of $500 that upon reversal will affect future GILTI

- Residual deductible outside basis difference of $500 that will not reverse in the ordinary course of business (e.g., a future sale or liquidation)

While the taxable temporary inside basis difference will reverse in the ordinary course of business and affect the future GILTI inclusion, the residual deductible outside basis difference will need to be further analyzed under ASC 740-30-25-9 to determine whether a deferred tax asset can be recognized.

Note: The above illustration is a simplified example of when the effects of GILTI deferred taxes and residual outside basis difference net to zero. In other situations, the overall outside basis difference could result in a net deferred tax asset or liability. In these cases, a company would still need to determine whether a residual outside basis difference exists and then determine whether the exceptions to recording outside basis differences are available under ASC 740-30-25-3 or ASC 740-30-25-9.

Overview of GILTI

The following discussion includes a high-level summary of how the GILTI inclusion is measured under US tax law. The discussion and illustrations that follow include many simplifying assumptions. The calculation of GILTI is extremely complex, depends on a company's facts and circumstances, and likely will require the involvement of experienced tax professionals.

The following discussion provides a high-level summary of how the GILTI inclusion is calculated.

$$\text{GILTI} = \underbrace{\text{Net CFC tested income}}_{\text{Tested income} - \text{Tested loss}} - \underbrace{\text{Net deemed tangible income return}}_{\text{10\% of QBAI} - \text{Specified interest expense}}$$

As mentioned above, pursuant to US tax law, a US shareholder of a CFC must include in its gross taxable income its GILTI for each taxable year, generally in a manner similar to Subpart F income. A US shareholder's GILTI for any taxable year equals, on an aggregate basis of all CFCs, the excess, if any, of its net CFC-tested income (tested income[45] less tested losses[46]) over its net deemed tangible income return for such taxable year. A company that has a net CFC tested loss for the period cannot carry forward the tested loss to reduce GILTI-tested income in a future period.

Net deemed tangible income return with respect to any US shareholder is the excess, if any, of:

(1) 10% of the aggregate of the shareholder's pro rata share of the QBAI of each CFC with tested income (QBAI of CFCs with tested losses are excluded) over specified interest expense, over

(2) specified interest expense, which is the excess (if any) of (3) the aggregate US shareholder's pro rata share of tested interest expense, over (4) the aggregate US shareholder's pro rata share of tested interest income.[47]

QBAI equals the CFC's average aggregate adjusted bases for specified depreciable tangible property

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[45] The tax law defines the tested income of a CFC as the excess (if any) by which (1) exceeds (2), if any: (1) the CFC's gross income for that year, excluding certain categories of income taxed in the US under historical provisions such as effectively connected income, Subpart F, gross income excluded under an elective high-tax exclusion/exception, dividends received from certain related persons, and certain foreign oil and gas extraction income, (2) the deductions (including taxes) properly allocable to such tested gross income.

[46] The tax law defines the tested loss of a CFC as the excess (if any) of the deductions (including taxes) properly allocable to the corporation's gross income determined without regard to the tested income exceptions over the amount of such gross income.

[47] Broadly, tested interest expense means interest expense paid or accrued by a CFC that is taken into account to determine the tested income or tested loss of that CFC, reduced by the CFC's qualified interest expense. Tested interest income means interest income included in the CFC's gross tested income, reduced by the CFC's qualified interest income.

(i.e., tangible property used in the production of tested income) during the taxable year, which should be calculated using the measurement rules included in the tax law.

US tax law also provides the US shareholder with:

- A deduction (Section 250(a)(1)(B) deduction) for up to 50% of GILTI through 2025 and up to 37.5% of GILTI for taxable years beginning after 31 December 2025
- A deemed paid FTC of up to 80% of foreign taxes paid and properly attributable to GILTI income with a deemed dividend inclusion equal to the full amount of foreign taxes deemed paid (Section 78 gross-up). However, unused FTCs associated with GILTI cannot be carried forward or back or used against other foreign source income

Refer to section 5.9.1, *Foreign-derived intangible income incentive*, for additional considerations related to the interaction with the FDII deductions.

Considerations for measuring GILTI deferred taxes

Because of the complexity of the GILTI measurement, there are additional accounting considerations for measuring deferred taxes related to temporary differences affecting the GILTI inclusion, as explained in the sections below.

Net deemed tangible income return

Questions exist regarding how the net deemed tangible income return should be considered in the measurement of deferred taxes related to GILTI. Based on discussions with the FASB staff and SEC staff, the following two methods are consistent with the accounting framework of ASC 740 when a company applies the two-step model discussed above:

- A company may account for the net deemed tangible income return in the period it arises; hence, the treatment would be analogous to a special deduction.
- A company may account for the net deemed tangible income return in measuring the deferred taxes related to a temporary difference that would be included in the future GILTI calculation. Under this approach, the GILTI inclusion is assumed to be taxed at a 0% tax rate up to the net deemed tangible income return and any amount greater than the net deemed tangible return would be subject to GILTI tax. This treatment would be analogous to a 0% tier in a graduated GILTI tax rate structure.

If the latter method is used and the graduated tax rate is a significant factor for the US shareholder, deferred tax liabilities or assets related to GILTI should be measured using the average graduated tax rate as discussed in ASC 740-10-30-9. Refer to section 5.1.1, *Average graduated tax rates*, for additional discussion on graduated tax rates.

While the two alternative approaches above are reasonable under ASC 740, other acceptable alternatives may exist. A company that applies one of the two alternatives described above or another acceptable method should apply that method consistently.

The GILTI (Section 250(a)(1)(B)) deduction

As described above, the US tax law provides for a deduction that, when applied, lowers the GILTI inclusion. This may lower the effective tax rate on the GILTI inclusion to 10.5% for taxable years beginning after 31 December 2017 and to 13.125% for taxable years beginning after 31 December 2025. ASC 740-10-55-24 requires deferred taxes to be measured using enacted tax rates that would apply to the type of taxable or deductible amounts expected in future years.

A company applying the two-step model discussed above therefore needs to assess whether it expects to be able to take the full GILTI deduction for the foreseeable future or expects the deduction to be limited because:

- A company that generally expects to be able to fully apply the GILTI deduction in the foreseeable future should consider this deduction in the measurement of GILTI deferred taxes.
- A company that generally expects limitations on its ability to fully apply the GILTI deduction (e.g., if it expects US losses to offset GILTI inclusions) or expects to use NOL carryforwards or other tax attributes to offset taxable income in future periods may conclude that factoring some or all of the deduction into the rate is not appropriate.

There may be other acceptable alternatives to account for the GILTI deduction. A company that applies the method described above or another acceptable method should apply that method consistently.

Refer to section 6.4.5, *Accounting considerations for the effect of GILTI on the realizability of US federal DTAs*, for additional considerations for a US shareholder electing an accounting policy of considering the effect of the limitations on the GILTI deductions on the realizability of its US deferred tax attributes.

Foreign tax credits

Companies should consider the effects of foreign tax credits that would be available to reduce GILTI when measuring deferred taxes for GILTI (similar to the guidance in ASC 740-10-55-24). However, the effect of FTCs should be considered only if they relate to events already recognized in the CFC's financial statements. The effects of the FTC would need to consider the limitations under the GILTI provisions discussed above.

FDII deduction

The tax law limits the amount of GILTI and FDII deductions to the US shareholder's taxable income. Therefore, a US shareholder will need to consider both the GILTI deduction and the FDII deduction to determine whether these deductions are limited (refer to section 5.9.1, *Foreign-derived intangible income incentive*, for additional discussion of the FDII deduction). While existing inside basis differences may affect future FDII calculations, FDII generally depends on future book income from a sale, lease, license or exchange of property or future service revenue. We believe the accounting for the FDII deduction is similar to a special deduction, and therefore, any expected tax effect of future FDII deductions should not be considered when measuring GILTI deferred taxes.

14.3.6.3 Hybrid structures

For many years, US tax law determined whether an entity was a partnership, corporation or trust based on whether the entity possessed more "corporate" than "noncorporate" characteristics. The IRS issued regulations under Section 7701, which replaced this factual characterization standard with an elective characterization commonly referred to as "check-the-box" regulations. "Checking the box" causes an otherwise taxable entity to elect to be treated as a flow-through entity (e.g., partnership if there is more than one owner) or as a disregarded entity (e.g., branch if there is a single owner) for US income tax purposes.

The most innovative aspect of the check-the-box regulations from a tax-planning perspective is the ability for a taxpayer to choose for most (but not all) entities whether the foreign legal entity will be taxed as a corporation or as a pass-through entity for US tax purposes. A foreign entity eligible for the check-the-box election is entitled to elect its characterization, which can result in varying tax implications for the parent entity (albeit US or foreign).

Parent entities may elect to check the box when a foreign entity owned by a US corporation is generating losses. The parent may be able to use losses related to a foreign branch or partnership to reduce taxable income in the parent's jurisdiction when they are incurred, even though the losses may result in a net operating loss carryforward in the foreign jurisdiction that the foreign entity is not able to realize.

A determination to elect pass-through or disregarded entity tax status may not be beneficial to the parent corporation, particularly when the branch generates income. Branch profits and a foreign partnership's earnings are subject to double taxation (both in the foreign and the parent's jurisdiction). As a dual taxed entity, while foreign taxes paid by the branch can give rise to foreign tax credits to the parent corporation subject to limitations, the income will be currently taxed at the owner or partner's US income tax rates. In addition, the entity is not eligible for the indefinite reinvestment exception under ASC 740-30 because the amounts are immediately taxable or deductible. See section 14.3.6.1, *Branch offices*, for further discussion related to the accounting for income taxes for branch operations.

14.3.6.4 Subpart F income

A company that asserts earnings from foreign operations will be indefinitely reinvested may still be required to include in taxable income in the current year certain types of income of the foreign subsidiary. For example, Subpart F of the Internal Revenue Code requires a US company to include in income certain earnings from controlled foreign corporations regardless of whether the earnings are repatriated to the US. Subpart F income is generally comprised of certain insurance income, passive income (e.g., interest, dividends, royalties) and certain operating income where transactions are designed to be subject to foreign tax rates that are lower than US tax rates.

Companies should take care in evaluating the tax effects of Subpart F because the possibility exists for foreign earnings to be subject to tax in the US, regardless of whether the earnings are repatriated from a foreign subsidiary. We don't expect a parent to be able to assert indefinite reinvestment for a foreign subsidiary's income that is subject to taxation in the US due to Subpart F. That is, if earnings are subject to Subpart F taxation in the US, US federal tax should be provided on those earnings regardless of whether the parent has asserted indefinite reinvestment in the earnings of the foreign subsidiary.

14.3.7 Deferred taxes allocated to translation adjustments

Foreign subsidiaries and affiliates of a US multinational company whose functional currency is the local (foreign) currency report translation adjustments as a component of other comprehensive income (commonly referred to as a cumulative translation adjustment). If a foreign subsidiary's earnings are indefinitely reinvested, deferred tax liabilities are not provided on the temporary differences. For the portion of foreign earnings that are not considered indefinitely reinvested, income taxes are required to be provided. In addition, income taxes attributable to translation adjustments are allocated to other comprehensive income and accumulated as a separate component of shareholders' equity (in a similar manner to the cumulative translation adjustment). The calculation of the income tax effects on the various translation adjustment components is complex and will vary depending on the facts and circumstances. One approach, as shown in Illustrations 14-9 and 14-10, allocates the US foreign tax credit entirely to earnings. Another approach, as shown in Illustration 14-11, allocates the US foreign tax credit to both earnings and the cumulative translation adjustment component of accumulated other comprehensive income (included in equity).

Illustration 14-9: Deferred taxes allocated to translation adjustments — US FTCs allocated entirely to earnings with a foreign currency devaluation

Facts

- A wholly owned foreign subsidiary of a US parent, whose functional currency is its local currency, has net assets of FC13,000 and FC15,000 at 31 December 20X0 and 20X1, respectively.
- During 20X1, the foreign currency devalues from FC1 = $1.00 to FC1 = $0.80.
- Deferred income taxes were not provided in 20X0 and prior years because the foreign earnings were considered indefinitely reinvested.

- In 20X1, a decision is made to remit all of the foreign entity's earnings to the US over the next several years.
  - The parent company continues to assert that its original investment in the foreign subsidiary is indefinitely reinvested.
  - The parent company accrues a deferred tax liability for the additional taxes payable in the US upon repatriation of all foreign earnings.
- The US parent's incremental tax rate, net of foreign tax credits, is assumed to be 10%.
- Deferred taxes are also provided on the cumulative translation component of comprehensive income related to unremitted earnings.
- The tax rate is assumed to be 21% because there are no offsetting credits in the foreign taxing jurisdiction relating to US dollar translation adjustments.

Analysis

Deferred taxes at 31 December 20X1 would be calculated as follows:

	Foreign currency	Exchange rate	US dollar equivalent	Deferred taxes
Common stock	FC 10,000	FC1 = $1.00	$ 10,000	$ –
Unremitted earnings	3,000	FC1 = $1.00	3,000	(300)
Net assets at 31 December 20X0	13,000	FC1 = $1.00	13,000	(300)
Earnings for 20X1	2,000	FC1 = $0.90	1,800	(180)
	15,000		14,800	(480)
Translation adjustment component of other comprehensive income related to:				
Common stock	N/A		(2,000)(a)	–
Unremitted earnings	N/A		(800)(b)	168(c)
	N/A		(2,800)	168
Net assets at 31 December 20X1	FC 15,000	FC1 = $0.80	$ 12,000	$ (312)

(a) FC10,000 * ($1.00 – $0.80)
(b) FC3,000 * ($1.00 – $0.80) + FC2,000 @ ($0.90 – $0.80)
(c) US 800 * 21%

For 20X1, net deferred tax expense is $312. For financial reporting purposes, $480 of the deferred tax expense ($180 related to current year earnings and $300 related to the change in reinvestment policy) is allocated to the income statement and a $168 tax benefit is allocated to the cumulative translation adjustment component of comprehensive income.

Note: In the US, companies will need to carefully analyze whether undistributed earnings were included in the entity's one-time transition tax obligation resulting from the TCJA or are subject to the dividend received deductions when measuring US federal deferred taxes on undistributed earnings. See section 14.3.7.1, *Original investment not indefinitely reinvested*, for a discussion of an original investment and when deferred taxes are required to be recognized.

Illustration 14-10: Deferred taxes allocated to translation adjustments — US FTCs allocated entirely to earnings when the foreign currency increases in value

Assume the same circumstances in Illustration 14-9, except that the foreign currency increases in value from FC1 = $1.00 to FC1 = $1.20. The deferred taxes calculated at 31 December 20X1 would be as follows:

	Foreign currency	Exchange rate	US dollar equivalent	Deferred taxes
Common stock	FC 10,000	FC1 = $1.00	$ 10,000	$ –
Unremitted earnings	3,000	FC1 = $1.00	3,000	(300)
Net assets at 31 December 20X0	FC 13,000	FC1 = $1.00	13,000	(300)
Earnings for 20X1	2,000	FC1 = $1.10	2,200	(220)
	FC 15,000		15,200	(520)
Translation adjustment component of other comprehensive income related to:				
Common stock	N/A		2,000[(a)]	–
Unremitted earnings	N/A		800[(b)]	(168)[(c)]
	N/A		2,800	(168)
Net assets at 31 December 20X1	FC 15,000	FC1 = $1.20	$ 18,000	$ (688)

(a) FC10,000 * ($1.00 – $1.20)
(b) FC3,000 * ($1.00 – $1.20) + FC 2,000 * ($1.10 – $1.20)
(c) US 800 * 21%

For 20X1, net deferred tax expense is $688. For financial reporting purposes, $520 of the deferred tax expense is allocated to the income statement and a $168 deferred tax expense is allocated to the cumulative translation adjustment component of other comprehensive income.

Note: In the US, companies will need to carefully analyze whether previously undistributed earnings were included in the entity's one-time transition tax obligation resulting from the TCJA or are subject to the dividend received deductions when measuring US federal deferred taxes on undistributed earnings.

See section 14.3.7.1, *Original investment not indefinitely reinvested*, for a discussion of an original investment and when deferred taxes are required to be recognized.

The following example illustrates an alternative approach that allocates the US foreign tax credit to both current earnings and the cumulative translation adjustment component of other comprehensive income (included in equity), when earnings are not permanently reinvested.

Illustration 14-11: Deferred taxes allocated to translation adjustments — US FTCs allocated to earnings and CTA

Assume a foreign subsidiary has earnings of FC600 in 20X2. Unremitted earnings are FC1,000 and FC1,600 at the end of 20X1 and 20X2, respectively. For all periods presented, the US parent expects the entire foreign subsidiary's unremitted earnings will be remitted in the foreseeable future, and, under ASC 740-30, a deferred US tax liability is recognized for those unremitted earnings. The US parent accrues the deferred tax liability at a 10% tax rate (that is, net of foreign tax credits, foreign tax credit carryforwards and so forth). The foreign currency is the functional currency. For 20X2, translated amounts are as follows:

	Foreign currency	Exchange rate	US dollar equivalent
Unremitted earnings at 31 December 20X1	FC 1,000	FC1 = $1.20	$ 1,200
Earnings during 20X2	600	FC1 = $1.10	660
Unremitted earnings at 31 December 20X2	1,600	FC1 = $1.00	1,600

Translation adjustment component of accumulated other comprehensive income as of 31 December 20X2:

	US dollar equivalent
Unremitted earnings	260[(a)]

(a) FC1,000 * ($1.20 – $1.00) + FC 600 * ($1.10 – $1.00)

An analysis of the net investment in the foreign subsidiary and the related deferred tax liability for 20X2 is as follows:

	Net investment	Deferred tax liability
Balances at 31 December 20X1	$ 1,200	$ 120
Earnings during 20X2 and related taxes	660	66
Translation adjustment and related taxes	(260)	(26)
Balances at 31 December 20X2	$ 1,600	$ 160

For 20X2, the net deferred tax expense is $40. For financial reporting purposes, $66 of deferred taxes is charged against earnings and $26 of deferred tax benefit is credited directly to the translation adjustment component of other comprehensive income.

Note: In the US, companies will need to carefully analyze whether undistributed earnings were included in the entity's one-time transition tax obligation resulting from the TCJA or are subject to the dividend received deductions when measuring US federal deferred taxes on undistributed earnings.

See section 14.3.7.1, *Original investment not indefinitely reinvested*, for a discussion of an original investment and when deferred taxes are required to be recognized.

14.3.7.1 Original investment not indefinitely reinvested

In Illustrations 14-9 and 14-10 in section 14.3.7, *Deferred taxes allocated to translation adjustments*, the original investment is considered indefinitely reinvested under ASC 740-30. Therefore, additional US income taxes are not provided, and income taxes are not allocated to the cumulative translation component of other comprehensive income based on changes in exchange rates relating to the original investment. If, however, a company's original investment did not qualify as indefinitely reinvested, income taxes would be provided on the translation adjustment attributable to the original investment.

An accrual for additional deferred income taxes, along with an allocation to the translation component of comprehensive income, is appropriate if the entire investment was not considered indefinitely reinvested.

Illustration 14-12: Deferred taxes allocated to translation adjustments when the original investment was not indefinitely reinvested

Scenario 1

Assume the same facts as in Illustration 14-9, except that the company's original investment did not qualify as indefinitely reinvested. In this case, instead of having a deferred tax liability of $312, there would be a net deferred tax asset of $108 [(21% of $2,000 = $420) − $312], which would require further evaluation due to ASC 740-30-25-9's prohibition against recognizing deferred tax assets attributable to outside basis differences that will not reverse in the foreseeable future (see section 14.5, *Limitations on deferred tax assets for outside basis difference of foreign and domestic subsidiaries, corporate joint ventures and investees*, for a further discussion).

Scenario 2

Assume the same facts as in Illustration 14-10, except that the company's original investment did not qualify as indefinitely reinvested. In this case, an additional deferred tax liability of $420 (21% of $2,000) would be charged to the cumulative translation adjustment component of other comprehensive income in the equity section.

See section 20.2.2, *Income tax effects of a change in an indefinite reinvestment assertion*, for further discussion of the accounting for cumulative translation adjustments related to an investment in a foreign subsidiary for which it is no longer asserted that the investment is essentially permanent in duration.

14.3.7.2 Hedge of a net investment

ASC 815, *Derivatives and Hedging*, allows the hedging of the foreign currency risk of a net investment in a foreign operation with either a foreign currency derivative instrument or a foreign-currency-denominated non-derivative financial instrument debt.

Investments in foreign operations include investments in incorporated and unincorporated foreign operations with a functional currency other than the reporting currency, including subsidiaries, divisions, branches, joint ventures and investments accounted for under the equity method. The change in the carrying amounts of these investments, measured at the spot exchange rate, is recorded in the cumulative translation adjustment account in other comprehensive income. Simultaneously, the effective portion of a hedge of this exposure is also recorded in the cumulative translation adjustment account. While the net investment may qualify for the ASC 740-30 exception for providing deferred taxes on the outside basis of a foreign subsidiary, the hedge of the net investment does not. That is, the hedge is a definite-lived instrument that will have tax consequences when it's terminated. As a result, the indefinite reinvestment exception under ASC 740-30 is not available. The tax consequences of an effective net investment hedge are also reported in other comprehensive income with the hedge in accordance with ASC 815.

14.3.8 Applicability of ASC 740-30 exception to consolidated variable interest entities

ASC 810-10 provides guidance on the consolidation of variable interest entities (VIEs), including entities referred to as special-purpose entities (SPEs). The scope of the VIE consolidation guidance in ASC 810-10 (the Variable Interest Model) applies to all legal entities, with certain exceptions. See sections 4.3, *Scope exceptions to consolidation guidance*, and 4.4, *Scope exceptions to the Variable Interest Model*, of our FRD, ***Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests***, for additional guidance on the scope exceptions to the consolidation guidance and the Variable Interest Model, respectively.

In general, an entity is subject to the Variable Interest Model's consolidation provisions if the entity: (1) has an insufficient amount of equity to finance its activities without additional subordinated financial support provided by any parties, (2) has a group of equity holders whose interests lack the characteristics of a controlling financial interest or (3) is structured with non-substantive voting rights. VIEs are to be evaluated for consolidation based on all contractual, ownership or other interests that expose their holders to the risks and rewards of the entity. These interests are termed variable interests and may include equity investments, loans, derivatives, guarantees, service and management contracts, and other instruments whose values change with changes in the fair value of the VIE's net assets (excluding variable interests). Any of these interests may require a holder to consolidate a VIE. The holder whose variable interest gives it power and benefits is the VIE's primary beneficiary and is required to consolidate the VIE. See our FRD, ***Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests***, for further discussion on accounting for VIEs.

We believe that, in evaluating whether a company can rely on the indefinite reinvestment exception to providing deferred taxes on the outside basis difference of a foreign subsidiary consolidated under the provisions of the Variable Interest Model, the key issue is whether the primary beneficiary (parent) can control this decision. If the primary beneficiary (parent) can control indefinite reinvestment (and the other ASC 740-30 criteria are met), the ASC 740-30 exception can be utilized. If the primary beneficiary cannot control this decision, we do not believe the primary beneficiary (parent) is eligible for this exception.

14.3.9 ASC 740-30 and acquisition accounting

See section 11.13.4, *Assertion regarding indefinite reinvestment*, for a discussion of the effect on acquisition accounting under ASC 805 when the acquiring company is able to support an assertion that its investment in an acquired foreign operation will be reinvested indefinitely.

14.3.10 Consideration of unborn foreign tax credits

Companies may have foreign subsidiaries that are taxed at a local tax rate that is higher than the parent's tax rate (e.g., a parent with a 30% tax rate may have a foreign subsidiary that is taxed at a 40% rate). Depending on the tax laws of the parent entity's jurisdiction, earnings from foreign subsidiaries remitted to the parent generate tax credits that may be available for use against taxes due on earnings of other foreign subsidiaries that pay taxes at a lower rate (e.g., if a parent with a 30% tax rate has a foreign subsidiary with a 15% local tax rate, the parent would be required to pay taxes, after considering the foreign tax credit, of 15% on repatriated earnings unless the parent has additional offsetting foreign tax credits).

FTCs that exist on unremitted earnings of foreign subsidiaries are often referred to as unborn foreign tax credits. Companies will need to carefully analyze whether the future foreign taxable income that will arise when undistributed earnings are remitted will generate foreign tax credits, or whether the foreign tax credits will be subject to limitations.

Unborn foreign tax credits generally are not reported as deferred tax assets but are considered in measuring deferred tax liabilities on outside basis differences in foreign subsidiaries with lower tax rates. However, this raises the question of what happens when the expected foreign tax credit exceeds the existing deferred tax liability on the outside basis difference in the foreign subsidiary. For example, certain foreign transactions result in foreign tax credits that exceed a parent's US tax liability on income from the transaction. The parent may use the excess to offset its tax liability on other foreign source income. We understand several views exist in practice as to whether it is appropriate to record a net deferred tax asset, including:

- **View A** — An entity would measure the deferred tax liability including the effects of unborn foreign tax credits, but would not reduce the deferred tax liability below zero and would not recognize a deferred tax asset because the outside basis difference is a taxable temporary difference (i.e., the book basis of the investment exceeds the tax basis). The unborn foreign tax credits that exceed the outside basis difference are not recognized until the foreign earnings are remitted.

- **View B** — An entity would measure the deferred tax liability including the effects of all expected foreign tax credits. This may result in a deferred tax asset being recognized. The net deferred tax asset would be subject to additional evaluation as noted below.

We generally believe the measurement of an outside basis difference should consider unborn foreign tax credits but only to the extent they reduce the deferred tax liability to zero (View A). Consideration of additional unborn credits would result in a deferred tax asset for an outside basis difference that is actually a taxable temporary difference. Further, because the foreign earnings have not yet been remitted to the parent, a deductible temporary difference does not yet exist.

While we believe View A is most appropriate, we would not object to an entity applying either View A or View B as long as the entity applies it consistently. An alternative view (View B) applied in practice is when a net deferred tax asset arises as a result of considering all unborn foreign tax credits, that net deferred tax asset should be evaluated like any other deferred tax asset related to an outside basis difference. When a net deferred tax asset is recognized, the entity would evaluate the reason that the foreign tax credit has not yet been included on a tax return. The fact that remittance of the foreign earnings has not occurred should be the only remaining reason why the unborn foreign tax credit is not included on the tax return. The net deferred tax asset arising under this alternative view should be evaluated under the model in ASC 740-30-25-9. According to that model, a deferred tax asset related to the outside basis difference is recognized for the investment in a subsidiary that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future (see section 14.5, *Limitations on deferred tax assets for outside basis difference of foreign and domestic subsidiaries, corporate joint ventures and investees*). Further, if recognized, any net deferred tax asset would also have to be evaluated for realizability (see chapter 6, *Valuation allowances*).

14.4 Investments in domestic subsidiaries, corporate joint ventures and domestic investees

Excerpt from Accounting Standards Codification

Income Taxes — Other Considerations or Special Areas

Recognition

740-30-25-7

Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference shall be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the entity expects that it will ultimately use that means. For example, tax law may provide that:

a. An entity may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the **parent** entity's tax basis for the stock of that subsidiary.

b. An entity may execute a statutory merger whereby a subsidiary is merged into the parent entity, the noncontrolling shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business entity, and certain other requirements of the tax law are met.

740-30-25-8

Some elections for tax purposes are available only if the parent owns a specified percentage of the subsidiary's stock. The parent sometimes may own less than that specified percentage, and the price per share to acquire a **noncontrolling interest** may significantly exceed the per-share equivalent of the amount reported as noncontrolling interest in the **consolidated financial statements**. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the noncontrolling interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the noncontrolling interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash.

As noted in section 14.2, *Determining foreign versus domestic subsidiaries*, the determination of whether an entity is a domestic or foreign subsidiary is based on the entity's immediate parent company (bottom-up approach). Thus, an entity that owns a majority of another entity in the same federal tax jurisdiction would consider that subsidiary a domestic subsidiary, even if the owner is an intermediate subsidiary of an ultimate parent company in a different federal tax jurisdiction.

14.4.1 Undistributed domestic earnings before 1992

Undistributed earnings from domestic subsidiaries or corporate joint ventures from fiscal years ending before 15 December 1992 can continue to be considered indefinitely reinvested under the ASC 740-30-25-18 exception as long as the reinvestment continues to be essentially permanent in duration. Reversals are determined on a last-in-first-out basis (see section 14.4, *Investments in domestic subsidiaries, corporate joint ventures and domestic investees*, for further discussion).

14.4.2 Basis differences with tax consequences

When the recorded amount of an investment in a less than 80% owned subsidiary is not expected to be recovered in a tax-free transaction (see section 14.4.4, *Basis differences without tax consequences*), the excess of the reported amount of the investment over the underlying tax basis is a taxable temporary difference, except in certain limited circumstances described in section 14.4.4.1, *Expected manner of recovery of investment.* A deferred tax liability is recognized for the excess of the reported amount of the investment over the tax basis, except for the difference caused by undistributed earnings that arose in fiscal years beginning on or before 15 December 1992.

Illustration 14-13: Domestic subsidiaries — Basis differences with tax consequences

Assume that RST Corporation acquired 60% of the stock of AB Company in 20X0 for $8,000 and a tax-free recovery of the investment in AB Company is not available. Also, assume the book and tax bases of RST Corporation's 60% investment in AB Company were as follows at 31 December 20X1 (tax rate is 21% and, for simplicity, the DRD is ignored):

	Book basis	**Tax basis**	**Difference**
AB Company:			
Assets	$ 11,000	$ 10,000	$ 1,000
Liabilities	(1,000)	(1,000)	–
	$ 10,000	$ 9,000	$ 1,000
RST Corporation's Investment in AB Company's stock:			
Original investment	$ 8,000	$ 8,000	$ –
Undistributed earnings	2,000	–	2,000
Purchase cost	$ 10,000	$ 8,000	$ 2,000

In this example, deferred tax liabilities would be recognized for both temporary differences as follows:

AB Company:	
Inside basis difference of net assets ($10,000 book less $9,000 tax)	$ 1,000
Tax rate	21%
Deferred tax liability	210
RST Corporation:	
Outside basis difference between RST's book basis and tax basis in AB Company's stock ($10,000 less $8,000)	2,000
Tax rate	21%
Deferred tax liability	420
Total deferred tax liabilities on a consolidated basis	$ 630

14.4.2.1 Outside basis differences in joint ventures

A deferred tax liability for the outside basis temporary difference would not exist if the parent company had the ability to obtain the accumulated earnings of a domestic subsidiary in a tax-free transaction. However, in contrast to the possible tax-free recovery of an investment in a domestic subsidiary, the US tax law does not currently provide a means by which an investment in a domestic corporate joint venture can be recovered tax free. Accordingly, a deferred tax liability must be recognized for the excess of the reported amount of an investment in a US domestic corporate joint venture over the underlying tax basis, except for the difference caused by undistributed earnings that arose in fiscal years beginning on or before 15 December 1992. In addition, the exception provided for in ASC 740-30-25-7 for domestic subsidiaries is not available for corporate joint ventures.

14.4.2.2 Outside basis differences in equity method investees — applicable rate

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-24

Deferred tax liabilities and assets are measured using enacted tax rates applicable to capital gains, ordinary income, and so forth, based on the expected type of taxable or deductible amounts in future years. For example, evidence based on all facts and circumstances should determine whether an investor's liability for the tax consequences of temporary differences related to its equity in the earnings of an investee should be measured using enacted tax rates applicable to a capital gain or a dividend. Computation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related dividends received deductions or foreign tax credits, and taxes that would be withheld from the dividend.

A basis difference between the financial statement carrying amount of an investment accounted for under the equity method and the tax basis in that investee creates a temporary difference for which deferred taxes should be provided. When determining the applicable tax rate to apply to the outside basis difference, investors must consider how that basis difference will reverse (i.e., through a sale, dividends received from the investee or other means). ASC 740-10-55-24 indicates that all facts and circumstances should be considered in making that determination.

We generally believe that undistributed earnings of an equity method investee will reverse through a capital transaction rather than through the receipt of dividends from the investee. The investor typically does not have the ability to control the investee's dividend policy and investees rarely issue dividends in excess of their current year earnings. Therefore, if the taxable temporary difference, or a portion of it, is expected to reverse through a sale, capital gains rates generally should be applied.

The taxable temporary difference, or a portion of it, would be expected to reverse through dividends if an equity method investee has a history of paying dividends from accumulated earnings that exceed current year income. In this case, the deferred tax liability should be measured using the enacted tax rates applicable to a dividend. The measurement of the deferred tax liability should also reflect DRDs, foreign tax credits and any withholding taxes applicable to the anticipated dividend.

See section 14.3.3.1, *Changes in ownership of investees and subsidiaries (before the adoption of ASU 2019-12)*, or section 14.3.3.1A, *Changes in ownership of investees and subsidiaries (after the adoption of ASU 2019-12)*, for a discussion of the tax effect of changes from consolidation to equity method of accounting, and vice versa. It is important to note that if an investor gains control of a domestic equity method investee, it would eliminate a previously recognized deferred tax liability for its outside basis difference if the investor can recover the investment tax-free and expects to use those means. If the investor previously recorded a deferred tax asset for its outside basis difference prior to gaining control, the investor would only continue to recognize the deferred tax asset if it is apparent that the temporary difference will reverse in the foreseeable future.

See discussion in section 15.2, *Income tax expense (benefit) allocated to continuing operations — the incremental approach*, for income statement presentation considerations related to equity method investments.

14.4.3 Dividends received deduction

In Illustration 14-12 (section 14.4.2, *Basis differences with tax consequences*), the DRD was ignored for simplicity. It should be noted that deferred tax liabilities related to outside basis differences of controlled (consolidated) subsidiaries are measured in accordance with ASC 740 by using tax rates applicable to capital gains, dividends (including any DRDs) or ordinary income, depending on the expected nature of the taxable difference in future years.

A US corporation is generally allowed a deduction against dividends received from a domestic corporation. A company may deduct 65% of dividends received from a domestic corporation in which it holds an interest of 20% (or more) or 50% of dividends received from a domestic corporation in which it holds less than a 20% interest.

Illustration 14-14: Domestic subsidiaries — Basis differences with tax consequences when a DRD is available

Assume that XYZ Corporation, a US corporation, has a $10,000 investment in a 60%-owned subsidiary and the tax basis of the investment is zero. XYZ Corporation believes it will recover its investment through future dividends. The tax rate is 21% and XYZ Corporation is entitled to a 65% DRD under existing tax laws (i.e., only 35% of the dividend is taxable to XYZ).

Deferred taxes would be computed as follows:

Taxable temporary difference	$ 10,000
65% DRD	(6,500)
Taxable income	3,500
Tax rate	21%
Deferred tax liability	$ 735

In determining the rate to be used to establish a deferred tax liability on the outside basis of an equity method investment, we believe it will be rare that an equity method investor, due to a lack of control, will be able to conclude that the DRD will be available. See section 14.4.2.1, *Outside basis differences in joint ventures*, above for additional discussion on accounting for outside basis of an equity method investment.

14.4.4 Basis differences without tax consequences

ASC 740-30-25-7 requires a company to assess whether the excess of the reported amount of an investment (including undistributed earnings) in a domestic subsidiary for financial reporting purposes over the underlying tax basis is a taxable temporary difference. The difference between the parent's book basis and tax basis of a subsidiary's stock is referred to as the outside basis difference. In this regard, taxable income attributable to a domestic subsidiary that is consolidated for tax purposes increases the tax basis in the subsidiary stock, and income taxes attributable to that income would decrease the parent's tax basis in the subsidiary stock. Inside basis differences refer to the book and tax basis differences of individual assets and liabilities of the subsidiary. Inside basis differences are not eligible for the ASC 740-30-25-7 domestic subsidiary exceptions. If the tax law provides a means by which the recorded amount of an investment in the stock of a domestic subsidiary's outside basis difference could be recovered in a tax-free transaction (e.g., a tax-free liquidation or a statutory merger) and the company expects that it ultimately will use that means, the outside basis difference *would not* be considered a taxable temporary difference because no taxes are expected to result upon the reversal of the temporary difference.

The determination of whether a subsidiary is a domestic subsidiary is made following a bottom-up approach. Domestic subsidiaries are those domiciled for tax purposes in the same country as their immediate parent. Tax laws in foreign countries would have to be analyzed in order to determine whether a foreign parent's investment in its domestic subsidiary could be recovered in a tax-free transaction. See section 14.2, *Determining foreign versus domestic subsidiaries*, for additional discussion regarding the classification of an investee as a domestic or foreign entity.

14.4.4.1 Expected manner of recovery of investment

In many situations involving domestic subsidiaries, a taxable difference may be avoided using available tax elections. However, some tax elections are available only if the parent company owns a specified percentage of the subsidiary's stock. For example, under current US federal tax law, a difference between the book basis and tax basis of a parent company's investment in an 80% to 100% owned domestic subsidiary that is consolidated for tax purposes generally is not a taxable temporary difference because it would not result in a future taxable amount if the subsidiary can be merged or liquidated in a tax-free transaction.

If a parent company has control of (i.e., consolidates) a subsidiary but does not have the specified ownership percentage required by the tax law to recover the investment tax free, ASC 740-30-25-8 permits the parent company to assume acquisition of additional shares to obtain the required ownership percentage when determining whether the excess of the parent's book basis over the tax basis is a taxable temporary difference. That book-tax difference is not considered to be a taxable temporary difference if acquisition of the minority interest is expected to occur at a point in time when settlement *would not result in a significant cost* (e.g., when a subsidiary has recovered and settled most of its assets and liabilities such that the fair value of the minority interest approximately equals the minority interest's percentage of the subsidiary's net assets) and the acquisition is within the control of the parent company.

In order to assume that an investment will be recovered tax free, the parent must have the ability to use that tax-free method of recovery before taking advantage of the exception to recording the outside basis difference as a taxable temporary difference. For example, if a US parent assumed that it would recover its investment in a 70% owned domestic subsidiary through a sale or dividends, it would be inappropriate for the parent to also assert that the recovery would be in a tax-free manner (e.g., through the acquisition of a minority interest). It would, for example, be inconsistent to treat a domestic subsidiary's outside basis difference other than as a taxable temporary difference, upon classification of the subsidiary's assets as held for sale under ASC 360, when the expected manner of disposal is a stock sale (an understanding of the company's plan for proceeds and related tax consequences would be necessary in an asset sale).

In assessing whether a parent can recover the investment tax free, numerous other factors must be evaluated, including whether the parent needs third-party approval to increase its ownership (e.g., from 70% to 80% in the prior example) and the implications of consolidation by other than voting control if the subsidiary is a VIE under ASC 810-10.

14.4.4.2 Change in expected manner of recovery of investment

If a parent changes its expected manner of recovery of an investment, either because of a change in intent or estimate of significant cost, or a change in the parent's ability to control the manner of recovery, any increase or decrease in tax related to the change should be recorded in operations as a discrete event (i.e., in the period in which the change occurs). Such a change in expectations is similar to a change in intention related to indefinitely reinvested amounts in a foreign subsidiary, as described in ASC 740-30-25-17.

14.4.5 State tax considerations for outside basis differences for investments in domestic subsidiaries

As noted in section 14.4.4, *Basis differences without tax consequences*, a taxable temporary difference does not exist for the excess of the amount for financial reporting over the tax basis of an investment in a more-than-50%-owned domestic subsidiary if (1) the tax law provides a means by which the recorded amount of an investment can be recovered tax free and (2) the company expects that it ultimately will use that means. However, if state tax law does not provide the same exception (i.e., a means by which the recorded amount of an investment can be recovered tax free) or the company does not expect that it ultimately will use that means, a state taxable temporary difference may arise even if there is no federal taxable temporary difference.

Illustration 14-15: Domestic subsidiries — State tax considerations for outside basis differences

Facts

Assume that a company acquires 100% of the stock of an entity domiciled in State C. At the date of acquisition, the financial reporting basis and the tax basis of the acquired stock are equal for both federal and state purposes. However, subsequent to the acquisition, the financial reporting basis of acquired stock exceeds its federal and state tax bases due to earnings of the acquired entity.

Analysis

US federal tax law provides a means by which the recorded amount of the company's investment can be recovered tax free and the company expects that it will ultimately use that means. Therefore, a federal taxable temporary difference does not exist with respect to the company's investment.

However, State C does not provide a means by which the recorded amount of the company's investment can be recovered tax free. As a result, a state taxable temporary difference exists for the company's investment, and the company records a deferred tax liability for that temporary difference.

In cases in which a state's tax law relating to recovery of the recorded amount of an investment differs from federal laws, consideration should be given to whether there are other state-specific means by which the investment may be recovered in a tax-free manner. Also see section 14.4.1, *Undistributed domestic earnings before 1992*, for a discussion of pre-1992 undistributed earnings.

14.5 Limitations on deferred tax assets for outside basis difference of foreign and domestic subsidiaries, corporate joint ventures and investees

Excerpt from Accounting Standards Codification

Income Taxes — Other Considerations or Special Areas

Recognition

740-30-25-9

A **deferred tax asset** shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future.

740-30-25-10

For example, if an entity decides to sell a subsidiary that meets the requirements of paragraphs 205-20-45-1A through 45-1D for measurement and display as a discontinued operation and the parent entity's tax basis in the stock of the subsidiary (outside tax basis) exceeds the financial reporting amount of the investment in the subsidiary, the decision to sell the subsidiary makes it apparent that the **deductible temporary difference** will reverse in the foreseeable future. Assuming in this example that it is more likely than not that the deferred tax asset will be realized, the tax **benefit** for the excess of outside tax basis over financial reporting basis shall be recognized when it is apparent that the temporary difference will reverse in the foreseeable future. The same criterion shall apply for the recognition of a deferred tax liability related to an excess of financial reporting basis over outside tax basis of an investment in a subsidiary that was previously not recognized under the provisions of paragraph 740-30-25-18.

740-30-25-11

The need for a **valuation allowance** for the deferred tax asset referred to in paragraph 740-30-25-9 and other related deferred tax assets, such as a deferred tax asset for foreign tax credit **carryforwards**, shall be assessed.

740-30-25-12

Paragraph 740-10-30-18 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences.

740-30-25-13

Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.

740-30-25-14

A tax benefit shall not be recognized, however, for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized under the requirements of paragraph 740-30-25-18.

ASC 740-30-25-9 restricts recognition of a deferred tax asset for the excess of the tax basis over the book basis of an investment (outside basis difference) in either a foreign or domestic subsidiary or corporate joint venture. For those outside basis differences, a deferred tax asset is recognized "only if it is apparent that the difference will reverse in the foreseeable future." Changes in assumptions should be recorded as discrete events in the period in which the assumption and/or underlying event occurs.

Of additional note, ASC 740-30-25-9 is a standard for initial recognition of deferred tax assets. It is not appropriate to apply the more-likely-than-not standard in ASC 740, which deals with realizability, to the initial recognition of a deferred tax asset. If and only if the asset qualifies for recognition under ASC 740-30-25-9 is it necessary to assess realizability. The restriction in ASC 740-30-25-9 does not apply to equity method investments that are not corporate joint ventures.

This restriction on the recognition of deferred tax assets on outside basis differences was included to bring some form of parity to the exceptions provided for deferred tax liabilities, in ASC 740-10-25-3 and ASC 740-30-25-7.

We believe that a primary beneficiary (parent) of a variable interest entity should apply the guidance in ASC 740-30-25-9 to determine if a deferred tax asset shall be recognized.

14.5.1 Disposals and assets held for sale

While the term foreseeable future is not defined, it means that the deferred tax asset would reverse in the near term based on a plan a company has committed to following. As noted in the guidance in ASC 740-30-25-10, when a subsidiary is classified as held for sale under ASC 360, the foreseeable future criterion is met, presuming the sale would cause the related basis difference to reverse.

14.6 Investments in partnerships and other pass-through entities

Partnerships and other pass-through entities that are treated as partnerships for tax purposes (e.g., limited liability companies, S corporations) are generally not subject to income tax in the jurisdictions in which they qualify as one of these entities. Instead, the tax consequences of transactions within the pass-through entity flow through to the partners (i.e., investors).

Since partnerships and other pass-through entities are generally not subject to income taxes, differences between the book and tax bases of their assets and liabilities (i.e., inside basis differences) are not considered temporary differences under ASC 740 because they generally do not have future tax consequences to the entity. However, a careful analysis of the tax law in the jurisdiction where the entity operates may still be necessary to determine whether certain income taxes are attributed to the entity rather than the investors, as may be the case in some jurisdictions. Refer to section 19.3.3, *Attribution of income taxes to the entity or its owners*, for details.

The investor in a partnership or another pass-through entity, by contrast, needs to recognize the future tax consequences of recovering the financial reporting basis of its investment in the entity (i.e., the outside basis difference) as a deferred tax asset or liability.

A foreign partnership (including a limited or general partnership) is a partnership created under the law of any jurisdiction other than the US, except as provided in the regulations. Depending upon a country's laws, the partnership may be recognized as an entity separate from its partners for tax purposes or the partners may be subject to foreign tax on a look-through basis. From a US tax perspective, the foreign partnership is subject to taxation as a partnership. Because the Internal Revenue Code regards a partnership as a nontaxable entity with each partner recognizing its distributive share of income or loss currently for US tax purposes, a US corporation participating in a foreign partnership will be subject to US tax on its distributive share of the foreign partnership's income or loss. As a result, a partnership causes double taxation problems because the US corporate partner is taxed by the foreign jurisdiction and is taxed in the US on its distributive share of the foreign partnership's income.

14.6.1 Accounting considerations when measuring the outside basis difference in a consolidated partnership

An investor recognizes deferred tax assets and liabilities for the difference between the financial reporting basis and tax basis of its investment in a domestic or foreign partnership (referred to as the outside basis difference). The exceptions provided in ASC 740-30 on the recognition of an outside basis difference for consolidated subsidiaries and corporate joint ventures do not apply to investments in partnerships. This is because an investor in a partnership is taxed currently on its distributive share of the partnership's earnings or generally cannot recover its investment in the partnership in a tax-free manner.

Questions have arisen about whether inside basis differences related to the partnership's assets and liabilities should affect the measurement of the outside basis difference recognized by the investor. We are aware of two accounting views in practice that may be appropriate in this situation:

- The investor in the consolidated partnership records a deferred tax asset or liability for the entire outside basis difference (View 1)
- The investor in the consolidated partnership "looks through" to the inside basis differences of the partnership's individual assets and liabilities and considers what the outside basis difference relates to when measuring deferred taxes on the outside basis difference (View 2)

We believe View 1 is the most appropriate accounting method. An investor generally cannot recover its investment in the consolidated partnership in a tax-free manner and should reflect the future tax consequences of recovering the financial reporting basis of its investment in the partnership. Therefore, the investor recognizes deferred taxes for the entire outside basis difference of the investment in the consolidated partnership should be recognized.

We understand in practice an investor in a consolidated partnership may apply View 2. Under this view, when an investor has analyzed and reconciled the inside basis differences of the consolidated partnership with the outside basis difference, the investor may then "look through" its partnership interest (outside basis difference) to the book and tax basis differences of individual assets and liabilities in the partnership (inside basis differences). Using this look-through method, an investor may conclude a deferred tax liability would not be recognized on a portion or all of the outside basis difference attributable to a temporary difference that, before contribution to the consolidated partnership, would not have been recognized (e.g., certain temporary differences related to goodwill and eligible investments in foreign or domestic subsidiaries).

For example, an investor contributes assets, including nondeductible goodwill, into a consolidated partnership upon formation. The investor's tax basis in its partnership on the formation date typically is equal to the tax basis of its contributed assets. Because the book basis of the contributed assets would include nondeductible goodwill and the tax basis would not, an outside basis difference exists upon contribution of the assets to the consolidated partnership. The same basis difference existed prior to contribution of the assets (i.e., goodwill's book basis in excess of its tax basis). However, because the inside basis difference relates to nondeductible goodwill, it was not recognized by the investor in accordance with ASC 740-10-25-3(d).

While we believe it is most appropriate to record deferred taxes on the entire outside basis difference of an investment in a consolidated partnership without regard to the underlying inside basis differences (View 1), we have not objected to looking through the investment in the consolidated partnership to determine whether the outside basis difference would otherwise not be recognized under ASC 740 (View 2) provided such a view is applied on a consistent basis to consolidated partnership investments and other consolidated pass-through entities.

14.6.2 Considerations for measuring deferred taxes related to outside basis differences of investments in consolidated partnerships and other pass-through entities

When measuring a deferred tax asset or liability, an entity is required to use the enacted tax rate expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be realized or settled.

An investor applying View 1 discussed above generally would measure the tax consequences of the entire outside basis difference in a consolidated partnership or other pass-through entity without considering how the inside basis differences may affect the measurement of the deferred tax asset or liability related to the outside basis difference. As a result, an investor in the consolidated partnership (or other pass-through entity) may conclude that the nature of the entire outside basis difference is capital in character because it expects to recover the outside basis difference upon disposal of its interest. Therefore, the related deferred tax amount would be measured using an applicable capital tax rate.

In addition, an investor in a partnership or other pass-through entity cannot use the exceptions to recording deferred tax liabilities provided in ASC 740-30 because the investor generally cannot recover its investment in the consolidated partnership in a tax-free manner. As a result, when the book basis of the investment is greater than the tax basis, a deferred tax liability is recorded. This deferred tax liability would only be considered a potential source of future taxable income when evaluating the realizability of the investor's other deferred tax assets with similar reversal patterns and in the same jurisdiction.

Similarly, if the investor recorded a deferred tax asset for its outside basis difference in the consolidated partnership, the investor may conclude that it needs to record a valuation allowance for the outside basis difference if it does not have sufficient available sources of future taxable income (e.g., reversing deferred tax liabilities, an available tax planning strategy, projections of future taxable income that will generate income of a similar nature (e.g., capital gain)).

While we believe it is most appropriate to not look through the partnership, we have not objected to an investor looking through a consolidated partnership to determine the expected character of its outside basis difference, regardless of whether the investor is applying View 1 or View 2 discussed above when measuring the outside basis difference. An investor may schedule the reversal of the individual inside basis differences of the consolidated partnership to determine the character (ordinary income or capital) and timing of the income expected to pass through to the investor when they reverse. When an investor has analyzed and reconciled the inside basis differences of the consolidated partnership with the outside basis difference, it may be able to determine whether the outside basis difference will reverse upon the sale or liquidation of the partnership (capital) or will reverse through the partnership's normal operations and pass ordinary income (loss) to the investor.

An investor may also consider looking through the partnership to schedule the reversal patterns of the individual inside basis differences of the consolidated partnership when evaluating the realizability of its other deferred tax assets to determine if a valuation allowance is required. When scheduling the inside basis differences of the consolidated partnership, an investor may be able to assess whether all or a portion of the outside basis difference will be realized through normal operations, relates to indefinite lived intangibles (therefore expected to reverse in an indeterminate future period), or will be recovered through sale or liquidation (generating a capital gain or loss).

An investor may determine, based on the nature of the inside basis differences and their reversal patterns, that all or a portion of the taxable temporary outside basis difference that will reverse from normal operations may provide a source of future taxable income to realize the investor's other deferred tax assets that have the same character (i.e., capital vs. ordinary), the same reversal patterns and are in the same tax jurisdiction.

We believe that the total amount of the future taxable income (either ordinary or capital in character) that would be used in the investor's valuation allowance assessment is limited to the investor's actual outside basis difference (i.e., the outside basis difference is a single unit of account). For example, if the investor has recorded a $1,000 deferred tax liability for the outside basis difference in a consolidated partnership, that amount is the maximum future taxable income the investor could consider when evaluating the realizability of its other deferred tax assets. This would be the case even if after the investor scheduled out the partnership's temporary differences it determined that a greater amount would be expected to reverse in the period when other deferred taxes are expected to reverse.

Similarly, an investor with a deductible temporary difference related to its outside basis difference for its investment in a consolidated partnership or pass-through entity may be able to look through the consolidated partnership to determine the nature and reversal pattern of the related deferred tax asset. As a result, the investor may be able to determine whether it has other appropriate sources of taxable income (e.g., other reversing deferred tax liabilities) to realize all or a portion of the deferred tax asset related to its investment in the consolidated partnership.

Regardless of whether an investor looks through to the inside basis when measuring the outside basis difference or evaluating the realizability of the outside basis difference (when the outside basis difference is a DTA), it should apply that approach consistently to all investments in consolidated partnerships or similar pass-through entities. Further, we believe that an investor that elects the look-through approach for determining the nature or the realizability of the outside basis must have the current intent and ability to hold its investment for a period consistent with its expected manner of recovery of its outside basis difference. An investor should not look through the partnership, nor continue to look through the partnership, for purposes of determining the nature or evaluating the realizability of the outside basis difference if it does not have the intent or ability to recover its investment through normal operations (e.g., if it plans to sell or liquidate the partnership).

14.7 Umbrella partnership corporation structure (Up-C) tax accounting considerations (updated August 2022)

It is common for entities that historically operated as a partnership or limited liability corporation (LLC) to use an umbrella partnership corporation structure (Up-C) when contemplating an initial public offering (IPO). These structures are also often used by entities that go public by merging with a special purpose acquisition company (SPAC).

Consider the following illustration of the formation of a common Up-C structure (the terms and conditions of Up-C structures may differ from the illustration):

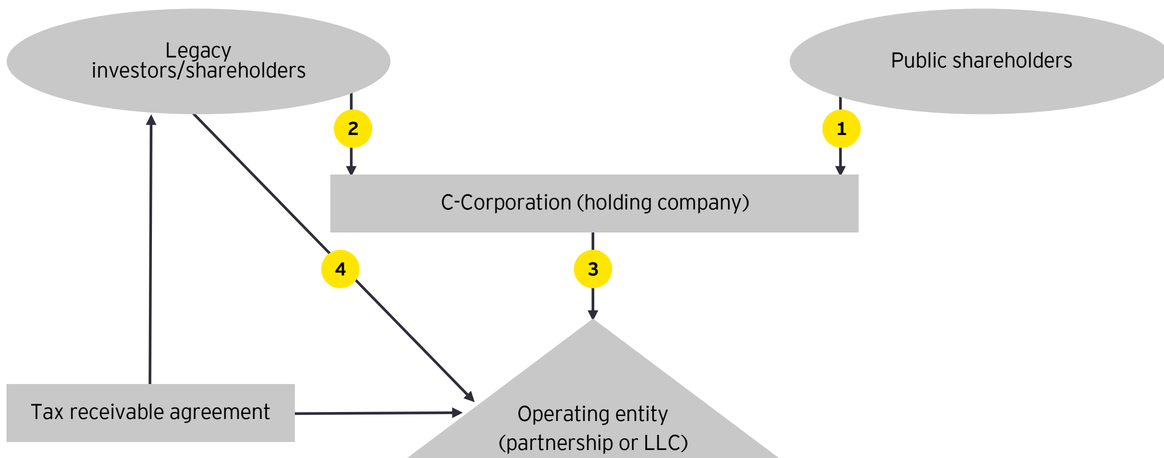
Illustration 14-16: Up-C structure

The existing investors in a partnership or LLC form a new C-corporation holding company (Holding Co.) that will own an interest in the operating partnership or LLC (the operating entity). Holding Co. sells Class A shares to the public and uses the proceeds to acquire a controlling financial interest in the operating entity by acquiring interests directly from the operating entity or from the operating entity's existing investors (legacy investors). The operating entity's legacy investors also receive Class B shares in Holding Co. that are convertible into the publicly traded Class A shares, as is typical in these transactions. The Class B shares give the operating entity's legacy investors voting rights but not economic rights in Holding Co.

Upon completion of the IPO and partnership unit exchanges with the operating entity's legacy investors, Holding Co. controls the operating entity, but the legacy investors have voting control of Holding Co. and a non-controlling interest in the operating entity. From an accounting perspective, the C-corporation's transaction to gain control of the operating entity typically is considered a transaction among entities under common control.

Additionally, the legacy investors enter into a tax receivable agreement (TRA) with Holding Co. to share the tax benefits that the Holding Co. may receive from a tax basis step-up resulting from the transaction. The TRA permits the legacy investors to receive payments from Holding Co. for the reduction in cash taxes otherwise due by Holding Co. as a result of the tax basis created on exchanges with the legacy investors.

The post-IPO Up-C structure may be illustrated as follows:



1. Class A shares
2. Class B shares
3. Partnership or members' interest/general partner or managing member
4. Partnership or members' interest

14.7.1 Up-C tax accounting considerations

Upon completion of the IPO, the holding company consolidates the operating entity, and the holding company will account for the income tax consequences of the outside basis difference between the carrying amount of its investment in the operating entity for financial reporting and the amount for tax purposes. The Up-C transaction depicted above results in the holding company's tax basis of its investment in the operating entity being equal to the amount paid to acquire the units in the operating entity. However, the financial reporting basis of the investment in the operating entity is not stepped up (i.e., the historical book basis of the investment in the operating entity is retained) because Up-C transactions are typically accounted for as transactions among shareholders rather than as business combinations. See Appendix C, *Accounting for common control transactions*, of our FRD, ***Business combinations***, for more information.

After an Up-C transaction, a C-Corporation's tax basis in the investment in the operating partnership is generally greater than its financial reporting basis. As a result, a deferred tax asset will be recognized by the C-Corporation since the exceptions in ASC 740-30 on the recognition of an outside basis difference for consolidated subsidiaries and corporate joint ventures do not apply to investments in partnerships or pass-through entities. The offsetting amount to record the deferred tax asset is recorded as an adjustment to additional paid-in capital. This is consistent with the guidance in ASC 740-20-45-11(g) that requires the tax effects of changes in tax bases caused by transactions among shareholders to be included in equity (see section 15.3.6). Consider the following example, which demonstrates an evaluation under the steps outlined in section 14.1.1, *Six-step process for deferred tax accounting of outside basis differences*.

Illustration 14-17: Tax accounting consequences of an Up-C structure

Facts

- The Up-C transaction in Illustration 14-16 is executed, resulting in the formation of a C-Corporation (Holding Co.), which has a controlling interest in a partnership (the operating entity).
- The tax basis of Holding Co.'s investment in the operating entity upon execution is $100 million, while its financial reporting basis is $85 million.
- Holding Co. is a domestic corporation, and the operating entity is a domestic partnership.
- The tax rate is 25%.

Analysis

Holding company analyzes the difference between the financial reporting basis of its investment in the operating company and its tax basis under ASC 740-30 to determine how and to what extent to recognize the tax effects of the basis difference. The analysis involves the following steps:

Step 1: Start at the bottom of the organizational chart

Holding Co. begins its analysis at the operating entity level because it is at the bottom of the organizational chart.

Step 2: Determine the legal form of the investee (e.g., C Corporation, partnership) and investee type (e.g., consolidated, unconsolidated)

The legal form of the investee, the operating entity, is a partnership and is consolidated by Holding Co.

Step 3: Determine whether the investor/investee relationship is domestic or foreign

This step is not applicable to the analysis since the investment is a partnership as the permanent reinvestment assertion is not available regardless of whether the partnership is a domestic or foreign entity.

Step 4: Determine the book and tax basis of the investor's investment in the investee

The book basis of the Holding Co.'s investment in the operating entity is $85 million, and the tax basis is $100 million.

Step 5: Determine whether the outside basis difference is a deductible temporary difference or a taxable temporary difference

The outside basis difference is a deductible temporary difference because the tax basis exceeds the book basis and will be recoverable upon eventual disposition.

Step 6: Determine whether the investor can apply an exception to the guidance for recognizing a deferred tax asset or deferred tax liability

No exception exists in ASC 740-30 for partnerships or pass-through entities.

Conclusion

Holding Co. concludes that it will recognize a deferred tax asset of $3.75 million ($15 million * 25%) because the exceptions in ASC 740-30 to the recognition of an outside basis difference for consolidated subsidiaries and corporate joint ventures do not apply to investments in partnerships or other pass-through entities.

Holding Co. records the following journal entry for the outside basis difference:

Deferred tax asset	$ 3.75	
Additional paid-in capital*		$ 3.75

* The credit is recorded to APIC in accordance with ASC 740-20-45-11(g), which requires all changes in the tax bases of assets and liabilities caused by transactions among or with shareholders shall be included in equity.

The C-corporation also will need to determine whether the deferred tax asset is realizable. If a valuation allowance is required at the time the deferred tax asset is initially recorded, the tax accounting effects of recording a valuation allowance should also be recorded in equity. Increases or decreases in valuation allowances in subsequent periods are included in the income statement and not allocated to equity.

14.7.2 Tax receivable agreements (TRAs)

It is common in Up-C transactions involving operating entities that are treated as partnerships or similar pass-through entities for income tax purposes for the legacy investors to enter into an agreement with the C-corporation to share the tax benefits the C-Corporation may receive from a tax basis step-up resulting from the transaction. These arrangements, commonly referred to as TRAs, permit the legacy operating partnership investors to receive payments from the C-Corporation for the reduction in cash taxes otherwise due by the C-corporation as a result of the tax basis created on exchanges with the legacy investors. The amount paid to legacy investors is typically 85% of the income tax savings realized by the C-corporation, but the amount may vary so it is important to evaluate the provisions of each arrangement.

Payments made under a TRA are treated for income tax purposes as additional purchase price in connection with the initial exchange of the operating entity's equity, resulting in an additional step-up in the tax basis (and outside basis difference), which generates additional future TRA payments (i.e., an iterative result). The measurement of the expected future tax benefits and related TRA obligation often is complex, and tax professionals should be involved.

A C-corporation generally recognizes a liability to legacy investors based on the future expected payments to be made under the terms of the TRA arrangement. Because the payout usually is contingent on the C-corporation realizing tax savings from a step-up in tax basis (or other tax attributes), the liability is generally recognized when it is probable of being paid and the payout amount is reasonably estimable based on the guidance in ASC 450.

While the liability for the TRA arrangement is in the scope of ASC 450, we believe that it would be acceptable to record a liability to the legacy investors when the tax benefits are determined to be realizable under ASC 740. For example, under this approach, if the C-corporation concludes that a valuation allowance is not required for deferred tax assets related to the step-up, a TRA liability would be recognized. Conversely, if the C-corporation determines that a valuation allowance (or partial valuation allowance) is required for the related deferred tax asset(s), the TRA liability is not recognized (or is partially recognized). The offsetting amount of the TRA liability initially is recognized as an adjustment to paid-in capital. Subsequent changes in the TRA liability resulting from increases or decreases in the valuation allowance are recognized in the income statement before income taxes, and the related changes in the valuation allowance are included as a component of income tax expense (i.e., the amounts are reported gross and not offset against each other). Depending on fact and circumstances, we understand that there are other approaches in practice for evaluating when a TRA liability should be recognized, and we have not objected to the use of other approaches that are consistent with the guidance in ASC 450.

14.8 Bad debt reserves of savings and loan associations

Excerpt from Accounting Standards Codification

Financial Services-Depository and Lending — Income Taxes

Subsequent Measurement

942-740-35-1

The temporary difference under current U.S. federal tax law for the base-year tax reserve of a savings and loan association is one of the exceptions to comprehensive recognition of deferred taxes under Topic 740. If a deferred tax liability is not recognized for that temporary difference, a savings and loan association shall not anticipate future percentage-of-taxable-income bad-debt deductions in determining the deferred tax liability for other types of temporary differences. See paragraphs 740-10-25-3, 740-10-25-37, 740-10-30-5, and 740-10-30-9.

942-740-35-2

The base-year tax reserve is the income tax bad-debt reserve that arose in tax years beginning before December 31, 1987 as provided by the income tax law changes enacted in 1986. The excess of a tax bad-debt reserve over the base-year reserve is a temporary difference for which deferred taxes must be provided.

942-740-35-3

Under Topic 740, deferred tax assets and liabilities for temporary differences shall be measured by applying the enacted tax rate expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be realized or settled. It is not permissible to reduce a deferred tax liability so determined by anticipated future percentage-of-taxable-income bad-debt deductions for the same reasons that other special deductions may not be anticipated as set forth in paragraphs 740-10-25-37 and 740-10-30-13. However, for associations for which graduated tax rates are a factor, the existence of the percentage-of-taxable-income bad-debt deduction may result in a lower average graduated tax rate being applied in measuring deferred taxes if it results in taxable income falling into a lower tax rate bracket.

Under ASC 942-740, the indefinite reversal exceptions for undistributed earnings do not apply for certain temporary differences related to bad debt reserves of thrifts. ASC 942-740 generally applies the indefinite reversal criteria to the amount of a thrift's tax bad debt reserves that existed at the end of its "base year" (the last tax year beginning before 1988).

ASC 942-740 requires a "two-difference" approach for savings and loan bad debt temporary differences: (1) a deferred tax liability generally is not recognized for the amount of the tax reserve that does not exceed the base year reserve balance, but a deferred tax liability is recognized for any excess of the tax reserve over the "base year amount", and (2) a deferred tax asset is recognized (subject to a valuation allowance and potential regulatory restrictions) for the entire book reserve. Generally, the base year is 1987 because the tax law for recapture of a savings and loan association's bad debt reserve for tax purposes changed for tax years beginning after 31 December 1987 and, for that reason, the FASB chose that date for prospective recognition of a deferred tax liability for this type of temporary difference.

Under the ASC 942-740 approach described above, it is possible that a financial institution might have future percentage-of-taxable-income tax bad debt deductions for which deferred tax liabilities will not be recognized (i.e., the cumulative tax reserve would still be below the base year amount). The FASB has indicated that these potential future tax deductions cannot be anticipated in determining the deferred tax liability for other types of temporary differences. In other words, the tax rate used to recognize deferred tax liabilities for federal income tax purposes should be the enacted tax rate and should not be adjusted to reflect possible future "special deductions." The FASB's position is based on ASC 740's treatment of statutory depletion and other special deductions.

15 Intraperiod tax allocation

15.1 Allocation of income tax expense or benefit for the period

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12, which simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the existing guidance to promote more consistency.

The general guidance in ASC 740-20 requires entities to first determine the tax effect of their pretax income from continuing operations without regard to the tax effect of the other items. However, an exception in ASC 740-20-45-7 requires that, when an entity has a loss from continuing operations, all items (i.e., discontinued operations, other comprehensive income and so forth) be considered in determining the amount of the tax benefit from the loss from continuing operations that is allocated to continuing operations. The amendments eliminate the legacy exception to the general guidance in ASC 740-20 on how to allocate income tax expense or benefit for the year to continuing operations, discontinued operations, other comprehensive income, and other changes or credits recorded directly to shareholders' equity.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Early adoption is permitted in interim or annual periods for which all other entities (i.e., entities that are not PBEs) have not made financial statements available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply this amendment prospectively.

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Overview and Background

740-20-05-2

This Subtopic addresses the process of intraperiod tax allocation that allocates total income tax expense or benefit of an entity for a period to different components of comprehensive income and shareholders' equity. This includes allocating income tax expense or benefit for the year to:

a. Continuing operations

b. Discontinued operations

c. Subparagraph superseded by Accounting Standards Update No. 2015-01.

d. Other comprehensive income

e. Items charged or credited directly to shareholders' equity.

This Subtopic provides guidance on the method for making those allocations of total income tax expense or benefit and provides several examples and illustrations.

ASC 740-20 provides guidance on how to allocate an entity's total income tax expense (or benefit) for the period between continuing operations, discontinued operations, other comprehensive income, and charges or credits recorded directly to shareholders' equity. This allocation is commonly referred to as intraperiod tax allocation and is one of the most complex areas in ASC 740.

The intraperiod allocation does not change the total income tax expense or benefit for the period. Instead, the allocation of income tax expense (or benefit) is performed after an entity has determined its total income tax expense or benefit (including current and deferred) under the requirements of ASC 740-10.

The tax effect of pretax income or loss from continuing operations recorded during the period is always allocated to continuing operations. However, additional amounts of an entity's total tax provision may be required to be allocated to continuing operations as well (e.g., the effect of a change in tax law). See section 15.2, *Income tax expense (benefit) allocated to continuing operations — the incremental approach*, which discusses the elements that are allocated to continuing operations.

The tax effect of pretax income or loss from continuing operations should be determined by a computation that does not consider the tax effects of items not included in continuing operations (unless an exception to this general principle applies or items are specifically required to be allocated to continuing operations). The rest of the total income expense or benefit (i.e., the difference between the total tax provision and the amount allocated to continuing operations) is allocated to items other than continuing operations. If there are two or more items other than continuing operations, the amounts that remain after allocation to continuing operations is allocated to those items in proportion to their individual effects on income tax expense or benefit for the year.

The general intraperiod allocation requirements can be summarized in the following steps:

General intraperiod allocation requirements
▸ Calculate the total income tax expense or benefit (current and deferred) in accordance with ASC 740-10
▸ Allocate to continuing operations the tax effect of the pretax income or loss from continuing operations that occurred during the year, adjusted by the income tax effects of elements listed in ASC 740-20-45-8
▸ Allocate any remainder of the income tax expense or benefit to items other than continuing operations (e.g., discontinued operations) in accordance with the guidance in ASC 740-20-45-12 and 740-20-45-14

See section 15.2, *Income tax expense (benefit) allocated to continuing operations — the incremental approach*, for further discussion on the general intraperiod allocation requirements.

When preparing the intraperiod tax allocation for an interim period, a company should also consider the guidance on accounting for income taxes in interim periods. See section 20.4, *Computation of interim period tax (or benefit).*

15.1.1 Level of application

We believe that, consistent with the jurisdictional approach used throughout ASC 740, the application of the intraperiod tax allocation guidance should be applied at the tax-paying component level.

Entities that apply the intraperiod allocation rules at a tax-paying component level will need to carefully track items recognized outside of continuing operations by tax-paying component to apply the intraperiod allocation rules each reporting period. However, there is diversity in practice.

Before the adoption of ASU 2019-12, some entities apply the exception in ASC 740-20-45-7 (i.e., when an entity has a loss from continuing operations), regardless of whether the loss from continuing operations and income from other items outside of continuing operations are within the same tax-paying component. That is, some entities apply the exception based on consolidated results rather than results at the tax-paying component level, and we have not objected to this application as long as it is applied on a consistent basis.

15.2 Income tax expense (benefit) allocated to continuing operations — the incremental approach

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Allocation to Continuing Operations

740-20-45-6

This guidance addresses the allocation methodology for allocating total income tax expense or benefit to continuing operations. The amount of income tax expense or benefit allocated to continuing operations may include multiple components. The tax effect of pretax income or loss from current year continuing operations is always one component of the amount allocated to continuing operations.

740-20-45-7

The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations. That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the **tax consequences** of **taxable income** expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

The tax effect of pretax income or loss from continuing operations should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations.

740-20-45-8

The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of:

a. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (see paragraph 740-10-45-20 for a discussion of exceptions to this allocation for certain items)

b. Changes in tax laws or rates (see paragraph 740-10-35-4)

c. Changes in tax status (see paragraphs 740-10-25-32 and 740-10-40-6)

d. Tax-deductible dividends paid to shareholders.

The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraphs 740-20-45-12 and 740-20-45-14.

Single Item of Allocation Other Than Continuing Operations

740-20-45-12

If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations shall be allocated to that item.

740-20-45-13

See Example 2 (paragraph 740-20-55-8) for an example of the allocation of total tax expense or benefit to continuing operations and one other item.

Multiple Items of Allocation Other Than Continuing Operations

740-20-45-14

If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items.

b. Apportion the tax benefit determined in (a) ratably to each net loss item.

c. Determine the amount that remains, that is, the difference between the amount to be allocated to all items other than continuing operations and the amount allocated to all net loss items.

d. Apportion the tax expense determined in (c) ratably to each net gain item.

ASC 740-20-45-7 requires that the tax effect of pretax income from continuing operations be determined without regard to the tax effects of items not included in continuing operations. This is commonly referred to as the "incremental approach." Before the adoption of ASU 2019-12, the exception to that incremental approach is that all items (e.g., discontinued operations, other comprehensive income) are considered in determining the amount of tax benefit that results from a loss from continuing operations, and these amounts are allocated to continuing operations. See section 15.2.1.1, *Exception to general principle of allocation to continuing operations (before the adoption of ASU 2019-12)*, for details on the exception to the general principle. After the adoption of ASU 2019-12, entities will no longer be able to consider the pretax income recorded in other categories when determining the tax benefit to allocate to continuing operations (except as required by ASC 740, as noted in the table below).

Under ASC 740-20-45-8, the income tax expense or benefit allocated to continuing operations represents the income tax effects of:

	Pretax income or loss from continuing operations during the year (see section 15.2.1, *Allocation of the tax effect of pretax income from continuing operations*)
+/−	Changes in tax laws or rates (see section 15.2.2.1, *Changes in tax laws, rates or tax status*)
+/−	Changes in tax status (see section 15.2.2.1, *Changes in tax laws, rates or tax status*)
+/−	Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (see section 15.2.2.2, *Changes in the valuation allowance*)
−	Tax-deductible dividends paid to shareholders, including dividends paid on unallocated or allocated shares held by an employee stock ownership plan (see section 15.2.3, *Tax benefit of dividends on shares held by ESOP*)
=	Amount allocated to continuing operations

The allocation of income tax expense (benefit) to continuing operations should include the deferred tax effects of temporary differences related to continuing operations. If there is only one item other than continuing operations (such as a discontinued operation), the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that one item. See section 15.3, *Items charged or credited directly to shareholders' equity*, for a further discussion of the allocation to items other than continuing operations under ASC 740-20-45-12 and ASC 740-20-45-14.

Equity method investments

If the equity method investee is a taxable entity, equity method earnings include the investor's share of the investee's income tax expense (benefit). Separately, the investor's own income tax expense (benefit) related to the equity method investment is presented with the investor's income tax expense (benefit) and is not presented with the equity method earnings. For example, the investor presents the deferred tax effects of the difference between the book and tax bases of an equity investment (i.e., the outside basis difference) in the investor's income tax provision. See sections 14.3.4, *Foreign equity method investees and corporate joint ventures*, and 14.4.2.2, *Outside basis differences in equity method investees — applicable rate*, for additional discussion of outside basis considerations related to equity method investments. Also refer to section 8.2, *Financial statement presentation*, of our FRD, ***Equity method investments and joint ventures***, for presentation of equity method investments.

15.2.1 Allocation of the tax effect of pretax income from continuing operations

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Other Presentation Matters

740-20-45-7

The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations. That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the **tax consequences** of **taxable income** expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

The tax effect of pretax income or loss from continuing operations should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations.

The following example illustrates the requirement to determine the tax effects of pretax income from continuing operations without consideration of the tax effects of items that are not included in continuing operations.

Illustration 15-1: Allocation of income tax effect of pretax income from continuing operations

Facts

Company A has $1,000 of income from continuing operations and a $1,000 loss from discontinued operations in the current year. At the beginning of the year, the company has a $2,000 net operating loss carryforward for which the $500 deferred tax asset, net of its valuation allowance, is zero, and the entity did not reduce that valuation allowance during the year. There are no other temporary differences or tax attributes. Company A's effective tax rate is 25% and there are no limitations on the use of the net operating loss carryforward.

Analysis

Calculate the overall tax provision

Pretax income from continuing operations	$ 1,000
Pretax loss from discontinued operations	(1,000)
Pretax income	$ -
Tax rate	25%
Tax expense/(benefit)	$ -

When calculating the overall tax provision, Company A includes the effects of discontinued operations in its total pretax income. Because there is no taxable income, the company is unable to use its NOL carryforward or reverse a portion of its existing valuation allowance.

Determine the tax effect of pretax income or loss from continuing operations

Pretax income from continuing operations	$ 1,000
Tax rate	25%
Tax provision before change in valuation allowance	250
Effect from the reversal of valuation allowance	(250)
Tax expense/(benefit) allocated to continuing operations	$ -

Allocate the remaining tax provision to items other than continuing operations

Company A's overall tax provision	$ -
Tax expense/(benefit) allocated to continuing operations	-
The remainder of the tax expense/(benefit) allocated to discontinued operations	$ -

Under ASC 740-20-45-7, the tax effect of pretax income from continuing operations is computed without regard to items not included in continuing operations (i.e., discontinued operations). In this illustration, no income tax expense is allocated to continuing operations because the intraperiod allocation rules require the company to use its existing NOL carryforward and related reduction in valuation allowance to offset current income tax expense allocated to continuing operations, rather than using the loss from the discontinued operations to offset that taxable income. Company A also recognized a full valuation allowance on the tax benefit from discontinued operations as illustrated in the table below.

	Balance sheet	Continuing operations	Discontinued operations
Deferred tax asset for NOLs	$ 500	$ –	$ –
Valuation allowance	(500)		
Income taxes expense/(benefit)		250	(250)
Reduction of valuation allowance against prior NOL assuming utilization against income from continuing operations	250	(250)	–
Additional valuation allowance recognized for originating NOL from discontinued operations	(250)	–	250
Net deferred tax asset/tax expense	$ –	$ –	$ –

ASC 740-20-55-4 includes an example of intraperiod tax allocation of a total tax expense that includes both current and deferred tax.

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Implementation Guidance and Illustrations

Illustrations — Example 1: Allocation to Continuing Operations

740-20-55-4

This Example illustrates allocation of current and **deferred tax expense.** The assumptions are as follows:

a. Tax rates are 40 percent for Years 1, 2, and 3 and 30 percent for Year 4 and subsequent years. No valuation allowances are required for deferred tax assets.

b. At the end of Year 1, there is a $500 **taxable temporary difference** relating to the entity's contracting operations and a $200 **deductible temporary difference** related to its other operations. Determination of the entity's deferred tax assets and liabilities at the end of Year 1 is as follows.

	Future Years			
Temporary Differences	**Year 2**	**Year 3**	**Year 4**	**Total**
Contracting operations	$ -	$ -	$ 500	$ 500
Other operations	(100)	(100)	-	(200)
	$ (100)	$ (100)	$ 500	$ 300
Enacted tax rate for future years	40%	40%	30%	
Deferred tax liability (asset)	$ (40)	$ (40)	$ 150	$ 70

c. During Year 2, the entity decides that it will sell its contracting operations in Year 3. As a result, all temporary differences related to the contracting operations (the $500 taxable temporary difference that existed at the end of Year 1, plus an additional $200 taxable temporary difference that arose during Year 2) are now considered to result in taxable amounts in Year 3 because the contracting operations will be sold in Year 3.

d. At the end of Year 2, the entity also has $300 of deductible temporary differences ($100 of the temporary difference that existed at the end of Year 1, plus an additional $200 that arose during Year 2) from continuing operations.

e. For Year 2, the entity has $50 of pretax reported income from continuing operations and $200 of pretax reported income from discontinued operations.

f. Determination of the entity's **deferred tax asset** and **liability** at the end of Year 2 is as follows.

	Future Years		
Temporary Differences	**Year 3**	**Year 4**	**Total**
Discontinued operations	$ 700	$ -	$ 700
Continuing operations	(200)	(100)	(300)
	$ 500	$ (100)	$ 400
Enacted tax rate for future years	40%	30%	
Deferred tax liability (asset) — net	$ 200	$ (30)	$ 170

740-20-55-5

Total deferred tax expense for Year 2 is $100 ($170 — $70). The deferred tax benefit of the deductible temporary differences related to the entity's continuing operations during Year 2 is determined as follows.

Deferred tax asset related to the entity's continuing operations at the end of Year 2 (40 percent of $200 and 30 percent of $100)	$ (110)
Deferred tax asset related to the entity's continuing operations at the beginning of Year 2 (40 percent of $200)	(80)
Deferred tax benefit for Year 2	$ (30)

740-20-55-6

The deferred tax expense for taxable temporary differences related to the entity's discontinued operations during Year 2 is determined as follows.

Deferred tax liability at the end of the Year 2 (40 percent of $700)	$ 280
Deferred tax liability at the end of Year 1 (30 percent of $500)	(150)
Deferred tax expense for Year 2	$ 130

740-20-55-7

Total tax expense and tax expense allocated to continuing and discontinued operations for Year 2 are determined as follows.

	Discontinued Operations	**Continuing Operations**	**Total**
Pretax reported income	$ 200	$ 50	$ 250
Originating and reversing temporary differences, net	(200)	100	(100)
Taxable income	$ -	$ 150	$ 150
Current tax expense (40 percent)	$ -	$ 60	$ 60
Deferred tax expense (benefit) as determined above	$ 130	$ (30)	$ 100
Income tax expense	$ 130	$ 30	$ 160

Exceptions to the general requirements of ASC 740 under the incremental approach are detailed in sections 15.2.1.1, *Exception to general principle of allocation to continuing operations (before the adoption of ASU 2019-12)*, and 15.2.2.2, *Changes in the valuation allowance*.

15.2.1.1 Exception to the general principle of allocation to continuing operations (before the adoption of ASU 2019-12)

ASC 740-20-45-7 includes an exception to the general principle of intraperiod tax allocations under ASC 740. The exception applies when a company has a pretax loss from continuing operations and pretax income from all other income items. This exception requires that all items (i.e., discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations that is allocated to continuing operations. That is, when a company has a current period loss from continuing operations, management must consider income recorded in other categories in determining the tax benefit that is allocated to continuing operations. The result of this computation (as well as the need to do the computation) is often counterintuitive. While we believe that it is most appropriate to conclude that the reference to "all items" in ASC 740-20-45-7 includes items charged or credited directly to shareholders' equity, we are aware of different views in practice.

While alternative policies may be appropriate, we believe companies would only be required to apply the exception in ASC 740-20-45-7 in situations where the company has a loss from continuing operations and combined pretax income from all other income items (e.g., discontinued operations, other comprehensive income). For example, if a company with a loss from continuing operations has income from discontinued operations but losses in other comprehensive income in excess of the income from discontinued operations, the application of the exception in ASC 740-20-45-7 would not be required. This is consistent with the guidance in ASC 740-20-45-8, which requires companies to allocate income tax expense or benefit first to continuing operations and the remainder to all other items. In determining whether there is income recorded in other categories, all items of other comprehensive income (including reclasses) should be aggregated.

The exception in ASC 740-20-45-7 applies in all situations in which there is a loss from continuing operations and income from other items outside of continuing operations. This would include situations in which a company has recorded a full valuation allowance at the beginning and end of the period and the overall tax provision for the year is zero (see Illustration 15-3 below). In that case, an income tax benefit would be recognized in continuing operations even though the loss from continuing operations does not provide a current year incremental tax benefit.

The exception in ASC 740-20-45-7 only relates to the allocation of the current year tax provision (which may be zero) and does not change a company's overall tax provision. That is, intraperiod tax allocation, including the application of ASC 740-20-45-7, is performed once the overall tax provision has been computed and simply allocates that provision to various income statement (e.g., continuing operations, and discontinued operations), other comprehensive income, and balance sheet (e.g., goodwill and paid-in capital) captions. While intraperiod tax allocation in general (and the application of ASC 740-20-45-7 in particular) does not change the overall tax provision, it may result in a gross-up of the individual components, thereby changing the amount of tax provision included in each category. The following examples illustrate several common fact patterns and the related application of ASC 740-20-45-7.

Before the adoption of ASU 2019-12, the illustration in ASC 740-20-55-10 is an example of the exception to the general principle of intraperiod tax allocation when there is a loss from continuing operations and income from other items.

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Implementation Guidance and Illustrations

Case A: Loss from Continuing Operations with a Gain on Discontinued Operations

740-20-55-10

This Case illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are as follows:

a. The entity's pretax financial income and **taxable income** are the same.

b. The entity's ordinary loss from continuing operations is $500.

c. The entity also has a gain on discontinued operations of $900 that is a capital gain for tax purposes.

d. The tax rate is 40 percent on ordinary income and 30 percent on capital gains. **Income taxes currently payable** are $120 ($400 at 30 percent).

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

Editor's Note: Paragraph 740-20-55-10 will be amended upon transition, together with its heading:

> Case A: Loss from Continuing Operations with a Gain on Discontinued Operations (Tax Benefit Realizable)

This Case illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are as follows:

a. The entity's pretax financial income and **taxable income** are the same.

b. The entity's ordinary loss from continuing operations is $500.

c. The entity also has a gain on discontinued operations of $900 that is a capital gain for tax purposes.

d. The tax rate is 40 percent on ordinary income and 30 percent on capital gains. **Income taxes currently payable** are $120 ($400 at 30 percent).

e. The entity has determined that the deferred tax asset that would have resulted from the loss from continuing operations if the gain on discontinued operations had not occurred would be expected to be realized (that is, a **valuation allowance** would not have been needed).

740-20-55-11

Income tax expense is allocated between the pretax loss from operations and the gain on discontinued operations as follows.

Total income tax expense	$ 120
Tax benefit allocated to the loss from operations	(150)
Incremental tax expense allocated to the gain on discontinued operations	$ 270

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

Income tax expense is allocated between the pretax loss from operations and the gain on discontinued operations as follows.

Total income tax expense	$ 120
Tax benefit allocated to the loss from operations	(200)
Incremental tax expense allocated to the gain on discontinued operations	$ 320

740-20-55-12

The effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at a 30 percent tax rate. Thus, $150 ($500 at 30 percent) of tax benefit is allocated to continuing operations. The $270 incremental effect of the gain on discontinued operations is the difference between $120 of total tax expense and the $150 tax benefit from continuing operations.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

The effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at a 30 percent tax rate. However, the guidance in paragraph 740-20-45-7 requires that an entity determine the tax effects of pretax income from continuing operations by a computation that does not consider the tax effects of items that are not included in continuing operations. The entity has determined that, absent the capital gain from discontinued operations, a valuation allowance would not have been needed on the deferred tax asset resulting from the $500 loss from continuing operations. Thus, $200 ($500 at 40 percent) of tax benefit is allocated to continuing operations. The $320 incremental effect of the gain on discontinued operations is the difference between $120 of total tax expense and the $200 tax benefit allocated to continuing operations.

Illustration 15-2: Exception to general intraperiod allocation principle with income from discontinued operations (before the adoption of ASU 2019-12)

Facts

Company C has a loss from continuing operations of $10,000 and income from discontinued operations of $18,000 for the year. Company C's income tax rate is 25%, and there are no temporary differences (i.e., the company's pretax financial income equals its taxable income) for simplicity. If Company C had no current year income from discontinued operations, the company would not be able to recognize a benefit from the loss in continuing operations, and a full valuation allowance would be recognized against any deferred tax assets (NOL carryforwards) originating in the current year.

Analysis

Income tax expense is allocated between the loss from continuing operations and income from discontinued operations as follows:

Calculation of the overall tax provision	
Pretax loss from continuing operations	$ (10,000)
Pretax income from discontinued operations	18,000
Pretax income	8,000
Effective tax rate	25%
Total income tax expense	$ 2,000

Determine the tax effect of pretax loss from continuing operations

Pretax loss from continuing operations	$ (10,000)
Tax rate	25%
Tax benefit allocated to continuing operations	$ (2,500)

Because there is a loss from continuing operations and income from other items outside of continuing operations, the exception to the general principal of allocating tax expense to continuing operations applies. ASC 740-20-45-7 requires that the $18,000 income from discontinued operations be considered in determining the benefit that is allocated to continuing operations. In this case, because the income from discontinued operations is greater than the loss from continuing operations, the entire $2,500 income tax benefit resulting from the loss in continuing operations is allocated to continuing operations.

Allocate the remainder of the tax provision to items other than continuing operations

Total income tax expense	$ 2,000
Less: tax benefits allocated to loss from continuing operations ($10,000 x 25%)	(2,500)
Tax expense allocated to income from discontinued operations (remainder)	$ 4,500

Illustration 15-3: Applying the exception to the general principle when there is a loss from continuing operations and other comprehensive income (before the adoption of ASU 2019-12)

Facts

Company C has a loss from continuing operations of $10,000 and other comprehensive income related to pension adjustments of $10,000 for the year. Further, for simplicity, assume that Company C's income tax rate is 25% and there are no temporary differences (i.e., the company's pretax financial income equals its taxable income). Company C began the year (and will end the year) with $15,000 of NOL carryforwards and a corresponding $15,000 valuation allowance. There are no limitations on the use of NOL carryforwards.

Analysis

Income tax expense is allocated between the loss from continuing operations and other comprehensive income as follows:

Calculation of the overall tax provision

Pretax loss from continuing operations	$ (10,000)
Other comprehensive income before tax	10,000
Pretax income	-
Effective tax rate	25%
Total income tax expense	$ -

Determine the tax effect of pretax loss from continuing operations

Pretax loss from continuing operations	$ (10,000)
Tax rate	25%
Tax benefit allocated to continuing operations	$ (2,500)

Because there is a loss from continuing operations and income from other items outside of continuing operations, the exception to the general principal of allocating tax expense to continuing operations applies. ASC 740-20-45-7 requires that the $10,000 income from the other comprehensive income be considered in determining the benefit that is allocated to continuing operations. In this case, because the income from other comprehensive income is at least equal to the loss from continuing operations, the entire $2,500 income tax benefit resulting from the loss is allocated to continuing operations.

Allocate the remainder of the tax provision to items other than continuing operations	
Total income tax expense	$ -
Less: tax benefits allocated to loss from continuing operations ($10,000 x 25%)	(2,500)
Tax expense related to other comprehensive income (remainder)	$ 2,500

Illustration 15-4: Applying the exception to the general principle when income from other items is less than the loss from continuing operations (before the adoption of ASU 2019-12)

Facts

Company C has a loss from continuing operations of $10,000 and other comprehensive income related to pension adjustments of $8,000 for the year. Further, for simplicity, assume that Company C's income tax rate is 25% and there are no temporary differences (i.e., the company's pretax financial income equals its taxable income). Company C does not expect to be able to realize the benefit from its NOL carryforwards because it is in a three-year cumulative loss position and, therefore, it recorded a full valuation allowance at the beginning and at the end of the year.

Analysis

Income tax expense is allocated between the loss from continuing operations and other comprehensive income as follows:

Calculate the overall tax provision	
Pretax loss from continuing operations	$ (10,000)
Other comprehensive income	8,000
Pretax income	(2,000)
Effective tax rate	25%
Total income tax benefit before valuation allowance	$ (500)
Increase in valuation allowance	500
Total income tax expense (benefit)	$ –

Determine the tax effect of pretax loss from continuing operations	
Pretax loss from continuing operations	$ (10,000)
Tax rate	25%
Tax benefit allocated to continuing operations before valuation allowance	$ (2,500)
Increase in valuation allowance	500
Total income tax benefit allocated to continuing operations	$ (2,000)

Because there is a loss from continuing operations and income from other items outside of continuing operations, the exception to the general principal of allocating tax expense to continuing operations applies. ASC 740-20-45-7 requires that the $8,000 income from the other comprehensive income be considered in determining the benefit that is allocated to continuing operations. In this case, because the income from other comprehensive income is less than the loss from continuing operations, the tax benefit allocated to continuing operations is limited to the amount of taxable income from the other item ($8,000 * 25% = $2,000).

Allocate the remainder of the tax provision to items other than continuing operations	
Total income tax benefit	$ -
Less: tax benefits allocated to loss from continuing operations	(2,000)
Tax expense related to other comprehensive income (remainder)	$ 2,000

Illustration 15-5: Exception to general intraperiod allocation principle with change in valuation allowance (before the adoption of ASU 2019-12)

Facts

Company A has a $1,000 loss from continuing operations and $1,200 of income from pension adjustments recorded in other comprehensive income in the current year. Further, assume that Company A's income tax rate is 25% and that its financial situation is such that it cannot rely on projections of future taxable income to justify the realization of deferred tax assets and that deferred tax assets at both the beginning and the end of the year require a full valuation allowance.

At the beginning of the year, Company A has a $2,000 net operating loss carryforward for which the $500 deferred tax asset, net of its valuation allowance, is zero. In addition, Company A started the year with a $3,000 liability related to pension accounting and a related deferred tax asset of $750, also offset by a full valuation allowance. The effects of the pension-related deferred tax assets were originally recorded through other comprehensive income and an offsetting balance remains in accumulated other comprehensive income. The valuation allowance recorded with an offset to other comprehensive income was originally recorded partially in conjunction with the minimum pension liability and partially in accordance with ASC 715. Because the valuation allowance was recorded at the same time the related deferred tax asset was created, the valuation allowance did not affect continuing operations but was instead recorded directly to other comprehensive income. See section 15.2.2.2, *Changes in the valuation allowance*, for additional discussion on changes in valuation allowances.

Analysis

The deferred tax balances at the beginning and end of the year are as follows:

	Beginning of year	End of year
NOL DTA	$ 500	$ 750
Pension DTA	750	450
	1,250	1,200
Valuation allowance	(1,250)	(1,200)
Net DTA	$ -	$ -

The company's total tax provision for the current period is as follows (for simplicity, no additional temporary differences exist):

Calculation of the overall tax provision	
Loss from continuing operations	$ (1,000)
Income in OCI	1,200
Pretax income	200
Tax rate	25%
Tax expense (before adjustment of valuation allowance)	50
Reduction in valuation allowance	(50)
Tax expense	$ -

Because the company has a $1,000 loss from continuing operations and income in other comprehensive income of $1,200, ASC 740-20-45-7 requires the company to consider the income included in other comprehensive income in determining the amount of tax benefit that results from a loss from continuing operations. Therefore, the company should allocate the tax provision of $0 to continuing operations and other comprehensive income as follows:

Determine the tax effect of pretax loss from continuing operations	
Loss from continuing operations	$ (1,000)
Tax rate	25%
Continuing operations tax (benefit)	(250)
Valuation allowance	-
Tax (benefit) — continuing operations	$ (250)

The loss from continuing operations is able to be fully benefited because income of at least that amount exists in OCI (presuming the same jurisdiction).

Allocate the remainder of the tax provision to items other than continuing operations	
Total tax expense (benefit)	$ -
Less: Amount allocated to continuing operations	(250)
Tax expense (benefit) allocated to other comprehensive income	$ 250

The effect of the change in the valuation allowance is reported in other comprehensive income because the change in the valuation allowance is attributed to, and only as a result of, income recognized in other comprehensive income in the current period. See section 15.2.2.2, *Changes in the valuation allowance*, for additional discussion of the intraperiod allocation guidance when there are changes in valuation allowances.

The following illustrates the income tax expense and the benefit from the reversal of the valuation allowance allocated to other comprehensive income.

Other comprehensive income	$ 1,200
Tax rate	25%
OCI tax expense	300
Reversal of valuation allowance due to OCI	(50)
Tax expense — OCI	$ 250

While alternative policies may be appropriate, we believe companies would only be required to apply the exception in ASC 740-20-45-7 when the company has a loss from continuing operations and combined pretax income from all other income items (e.g., discontinued operations, other comprehensive income and so forth).

Illustration 15-6: Exception to general intraperiod allocation principle with change in valuation allowance (before the adoption of ASU 2019-12)

Assume a company has a $1,000 loss from continuing operations, a $600 loss from discontinued operations and $1,000 in income recorded in other comprehensive income related to the company's pension plan in the current year. At the beginning of the year, the company has a $2,000 net operating loss carryforward for which the $500 deferred tax asset, net of its valuation allowance, is zero, and the entity did not reduce that valuation allowance during the year. The company's effective tax rate is 25%.

Calculation of the overall tax provision	
Loss from continuing operations	$ (1,000)
Loss from discontinued operations	(600)
Other comprehensive income	1,000
Pretax loss	(600)
Tax rate	25%
Tax benefit (before adjustment of valuation allowance)	(150)
Increase in valuation allowance	150
Total tax expense	$ -

Because the company has a net loss in total and increased its valuation allowance during the year, the total tax provision for the company would be zero.

Determine the tax effect of pretax loss from continuing operations	
Loss from continuing operations	$ (1,000)
Tax rate	25%
Continuing operations tax (benefit)	(250)
Valuation allowance	150
Tax (benefit) — continuing operations	$ (100)

Because the company has a $1,000 loss from continuing operations and income from other items of $400 ($1,000 income in other comprehensive income — $600 loss from discontinued operations) a benefit of $100 ($400 X 25%) should be allocated to continuing operations for the year.

Therefore, $100 of the total tax expense should be allocated to the other items in accordance with ASC 740-20-45-14.

15.2.1.1.1 Level of application for the exception to the general approach (before the adoption of ASU 2019-12)

While the exception in ASC 740-20-45-7 applies in all situations in which there is a loss from continuing operations and income from other items outside of continuing operations, questions often arise as to whether this exception applies when the loss from continuing operations and the income from other items outside of continuing operations occur in differing tax-paying components or only when both the loss from continuing operations and income from other items outside of continuing operations are in the same tax-paying component. ASC 740-10-30-5 describes tax-paying components as an individual entity or group of entities that file a consolidated return in the same tax jurisdiction.

We believe that, consistent with the jurisdictional approach used throughout ASC 740 and our discussion in section 15.1.1, *Level of application*, the exception most appropriately applies when the loss from continuing operations and income from other items outside of continuing operations are in the same tax-paying component.

Companies applying the intraperiod allocation rules at a tax-paying component level will need to carefully track items recognized outside of continuing operations by tax-paying component to apply the intraperiod allocation rules each reporting period. However, we are aware of diversity in practice such that some companies apply the exception in ASC 740-20-45-7 regardless of whether the loss from continuing operations and income from other items outside of continuing operations are within the same tax-paying component (i.e., applying the exception based on consolidated results), and we have not objected to this application as long as it is applied on a consistent basis.

Note: The exception to the general principle of intraperiod tax allocations under ASC 740 (as detailed in section 15.2.1.1, *Exception to the general principle of allocation to continuing operations (before the adoption of ASU 2019-12)*) only applies when there is a loss from continuing operations. Unless specifically mentioned, the remaining sections of this chapter assume income from continuing operations.

15.2.2 Other tax effects allocated to continuing operations

15.2.2.1 Changes in tax laws, rates or tax status

The effect of a change in tax law, rates, or tax status should be reflected in continuing operations, regardless of whether the item was initially established through another source (e.g., business combination or other comprehensive income). See chapter 8, *An enacted change in tax laws or rates*, and chapter 9, *Change in the tax status of an entity*, for further discussion.

15.2.2.2 Changes in the valuation allowance

The intraperiod tax allocation of the effects of changes in valuation allowances depends on the nature of the event that triggered the change.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Other Presentation Matters

740-10-45-20

The effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related **deferred tax asset** in future years ordinarily shall be included in income from continuing operations. The only exceptions are changes to valuation allowances of certain tax benefits that are adjusted within the measurement period as required by paragraph 805-740-45-2 related to business combinations and the initial recognition (that is, by elimination of the valuation allowances) of tax benefits related to the items specified in paragraph 740-20-45-11(c) through (f). The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations as required by paragraphs 740-20-45-2 and 740-20-45-8.

If a change in circumstances causes a change in judgment about the realizability of all or portion of a deferred tax asset, ASC 740-10-45-20 generally requires the effect of that change on the *beginning-of-the-year* balance of the valuation allowance to be reported as a component of income tax expense from continuing operations. However, in the following situations, the effect of a change in the valuation allowance is not reported in income.

1. In a business combination, changes to the valuation allowance within the measurement period that result from new information about facts and circumstances that existed at the acquisition date should be recognized through a corresponding adjustment to goodwill (or reduce the amount of bargain purchase recognized under ASC 805). See section 11.11, *Valuation allowance in a business combination*, for further discussion on accounting for changes in valuation allowances in accordance with ASC 805.

2. Initial recognition of tax benefits (by elimination or reduction of a valuation allowance) for the items listed below, which is required by ASC 740-20-45-11(c) and (f) (as required by paragraph ASC 740-10-45-20) to be allocated directly to the related components of shareholders' equity or other comprehensive income as opposed to a reduction in income tax expense:
   - Increases or decreases in contributed capital (for example, deductible expenses reported as a reduction of the proceeds from issuing capital stock (ASC 740-20-45-11(c)) and
   - Deductible temporary differences and carryforwards that existed at the date of a quasi-reorganization (ASC 740-20-45-11(f)).
3. Changes in the beginning of the year valuation allowance (except as listed in 1 or 2) that are attributed to, and only as a result of, income or loss recognized in a category other than income from continuing operations are allocated to that other item. However, if the change in the valuation allowance is attributable to a change in judgment related to realizability or not solely due to an item outside continuing operations, the impact of the change in valuation allowance would be allocated to continuing operations.

Illustration 15-7: Change in valuation allowance resulting from change in judgment about future years' taxable income

Facts

Company B has $10 million in deductible temporary differences relating to environmental liabilities at 31 December 20X0, taxes paid in the past have been minor, and the enacted tax rate is 25%. In addition, assume that a deferred tax asset of $2.5 million was recorded at 31 December 20X0 and a valuation allowance was not considered necessary, based on an assessment of all available evidence.

In 20X1, the company incurred a loss of $8 million and still has the same $10 million in deductible temporary differences. Deferred tax assets of $4.5 million (existing $10 million deductible difference plus $8 million NOL carryforward arising in the current year multiplied by the 25% tax rate) would be recorded at 31 December 20X1. However, based on an assessment of all available evidence, management concludes a valuation allowance is required for the entire $4.5 million deferred tax asset at 31 December 20X1. The $2.5 million net adjustment to deferred tax expense as a result of a change in the beginning period valuation allowance due to a change in judgment would be reported in 20X1 as part of income tax expense from continuing operations, and no benefit would be reflected for the $8 million current-period loss.

(in thousands)	20X0	20X1 activity	20X1
Deferred tax asset-environmental liabilities	$ 2,500	-	$ 2,500
NOL carryforward	-	2,000	2,000
Total before valuation allowance	2,500	2,000	4,500
Valuation allowance	-	(4,500)	(4,500)
Net deferred tax assets	$ 2,500	$ (2,500)	$ -

Analysis

Calculation of the overall tax provision	*(in thousands)*
Pretax loss	$ (8,000)
Tax rate	25%
Tax benefit before valuation allowance	$ (2,000)
Increase in valuation allowance	4,500
Tax expense	$ 2,500

Based on the intraperiod allocation rules, because there was a change in circumstances that resulted in a change in judgment about the realizability of the beginning of the year deferred tax assets ($2,500 deferred tax asset related to the environmental liabilities), that portion of the increase in the valuation allowance is allocated to continuing operations. If there were components other than continuing operations, the allocation of the remaining increase ($2,000) would be allocated following ASC 740-10-45-20.

Illustration 15-8: Change in valuation allowance resulting from change in judgment about future years' taxable income, with income from continuing operations and discontinued operations

Facts

Company B has $10 million in deductible temporary differences relating to environmental liabilities at 31 December 20X0 and the enacted tax rate is 25%. In addition, assume that the deferred tax asset of $2.5 million was recorded at 31 December 20X0 and a full valuation allowance was considered necessary based on an assessment of all available evidence.

In 20X1, Company B reported income from continuing operations of $8 million, income from discontinued operations of $5 million, and it still has the same $10 million in deductible temporary differences. Company B would still have a deferred tax asset of $2.5 million recorded at 31 December 20X1. However, based on a new assessment of all available evidence at 31 December 20X1, management concluded that the valuation allowance is no longer necessary. The $2.5 million income tax benefit as a result of a reduction in the beginning period valuation allowance due to a change in judgment would be allocated in 20X1 to income tax expense from continuing operations.

(in thousands)	20X0	20X1 activity	20X1
Deferred tax asset-environmental liabilities	$ 2,500	-	$ 2,500
Total before valuation allowance	2,500	-	2,500
Valuation allowance	(2,500)	2,500	-
Net deferred tax assets	$ -	$ 2,500	$ 2,500

Analysis

Calculation of the overall tax provision	*(in thousands)*
Income from continuing operations	$ 8,000
Income from discontinued operations	$ 5,000
Pretax income	$ 13,000
Tax rate	25%
Tax expense before change in valuation allowance	$ 3,250
Decrease in valuation allowance	(2,500)
Tax expense	$ 750

Determine the tax effect of pretax loss from continuing operations	*(in thousands)*
Income from continuing operations	$ 8,000
Tax rate	25%
Continuing operations tax expense	$ 2,000
Valuation allowance	(2,500)
Tax benefit — Continuing operations	$ (500)

Allocate the remainder of the tax provision to items other than continuing operations	*(in thousands)*
Total tax expense	$ 750
Less: Benefit allocated to continuing operations	(500)
Remainder of the tax expense allocated to discontinued operations	$ 1,250

Based on the intraperiod allocation rules, because there was a change in circumstances that resulted in a change in judgment about the realizability of the beginning-of-the-year deferred tax assets ($2,500 deferred tax asset related to the environmental liabilities), the decrease in the valuation allowance is allocated to continuing operations.

Illustration 15-9: Changes in the valuation allowance after a business combination

Facts

Company A acquired Company B on 30 December 20X0 and accounted for the acquisition pursuant to ASC 805. Company B had a net operating loss carryforward of $10 million and Company A recorded a gross deferred tax asset of $2.5 million in the purchase price allocation. Company A concluded that a full valuation allowance was required at the acquisition date and, accordingly, established a $2.5 million valuation allowance in the purchase price allocation. Because its operations were profitable in 20X1, Company A subsequently concluded that the valuation allowance was no longer required.

Analysis

Because the elimination of the allowance is triggered by facts and circumstances that did not exist at the acquisition date, the effect of the change in the valuation allowance would be reported as a reduction in income tax expense for 20X1. The allocation in this case is the same, regardless of whether the adjustment is recorded during or after the measurement period.

Illustration 15-10: Changes in the valuation allowance due to a current year event

Facts

Company EAE has a deferred tax asset related to a net operating loss carryforward that has been offset by a full valuation allowance as of 31 December 20X0. Also, assume that Company EAE has no other temporary differences and had income in continuing operations for the year. In 20X1, Company EAE records a significant unrealized gain through other comprehensive income on an available-for-sale debt security. The unrealized appreciation on the available-for-sale debt security is sufficient to reverse the valuation allowance, and it is solely because of the current year appreciation in the market value of the available-for-sale debt security that the valuation allowance is reversed.

Analysis

In this example, because the reversal of the valuation allowance is due solely to the current year unrealized appreciation in the available-for-sale debt security, the benefit of the reduction in the valuation allowance would be recorded in other comprehensive income. If, however, it was unclear whether the reduction in valuation allowance was due to a change in judgment or the unrealized appreciation, the benefit of the reduction in the valuation allowance would be recorded in continuing operations as a change in judgment.

15.2.3 Tax benefit of dividends on shares held by ESOP

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12, which simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the existing guidance to promote more consistency. The amendments to ASC 718-740-45-7 specify that the tax benefit of tax-deductible dividends on allocated and unallocated employee stock ownership plan shares must be recognized in continuing operations.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Early adoption is permitted in interim or annual periods for which all other entities (i.e., entities that are not PBEs) have not made financial statements available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply this amendment prospectively.

Excerpt from Accounting Standards Codification

Compensation — Stock Compensation

Income Taxes

Other Presentation Matters

Employee Stock Ownership Plans

718-740-45-7

The tax benefit of tax-deductible dividends on allocated and unallocated **employee stock ownership plan** shares shall be recognized in the income statement.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

The tax benefit of tax-deductible dividends on allocated and unallocated **employee stock ownership plan** shares shall be recognized in income taxes allocated to continuing operations.

Pursuant to US tax laws, an entity that sponsors an employee stock ownership plan (ESOP) is entitled to deduct cash dividends paid on stock held by an ESOP. Shares held by an ESOP are either allocated or unallocated. Allocated shares are shares held by the ESOP that have been earned by employees and allocated to a specific employee account while unallocated shares are shares held by the ESOP that have not yet been earned by employees and remain in the general asset pool of the ESOP.

15.2.3.1 Tax benefit of dividends on allocated ESOP shares

The tax benefit of tax-deductible dividends paid on allocated shares of an ESOP (i.e., shares already earned by employees) is recognized as a reduction of income tax expense. ASU 2019-12 clarified this tax benefit should be allocated to continuing operations (ASC 718-740-45-7). This is consistent with ASC 740-20-45-8(d), which requires that the tax effects of tax-deductible dividends paid to shareholders be allocated to continuing operations, similar to other tax-deductible dividends paid to other shareholders. The tax deduction for ESOP dividends on allocated shares is effectively an exemption from taxation of an equivalent level of corporate earnings. For that reason, the FASB concluded that the tax benefit should be recognized as a reduction of tax expense and should not be allocated directly to shareholders' equity.

15.2.3.2 Tax benefit of dividends on unallocated ESOP shares

Pursuant to ASC 718-40-25-16, dividends paid on unallocated ESOP shares are not treated as dividends for accounting purposes because the employer controls the use of the dividends. Consequently, ESOP dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation expense, and dividends on unallocated shares that are used to pay debt service should be reported as a reduction of debt or of accrued interest payable.

As a result of the application of ASC 718-40-25-16, dividends on unallocated shares do not result in a credit to paid-in capital, nor is the tax effect recorded there. The tax benefit of dividends on unallocated ESOP shares is included in income tax expense from continuing operations (as clarified by ASU 2019-12 in ASC 718-740-45-7), rather than paid-in capital.

15.3 Items charged or credited directly to shareholders' equity

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Other Presentation Matters

740-20-45-11

The tax effects of the following items occurring during the year shall be charged or credited directly to other comprehensive income or to related components of shareholders' equity:

a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error. Paragraph 250-10-45-8 addresses the effects of a change in accounting principle, including any related income tax effects.

b. Gains and losses included in comprehensive income but excluded from net income (for example, translation adjustments accounted for under the requirements of Topic 830 and changes in the unrealized holding gains and losses of securities classified as available-for-sale as required by Topic 320).

c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock).

d. Subparagraph superseded by Accounting Standards Update No. 2016-09.

e. Subparagraph superseded by Accounting Standards Update No. 2016-09.

f. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization.

g. All changes in the tax bases of assets and liabilities caused by transactions among or with shareholders shall be included in equity including the effect of valuation allowances initially required upon recognition of any related deferred tax assets. Changes in valuation allowances occurring in subsequent periods shall be included in the income statement.

ASC 740-20-45-11 specifies five items for which the tax effects are charged or credited directly to related components of shareholders' equity. Those items are:

1. Adjustments to beginning retained earnings for certain changes in accounting principles or a correction of an error.

2. Gains and losses included in comprehensive income but excluded from net income. Under present generally accepted accounting principles, items of this nature include unrealized gains and losses on investments in debt securities classified as available-for-sale (AFS) (see section 15.3.1, *Income taxes for debt securities classified as available-for-sale*, certain derivative financial instruments classified as hedges (see section 15.3.3, *Cash flow hedges*), investments in industries having specialized accounting practices for marketable securities, adjustments from recognizing certain additional pension liabilities (see section 15.3.4, *Deferred taxes for postretirement benefit plans*) and foreign currency translation adjustments (see section 15.3.2, *Cumulative translation adjustment*).

3. An increase or decrease in contributed capital (for example, certain expenses incurred in connection with issuing capital stock that are deductible for tax purposes but are treated as a reduction of the stock's proceeds for financial reporting) (see section 15.3.5.1, *Income tax consequences of issuing convertible debt with a beneficial conversion feature (before the adoption of ASU 2020-06)*).[48]

4. Deductible temporary differences and carryforwards that existed at the date of a quasi-reorganization (see chapter 16, *Reorganizations*).

5. All changes in the tax bases of assets and liabilities caused by transactions among or with shareholders, including the effect of valuation allowances initially required upon recognition of any related deferred tax assets.

15.3.1 Income taxes for debt securities classified as available for sale

ASC 320, *Investments — Debt Securities*, addresses the accounting and reporting for investments in debt securities. The carrying amount of the security will depend on whether the security is classified as "held-to-maturity," "trading" or "available-for-sale." ASC 320 requires companies to present investments in debt securities at fair value unless such investment meets strict criteria for classification as HTM. After the adoption of ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, entities follow the guidance in ASC 326-30, *Financial Instruments — Credit Losses — Available-For-Sale Debt Securities*, to account for impairment on AFS debt securities. ASC 326-30 requires an investor to record any impairment that is not credit related in OCI, net of applicable taxes. Credit-related impairment is recognized as an allowance on the balance sheet with a corresponding adjustment to earnings. However, if an entity intends to sell an impaired AFS debt security or more likely than not will be required to sell such a security before recovering its amortized cost basis, the entire impairment amount must be recognized in earnings with a corresponding adjustment to the security's amortized cost basis. Our FRD, ***Certain investments in debt and equity securities***, discusses the accounting and reporting requirements for investments in debt securities in detail, and our FRD, ***Credit impairment under ASC 326***, discusses the impairment accounting for AFS debt securities after the adoption of ASU 2016-13.

Investments in debt securities classified as trading or available-for-sale which are measured at fair value generally result in temporary differences because the tax law generally defers recognition of gains and losses from investments until disposition. ASC 740 distinguishes between gains and losses included directly in other comprehensive income and those included in net income and requires that unrealized gains and losses included in other comprehensive income be reported net of any related income tax effects. Thus, the tax effects of the recognition of unrealized gains and losses on debt securities classified as available-for-sale reported as a component of other comprehensive income also should be charged or credited directly to other comprehensive income.

The following example assumes the debt security has a different carrying amount for financial reporting and tax purposes. It also assumes all deferred tax assets meet the more-likely-than-not standard of realizability. If the security is required to be marked-to-market for tax purposes, then a current tax receivable or payable might result rather than a deferred tax asset or liability.

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[48] In August 2020, the FASB issued ASU 2020-06, *Debt-Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging-Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. The new guidance eliminates two of the three models in ASC 470-20 that require an issuer of convertible instruments to separate the accounting for embedded conversion features from convertible instruments. The guidance is effective for PBEs for fiscal years beginning after 15 December 2021, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2023, and interim periods within those years. Early adoption is permitted, but no earlier than fiscal years beginning after 15 December 2020, including interim periods within those years.

Illustration 15-11: Income taxes for debt securities classified as available for sale

Debt security A, with a par value of $10,000, is purchased on 1 June 20X1 for $10,000 and classified as available-for-sale. At 31 December 20X1, the security has a market value of $11,000, resulting in an unrealized gain of $1,000. The following entries would be made to record the unrealized gain and the related tax effect (assuming a 25% statutory tax rate and income from continuing operations is zero):

Available-for-sale debt securities — fair value adjustment (fair value of $11,000 less the amortized cost of $10,000)	$ 1,000	
Other comprehensive income — unrealized gains and losses		$ 1,000
Other comprehensive income — unrealized gains and losses (tax effect)	$ 250	
Deferred tax liability (the computed tax effect on the temporary difference, or $1,000 times the statutory tax rate of 25%)		$ 250

At 31 December 20X2, assume the security has a market value of $9,000, resulting in an unrealized loss of $1,000, based on original cost. The decline in market value is not due to credit and the company expects to recover its entire amortized cost basis. The following entries would be made to reverse the previously recorded unrealized gain and record an unrealized loss:

Other comprehensive income — unrealized gains and losses	$ 2,000	
Available-for-sale debt securities — fair value adjustment (fair value of $9,000 less the prior carrying value of $11,000)		$ 2,000
Deferred tax asset (the computed tax effect on the temporary difference or $1,000 multiplied by the statutory tax rate of 25% assuming no valuation allowance is required)	$ 250	
Deferred tax liability (reversal of the previous deferred tax liability)	250	
Other comprehensive income — unrealized gains and losses		$ 500

During 20X3, the security is sold for $9,000. The following entries would be made:

Cash	$ 9,000	
Loss on sale of securities	1,000	
Available-for-sale debt securities — fair value adjustment	1,000	
Available-for-sale debt securities		$ 10,000
Deferred tax asset (reversal of the previous deferred asset)		250
Other comprehensive income — unrealized gains and losses (reversal of the balance in other comprehensive income)		750
Current tax payable	$ 250	
Current income tax benefit (the loss on sale of securities of $1,000 times the statutory tax rate of 25%)		$ 250

There is no net effect on total shareholders' equity as the realized loss should result in a current tax benefit in an amount equal to the previously deferred tax asset.

15.3.1.1 Initial recognition of unrealized loss

Many companies with investments in fixed-rate debt securities experience significant declines in the market value of their investment portfolios when market interest rates increase. To the extent that those securities are classified as available-for-sale in accordance with ASC 320-10-25-1(b), those market declines result in charges directly to other comprehensive income assuming the decline is not due to credit, the company does not intend to sell and it is not more likely than not that the entity will be required to sell the debt securities. Questions have arisen regarding the appropriate accounting for deferred tax assets and related valuation allowances recorded in accordance with ASC 740, as a result of the application of ASC 320 (and ASC 326 after the adoption of ASU 2016-13).

Illustration 15-12: Initial recognition of an unrealized loss on debt securities

Assume in year 1, Insurance Co. purchased an available-for-sale debt securities portfolio with a cost basis of $1,000. Subsequent to the purchase date, the portfolio's market value declines to $900. Also assume that Insurance Co. determines that the decline is not due to credit, does not intend to sell the security and is not more likely than not the entity will be required to sell the debt securities. In accordance with ASC 740 and ASC 320, the following entries record the unrealized loss on the portfolio and the related deferred tax asset (assuming a 25% tax rate, no valuation allowance is required and there is no other-than-temporary impairment):

Other comprehensive income — unrealized losses	$ 100	
Available-for-sale debt securities — fair value adjustment		$ 100
Deferred tax assets	$ 25	
Other comprehensive income — unrealized losses		$ 25

15.3.1.2 Valuation allowances

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Other Presentation Matters

740-20-45-15

An entity that recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may at the same time conclude that it is more likely than not that some or all of that deferred tax asset will not be realized. In that circumstance, the entity shall report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in **debt securities** because the valuation allowance is directly related to the unrealized holding loss on the available-for-sale securities. The entity shall also report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt securities if the entity concludes on the need for a valuation allowance in a later interim period of the same fiscal year in which the deferred tax asset is initially recognized.

740-20-45-16

An entity that does not need to recognize a valuation allowance at the same time that it establishes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may, in a subsequent fiscal year, conclude that it is more likely than not that some or all of that deferred tax asset will not be realized. In that circumstance, if an entity initially decided that no valuation allowance was required at the time the unrealized loss was recognized but in a subsequent fiscal year decides that it is more likely than not that the deferred tax asset will not be realized, a valuation allowance shall be recognized. The entity shall include the offsetting entry as an item in determining income from continuing operations. The offsetting entry shall not be included in other comprehensive income.

740-20-45-17

An entity that recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may, at the same time, conclude that a valuation allowance is warranted and in a subsequent fiscal year makes a change in judgment about the level of future years' taxable income such that all or a portion of that valuation allowance is no longer warranted. In that circumstance, the entity shall include any reversals in the valuation allowance due to such a change in judgment in subsequent fiscal years as an item in determining income from continuing operations, even though initial recognition of the valuation allowance affected the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt securities. If, rather than a change in judgment about future years' taxable income, the entity generates taxable income in the current year (subsequent to the year the related deferred tax asset was recognized) that can use the benefit of the deferred tax asset, the elimination (or reduction) of the valuation allowance is allocated to that taxable income. Paragraph 740-10-45-20 provides additional information.

740-20-45-18

An entity that has recognized a deferred tax asset relating to other deductible temporary differences in a previous fiscal year may at the same time have concluded that no valuation allowance was warranted. If in the current year an entity recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities that arose in the current year and at the same time concludes that a valuation allowance is warranted, management shall determine the extent to which the valuation allowance is directly related to the unrealized loss and the other deductible temporary differences, such as an accrual for other postemployment benefits. The entity shall report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt securities only to the extent the valuation allowance is directly related to the unrealized loss on the available-for-sale securities that arose in the current year.

Determining whether a valuation allowance is required is important not only because of its initial effect on other comprehensive income, but also because of the accounting implications resulting from changes in the valuation allowance in subsequent fiscal years. In that regard, subsequent changes in the valuation allowance can result in adjustments to (1) other comprehensive income for subsequent changes in the market value of the portfolio, or (2) income tax expense for changes in circumstances that cause a change in judgment in future years about the realizability of the deferred tax asset. In the first case, if the subsequent reversal of the valuation allowance solely due to changes in market value in a year after the year the related deferred tax assets were recognized, ASC 740-20-45-17 requires the reduction or elimination of the valuation allowance be allocated to that income (i.e., other comprehensive income). In the latter case, ASC 740-10-45-20 requires the adjustment to be made to income tax expense in the income statement, notwithstanding that the allowance was initially established through equity.

As discussed in chapter 6, *Valuation allowances*, ASC 740-10-30-17 requires an assessment of all available evidence, both positive and negative, to determine the amount of any required valuation allowance. In determining the need for a valuation allowance, a company should consider four sources of taxable income: taxable income in prior carryback years, taxable income from future reversals of existing taxable temporary differences, taxable income from prudent and feasible tax-planning strategies and, in certain circumstances, future taxable income exclusive of reversing temporary differences and carryforwards. It is important that the existence of sufficient taxable income of the appropriate character (e.g., capital gain income) in either the carryback or carryforward period as provided for under the applicable tax law is available.

The Illustration 15-12 above assumes, at the time the deferred tax asset of $25 was recorded, Insurance Co. concluded it was more likely than not it would be able to offset the estimated capital loss related to available-for-sale debt securities portfolio against a capital gain and therefore recorded the full tax benefit of the unrealized loss. The following illustration assumes that the company concluded it was more likely than not that some portion or all of the deferred tax asset would not be realized.

Illustration 15-13: Unrealized loss on AFS debt securities and recognition of a valuation allowance

Assume the same facts and circumstances as Illustration 15-12. However, in this case, Insurance Co. concluded, based on the weight of the available evidence, it was more likely than not that some portion or all of the deferred tax asset would *not* be realized and a valuation allowance would have been required.

The offsetting entry to the valuation allowance established when the deferred tax asset is initially recorded is reported in the available-for-sale debt securities component of other comprehensive income as the valuation allowance is directly related to the unrealized holding loss on the available-for-sale debt securities. The offsetting entry to the valuation allowance would also be reported in the available-for-sale debt securities component of other comprehensive income if the entity reaches its conclusion on the need for a valuation allowance in a later interim period of the same fiscal year in which the deferred tax asset is initially recognized (ASC 740-20-45-15).

Alternatively, assume a company that recognized a deferred tax asset relating to other deductible temporary differences in a previous fiscal year (i.e., no valuation allowance was warranted). If in the current year the company recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale debt securities that arose in the current year and, at the same time, concludes a valuation allowance is now warranted, the company should determine the extent to which the valuation allowance is directly related to the unrealized loss on the available-for-sale debt securities arising in the current year and other deductible temporary differences. The offsetting entry to the valuation allowance reported in the available-for-sale debt securities component of other comprehensive income is *only* the amount of the valuation allowance directly related to the unrealized loss on the available-for-sale securities arising in the current year (ASC 740-20-45-18).

If an unrealized loss is subsequently realized (i.e., the debt securities are sold at a loss), the loss, in the United States, may be subject to the capital loss rules of the IRC. Under those rules, the realization of a tax benefit from a capital loss generally can only be obtained by offsetting the loss against a capital gain. The rules generally provide that capital losses not utilized in the year incurred may be carried back three years and carried forward five years. As a consequence of the tax rules, companies may conclude a valuation allowance is required. In determining whether a valuation allowance is required on deferred tax assets arising from unrealized capital losses, the ability to carry back the capital loss that would be realized upon sale to recover taxes from capital gain income in a carryback year might support a conclusion a valuation allowance is not required. However, even in this case, consideration would have to be given as to whether it is reasonable to conclude the loss securities would be sold in the appropriate time period to allow the loss to be carried back.

Illustration 15-14: Subsequent changes in the valuation allowance due to changes in the market value of the portfolio

Assume in year 1, Insurance Co. has an available-for-sale debt securities portfolio with a cost basis of $1,000. After the purchase date, the portfolio's market value declines to $900. The decline is not due to credit and Insurance Co. expects to recover its entire amortized cost basis. In accordance with ASC 740 and ASC 320, the following entries record the unrealized loss on the portfolio and the related deferred tax asset (assuming a 25% tax rate):

Other comprehensive income — unrealized losses	$ 100	
Available-for-sale debt securities — fair value adjustment		$ 100
Deferred tax assets	$ 25	
Other comprehensive income — unrealized losses		$ 25

If Insurance Co. concludes, based on the weight of available evidence, it is more likely than not it would **not** realize the deferred tax asset (when the deferred tax asset is initially recorded), the following entry would be necessary:

Other comprehensive income — unrealized losses	$ 25	
Valuation allowance — deferred tax assets		$ 25

15.3.1.2.1 *Deferred tax assets related to unrealized losses on debt securities (updated August 2022)*

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Initial Measurement

740-10-30-16

As established in paragraph 740-10-30-2(b), there is a basic requirement to reduce the measurement of deferred tax assets not expected to be realized. An entity shall evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with the entity's other deferred tax assets.

The remeasurement of a financial instrument at fair value generally creates a temporary difference between the reporting basis and the tax basis of the instrument under ASC 740 because the tax basis generally remains unchanged. This difference requires recognition of deferred taxes. An unrealized loss can give rise to a deferred tax asset, which must be assessed for realizability.

In accordance with ASC 740-10-30-16, an entity has to assess the realizability of a DTA related to an AFS debt security in combination with its other DTAs. The FASB believes that there is no conceptual basis for segregating deferred tax assets relating to fair value changes of available-for-sale debt securities without also segregating other individual deferred tax assets. The future realization of DTAs depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period under the tax law. An entity must assess the realizability of DTAs related to AFS debt securities using the same four sources of taxable income that are used to assess other DTAs. For example, an appropriate tax planning strategy (source 3) may exist if an entity has both the intent and ability to hold an available-for-sale debt security to recover the non-credit-related unrealized loss because it would be expected to be recovered from the remaining expected contractual cash flows. See section 6.5, *Source three — tax-planning strategies*, for additional discussion on tax planning strategies.

When an entity develops its projections of future taxable income (source 4) to assess the realizability of all DTAs, including those related to AFS debt securities, it would include the expected reversal of unrealized losses on AFS debt securities that it has both the intent and ability to hold over the projection period or the remaining period until recovery, if shorter, as a component of its overall projection of future taxable income. The analysis would be based on the total projection of future taxable income. However, while the expected reversal of unrealized losses during the recovery period may be included in projections of future taxable income, it would not be appropriate to forecast future appreciation in fair values of AFS debt securities related to other factors, such as anticipating the effect of future interest rate reductions or favorable changes to a debtor's credit worthiness. See section 6.6, *Source four — future taxable income (exclusive of reversing temporary differences and carryforwards)*, for additional discussion on using source four.

An entity may not be able to rely on projections of future taxable income for purposes of evaluating realizability of DTAs if significant negative evidence exists (e.g., cumulative losses in recent years).

Illustration 15-15: Realizability assessment for deferred tax assets related to unrealized losses on debt securities

Company A has DTAs related to the following at 31 December 20X2 (there are no DTLs):

Net operating loss carryforwards	$ 400
Unrealized losses on AFS debt securities	15
Total	$ 415

To evaluate the realizability of its DTAs, Company A considers the four sources of taxable income described in ASC 740. Assume that Company A is not in a cumulative loss position and concludes that it will have no taxable income from prior carryback years, future reversals of existing taxable temporary differences or tax-planning strategies at the end of 20X2. In that case, Company A must look to the fourth source, which is a projection of taxable income exclusive of reversing temporary differences and carryforwards. Company A would develop its projection of future taxable income considering all sources of income. Since Company A has the intent and ability to hold the debt security until recovery, the projections of future taxable income will include the expected reversal of the previously recognized unrealized loss over the projection period or the remaining holding period until recovery, if shorter. The overall projection of future taxable income is a source of income for all DTAs. Because Company A is not in a cumulative loss position, the projections of future taxable income may be used to evaluate the realizability of the DTA for unrealized losses on available-for-sale debt securities in combination with the Company's other deferred tax assets.

By their very nature, projections of taxable income require judgments and estimates about future events that are less certain than past events that can be objectively measured. Both positive and negative evidence should be considered in determining whether a valuation allowance is needed. Because estimates of future taxable income require significant judgment, the more negative evidence that exists (e.g., cumulative losses in recent years), the less reliance can be placed on projections of future taxable income.

That is, expectations about future taxable income would rarely be sufficient to overcome the negative evidence of recent cumulative losses, even if an entity supports its expectations with detailed forecasts and projections. In this fact pattern, if Company A were to conclude that significant negative evidence exists (e.g., cumulative losses in recent years), it is unlikely that the positive evidence from its projections of future taxable income would overcome this significant negative evidence, and a valuation allowance of $415 likely would be required on its DTAs at 31 December 20X2. In that case, even though Company A has the intent and ability to hold the debt security over the projection period, ASC 740-10-30-16 requires the related DTA be evaluated in combination with the Company's other deferred tax assets. That is, the projection of future taxable income from recovery of unrealized losses over the projection period is not a separate source of future taxable income (source 4) that can be used separately to evaluate the realizability of the related deferred tax asset.

15.3.1.2.2 Changes in valuation allowances after initial recognition

Based on the analysis of whether a valuation allowance is required, many entities establish a full valuation allowance when the deferred tax asset is initially recorded, but others establish a partial, or no, valuation allowance. Regardless of the initial decision, estimates of the need for or the amount of a valuation allowance may subsequently change. With regard to unrealized losses on available-for-sale debt securities, changes in the amount of the deferred tax asset valuation allowance generally will result from: (1) changes in the market value of the available-for-sale debt securities portfolio or (2) changes due to a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future periods. The accounting for the change in the valuation allowance (i.e., as a debit or credit to income or other comprehensive income) will depend on the reasons underlying the change.

15.3.1.2.2.1 Changes due to changes in the value of an available-for-sale debt securities portfolio

In periods after the establishment of a deferred tax asset and related valuation allowance, the market value of the AFS debt securities portfolio may increase. Before the adoption of ASU 2016-13, this would result in a decrease (or possible elimination) of the unrealized loss that previously was recognized in other comprehensive income, with a resulting decrease in the deferred tax asset and related valuation allowance. In such circumstances, the decrease in both the deferred tax asset and the valuation allowance would be recorded as an offset to other comprehensive income.

Illustration 15-16: Changes in the valuation allowance due to changes in portfolio value

Continuing with the Illustration 15-14 (including the recording of the 100% valuation allowance), assume in year 2 the only change was an increase in the market value of Insurance Co.'s available-for-sale debt securities portfolio to $960 (an unrealized gain of $60) and the tax rate remains at 25%. The following entries would be made:

Available-for-sale debt securities — fair value adjustment	$ 60	
Other comprehensive income — unrealized losses		$ 60
Other comprehensive income — unrealized losses	$ 15	
Deferred tax assets		$ 15
Valuation allowance — deferred tax assets	$ 15	
Other comprehensive income — unrealized losses		$ 15

In accordance with the provisions of ASC 740-10-45-20 and ASC 740-20-45-17, because the change in the value of the portfolio is reported in other comprehensive income, the corresponding changes in the deferred tax asset and valuation allowance also are recorded in other comprehensive income. Accordingly, at the end of year 2, the separate component of other comprehensive income would reflect an unrealized loss of $40. In addition, assuming a full valuation allowance is still deemed necessary, the deferred tax asset of $10 would be offset by a valuation allowance of $10.

Before the adoption of ASU 2016-13, a decrease in the valuation allowance that results from a decrease in the deferred tax asset directly associated with an increase in the debt security portfolio value (assuming the increase in portfolio value is recognized in other comprehensive income) would be recorded in other comprehensive income even if the valuation allowance was originally recognized through income. For instance, an other-than-temporary impairment (OTTI) is recorded resulting in a deferred tax asset and a valuation allowance is required when the deferred tax asset is initially recorded (as it is not more likely than not that the deferred tax asset will be realized). A portion of the OTTI is related to credit loss and is recognized in earnings and a portion of the loss is related to other factors and is recognized in OCI. The tax effects of recording the deferred tax asset and the valuation allowance would be recorded in continuing operations for the portion related to the credit loss (along with the credit loss) and in other comprehensive income for the portion related to other factors. A subsequent increase in the market value of the available-for-sale debt security would result in a decrease in both the deferred tax asset and the valuation allowance. The decrease in both the deferred tax asset and the valuation allowance would be recorded to other comprehensive income consistent with the unrealized gain, even though a portion of the deferred tax asset and valuation allowance was originally recorded in continuing operations.

After the adoption of ASU 2016-13, the same approach described above is taken when the entity plans to sell or will more likely than not be required to sell, an impaired security before it recovers and records the entire decline in fair value in earnings. When an entity does not plan to sell, or more likely than not will not be required to sell, the security before it recovers, it records credit-related impairment as an allowance on the balance sheet with a corresponding adjustment to earnings. The portion of the impairment that is not credit related is recorded in OCI, net of applicable taxes. In this situation, a decrease in a deferred tax asset and valuation allowance due to a subsequent increase in the market value of the available-for-sale debt security is recorded in the same account where the impairment was originally recorded. As such, for changes attributable to the credit-related impairment (improvement in the debtor's credit), the related change in the deferred tax asset and valuation allowance should be recorded in continuing operations. For non-credit-related impairment, the income tax effect of reducing the related deferred tax asset and valuation allowance is recorded in other comprehensive income.

See section 15.2.2.2, *Changes in the valuation allowance*.

Illustration 15-17: Subsequent decreases in the market value of the available-for-sale investment due to credit deterioration (before the adoption of ASU 2016-13)

Assume Company A has an available-for-sale debt security with a cost basis of $1,000 and the investment market value declines to $600. Before the adoption of ASU 2016-13, in accordance with ASC 320, the company determines that the decline is solely based on credit deterioration and records an other-than-temporary impairment related to credit deterioration in income from continuing operations. The following journal entries would be recorded (assuming a 25% tax rate):

Other-than-temporary impairment	$ 400	
Available-for-sale debt securities		$ 400
Deferred tax assets	$ 100	
Deferred income tax expense		$ 100

Company A determined that it was not more likely than not that the deferred tax asset would be realized. Therefore, Company A recorded a full valuation allowance.

Deferred income tax expense	$ 100	
Valuation allowance — deferred tax assets		$ 100

In the subsequent year the AFS debt security's market value increases to $700. In addition, assume Company A has income from continuing operations for the year. Company A has no other deferred tax assets or liabilities. In accordance with ASC 740 and ASC 320, the following journal entries would be recorded (assuming a 25% tax rate):

Available-for-sale debt securities — fair value adjustment	$ 100	
Other comprehensive income — unrealized gains		$ 100
Other comprehensive income — unrealized gains	$ 25	
Deferred tax asset		$ 25
Valuation allowance — deferred tax assets	$ 25	
Other comprehensive income — unrealized gains		$ 25

In accordance with the provisions of ASC 740-10-45-20 and ASC 740-20-45-17, because the increase in the value of the AFS debt security is reported in other comprehensive income, the corresponding changes in the deferred tax asset and valuation allowance also are recorded in other comprehensive income. In addition, assuming a full valuation allowance still is necessary, the remaining deferred tax asset of $75 would continue to be offset by a valuation allowance of $75.

Illustration 15-17A: Subsequent decreases in the fair value of the available-for-sale investment due to credit deterioration (after the adoption of ASU 2016-13)

Company A has an available-for-sale debt security with a cost basis of $1,000, and the investment's fair value declines to $600. In accordance with ASC 326 (after the adoption of ASU 2016-13), the company determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security before it recovers its amortized cost basis. Company A determines that $300 of the unrealized loss is due to credit-related factors and $100 of the unrealized loss is due to non-credit-related factors. The following journal entries would be recorded (assuming a 25% tax rate):

Credit loss expense	$ 300	
Allowance for credit losses		$ 300
Other comprehensive income — unrealized losses	$ 100	
Available-for-sale debt securities		$ 100
Deferred tax assets	$ 75	
Deferred income tax expense		$ 75
Deferred tax assets	$ 25	
Other comprehensive income — unrealized losses		$ 25

At the time it recorded the related deferred tax assets, Company A determined that it was not more likely than not that the deferred tax asset would be realized. Therefore, Company A recorded a full valuation allowance.

Deferred income tax expense	$ 75	
Valuation allowance — deferred tax assets		$ 75
Other comprehensive income — unrealized losses	$ 25	
Valuation allowance — deferred tax assets		$ 25

In the following year, the available-for-sale debt security's fair value increases by $100 to $700 and the increase is solely related to an improvement in credit-related factors. In addition, assume Company A has income from continuing operations for the year. Company A has no other deferred tax assets or liabilities. In accordance with ASC 740 and ASC 326, the following journal entries would be recorded (assuming a 25% tax rate):

Allowance for credit losses	$ 100	
Credit loss expense		$ 100
Deferred income tax expense	$ 25	
Deferred tax asset		$ 25
Valuation allowance — deferred tax assets	$ 25	
Deferred income tax expense		$ 25

In accordance with the provisions of ASC 740-10-45-20 and ASC 740-20-45-17, because the increase in the fair value of the available-for-sale debt security is reported in continuing operations as a reversal of the credit loss expense, the corresponding changes in the deferred tax asset and valuation allowance also are recorded in continuing operations. In addition, assuming a full valuation allowance still is necessary, the remaining deferred tax asset of $75 would continue to be offset by a valuation allowance of $75.

15.3.1.2.2.2 *Reductions resulting from a change in judgment*

Based on an evaluation of new facts and circumstances, a company might conclude in a subsequent fiscal year that a deferred tax asset related to an unrealized loss on an available-for-sale debt portfolio, for which a valuation allowance previously had been established, may be either fully or partially realizable. Such an evaluation would result in an elimination or reduction of the previously established valuation allowance. The central issue is whether the offsetting credit (to the reduction or elimination of the valuation allowance) would be to income from continuing operations or to other comprehensive income. ASC 740-10-45-20 requires the effect of a change in the beginning-of-the-year balance of a valuation allowance resulting from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years to be included in income from continuing operations (i.e., as a component of income tax expense). This would be the case when a valuation allowance is reduced or eliminated even though the valuation allowance was initially established by a charge against other comprehensive income, provided the reversal in the valuation allowance was due to a change in judgment about the level of future taxable income (ASC 740-20-45-17). While this appears counter-intuitive, this treatment is required because of the general prohibition against backward tracing with respect to changes in valuation allowances under ASC 740. However, if the reversal of the valuation allowance (either complete elimination or partial reduction) is attributable to taxable income generated in the current period that will allow the company to utilize the tax benefit, the valuation allowance reversal is allocated to that taxable income in accordance with the intraperiod tax allocation rules in ASC 740-20-45.

Illustration 15-18: Decrease in the valuation allowance from a change in judgment (before the adoption of ASU 2016-13)

Assume in year 1, Insurance Co. has an available-for-sale debt securities portfolio with a cost basis of $1,000 and has not adopted ASU 2016-13. After the purchase date, the portfolio's market value declines to $900. Insurance Co. expects to recover its entire cost basis and did not recognize an other-than-temporary credit loss. In accordance with ASC 740 and ASC 320, the following entries record the unrealized loss on the portfolio and the related deferred tax asset (assuming a 25% tax rate):

Other comprehensive income — unrealized losses	$ 100	
Available-for-sale debt securities — fair value adjustment		$ 100
Deferred tax assets	$ 25	
Other comprehensive income — unrealized losses		$ 25

If Insurance Co. concludes, based on the weight of available evidence, it is more likely than not it would **not** realize the deferred tax asset (when the deferred tax asset is initially recorded), the following entry would be necessary:

Other comprehensive income — unrealized losses	$ 25	
Valuation allowance — deferred tax assets		$ 25

Assume in year 2 there was no change in the market value of the available-for-sale debt securities portfolio, but there were significant unrealized gains in its investment portfolio consisting of marketable equity securities which is recorded in income from continuing operations. Inclusive of the unrealized gain, net income from continuing operations is zero. Insurance Co. determines, based on these new facts, it expects it would minimize its future tax liability (assuming market prices do not change) by selling loss securities from its available-for-sale debt securities portfolio when it realizes gains on the sale of equity securities in future years. Accordingly, Insurance Co. determines the valuation allowance established in year 1 on the deferred tax asset related to the unrealized loss on its available-for-sale debt securities portfolio is no longer needed. In these circumstances, ASC 740-10-45-20 would require the following entry:

Valuation allowance — deferred tax assets	$ 25	
Income tax expense		$ 25

This example illustrates that income from continuing operations increases as a result of concluding that a valuation allowance is no longer required in a fiscal year after the fiscal year the deferred tax asset was initially recorded. If, however, that decision had been reached in the year the tax benefit was initially recorded (either contemporaneous with initial recognition of the asset or in a subsequent interim period within that fiscal year), the effect would have been to increase other comprehensive income rather than income from continuing operations. That is, the tax benefit allocated to other comprehensive income would not be impacted by interim versus annual financial reporting because changes in the amount of the valuation allowance associated with deferred tax assets originating in the current year would be reflected in the year-to-date intraperiod tax allocation. Because of these accounting consequences, reaching a conclusion in a subsequent fiscal year that a valuation allowance is no longer required should only be made when it can be clearly demonstrated that there has been a change in the facts and circumstances. Even in the previous example, the company might conclude in establishing its valuation allowance it is still too uncertain to offset unrealized losses recognized through other comprehensive income on an available-for-sale debt securities portfolio against unrealized gains recognized through income on its equity securities portfolio. Thus, a full valuation allowance may still be appropriate.

15.3.1.2.2.3 Increases resulting from a change in judgment

If a valuation allowance had not been established in the year the tax benefit was initially recorded, and it is determined a valuation allowance is needed in a subsequent fiscal year because a change in circumstances causes a change in judgment about the future realization of the deferred tax asset, ASC 740-10-45-20 requires the offsetting debit be made to income tax expense (ASC 740-20-45-16). In that case, the ASC 740 prohibition against backward tracing has the opposite effect — what would have been a charge to other comprehensive income in the year the deferred tax asset was initially recorded is now a charge to income from continuing operations in the subsequent year.

15.3.1.3 Income tax rate changes

ASC 740-20-45-8 requires companies to include in income from continuing operations the effects of adjustments to a deferred tax liability or asset resulting from enacted changes in tax laws or rates or a change in the company's tax status. Accordingly, such changes affecting deferred tax assets or liabilities previously credited or charged directly to shareholders' equity should be included in income as part of the current year's income tax benefit or expense relating to the income or loss from continuing operations. This is illustrated in the following example.

Illustration 15-19: Changes in income tax rate

During 20X0, Company A purchases a debt security for $10,000 and classifies it as available for sale. At the end of 20X0, the security has a fair value of $9,000. The decline is not due to credit and the company expects to recover its entire amortized cost basis. Accordingly, the unrealized loss of $1,000 is charged to other comprehensive income net of the estimated income tax benefit of $350 (assuming a 35% tax rate). It is assumed a valuation allowance is not considered necessary for the deferred tax asset.

In 20X1, there is no change in the security's fair value; however, the statutory tax rate is decreased from 35% to 21%. The reduction in estimated future tax benefit of $140 related to the unrealized loss (the old tax rate of 35% less the new tax rate of 21% multiplied by the unrealized loss of $1,000) would result in a decrease to the deferred tax asset and a corresponding debit to income tax expense (assuming a valuation allowance is not required) attributable to income from continuing operations. No adjustment is made to the separate component of shareholders' equity for the effect of the tax rate change.

15.3.1.4 Backward tracing of tax effects

Excerpt from Accounting Standards Codification

Income Statement — Reporting Comprehensive Income — Overall

Other Presentation Matters

Presentation of Income Tax Effects

220-10-45-12A

H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act), reduced the U.S. federal corporate income tax rate and made other changes to U.S. federal tax law. An entity may elect to reclassify the income tax effects of the Tax Cuts and Jobs Act on items within accumulated other comprehensive income to retained earnings. If an entity does not elect to reclassify the income tax effects of the Tax Cuts and Jobs Act, it shall provide the disclosures in paragraph 220-10-50-3. If an entity elects to reclassify the income tax effects of the Tax Cuts and Jobs Act, the amount of that reclassification shall include the following:

a. The effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of enactment of the Tax Cuts and Jobs Act related to items remaining in accumulated other comprehensive income. The effect of the change in the U.S., federal corporate income tax rate on gross valuation allowances that were originally charged to income from continuing operations shall not be included.

b. Other income tax effects of the Tax Cuts and Jobs Act on items remaining in accumulated other comprehensive income that an entity elects to reclassify, subject to the disclosures in paragraph 220-10-50-2(b).

In May 1994, the FASB met with us and several other constituents to discuss requests to reconsider the intraperiod tax allocation provisions of ASC 740. Specifically, the FASB discussed the "backward tracing" prohibition as it relates to the interplay between ASC 740 and ASC 320 (e.g., if capital gain rates are reduced, the reduction in the deferred tax asset related to unrealized losses in the available-for-sale portfolio is recognized in income even though the original tax benefit was recognized in other comprehensive income). Several FASB members noted the issues involving intraperiod tax allocation had been addressed during the development of ASC 740; therefore, the FASB ultimately decided not to undertake this narrow project. Consequently, backward tracing of the income tax effect (i.e., tax rate changes as well as changes in the valuation allowance) of unrealized gains and losses on available-for-sale securities continues to be prohibited.

Because of the prohibition against backward tracing, dangling debits or credits will exist in other comprehensive income. Two methods have developed to address these items:

- *Portfolio approach:* The portfolio approach would clear out the remaining other comprehensive income balance related to income taxes when all securities have been sold (an event unlikely to occur for most large investors).
- *Individual security approach*: The individual security approach would track the differences on a security-by-security basis and clear out the deferred tax component of the other comprehensive income balance upon sale of each individual security.

ASU 2018-02, *Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, gave entities the one-time option to reclassify to retained earnings tax effects related to items in AOCI that the FASB refers to as having been stranded in AOCI as a result of the TCJA. ASU 2018-02, however, did not change the "backward tracing" prohibition in ASC 740. ASU 2018-02 also requires companies to make disclosures about their accounting policies for reclassifying amounts from accumulated other comprehensive income (e.g., the portfolio approach or the individual security approach discussed above). The guidance in ASC 220-10-45-12A provided specific guidance to address the tax effects from TCJA and should not be analogized to other tax law changes.

15.3.2 Cumulative translation adjustment

Subsidiaries and affiliates of a US multinational company that use the foreign currency as the functional currency report translation adjustments in a separate component of shareholders' equity. This includes translation of the net investment as well as intercompany foreign currency transactions that are of a long-term investment nature. Income taxes relating to translation adjustments would be required to be allocated to other comprehensive income (i.e., a separate component of shareholders' equity). The calculation of this allocation is complex and will vary depending on the specific facts and circumstances. The approach illustrated in section 14.3.7, *Deferred taxes allocated to translation adjustments*, in this publication allocates the US foreign tax credit to earnings. Another approach, as illustrated in ASC 740-20-55-18 through ASC 740-20-55-24, allocates the US foreign tax credit to both earnings and the translation component of equity.

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Implementation Guidance and Illustrations

740-20-55-18

Income taxes are sometimes allocated directly to shareholders' equity or to other comprehensive income. This Example illustrates the allocation of income taxes for translation adjustments under the requirements of Subtopic 830-30 to other comprehensive income. In this Example, FC represents units of foreign currency.

740-20-55-19

A foreign subsidiary has earnings of FC 600 for Year 2. Its net assets (and unremitted earnings) are FC 1,000 and FC 1,600 at the end of Years 1 and 2, respectively.

740-20-55-20

The foreign currency is the functional currency. For Year 2, translated amounts are as follows.

	Foreign Currency	Exchange Rate	Dollars
Unremitted earnings, beginning of year	1,000	FC1 = $1.20	$ 1,200
Earnings for the year	600	FC1 = $1.10	660
Unremitted earnings, end of year	1,600	FC1 = $1.00	$ 1,600

740-20-55-21

A $260 translation adjustment ($1,200 + $660 − $1,600) is reported in other comprehensive income and accumulated in shareholders' equity for Year 2.

740-20-55-22

The U.S. parent expects that all of the foreign subsidiary's unremitted earnings will be remitted in the foreseeable future, and under the requirements of Subtopic 740-30, a deferred U.S. tax liability is recognized for those unremitted earnings.

740-20-55-23

The U.S. parent accrues the **deferred tax liability** at a 20 percent tax rate (that is, net of foreign tax credits, foreign tax credit carryforwards, and so forth). An analysis of the net investment in the foreign subsidiary and the related deferred tax liability for Year 2 is as follows.

	Net Investment	**Deferred Tax Liability**
Balances, beginning of year	$ 1,200	$ 240
Earnings and related taxes	660	132
Translation adjustment and related taxes	(260)	(52)
Balances, end of year	$ 1,600	$ 320

740-20-55-24

For Year 2, $132 of deferred taxes are charged against earnings, and $52 of deferred taxes are reported in other comprehensive income and accumulated in shareholders' equity.

See section 20.2.1, *Income tax effects of a change in an indefinite reinvestment assertion*, for further discussion of the accounting for cumulative translation adjustments related to an investment in a foreign subsidiary for which it is no longer asserted that the investment is essentially permanent in duration.

See chapter 14, *Foreign and domestic subsidiaries*, in this publication for a discussion of ASC 740-30 exceptions as well as section 14.5, *Limitations on deferred tax assets for outside basis difference of foreign and domestic subsidiaries, corporate joint ventures and investees*, in this publication for a discussion of the requirements of ASC 740-30-25-9 regarding the recognition of deferred tax assets attributable to outside basis differences.

15.3.2.1 Foreign currency hedges

Consistent with ASC 830, ASC 815 allows the hedging of foreign currency risks of a net investment in a foreign operation with either a foreign currency derivative instrument or a foreign-currency-denominated non-derivative financial instrument (e.g., foreign-currency-denominated debt). Consistent with the net investment discussed in section 14.3.7, *Deferred taxes allocated to translation adjustments*, the effective portion of a hedge of this exposure is also recorded in the cumulative translation adjustment component of other comprehensive income. See our FRD, ***Derivatives and hedging***, for a detailed discussion of ASC 815 and related implementation issues.

15.3.3 Cash flow hedges

Cash flow hedges protect against the risk that variable prices, costs, rates or terms make future cash flows uncertain. A cash flow hedge is a hedge of the variability in the cash flows of an anticipated or forecasted transaction that is probable of occurring in the future, but the amount of the transaction has not been fixed. In some circumstances, the anticipated or forecasted transaction is related to a contractual requirement (e.g., a stock appreciation right (SAR), or SAR award), or an existing balance (e.g., variable-rate long-term debt). There is no requirement that the company be contractually committed to the anticipated or forecasted transaction — only that the transaction be probable of occurring. In fact, some of the most common cash flow hedges relate to probable but not contractually committed transactions, such as the budgeted purchase of a commodity or the expected issuance of debt.

A derivative designated as a cash flow hedge of a forecasted transaction is carried at fair value. The entire change in the fair value of the hedging derivative that is included in the assessment of hedge effectiveness is recorded in other comprehensive income (i.e., a separate component of shareholders' equity) net of the related tax effects and, in most cases, subsequently recognized in earnings in the same period or periods the hedged forecasted transaction affects earnings (with a corresponding recognition of the tax effects in earnings). The initial value of any components of the hedging instrument excluded from the assessment of hedge effectiveness (e.g., the time value associated with a purchased option) is recognized in earnings through an amortization approach, unless the entity makes an accounting policy election to immediately recognize the change in fair value of any excluded components in earnings.

It is important to note that the amounts stored in accumulated other comprehensive income representing the entire change in the fair value of the derivative instrument that is included in the assessment of hedge effectiveness for highly effective hedges are not reclassified into earnings until the hedged transaction affects earnings. This timing could be after the occurrence of the forecasted transaction if, upon occurrence of the forecasted transaction, it is initially recognized on the balance sheet and not the income statement (e.g., the purchase of inventory will not affect earnings until the inventory is sold).

15.3.4 Deferred taxes for postretirement benefit plans

ASC 740 distinguishes between gains and losses included in net income (e.g., income from continuing operations, and discontinued operations) from gains and losses included directly in other comprehensive income. ASC 740-20-45-11(b) requires gains and losses included in other comprehensive income but excluded from net income to be reported net of any related income tax effects. Thus, the tax effects of gains or losses recorded in other comprehensive income related to postretirement benefit plans would be recorded net of the related tax effects.

15.3.4.1 Recognition of deferred taxes for activity in postretirement benefit plans

Generally, a deferred tax asset (or liability) is recognized related to amounts recognized in other comprehensive income (e.g., actuarial gains and losses, prior service costs or credits, or transition assets or obligations), in accordance with ASC 715, concurrent with recognition of those amounts in other comprehensive income.

To the extent ASC 715 results in the generation of incremental deferred tax assets, management will have to determine the amount, if any, of any required valuation allowance related to these assets.

Illustration 15-20: Recognizing deferred taxes for activity in postretirement benefit plans

Assume Company LML records a $1,000 liability for pension benefits and a corresponding adjustment to other comprehensive income in 20X6 when the statutory tax rate is 25%. For simplicity purposes, assume there are no prior period balances and no other current period activity related to this pension plan. Based on the weight of all available evidence, Company LML determines it is more likely than not that the future tax deductions related to the liability for pension benefits will be realized. The following entries are required:

Other comprehensive income	$ 1,000	
Liability for pension benefits		$ 1,000
Deferred tax assets	$ 250	
Other comprehensive income — deferred tax benefit		$ 250

15.3.4.2 Valuation allowances

ASC 740-10-30-17 requires an assessment of all available evidence, both positive and negative, to determine the amount of any required valuation allowance. In determining the need for a valuation allowance, a company should consider four sources of taxable income (as required by ASC 740-10-30-18): (1) taxable income in prior carryback years, (2) taxable income from future reversals of existing taxable temporary differences, (3) taxable income from prudent and feasible tax-planning strategies and (4) in certain circumstances future taxable income exclusive of reversing temporary differences and carryforwards.

Determining whether a valuation allowance is required is important not only because of its initial effect on other comprehensive income, but also because of the accounting implications resulting from changes in the valuation allowance in subsequent fiscal years. In that regard, subsequent changes in the valuation allowance can result in adjustments to (1) other comprehensive income for subsequent changes in the funded status of the postretirement benefit plan that are recognized in other comprehensive income or (2) income tax expense for changes in circumstances that cause a change in judgment in future years about the realizability of the deferred tax asset. In the latter case, ASC 740-10-45-20 requires the adjustment to be made to income tax expense in the income statement, notwithstanding the allowance being initially established through other comprehensive income.

When companies are unable to conclude, based on the weight of the available evidence, that it is more likely than not that the deductible temporary difference will be realized, a valuation allowance against the deferred tax asset is required. The offsetting entry to the valuation allowance established when the deferred tax asset is initially recorded is reported as a component of other comprehensive income (in the same line as the other comprehensive income items related to the postretirement benefit obligation amounts and related deferred tax benefit was reported) in accordance with ASC 740's rules on intraperiod tax allocation.

Illustration 15-21: Recognizing valuation allowances for postretirement benefit plans

If Company LML concludes, based on the weight of available evidence, in the period in which the deferred tax asset is initially recorded that it is not more likely than not that Company LML will realize the deferred tax asset attributable to the $1,000 liability for pension benefits, a valuation allowance is required. The following entry (assuming a 25% statutory tax rate) would be necessary at the initial recognition of the pension liability and related gross deferred tax asset:

Other comprehensive income — deferred tax benefit	$ 250	
Valuation allowance		$ 250

15.3.4.2.1 Subsequent recognition of valuation allowance

Based on the analysis of whether a valuation allowance is required, some entities establish a full valuation allowance when the deferred tax asset is initially recorded, while others may establish a partial or no valuation allowance. Regardless of the initial decision, estimates of the need for or the amount of a valuation allowance may change. The accounting for the change in the valuation allowance (i.e., as a debit or credit to earnings or other comprehensive income) will depend on the reasons underlying the change.

15.3.4.2.2 Valuation allowance changes due to changes in amounts in other comprehensive income related to postretirement benefit plans

In periods after the initial recognition of a deferred tax asset and related valuation allowance, the amounts previously recognized in other comprehensive income may increase or decrease due to the experience of the postretirement benefit plan (e.g., previously unrecognized net actuarial gains and losses may increase or decrease). Assuming all other factors were held constant, this would result in an increase or decrease in the deferred tax asset and related valuation allowance. In such circumstances, the increase or decrease in both the deferred tax asset and the valuation allowance would be recorded as an offset to other comprehensive income in the period of the change.

Illustration 15-22: Valuation allowance changes due to changes in amounts in other comprehensive income related to postretirement benefit plans

Continuing with Illustration 15-21, including the 100% valuation allowance, assume the only change in 20X7 was a decrease in Company LML's liability for pension benefits to $900, resulting in a gross deferred tax asset of $225. Also assume income from continuing operations was zero. The following entries would be made:

Liability for pension benefits	$ 100	
Other comprehensive income		$ 100
Other comprehensive income — deferred tax benefit	$ 25	
Deferred tax assets		$ 25
Valuation allowance	$ 25	
Other comprehensive income		$ 25

At the end of 20X7, the component of other comprehensive income related to the liability for pension benefits is $900. In addition, because a full valuation allowance is still deemed necessary, the deferred tax asset of $225 would be offset by a valuation allowance of $225.

Because the pretax activity is reported in other comprehensive income, the corresponding changes in the deferred tax asset and valuation allowance also are reported in other comprehensive income pursuant to ASC 740-10-45-20 and ASC 740-20-45-8 (intraperiod tax allocation). This is not viewed as a change in judgment.

15.3.4.2.3 Change in judgment resulting in decreased valuation allowance

Based on an evaluation of new facts and circumstances, a company might conclude in a subsequent fiscal year that a deferred tax asset related to amounts recognized in other comprehensive income, for which a valuation allowance previously had been established, may be either fully or partially realizable. Such an evaluation would result in an elimination or reduction of the previously established valuation allowance. The central issue is whether the offsetting credit would be to income from continuing operations or to other comprehensive income.

ASC 740-10-45-20 requires that the effect of a change in a beginning-of-the-year valuation allowance resulting from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years be included in income from continuing operations (that is, as a component of income tax expense in the statement of operations). This would be the case even though the valuation allowance was initially established by a charge against other comprehensive income (exceptions noted in ASC 740-10-45-20 deal with benefits initially attributable to contributed capital, stock options, business combinations, etc. — not amounts related to postretirement benefit plans reported in other comprehensive income). While this appears counter-intuitive, the FASB staff confirmed that ASC 740 requires this treatment because of its general prohibition against backward tracing with respect to changes in valuation allowances.

Illustration 15-23: Change in judgment resulting in decreased valuation allowance

Assume the same facts for Company LML as in Illustration 15-22, including the full valuation allowance. Further, assume in 20X8 there was no change in the liability for pension benefits, but the company returned to profitability (for both 20X7 and 20X8 such that Company LML now was no longer in a cumulative loss position). Company LML determines, based on these new facts, it is more likely than not that the deferred tax asset will be realized. Accordingly, Company LML determines the valuation allowance is no longer needed. In this circumstance, ASC 740-10-45-20 would require the following entry:

Valuation allowance	$ 225	
Income tax expense		$ 225

This example illustrates income from continuing operations increases as a result of concluding a valuation allowance was no longer required in a fiscal year after the fiscal year the deferred tax asset was initially recorded. If that decision had been reached initially in 20X6 when the asset was established (either contemporaneous with the initial recording of the asset or in a subsequent interim period within that fiscal year), the effect of recording the tax benefit without a valuation allowance in 20X6 would have been to increase other comprehensive income rather than income from continuing operations. That is, the tax benefit allocated to other comprehensive income would not be affected by interim versus annual financial reporting because changes in the amount of the valuation allowance associated with deferred tax assets originating in the current fiscal year would be reflected in the year-to-date intraperiod tax allocation.

15.3.4.2.4 *Change in judgment resulting in increased valuation allowance*

If a valuation allowance is not established in the year the deferred tax asset is initially recorded, and it is subsequently determined that a valuation allowance is needed because a change in circumstances causes a change in judgment about the future realization of the deferred tax asset, ASC 740-10-45-20 requires the offsetting debit be made to income tax expense. In that case, ASC 740's prohibition against backward tracing has the opposite effect — what would have been a charge to other comprehensive income when the deferred tax asset was initially recorded would be charged to income from continuing operations in subsequent periods.

Illustration 15-24: Change in judgment resulting in increased valuation allowance

Assume the same facts for Company LML in Illustration 15-20 for 20X6. Further, assume in 20X7 there was no change in the liability for pension benefits; however, Company LML experienced significant losses and, based on the weight of all available evidence, determines it is no longer more likely than not that the deferred tax asset will be realized. Accordingly, Company LML determines a full valuation allowance is needed on the deferred tax asset initially recognized in 20X6.

In this circumstance, ASC 740-10-45-20 would require the following entry:

Income tax expense	$ 250	
Valuation allowance		$ 250

15.3.4.3 'Lingering effects' of changes in judgment on other comprehensive income

A change in judgment regarding recognition of deferred tax assets that occurs after initial recognition of the related amounts in other comprehensive income (and therefore is recognized in income from continuing operations) will result in dangling debits or credits in other comprehensive income.

We believe subsequent changes to postretirement benefit obligations recognized in other comprehensive income are analogous to unrealized gains and losses attributable to securities accounted for as available-for-sale pursuant to ASC 320. Thus, backward tracing is prohibited, and, while other methods may be acceptable, we believe it is most appropriate to eliminate dangling debits and credits related to postretirement benefit plans in other comprehensive income when the plan is extinguished.

15.3.4.4 Income tax rate changes

ASC 740-20-45-8 requires companies to include in income the effects of adjustments to a deferred tax liability or asset resulting from enacted changes in tax laws or rates or a change in the company's tax status. Accordingly, such changes affecting deferred tax assets or liabilities previously credited or charged directly to other comprehensive income should be included in income as part of the current year's income tax benefit or expense relating to the income or loss from continuing operations.[49] This is illustrated in the following example.

Illustration 15-25: Income tax rate changes

Assume the same facts for Company LML in Illustration 15-20 for 20X6. Further, assume in 20X7 there was no change in the liability for pension benefits; however, the statutory tax rate is increased from 25% to 30%.

The additional estimated tax benefit of $50 related to the amount recognized in other comprehensive income related to the liability for pension benefits (the new tax rate of 30% less the old tax rate of 25% times the amount recognized in other comprehensive income related to the liability for pension benefits of $1,000) would result in an increase to the deferred tax asset and a corresponding credit to income tax expense (assuming a valuation allowance is not required) attributable to income from continuing operations. No adjustment is made to other comprehensive income for the effect of the tax rate change.

15.3.5 Income tax consequences of issuing convertible debt

Standard setting

In August 2020, the FASB issued ASU 2020-06, *Debt-Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging-Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. The new guidance eliminates two of the three models, including the beneficial conversion feature and cash conversion models, in ASC 470-20 that require an issuer of certain convertible debt and preferred stock to separately account for embedded conversion features as a component of equity. As a result, ASU 2020-06 supersedes the guidance on beneficial conversion feature models in ASC 740-10-55-51 and the guidance on cash conversion models in ASC 470-20-25-22 and ASC 470-20-25-23. Under the new guidance, an issuer will account for convertible instruments with beneficial conversion and cash conversion features as a single unit of account, unless the conversion feature meets the criteria for accounting under the substantial premium model or meets the criteria in ASC 815-15 to be considered a derivative that must be bifurcated from the host contract. The guidance is effective for public business entities for fiscal years beginning after 15 December 2021, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2023, and interim periods within those years. Early adoption is permitted, but no earlier than fiscal years beginning after 15 December 2020, including interim periods within those years.

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[49] ASU 2018-02, *Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, gives entities the one-time option to reclassify to retained earnings tax effects related to items in AOCI that the FASB refers to as having been stranded in AOCI as a result of the TCJA.

15.3.5.1 Income tax consequences of issuing convertible debt with a beneficial conversion feature (before the adoption of ASU 2020-06)

ASC 740-10-55-51 provides guidance on tax basis differences that arise from issuing convertible debt with a beneficial conversion feature. ASC 470-20 requires that an in-the-money nondetachable conversion feature embedded in a convertible security be accounted for separately. This type of "beneficial conversion" feature is recognized and measured separately by allocating a portion of the proceeds on the issuance of the instrument, equal to the intrinsic value of the conversion option, to additional paid-in capital. The convertible security is recorded at par (assuming no discount or premium based on interest rates at issuance) and a discount is recognized equal to the amount that is allocated to additional paid-in capital.

ASC 740-10-55-51 provides that the recognition of a beneficial conversion feature effectively creates two separate instruments — a debt instrument and an equity instrument. However, under the US Federal Income Tax Code the instrument is accounted for only as a debt instrument.[50] Consequently, the book basis in the debt instrument is different from the tax basis of the debt instrument. ASC 740-10-55-51 provides the following:

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation

740-10-55-51

The issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying this Topic. The recognition of a beneficial conversion feature effectively creates two separate instruments-a debt instrument and an equity instrument-for financial statement purposes while it is accounted for as a debt instrument, for example, under the U.S. Federal Income Tax Code. Consequently, the reported amount in the financial statements (book basis) of the debt instrument is different from the tax basis of the debt instrument. The basis difference that results from the issuance of convertible debt with a beneficial conversion feature is a temporary difference for purposes of applying this Topic because that difference will result in a taxable amount when the reported amount of the liability is recovered or settled. That is, the liability is presumed to be settled at its current carrying amount (reported amount). The recognition of deferred taxes for the temporary difference of the convertible debt with a beneficial conversion feature should be recorded as an adjustment to additional paid-in capital. Because the beneficial conversion feature (an allocation to additional paid-in capital) created the basis difference in the debt instrument, the provisions of paragraph 740-20-45-11(c) apply and therefore the establishment of the deferred tax liability for the basis difference should result in an adjustment to the related components of shareholders' equity.

Pending Content:

Transition Date: *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

Editor's Note: *Paragraph 740-10-55-51 will be superseded upon transition, together with its heading:*

> Beneficial Conversion Features

Paragraph superseded by Accounting Standards Update No. 2020-06.

[50] A company that issues convertible debt should carefully consider the specific facts, circumstances and tax technical analysis when evaluating the accounting for the instrument.

The following example illustrates the consensus.

Illustration 15-26: Income tax consequences of issuing convertible debt with a beneficial conversion feature

Assume at the beginning of year 1 Company A issues, at par, a 10% $100 convertible debt instrument with a stated redemption date 10 years from the date of issuance. The debt is convertible into four shares of Company A's stock with a fair market value of $30 per share. Further, assume that Company A's enacted statutory rate is 25%. For financial reporting purposes, Company A recognizes cash proceeds of $100, convertible debt of $100 with a debt discount of $20 (net book basis of $80) and a $20 beneficial conversion feature recorded in APIC. Company A also recognizes a deferred tax liability equal to the beneficial conversion feature with the offsetting entry charged directly to additional paid-in capital.

The entries to record the issuance of the convertible security, accompanying beneficial conversion feature and the deferred tax liability are as follows:

Cash	$ 100	
Debt discount	20	
Convertible debt		$ 100
APIC (beneficial conversion feature — see calculation below)		20
APIC ($20 x 25%)	$ 5	
Deferred tax liability		$ 5

The beneficial conversion feature is calculated as follows:

Fair value of Company's A stock	$ 30
Exercise price of Company A's stock ($100 proceeds divided by four shares of common stock)	25
Excess of the fair market value over the exercise price	$ 5
Number of shares convertible into Company A's stock	4
Beneficial conversion feature (calculated by multiplying the excess of the fair market value over the exercise price times the number of shares convertible into Company A's stock)	$ 20

The charge recorded directly to additional paid-in capital, net of the temporary difference in the tax basis of the convertible debt instrument, remains in additional paid-in capital indefinitely.

Illustration 15-27: Accounting for the amortization of debt discount

Company A's debt discount is being accreted to interest expense from the date of issuance to the stated redemption date utilizing the effective interest method, which is the method required by ASC 470-20-35-7. For the purposes of this example, the effective yield rate was estimated to be approximately 15%, which resulted in $1,200 of additional interest expense from the amortization of the debt discount for year 1.

Assume at the end of year 1 Company A earns $100 of pretax income (after consideration of the $1,200 of interest expense) and has no other temporary or permanent differences other than the taxable temporary difference arising from the beneficial conversion feature on the convertible debt instrument.

Company A would record the following entries to recognize the amortization of the debt discount for the full year and to record its current year tax provision and the change in the deferred tax liability:

Interest expense	$ 1,200	
Debt discount		$ 1,200
Current income tax expense (($100 + $1,200) x 21%)	$ 273	
Deferred tax liability ($1,200 x 21%)	252	
Current income tax payable		$ 273
Deferred tax benefit		252

15.3.5.2 Income tax consequences of issuing convertible debt instruments that may be settled in cash upon conversion (before the adoption of ASU 2020-06)

ASC 470-20-25-22 and ASC 470-20-25-23 require the issuer of certain convertible debt instruments that may be settled in cash (or other assets) on conversion to separately account for the liability (debt) and equity (conversion option) components of the instrument in a manner that reflects the issuer's nonconvertible debt borrowing rate.

The recognition of a liability and an equity component may result in a basis difference that represents a temporary difference under ASC 740. The temporary difference represents the difference between the carrying amount (book basis) and tax basis of the liability (i.e., the issuance is treated as two instruments for book — debt and equity and one instrument for tax — debt). This temporary difference likely will be a taxable temporary difference resulting in the recognition of a deferred tax liability because the tax basis of the liability component generally will exceed the book basis. The initial recognition of deferred taxes related to this temporary difference is recorded as an adjustment to APIC.

The deferred tax liability recognized upon the issuance of convertible debt that may be settled in cash upon conversion represents a source of future taxable income pursuant to ASC 740 (i.e., future reversals of existing taxable temporary differences represent a source of taxable income). As such, the application of the guidance for accounting for convertible debt instruments that may be settled in cash may affect a company's judgment about the realizability of its deferred tax assets. If a company determines, upon issuance of a convertible debt instrument, that a preexisting valuation allowance is no longer required solely because of the planned reversal of the taxable temporary difference recognized as an adjustment to APIC, the tax benefit from reversing the valuation allowance at that time also should be recorded in APIC.

After the issuance date, the deferred tax liability will reverse and a deferred tax benefit will be recognized as an adjustment to income tax expense as the related debt discount is amortized. As a result, tax expense will include both a current tax benefit for tax-deductible interest paid during the period and a deferred tax benefit from reversing the portion of the deferred tax liability related to the debt discount that was accreted during the period. The effect of the reversal of the deferred tax liability on the realizability of deferred tax assets should be assessed in subsequent periods. Generally, changes in a valuation allowance after the issuance of a convertible debt instrument should be recognized as an adjustment to income from continuing operations.

If the debt instrument is settled through conversion before its maturity date (i.e., the liability is extinguished before maturity), a book gain (or loss) may result. Consistent with ASC 470-20-55-80, the deferred tax expense (or benefit) related to the book gain (or loss) is recorded first with an offsetting increase (or decrease) to the deferred tax liability. The remaining deferred tax liability, if any, is reversed with an adjustment to APIC.

The following example summarizes certain aspects of ASC 470-20-55-71 through ASC 470-20-55-80 and illustrates the journal entries when a debt instrument is settled through conversion before its maturity date and a book loss results.

Illustration 15-28: Income tax consequences of issuing convertible debt instruments that may be settled in cash upon conversion

Assume Entity A issues $100,000,000 of convertible notes. Each note is convertible at any time into the equivalent of 10 shares of Entity A's common stock. Upon conversion, Entity A can elect to settle the entire if-converted value (that is, the principal amount of the debt plus the conversion spread) in cash, common stock or any combination thereof. Upon issuance, Entity A measures the liability and equity components at $59,740,000 and $40,260,000, respectively. Assume Entity A's tax rate is 25%. Entity A makes the following journal entry upon the issuance of the notes.

Cash	$ 100,000,000	
Debt discount	40,260,000	
Debt		$ 100,000,000
Additional paid-in capital		40,260,000
Additional paid-in capital	$ 10,065,000	
Deferred tax liability [$40,260,000 x 25%]		$ 10,065,000

During the first five years after issuance, Entity A recognizes $16,304,000 of debt discount amortization under the interest method and reverses $4,076,000 ($16,304,000 x 25%) of the deferred tax liability related to that amortization.

Five years after issuance, assume that all holders of the convertible notes exercise their conversion options. Based on the quoted market price of Entity A's common stock, the aggregate consideration for the conversion is $140,000,000. Regardless of the form of the $140,000,000 consideration transferred at settlement, $77,748,000 is attributed to the extinguishment of the liability component and $62,252,000 is attributed to the reacquisition of the equity component. The carrying amount of the liability is $76,044,000 ($100,000,000 issued convertible notes less unamortized debt discount of $23,956,000) on the date of conversion resulting in $1,704,000 loss on extinguishment. At settlement, Entity A elects to transfer to the note holders cash of $100,000,000 and common stock with a fair value of $40,000,000. The journal entry below (included in ASC 470-20-55-80) illustrates the pretax accounting of the conversion.

Debt	$ 100,000,000	
Additional paid-in capital — conversion option	62,252,000	
Loss on extinguishment	1,704,000	
Debt discount		$ 23,956,000
Cash		100,000,000
Common stock at par		3,000
Additional paid-in capital — share issuance		39,997,000

Entity A receives no tax deduction for the payment of consideration ($140,000,000) upon conversion in excess of the tax basis of the convertible notes ($100,000,000), regardless of the form of that consideration (cash or stock). Entity A makes the following journal entries to its deferred tax liability account, which had a balance of $5,989,000 immediately before conversion, to (1) record the deferred tax benefit for the loss on extinguishment and (2) reverse the remaining deferred tax liability balance to additional paid-in capital.

Deferred tax liability [$1,704,000 x 25%]	$	426,000		
Deferred income tax benefit			$	426,000
To record the deferred tax benefit for the loss on extinguishment				
Deferred tax liability [$5,989,000 — $426,000]	$	5,563,000		
Additional paid-in capital			$	5,563,000
To reverse remaining deferred tax liability upon settlement of the notes				

As a result of these entries, the balance in the deferred tax liability account related to the convertible debt instrument has been reduced to zero at settlement. The difference between the deferred tax liability recorded as a reduction to additional paid-in capital upon the issuance of the notes ($10,065,000) and the deferred tax liability reversed to additional paid-in capital upon settlement of the notes ($5,563,000) remains in additional paid-in capital.

It is important to note that the example in ASC 470-20-55-71 to ASC 470-20-55-80 and this example assume that the company receives no tax deduction for the payment of consideration upon conversion in excess of the tax basis of the convertible notes. Careful consideration of an instrument's tax basis and the tax consequences of consideration paid upon conversion is necessary to determine whether the assumptions used in these examples are consistent with an entity's particular fact pattern.

Further discussion on the application of the guidance for accounting for convertible debt instruments that may be settled in cash, including an example, is included in our FRD, ***Issuer's accounting for debt and equity financings***. In addition, further discussion on accounting for changes in valuation allowances is included in section 15.2.2.2, *Changes in valuation allowance*.

15.3.6 Tax effects of transactions among or with shareholders

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Other Presentation Matters

740-10-45-21

Changes in valuation allowances due to changed expectations about the realization of deferred tax assets caused by transactions among or with shareholders shall be included in the income statement. A write-off of a preexisting deferred tax asset that an entity can no longer realize as a result of a transaction among or with its shareholders shall similarly be charged to the income statement. The same net effect results from eliminating a deferred tax asset and increasing a valuation allowance to 100 percent of the amount of the related deferred tax asset.

Some transactions among shareholders or between a company and its shareholders affect the tax attributes of the company itself. For example, in the United States, if more than 50% of the stock of a company changes hands within a specified period, future utilization of any existing net operating loss carryforwards of the company is generally limited or prohibited. See section 6.4.1, *Considerations when NOL carryforwards do not expire or when tax law limits the use of NOL carryforwards*, for further discussion on the limitation of net operating loss carryforwards based on changes in ownership. Other transactions among shareholders may change the tax bases of the assets and liabilities of the company (e.g., an investor purchases 100% of the outstanding stock of a company in a transaction that is treated as a purchase of assets for tax purposes but does not "push down" the purchase price for financial reporting purposes to the acquired company).

A transaction may occur that affects tax attributes and the transaction may be entirely within a consolidated group (i.e., an intercompany transaction). Because intercompany transactions do not result in a change in the ultimate parent's consolidated financial statements (for financial reporting purposes), the guidance in ASC 740-10-45-21 is not applicable.

Change valuation allowance as a result of a transaction with shareholders

ASC 740-10-45-21[51] requires that a change in the valuation allowance due to changed expectations about the realization of deferred tax assets caused by transactions among or with shareholders be included in the income statement. For example, a parent company and its subsidiaries file a consolidated tax return. The parent has a deferred tax asset that is considered more likely than not to be realized as there is sufficient future taxable income. The source of the future taxable income is the reversal of deferred tax liabilities attributable to a subsidiary. In a subsequent period, the parent's shareholders enter into transactions (e.g., spin-off of the subsidiary) that limit the parent's ability to realize its deferred tax asset. That is, due to a transaction with the parent's shareholders, the source of income that allows for the parent's deferred tax asset to be more likely than not realizable is no longer a source of taxable income to the parent in the periods that the deferred tax assets are expected to be realized. Consequently, the parent may be required to record a valuation allowance to reduce the carrying amount of its deferred tax asset to the amount that is more likely than not to be realized. The change in the valuation allowance due to a change in expectations about the realization of deferred tax assets caused by a transaction with the parent's shareholders is included in the income statement. See section 15.3.6.2, *Need for a valuation allowance by the subsidiary when there is a spin-off transaction*, for further discussion on the need for a valuation allowance by the subsidiary when there is a spin-off transaction.

Write off of preexisting deferred tax asset as a result of a transaction with shareholders

Also, ASC 740-10-45-21 requires that a preexisting deferred tax asset that an entity can no longer realize as a result of a transaction among or with its shareholders be written off through a charge to the income statement. For example, if the transaction by the company's shareholders eliminates a deferred tax asset (e.g., portion of the net operating loss carryforward that is limited under Section 382 and is determined to expire unused), the asset would no longer exist, and the company should write off the deferred tax asset upon consummation of the shareholders' transaction. However, the FASB did acknowledge that eliminating the deferred tax asset and increasing a valuation allowance to 100% of the amount of the related deferred tax asset had the same net effect.

Changes in the tax bases of assets and liabilities as a result of a transaction with shareholders

ASC 740-20-45-11(g) requires that the tax effects of all changes in the tax bases of assets and liabilities caused by transactions among or with shareholders be included in equity. In addition, the effect of any valuation allowances initially required related to such deferred tax assets (i.e., deferred tax assets established through equity) should also be included in equity. Changes in valuation allowances occurring in subsequent periods should be included in the income statement.

Another example of a transaction between shareholders that may result in changes in tax bases of a subsidiary's assets and liabilities is a business combination transaction in which the business combination accounting is not pushed down to the subsidiary, but changes in the tax bases of the subsidiary's assets and liabilities occur with the change in control. Such changes in tax bases are caused by transactions among or with shareholders and should be reflected in equity in accordance with ASC 740-20-45-11(g). That is, in the separate financial statements of the subsidiary, a business combination has not occurred as new book basis is not established. Instead, it is a transaction among shareholders and the change in deferred tax assets and liabilities as a result of the change in tax bases would be reflected in equity.

[51] For purposes of applying ASC 740-10-45-21 and 740-20-45-11(g), shareholders refer to shareholders of the reporting entity.

Additionally, as discussed above, to the extent that the change in tax bases resulted in additional deferred tax assets, the effect of a valuation allowance initially required related to these additional deferred tax assets also would be included in equity. The key difference in this instance versus other business combinations (where the effects of changing tax bases are reflected in business combination accounting) is that the business combination is not pushed down to the separate financial statements of the subsidiary. Noteworthy is that to the extent that the change in tax bases results in the subsidiary establishing tax-deductible goodwill, the standalone financial statements of the subsidiary should reflect the associated deferred tax asset (resulting from no book basis and the establishment of tax basis goodwill). Business combination accounting (including restrictions on recognition of deferred tax liabilities associated with goodwill) are not applicable to the separate financial statements of the subsidiary as no business combination has occurred in the separate financial statements of the subsidiary.

15.3.6.1 Tax effects of spin-off transactions

In a spin-off transaction, a parent company distributes a portion or all of its ownership interest in a subsidiary to its shareholders.[52] Since a spin-off transaction is also considered a transaction among or with shareholders, any changes in the parent's tax basis of assets and liabilities or the parent's changes in valuation allowances should be accounted for in the parent's financial statements in accordance with ASC 740-20-45-11(g) as described in section 15.3, *Items charged or credited directly to shareholder's equity*, or ASC 740-10-45-21 as described in section 15.3.6, *Tax effects of transactions among or with shareholders*.

In most cases, a deferred tax liability would not have been recorded by the parent for an outside basis difference in a domestic subsidiary because ASC 740-30-25-7 permits an entity to assert that the investment in a domestic subsidiary would be recovered in a tax-free manner and the tax law provides such a means. A parent that expects to spin off a domestic subsidiary in a tax-free manner can continue to assert that the investment in a domestic subsidiary would be recovered in a tax-free manner. In this instance, the parent would continue to not record a deferred tax liability for an outside basis difference in a domestic subsidiary. When an entity expects to spin off a domestic subsidiary in a manner that will be taxed, a deferred tax liability should be recorded for the outside basis difference with a corresponding charge to income tax expense at the time the company can no longer assert that the outside basis will be recovered in a tax-free manner.

It is noteworthy that a similar issue would develop if a parent company previously asserted that it would indefinitely reinvest in a foreign subsidiary. The decision to spin off the foreign subsidiary in a taxable manner would contradict the indefinite reinvestment. Therefore, the parent company would be required to record a deferred tax liability for the outside basis difference at the time the change in assertion occurs. To the extent the parent expects to spin off a foreign subsidiary in a tax-free manner, the parent may continue to assert that the outside basis difference will be recovered in a tax-free manner and therefore the indefinite reinvestment assertion may continue to be asserted (if appropriate).

At the time of the spin-off, any taxes payable that are recognized as a result of the fair value of the subsidiary exceeding the financial reporting value should be accounted for in equity. The additional tax obligation is considered an incremental tax effect of a transaction with shareholders.

15.3.6.2 Need for a valuation allowance by the subsidiary when there is a spin-off transaction

In some spin-off transactions, the subsidiary may not have prepared separate financial statements and certain deferred tax assets attributable to the subsidiary may have no valuation allowance because in consolidation (presuming the subsidiary is part of a consolidated tax return), there was sufficient future taxable income to allow for realization of the deferred tax assets. However, in the subsidiary's separate financial statements, a valuation allowance would be necessary if the subsidiary determines that it is not

[52] For purposes of this discussion, it is presumed that the spin-off is of a subsidiary whose operations qualify as a business.

more likely than not that it will realize all or a portion of the deferred tax asset. If a valuation allowance is required, the subsidiary, in its separate financial statements, should record a valuation allowance with an offsetting charge to income tax expense (subject to the separate financial statement guidance discussed in chapter 17, *Separate financial statements of a subsidiary*). If the subsidiary's financial statements are prepared on a standalone return basis (as described in section 17.2, *SEC staff position on determining income taxes in separate financial statements*), a valuation allowance would have been required in the period when it is no longer more likely than not that it will realize all or a portion of the deferred tax asset — likely before the spin date. However, if the subsidiary prepared its financial statements utilizing the pro rata method (which is a permissible allocation method in practice as described in section 17.4, *Other allocation methods (non-SEC filers)*), a valuation allowance would be required at the time of the spin.

In a related issue, if a subsidiary needs a valuation allowance upon spin-off from the parent, a question arises as to whether the parent should also record a valuation allowance for that deferred tax asset at the time of the spin. We understand that the FASB staff has answered this question in a technical inquiry noting that they believe the parent should record a charge at the time of the spin-off. The answer appears to be based on a view that the parent is removing the taxable income that supported the realizability of the deferred tax asset via the spin and as a result, the deferred tax asset should be reduced by an appropriate valuation allowance (through the parent's income statement) at the time of the spin.

15.3.7 Tax benefits of pre-reorganization temporary differences and carryforwards

Excerpt from Accounting Standards Codification

Reorganizations — Income Taxes

Other Presentation Matters

852-740-45-1

For entities that meet the paragraph 852-10-45-19 requirements for fresh-start reporting, deferred taxes shall be reported in conformity with generally accepted accounting principles (GAAP). If not recognizable at the plan confirmation date, initial recognition (that is, by elimination of the valuation allowance) of tax benefits realized from preconfirmation net operating loss **carryforwards** and deductible temporary differences shall be reported as a reduction to income tax expense.

After a company emerges from a reorganization transaction, questions often arise regarding the evaluation and reporting of post-reorganization net operating losses when the company retained deductible temporary differences, net operating loss carryforwards and tax credit carryforwards generated before the reorganization and a valuation allowance was recognized for those pre-reorganization items at the reorganization date.

ASC 852-740-45-1 requires that if not recognizable at the plan confirmation date, initial recognition (that is, by elimination of the valuation allowance) of tax benefits realized from pre-confirmation net operating loss carryforwards and deductible temporary differences be reported as a reduction of income tax expense.

When considering the realizability of deferred tax assets (e.g., net operating losses and deductible temporary differences), ASC 740-10-30-18 requires consideration of deferred tax liabilities expected to reverse before expiration of the deferred tax asset. Therefore, net operating losses generated after the reorganization date should be recognized and the need for a valuation allowance should be assessed based on the existence and reversal of deferred tax liabilities, including those related to the pre-reorganization activities, assuming the tax law allows the company to utilize pre-reorganization deductible temporary differences, net operating losses and tax credits in its post-reorganization return.

15.4 Operating loss tax benefit — backward tracing prohibited

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Other Presentation Matters

740-20-45-3

The tax benefit of an operating loss carryforward or carryback (other than for the exceptions related to the **carryforwards** identified at the end of this paragraph) shall be reported in the same manner as the source of the income or loss in the current year and not in the same manner as the source of the operating loss carryforward or taxes paid in a prior year or the source of expected future income that will result in realization of a **deferred tax asset** for an operating loss carryforward from the current year. The only exception is the tax effects of deductible temporary differences and carryforwards that are allocated to shareholders' equity in accordance with the provisions of paragraph 740-20-45-11(c) through (f).

a. Subparagraph not used

b. Subparagraph not used

As a general rule, the income statement classification of a tax benefit recognized in the current year for an operating loss carryforward from a prior year(s) is based solely on the nature of the current year's income or loss and is not based on either the source of the previous operating loss or the source of expected future income that will result in realization of a deferred tax asset recognized for the net operating loss carryforward. This same general rule also applies to a tax benefit recognized in the current year for a loss carryback (i.e., the classification does not depend on the source of the taxes paid in the year(s) to which the loss is carried back). For example, the tax benefit of an operating loss carryforward recognized in a year with only income from continuing operations would be reported as part of the income tax provision on continuing operations, even if the carryforward arose from a large loss from discontinued operations in a prior year. Likewise, the tax benefit recognized for the carryback of a current year loss from continuing operations would be reported as an income tax benefit relating to continuing operations, even if the loss was carried back to a year in which the income was related entirely to a gain on discontinued operations. See section 19.7.7, *Intraperiod tax allocation*, for additional information on intraperiod allocation for changes in uncertain tax positions allocated to discontinued operations and shareholders' equity.

15.5 Intraperiod tax allocation examples

Excerpt from Accounting Standards Codification

Income Taxes — Intraperiod Tax Allocation

Other Presentation Matters

740-20-45-12

If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations shall be allocated to that item.

740-20-45-13

See Example 2 (paragraph 740-20-55-8) for an example of the allocation of total tax expense or benefit to continuing operations and one other item.

740-20-45-14

If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items.

b. Apportion the tax benefit determined in (a) ratably to each net loss item.

c. Determine the amount that remains, that is, the difference between the amount to be allocated to all items other than continuing operations and the amount allocated to all net loss items.

d. Apportion the tax expense determined in (c) ratably to each net gain item.

Illustration 15-29: Intraperiod tax allocation example applying the exception to the general principle (before the adoption of ASU 2019-12)

Facts

Company A has a pretax loss from continuing operations of $10,000 and pretax income from discontinued operations of $12,000 for the year. Company A's income tax rate is 25%.

This example assumes that there are no temporary differences (i.e., the company's pretax financial income equals its taxable income) for simplicity. This example also assumes that the company would not be able to realize the benefit of the NOL carryforward from the loss in continuing operations (i.e., would need a full valuation allowance) if it can't consider the income from discontinued operations.

The calculation of the total income tax expense is shown below.

Calculation of the total income tax expense	
Pretax loss from continuing operations	$ (10,000)
Pretax income from discontinued operations	12,000
Pretax income	$ 2,000
Income tax rate	25%
Total income tax expense	$ 500

Analysis

Because there is a loss from continuing operations and income from other items, the exception to the general principle of allocating income tax expense to continuing operations applies, and the $12,000 income from discontinued operations is considered in determining the tax benefit that is allocated to continuing operations. Under this guidance, the total income tax expense of $500 is allocated to continuing operations and discontinued operations as follows:

Allocate income tax expense to continuing operations and other items	
Income tax benefit allocated to continuing operations (realizable pretax loss from continuing operations of $10,000 * 25% tax rate)	$ (2,500)
Income tax expense allocated to discontinued operations (total income tax expense less amount allocated to continuing operations or $500 — $(2,500) = $3,000)	3,000
Total income tax expense	$ 500

In this example, the entire tax benefit from the loss from continuing operations is allocated to continuing operations.

Illustration 15-29A: Intraperiod tax allocation example with loss from continuing operations and income from discontinued operations (after the adoption of ASU 2019-12)

Facts

Company A has a pretax loss from continuing operations of $10,000 and pretax income from discontinued operations of $12,000 for the year. Company A's income tax rate is 25%.

This example assumes that there are no temporary differences (i.e., the company's pretax financial income equals its taxable income) for simplicity. This example also assumes that the company would not be able to realize the benefit of the NOL carryforward from the loss in continuing operations (i.e., would need a full valuation allowance) if it can't consider the income from discontinued operations.

The calculation of the total income tax expense is shown below.

Calculation of the total income tax expense	
Pretax loss from continuing operations	$ (10,000)
Pretax income from discontinued operations	12,000
Pretax income	$ 2,000
Income tax rate	25%
Total income tax expense	$ 500

Analysis

Company A cannot consider the tax effects of items that are not included in continuing operations when it determines the tax benefit to allocate to continuing operations. Company A's total income tax expense is allocated between the loss from continuing operations and income from discontinued operations as follows:

Allocate income tax expense to continuing operations and other items	
Income tax benefit allocated to continuing operations (income from discontinued operations is not considered in determining the amount allocated)	$ -
Income tax expense allocated to discontinued operations (total income tax expense less amount allocated to continuing operations or $500 — $0 = $500)	500
Total income tax expense	$ 500

Because Company A cannot consider income from other categories and would be unable to realize the tax benefit of the loss from continuing operations without considering the income from discontinued operations, it cannot allocate any tax benefit to continuing operations. Instead, the total income tax expense amount is allocated to discontinued operations.

Illustration 15-30: Intraperiod tax allocation example applying the exception to the general principle with discontinued operations subject to differing rates (before the adoption of ASU 2019-12)

Facts

Company A's pretax financial income and taxable income are the same. In the jurisdiction in which the company operates, ordinary losses can first be used to offset capital gains. The tax rate is 40% on net ordinary income and 30% on net capital gains. The company has recorded a valuation allowance because it does not expect to be able realize a benefit from its net DTA and NOL carryforwards.

Analysis

The calculation of the total income tax expense is shown below.

Ordinary loss from continuing operations	$	(500)
Gain on discontinued operations (capital gain for tax purposes)		900
Taxable income	$	400
Income tax expense (400 * 30%)	$	120

Income tax expense is allocated between the pretax loss from continuing operations and the gain on discontinued operations as follows:

Total income tax expense	$	120
Tax benefit allocated to the loss from continuing operations ($500 x 30%)		(150)
Tax expense allocated to the gain on discontinued operations (remainder)	$	270

In this case, the effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at 30%. Thus, $150 ($500 at 30%) of tax benefit is allocated to continuing operations. The $270 incremental tax effect of the gain on discontinued operations is the difference between $120 of total tax expense and the $150 benefit from continuing operations.

Illustration 15-30A: Intraperiod tax allocation example with loss from continuing operations (tax benefit realizable) (after the adoption of ASU 2019-12)

Company A's pretax financial income and taxable income are the same. In the jurisdiction in which the company operates, ordinary losses can first be used to offset capital gains. The tax rate is 40% on net ordinary income and 30% on net capital gains. The company determined that the deferred tax asset (i.e., NOL) that would have resulted from the loss from continuing operations if the gain on discontinued operations had not occurred would be expected to be realized (that is, a valuation allowance would not have been needed).

Ordinary loss from continuing operations	$	(500)
Gain on discontinued operations (capital gain for tax purposes)		900
Taxable income	$	400
Income tax expense (400 * 30%)	$	120

Income tax expense is allocated between the pretax loss from continuing operations and the gain on discontinued operations as follows:

Total income tax expense	$	120
Tax benefit allocated to the loss from continuing operations ($500 x 40%)		(200)
Tax expense allocated to the gain on discontinued operations (remainder)	$	320

In this case, the effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at 30%. However, the guidance in ASC 740-20-45-7 requires that an entity determine the tax effects of pretax income from continuing operations by a computation that does not consider the tax effects of items that are not included in continuing operations. The company has determined that, absent the capital gain from discontinued operations, a valuation allowance would not have been needed on the deferred tax asset resulting from the $500 loss from continuing operations. Therefore, $200 ($500 x 40%) of tax benefit is allocated to continuing operations. The $320 incremental effect of the gain on discontinued operations is the difference between $120 of total tax expense and the $200 tax benefit allocated to continuing operations.

Illustration 15-30B: Intraperiod tax allocation example with loss from continuing operations (tax benefit not realizable) (after the adoption of ASU 2019-12)

Company A's pretax financial income and taxable income are the same. In the jurisdiction in which the company operates, ordinary losses can first be used to offset capital gains. The tax rate is 40% on net ordinary income and 30% on net capital gains. The company determined that the deferred tax asset that would have resulted from the loss from continuing operations if the gain on discontinued operations had not occurred would not be expected to be realized (that is, a valuation allowance would have been needed).

Ordinary loss from continuing operations	$ (500)
Gain on discontinued operations (capital gain for tax purposes)	900
Taxable income	$ 400
Income tax expense (400 * 30%)	$ 120

Income tax expense is allocated between the pretax loss from continuing operations and the gain on discontinued operations as follows:

Total income tax expense	$ 120
Tax benefit allocated to the loss from continuing operations	–
Tax expense allocated to the gain on discontinued operations (remainder)	$ 120

In this case, the effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at 30%. However, the guidance in ASC 740-20-45-7 requires that an entity determine the tax effects of pretax income from continuing operations by a computation that does not consider the tax effects of items that are not included in continuing operations. The company has determined that, absent the capital gain from discontinued operations, a valuation allowance would have been needed on the deferred tax asset resulting from the $500 loss from continuing operations. Therefore, no tax benefit is allocated to continuing operations. The $120 incremental effect of the gain on discontinued operations is the difference between $120 of total tax expense and the zero allocated to continuing operations.

If there are two or more items other than continuing operations, ASC 740-20-45-14 requires the amount remaining after the allocation to continuing operations is allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year.

Illustration 15-31: Intraperiod tax allocation example when there are two or more items other than continuing operations

Assume results for the year ended 31 December 20X0 were as follows (tax rate is 25%, the company's pretax financial income equals its taxable income, and tax credits of $400 were generated in 20X0):

Income from continuing operations	$ 500
Loss from discontinued operations	(100)
Gain on available-for-sale debt securities recorded in other comprehensive income	600
Pretax income	$ 1,000

Further, assume income taxes currently payable are zero because tax credits of $400 generated in the current year more than offset the $250 of income tax expense ($1,000 x 25%). Assuming the weight of available evidence indicates no valuation allowance is necessary against the tax credit carryforward, the company would recognize an income tax benefit of $150.

The income tax benefit would be allocated among income from continuing operations and other items as follows:

Total income tax expense (benefit)		$ (150)

Tax expense (benefit) allocated to income from continuing operations:

Tax expense before tax credits ($500 x 25%)	$ 125	
Tax credits	(400)	
Tax expense (benefit) allocated to income from continuing operations		(275)
Tax expense (benefit) allocated to other items		$ 125

Expense (benefit) allocated to other items:

Discontinued operations ($(100) x 25%)	$ (25)
Other comprehensive income ($600 x 25%)	150
	$ 125

The presentation above assumes the discontinued operations gain was not a factor in concluding no valuation allowance is needed against the tax credit carryforward. Accordingly, the entire tax benefit of the $400 of tax credits was allocated to continuing operations. The existence of the other comprehensive income or discontinued operations does not affect that allocation.

If the existence of the other comprehensive income or discontinued operations was the sole reason in concluding no valuation allowance was needed against the tax credit carryforward, the reduction in the valuation allowance would be allocated to the respective source of income (e.g., other comprehensive income or discontinued operations). See section 15.2.2.2, *Changes in the valuation allowance*, for further details.

Illustration 15-32: Intraperiod tax allocation example when there are two or more items other than continuing operations

Assume the same facts in Illustration 15-31, except that the company is in a breakeven position:

Income from continuing operations	$ 200
Loss from discontinued operations	(300)
Gain on securities recorded in other comprehensive income	100
Pretax income	$ –

Income taxes currently payable are zero (as the company is in a current year breakeven position) and the income tax credit of $400 generated in the current year is carried forward to offset future year taxable income. Assuming the weight of available evidence indicates no valuation allowance is necessary against the tax credit carryforward, the company would recognize an income tax benefit of $400. The income tax benefit would be allocated among income from continuing operations and other items as follows:

Total income tax expense (benefit) (($0 Taxable income *25%) + $400 tax credits)		$ (400)
Tax expense (benefit) allocated to income from continuing operations:		
Current income tax expense before tax credits ($200 x 25%)	$ 50	
Tax credits	(400)	

Tax expense/(benefit) allocated to income from continuing operations	(350)
Tax expense (benefit) allocated to other items	$ (50)
Expense (benefit) allocated to other items:	
Discontinued operations ($300 x 25%)	$ (75)
Gain on securities recorded in other comprehensive income ($100 x 25%)	25
	$ (50)

Illustration 15-33: Intraperiod tax allocation example with a change in valuation allowance

Assume that Company A had the following results for the year:

Income from continuing operations	$ 1,000
Income from discontinued operations	500
Pretax income	$ 1,500

In previous years, the operations that are now presented as discontinued operations generated an NOL carryforward that was reflected at the beginning of the year in the company's balance sheet as a $1,000 deferred tax asset with a full valuation allowance. The tax rate is 25%.

At the end of the year, the company reassesses the realizability of its DTA. Based on the weight of all the available evidence, the company now concludes that they are realizable and reverses the entire valuation allowance.

Calculate total tax expense/(benefit) for the year	
Pretax income	$ 1,500
Tax rate	25%
Tax expense/(benefit) before changes in valuation allowances	$ 375
Valuation allowance release	(1,000)
Total tax expense/(benefit)	$ (625)

Tax expense/(benefit) allocated to continuing operations	
Income from continuing operations	$ 1,000
Tax rate	25%
	$ 250
Valuation allowance release due to current year income ($1,000 x 25%)	$ (250)
Valuation allowance release due to change in a judgment ($1,000 – $250)	(750)
Tax expense/(benefit) allocated to continuing operations	$ (750)

Under ASC 740-10-45-20, the effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances causing a change in judgment about the realizability of the related deferred tax asset is allocated to income from continuing operations, regardless of where the DTA was recorded when originated. Therefore, $250 of the change in the valuation allowance is due to current year income from continuing operations, and the release of the remaining valuation allowance due to the change in judgment ($750) is likewise allocated to continuing operations, notwithstanding the fact that the NOL was originally generated by the discontinued operations.

Allocate the remainder tax expense/(benefit) for the year	
Total tax expense/(benefit) for the year	$ (625)
Tax expense/(benefit) allocated to continuing operations	(750)
Tax expense/(benefit) allocated to discontinued operations	$ 125

16 Reorganizations

Excerpt from Accounting Standards Codification

Reorganizations — Income Taxes

Other Presentation Matters

852-740-45-3

The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi-reorganization as defined and contemplated in Subtopic 852-20 shall be reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years.

16.1 General

ASC 852-20 addresses accounting for companies effecting a quasi-reorganization. After the quasi-reorganization has been completed, the company's accounting should be substantially similar to that of a new company. Because the purpose of a quasi-reorganization is to create a fresh start for a company, tax benefits attributable to deductible temporary differences and carryforwards existing at the quasi-reorganization date should not be reflected in income because those benefits would not exist for a new company. Therefore, ASC 852-740-45-3 and SAB Topic 5.S (ASC 852-20-S99-2, Question 4) require that subsequent recognition (through reduction or elimination of a valuation allowance) of the tax benefits of deductible temporary differences and carryforwards existing at the date of the quasi-reorganization is credited directly to contributed capital.

16.2 Bankruptcies

Companies that emerge from bankruptcy and qualify for fresh-start accounting under ASC 852-10 are considered new entities for accounting purposes. As noted in ASC 852-10-45-19, to qualify for fresh-start accounting, the post-petition liabilities and allowed claims must exceed the reorganization value of the assets of the emerging entity and holders of existing voting shares immediately preceding the confirmation must receive less than 50% of the voting shares of the emerging entity.

As a new entity for accounting purposes, the tax attributes associated with the pre-reorganization entity are reflected in the fresh-start balance sheet in a manner similar to a business combination under ASC 805-20. If the emerging entity does not qualify for fresh-start accounting under ASC 852-10-45-19, the entity applies carryover basis for accounting purposes. Consistent with the business combination guidance provided in ASC 805-740, initial recognition (i.e., through reduction or elimination of a valuation allowance) of tax benefits from pre-confirmation NOL carryforwards and deductible temporary differences that were not recognizable at the plan of reorganization confirmation date should be reported as a reduction to income tax expense.[53] See section 1.2.1.13, *Final decree*, of our FRD, ***Bankruptcies, liquidations and quasi-reorganizations***, for discussion of the plan of reorganization confirmation date.

[53] "Plan of reorganization" is defined by ASC 852-10-20 as an agreement formulated in Chapter 11 proceedings under the supervision of the Bankruptcy Court that enables the debtor to continue in business.

We generally believe that the bankruptcy proceeding serves as a measurement period and that generally no remaining measurement period exists subsequent to emergence (see section 4.2.3, *Measurement period*, of our FRD, ***Bankruptcies, liquidations and quasi-reorganizations***). As such, after emergence from bankruptcy, changes to deferred tax assets and liabilities, including changes in judgment regarding realizability of deferred tax assets, as well as changes in judgment with respect to income tax uncertainties, are recorded as adjustments to income tax expense (benefit), rather than as adjustments to goodwill. This treatment is consistent with the business combinations guidance in ASC 805 and the FASB's decision that the integrity of asset bases established in acquisition accounting (or for entities emerging from bankruptcy protection, the asset bases established in fresh-start accounting) should be maintained and not adjusted as a result of subsequent realization of acquired tax benefits or changes in judgment with respect to uncertain tax positions.

The recognition of deferred taxes related to bankrupt entities is discussed further in the following sections:

- 15.3.7, *Tax benefits of pre-reorganization temporary differences and carryforwards*
- 6.1.1.1.2, *Emergence from bankruptcy*

17 Separate financial statements of a subsidiary

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12, which simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the legacy guidance to promote more consistency. The amendments clarify that an entity is not required to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of legal entities that are not subject to income tax. However, the new guidance allows an entity to make an election to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of wholly owned legal entities that are both not subject to tax and disregarded by the taxing authority (e.g., a single-member limited liability company).

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Early adoption is permitted in interim or annual periods for which all other entities (i.e., entities that are not PBEs) have not made financial statements available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply this amendment retrospectively for all periods presented.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Initial Measurement

740-10-30-27

The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Subtopic does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Subtopic. A method that allocates current and deferred taxes to members of the group by applying this Topic to each member as if it were a separate taxpayer meets those criteria. In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amount. That may also be the result when there are intra-entity transactions between members of the group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

740-10-30-28

Examples of methods that are not consistent with the broad principles established by this Subtopic include the following:

a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences

b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Subtopic (for example, the deferred method that was used before 1989)

c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

17.1 General

ASC 740-10-30-27 specifies that the amount of current and deferred tax expense for an income tax return group that files a consolidated income tax return is allocated among the members of that group when those members issue separate financial statements, but does not establish a mandatory method of allocation. An allocation will be required, for example, in call reports or separate financial statements of a bank that is a member of a consolidated income tax return group or when separate subsidiary financial statements are required for regulatory filings. The allocation method adopted must be systematic, rational and consistent with the broad principles of ASC 740.

One such method would be to allocate current and deferred taxes as if each member were a separate taxpayer. Under this method, ASC 740-10-30-27 notes that the sum of the amounts allocated to individual members of the income tax return group may not equal the consolidated amount. The separate return method is considered preferable by the SEC (see section 17.2, *SEC staff position on determining income taxes in separate financial statements*, for further discussion).

Another permissible method would be to calculate tax expense at a consolidated level, and then allocate that current and deferred tax expense to members of the group based on their relative contributions to the group's current and deferred income taxes (i.e., the pro rata method). Unlike the separate return method, the use of the pro rata method would result in the sum of amounts allocated to individual members to be equal to the consolidated amount.

The following methods are not consistent with the broad principles of ASC 740 and are, therefore, *not* acceptable:

- Allocating only current taxes payable to a member of the group that has taxable temporary differences
- Allocating deferred taxes to a member of the group using a method fundamentally different from the asset and liability method of ASC 740 (for example, the deferred method that was used before 1989)
- Allocating no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense

For a private company, using an allocation method based on the terms of a tax-sharing agreement, whereby a profitable parent company (from a consolidated standpoint) agrees to pay a subsidiary for the tax effects of the subsidiary's separate losses (e.g., net operating losses), would be an acceptable approach even though the subsidiary might not be able to record a benefit for its losses based on a separate return calculation. See section 17.4, *Other allocation methods (non-SEC filers)*, for additional discussion of other allocation methods.

See section 11.15, *Differences in measurement of deferred taxes in separate financial statements of subsidiary*, for additional income tax considerations for separate financial statements of an acquired subsidiary.

17.1.1 Allocation of consolidated income tax expense to separate financial statements of entities not subject to income tax

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Initial Measurement

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* **| Transition Guidance:** 740-10-65-8

740-10-30-27A

An entity is not required to allocate the consolidated amount of current and deferred tax expense to legal entities that are not subject to tax. However, an entity may elect to allocate the consolidated amount of current and deferred tax expense to legal entities that are both not subject to tax and disregarded by the taxing authority (for example, disregarded entities such as single-member limited liability companies). The election is not required for all members of a group that files a consolidated tax return; that is, the election may be made for individual members of the group that files a consolidated tax return. An entity shall not make the election to allocate the consolidated amount of current and deferred tax expense for legal entities that are partnerships or are other pass-through entities that are not wholly owned.

ASC 740-10-30-27A clarifies that an entity is not required to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of legal entities that are not subject to income tax.

However, the guidance allows an entity to make an election to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of legal entities that are both not subject to tax and disregarded by the taxing authority (e.g., a single member limited-liability company (SMLLC)). The election is not required for all such members of a group that file a consolidated tax return. Therefore, an entity may elect to make the allocation in the separate legal entity financial statements on an entity-by-entity basis. An entity cannot make the election to allocate the consolidated amount of current and deferred tax expense for legal entities that are partnerships or other pass-through entities that are not wholly owned.

The FASB said it is allowing SMLLCs and other similar disregarded entities (that are wholly owned by the entity) that are not subject to income tax to recognize an allocation of income taxes in their separate financial statements because certain entities (e.g., rate-regulated entities) may need to do so for business reasons. However, an SMLLC or a similar disregarded entity that elects to recognize such an allocation must disclose that fact and provide certain other disclosures required by ASC 740 (see chapter 18, *Financial statement presentation and disclosures*).

In addition, entities that elect to allocate a tax provision to the separate financial statements of legal entities not subject to income tax should consider the guidance in ASC 740-10-30-27. See section 17.1 for details.

17.2 SEC staff position on determining income taxes in separate financial statements

As indicated in Staff Accounting Bulletin No. 55 (Topic 1-B), *Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity; Cheap Stock* (codified in ASC 220-10-S99-3), the SEC staff believes the preferable method for determining income taxes in separate financial statements filed with the SEC of companies that file a consolidated tax return is a computation based on a separate return (i.e., as if the registrant had not been included in a consolidated income tax return group with its parent). This approach meets the requirement of ASC 740 to use an allocation method that is "systematic, rational, and consistent with the broad principles established by this Subtopic." In this regard, the SEC staff believes it is material to investors to know what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return group with its parent. If income taxes have not been computed on a separate return basis in the historical financial statements, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on a separate return basis.

Illustration 17-1: Allocating income taxes to separate financial statements using the separate return method

Facts

Assume Company B's parent files a consolidated federal income tax return that includes all of its eligible subsidiaries, including Company B. Further, assume that in 20X0 and 20X1, Company B had permanent differences of $500,000 that increased taxable income over pretax book income, no net temporary differences, a blended statutory rate of 25%, and 10 million shares outstanding for the entire period. Additionally, assume Company B's income before federal income tax is $10 million in 20X0 and 20X1 and is earned ratably throughout the year.

Analysis

If federal income taxes were computed assuming Company B filed a separate federal income tax return, the effect on pro forma net income and pro forma earnings per share would be as follows:

	Year ended 31 December 20X0	Quarter ended 31 March 20X1
Income before federal income tax as reported in the accompanying financial statements	$ 10,000,000	$ 2,500,000
Provision for federal income taxes assuming computation on a separate return basis	(2,625,000)	(656,250)
Pro forma net income	$ 7,375,000	$ 1,843,750
Pro forma earnings per share of common stock	$ 0.74	$ 0.18

The following is an example of a disclosure that would be included in a company's separately filed financial statements to describe the method utilized by the subsidiary to calculate its standalone tax provision.

Illustration 17-2: Example disclosure on the method used to calculate the standalone tax provision

The Company's financial statements recognize the current and deferred income tax consequences that result from the Company's activities during the current and preceding periods pursuant to the provisions of Accounting Standards Codification Topic 740, *Income Taxes* (ASC 740), as if the Company were a separate taxpayer rather than a member of the parent company's consolidated income tax return group. Differences between the Company's separate company income tax provision and cash flows attributable to income taxes pursuant to the provisions of the Company's tax-sharing arrangement with the parent company have been recognized as capital contributions from, or dividends to, the parent company (the actual footnote would also provide a description of the specific provisions of the tax-sharing arrangement and may include disclosure of NOLs used by the parent). Current taxes payable are included in the payable to parent line item in the Company's balance sheet.

17.3 Carve-out financial statements

The following discusses the SEC staff view, as expressed in the 12 June 2001 AICPA SEC Regulations Committee Minutes, of tax provisions related to non-legal entities (e.g., divisions and single-member LLCs) in carve-out financial statements:

Presenting income taxes in carve-out financial statements

Question

Should carve-out financial statements (i.e., financial statements of a business that is not a legal entity, e.g., a division) reflect income tax expense and deferred tax assets/liabilities if the reporting entity is a component of a taxable entity?

Background

The accounting literature does not clearly address the issue of accounting for income taxes by a reporting entity that is not a legal entity.

Paragraph 1 of Statement 109 [ASC 740-10-05-1] states that it "addresses financial accounting and reporting for the effects of income taxes that result from *an enterprise's* activities..." Paragraph 40 [ASC 740-10-30-27] provides standards for accounting for income taxes in the "separate financial statements of a *subsidiary*." It states that tax expense "shall be allocated among *the members* of the group when *those members* issue separate financial statements." (Emphasis added.) Statement 109 [ASC 740] does not define the term "enterprise." However, paragraph 40 [ASC 740-10-30-27] seems to apply only to legal entities.

SAB Topic 1-B [ASC 220-10-S99-3] is entitled Allocation of Expenses and Related Disclosures in Financial Statements of Subsidiaries, Divisions, or Lesser Business Components of Another Entity. In its text, it seems to use the word "subsidiary" as a surrogate for the larger collection of reporting entities listed in its title. The response to Question 1 states that "the historical income statements of a registrant should reflect all of its costs of doing business." However, the response then states that "income taxes . . . are discussed separately below." Question 3 addresses income tax expense. Although the SAB seems to use the term "subsidiary" broadly, the discussion of subsidiary income taxes in the response to Question 3 seems to be written in the context of legal entities, referring to issues of whether the entity can be included in a consolidated tax return (this is not an issue for a component of a legal entity) with its "parent." The response states the need to provide a pro forma tax provision if the financial statements do not reflect income taxes on a separate return basis. Guidance in the SEC Financial Reporting Manual (at Topic 3, Section 3410 and Topic 7, Section 7430) also focuses on the need for pro forma tax provision information.

Although an allocation of deferred tax assets and liabilities needs to be made to apply the separate return method, none of this guidance specifically addresses balance sheet presentation or footnote disclosure issues. The guidance calling for pro forma information focuses on the need for tax provision information.

Discussion

Many accountants focus on the concept stated in SAB Topic 1-B [ASC 225-10-S99-3] [54] that income statements should reflect all costs of doing business. They present income tax provisions as part of the historical accounts reflected in carve-out financial statements. Others believe that since reporting entities that are not legal entities do not have legal tax status, they do not have tax liabilities or expenses. Therefore, they present income tax information in carve-out financial statements only on a pro forma basis. Although practice does not appear to be uniform, it appears that registrants present income taxes in carve-out financial statements as part of the historical accounts more frequently than they present them as pro forma information. This observation is based in part on comments made by the Big 5 accounting firms in communications discussing the question of whether a single-member LLC should present a tax provision in its financial statements. A single-member LLC is treated as a "disregarded

[54] Editorial and Maintenance Update 2017-19 superseded Topic 225 and relocated the guidance contained therein to Topic 220. This guidance is now codified in ASC 220-10-S99-3.

entity" for tax purposes. In other words, it is treated no differently than a division of a taxpayer. The majority of the firms felt that a single-member LLC should present a tax provision.[55] The other firms did not have strong views.

Staff comment As stated in SAB Topic 1B [ASC 225-10-S99-3],[54] the staff believes that financial statements are more useful to investors if they reflect all costs of doing business. As the transactions reported in the carve-out financial statements have income tax implications to the taxable entity of which the reporting entity is a part, the staff believes that carve-out financial statements should reflect income tax expense and deferred tax assets/liabilities attributable to the reporting entity.

Refer to our publication, ***Guide to preparing carve-out financial statements***, for further discussion on accounting considerations while preparing carve-out financial statements.

17.3.1 Other SEC considerations related to tax-sharing arrangements

A parent company may enter into a formal tax-sharing arrangement with a subsidiary to allocate income tax expense and to pay its subsidiary for the tax benefits related to the subsidiary's losses. In some cases, the terms of these arrangements may also require the subsidiary to settle with the parent the net deferred tax position each period. For financial reporting purposes, the parent company allocates income tax expense to its subsidiary using the separate return method.

In these situations, because the tax-sharing arrangement requires the subsidiary to settle its deferred tax position (i.e., the subsidiary's net temporary differences and operating loss carryforwards) with its parent, a question arises about whether it is appropriate for the subsidiary in its separate financial statements to derecognize the deferred tax assets and liabilities (including NOLs that arise on a separate-return basis) that are settled with its parent under the tax-sharing arrangement.

Based on a discussion with the SEC staff, we understand that the SEC staff does not believe it is appropriate for a subsidiary to derecognize its deferred tax balances when they are settled with its parent under a tax-sharing arrangement. The SEC staff indicated that derecognizing deferred tax assets and liabilities under such arrangements would not be consistent with the broad principles established by ASC 740.

However, if the arrangement requires the parent to pay its subsidiary for the tax benefits of operating losses, the SEC staff noted it would not object to the subsidiary derecognizing the NOLs in its separate financial statements. The SEC staff also noted that it would not object to a company choosing to recognize these operating losses as NOLs in its separate financial statements. We believe an entity should consistently apply its accounting method for settling operating losses with a parent and, if the amounts settled are significant, it should disclose the terms of its tax-sharing arrangement in its separate financial statement and its accounting policy for settling the tax benefits of its operating losses (see section 17.2, *SEC staff position on determining income taxes in separate financial statements*, for additional discussion of the SEC staff's views on presenting income taxes in carve-out financial statements).

17.4 Other allocation methods (non-SEC filers)

As discussed in section 17.1, *General*, ASC 740-10-30-27 specifies that the amount of current and deferred tax expense for an income tax return group that files a consolidated income tax return is allocated among the members of that group when those members issue separate financial statements. The method used to allocate consolidated income tax expense (benefit) to a subsidiary (which is a

[55] ASU 2019-12 clarifies that an entity can make the election to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of wholly owned legal entities that are both not subject to tax and disregarded by the taxing authority (e.g., for single-member LLCs and other similar disregarded entities) (see section 17.1.1, *Allocation of consolidated income tax expense to separate financial statements of entities not subject to income tax*, for further discussion on this election).

member of an income tax group filing a consolidated return) that issues separate financial statements is required to be systematic, rational and consistent with the broad principles established by ASC 740. As discussed in section 17.1, *General*, one such method is to allocate current and deferred taxes as if each member were a separate taxpayer (separate return method). The separate return method is considered preferable by the SEC staff (see section 17.2, *SEC staff position on determining income taxes in separate financial statements*, for a discussion of the SEC staff expectations). A company whose financial statements will not be included in an SEC filing may apply methods other than the separate return method as long as the method complies with ASC 740-10-30-27. For example, use of an allocation method based on the terms of a tax-sharing agreement whereby a profitable parent company (from a consolidated reporting entity standpoint) agrees to pay a subsidiary for the tax effects of the subsidiary's separate losses would be an acceptable approach, even though the subsidiary might not be able to record a benefit for its losses based on a separate return calculation.

The following example illustrates the application of this method for operating losses (i.e., when a tax-sharing arrangement results in the profitable consolidated parent agreeing to pay a wholly owned subsidiary for the tax effects of the subsidiary's separate losses). Similar considerations are applicable to other tax attributes (tax credits).

Illustration 17-3: Allocating income taxes to separate financial statements based on terms of a tax-sharing agreement

Facts

- Subsidiary B's parent, Company P, files a consolidated federal income tax return that includes all of its eligible subsidiaries, including Subsidiary B, wholly owned by Company P.
- In 20X0 Subsidiary B incurred an operating loss of $500,000, had no other temporary or permanent differences and has a statutory rate of 25%.
- Based solely on Subsidiary B's sources of taxable income, Subsidiary B is not more likely than not to realize its deferred tax asset related to its 20X0 net operating loss.
- Company P has historically been profitable (from a consolidated standpoint) and in 20X0 Company P had ordinary income sufficient to utilize Subsidiary B's 20X0 net operating loss.
- Company P and Subsidiary B have a tax-sharing agreement under which Subsidiary B is compensated for any net operating loss that Company P is able to utilize.

Analysis

If federal income tax was computed factoring in the compensation from Company P to Subsidiary B for any net operating losses used by Company P, the reported net income would be as follows:

	Year ended 31 December 20X0
Separate return method before consideration of tax-sharing agreement:	
Subsidiary B's loss before federal income tax as reported in its standalone financial statements	$ (500,000)
Tax rate	25%
Income tax benefit associated with net operating loss	125,000
Valuation allowance	(125,000)
Total income tax benefit	$ -

Separate return method after consideration of tax-sharing agreement:

Loss before federal income tax as reported in the accompanying financial statements	$ (500,000)
Tax rate	25%
Income tax benefit associated with net operating loss	$ 125,000[a]

The income tax journal entries recorded by Subsidiary B under the separate return method after consideration of the tax-sharing agreement are as follows:

Deferred tax asset	$ 125,000	
Income tax benefit		$ 125,000
To record the NOL carryforwards for the net operating loss		
Intercompany receivable from Company P	$ 125,000	
Deferred tax asset		$ 125,000
To record the effects of the tax-sharing agreement between Company P and Subsidiary B. Subsidiary B accrues the amount due from Company P for the use of its NOL carryforwards.		

[a] No valuation allowance is necessary because Company P's tax-sharing agreement with Subsidiary B provides for Subsidiary B to be compensated for any net operating loss that Company P is able to utilize.

18 Financial statement presentation and disclosures

Standard setting

The FASB issued a proposed Accounting Standards Update to ASC 740, *Improvements to Income Tax Disclosures*, to improve the transparency and decision usefulness of income tax disclosures. The proposal addresses investor requests for more transparency about income tax information, particularly by jurisdiction. It would require more details in the rate reconciliation and the disclosure about income tax paid. The proposal would also eliminate the requirement in ASC 740-10-50-15(d) for all entities to (1) disclose the nature and estimate of the range of reasonably possible change in unrecognized tax benefits balance in the next 12 months or (2) make a statement that an estimate of the range cannot be made, among other things. In addition, the proposal would eliminate the requirement to disclose the cumulative amount of each type of temporary difference when a deferred tax liability is not recognized because of a recognition exception (e.g., indefinite reinvestment exception) related to deferred taxes for subsidiaries and corporate joint ventures.

See our To the Point: ***FASB proposes improvements to income tax disclosures***. Readers should monitor developments.

18.1 Balance sheet presentation

ASC 740 requires companies to classify all deferred tax assets and liabilities as noncurrent on the balance sheet instead of separating deferred taxes into current and noncurrent amounts. In addition, valuation allowances are classified as noncurrent. Companies are required to offset deferred tax assets and liabilities for each taxpaying component within a tax jurisdiction. See section 18.1.1, *Offset of deferred tax assets and liabilities*.

18.1.1 Offset of deferred tax assets and liabilities

ASC 740-10-30-5 describes a tax-paying component as an individual entity or group of entities that is consolidated for tax purposes. If noncurrent deferred tax assets and liabilities relate to a particular tax-paying component of a company within a particular jurisdiction, ASC 740-10-45-6 requires that those noncurrent deferred tax assets and liabilities be offset and presented as a single amount. ASC 740-10-45-6 does not permit deferred tax assets and liabilities attributable to different tax-paying components (e.g., a subsidiary filing a separate return) or to different tax jurisdictions (e.g., the US and the United Kingdom, New York and New Jersey) to be offset for financial reporting purposes. As noted in ASC 740-10-45-3, this guidance is incremental to the general offsetting guidance in ASC 210.

Because the right to offset amounts relating to different tax jurisdictions or components is prohibited, some companies will report multiple net noncurrent deferred tax amounts in their balance sheet. As illustrated in the following example, a company may have to present up to two separate deferred tax amounts in its balance sheet (i.e., noncurrent asset and noncurrent liability).

Illustration 18-1: Offset of deferred tax assets and liabilities

Assume a company has the following deferred tax amounts related to different tax jurisdictions:

	Assets Noncurrent	Liabilities Noncurrent
US federal income taxes (consolidated)	$ –	$ 5,000
State A income taxes*	–	2,000
German income taxes	4,000	–
State B income taxes*	1,000	–
Totals	$ 5,000	$ 7,000

The company would be required to report the total amounts for both its noncurrent DTAs (i.e., 5,000) and its noncurrent DTLs (i.e., 7,000) in its balance sheet. Offsetting the noncurrent deferred tax assets and liabilities is not be permitted because the deferred tax balances relate to either different tax-paying components or different tax jurisdictions.

* Assuming all state taxes are due by a single entity.

Some tax jurisdictions do not allow for consolidated tax returns but may have provisions that provide some of the same benefits. For example, while entities may be required to file separate tax returns, the taxable income in one entity's separate tax return may be legally offset with tax losses in an affiliated entity's separate tax return in the same jurisdiction in the same year (e.g., under the United Kingdom's "group relief" provisions). In evaluating the offsetting requirements of ASC 740-10-45-6, careful consideration of the facts and circumstances is necessary before concluding that an affiliated group of entities that file separately in a particular jurisdiction may be considered, in substance, a single tax-paying component within that tax jurisdiction.

18.1.1.1 State and local income taxes and valuation allowance

As discussed in section 5.8.1, *State applied versus enacted tax rates*, the computation of state deferred taxes considers expected federal tax effects, if any. However, ASC 740 does not permit netting of deferred tax assets and liabilities related to different jurisdictions. An interesting issue arises if a valuation allowance is necessary for a state deferred tax asset that is not more likely than not to be realized. The issue is whether a state deferred tax asset should be assessed for realizability before or after the related federal deferred tax liability is recognized.

When a state deferred tax asset is not realizable and a valuation allowance is required, we believe an entity may either:

- First record a valuation allowance associated with the state deferred tax asset resulting in the entity not recording the related federal deferred tax liability
- First record a federal deferred tax liability and then record a valuation allowance based on the deferred tax asset after considering the federal deferred tax liability

18.1.2 Balance sheet classification related to TCJA's transition tax

Foreign earnings on which US income taxes were previously deferred are subject to a one-time tax (transition tax) under the TCJA. Generally, US corporations were required to include in income for each specified foreign subsidiary's last tax year beginning before 2018 their pro rata share of the net post-1986 historical earnings and profits (E&P) that had not been previously taxed. Under ASC 740-10-45-15, a company recognized the income tax accounting consequences of the one-time transition tax as a component of income tax expense from continuing operations in the period the TCJA was enacted or during the measurement period provided by SAB 118. Companies that recognized deferred taxes on undistributed foreign earnings before the enactment of the TCJA may have needed to adjust previously recognized deferred tax liabilities and consider the classification of the transition income tax payable. Companies that previously did not record deferred taxes related to undistributed earnings because they asserted those earnings were permanently reinvested could no longer continue to assert indefinite reinvestment of those earnings for federal income tax purposes.

Companies could elect to pay the transition tax without incurring interest over a period of up to eight years. Companies that elected to pay the transition tax over time need to consider the balance sheet classification between current and noncurrent. The transition tax represents an income tax payable as opposed to a deferred tax liability.

Questions existed about whether the guidance in ASC 835-30, *Interest — Imputation of Interest*, applies to long-term income taxes payable. In response to these questions, the FASB staff made the following recommendations in its Staff Q&A:

FASB staff question and answer on whether to discount the tax liability on the deemed repatriation

Question

Does the FASB staff believe that the tax liability on the deemed repatriation of earnings should be discounted?

Response

The FASB staff believes that the tax liability on the deemed repatriation of earnings should not be discounted. The FASB staff notes that paragraph 740-10-30-8 prohibits the discounting of deferred tax amounts. Due to the unique nature of the tax on the deemed repatriation of foreign earnings, the staff believes that the guidance in paragraph 740-10-30-8 should be applied by analogy to the payable recognized for this tax.

Further, the FASB staff does not believe that Subtopic 835-30 on the imputation of interest applies to the unique circumstances related to this tax liability. The guidance in Subtopic 835-30 addresses the accounting for business transactions that often involve the exchange of cash or property, goods or services for a note or similar instrument. Subtopic 835-30 is premised on the fact that when a note is exchanged for property, goods or services in a bargained transaction entered into at arm's length, the interest rate should represent fair and adequate compensation to the supplier. The FASB staff believes that the transition tax liability is not the result of a bargained transaction and that the scope exception in paragraph 835-30-15-3(e) for transactions where interest rates are affected by tax attributes or legal restrictions prescribed by a governmental agency (such as income tax settlements) would apply.

The FASB staff also notes that the tax liability may not be a fixed obligation because it may be subject to estimation and future resolution of uncertain tax positions (for example, amount of earnings and profits from foreign subsidiaries, amount of earnings held in cash and cash equivalents, reduction of the tax for foreign tax credits). Any recognized uncertain tax position related to the deemed repatriation of foreign earnings would not be discounted, and the staff does not believe it is appropriate to have a discounted tax liability when the uncertain tax position is undiscounted.

18.2 Disclosures about balance sheet accounts

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Disclosure

740-10-50-2

The components of the net **deferred tax liability** or **asset** recognized in an entity's statement of financial position shall be disclosed as follows:

a. The total of all deferred tax liabilities measured in paragraph 740-10-30-5(b)

b. The total of all deferred tax assets measured in paragraph 740-10-30-5(c) through (d)

c. The total **valuation allowance** recognized for deferred tax assets determined in paragraph 740-10-30-5(e).

The net change during the year in the total valuation allowance also shall be disclosed.

740-10-50-3

An entity shall disclose both of the following:

a. The amounts and expiration dates of operating loss and tax credit **carryforwards** for tax purposes

b. Any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be credited directly to contributed capital (see paragraph 740-20-45-11).

740-10-50-4

In the **event** that a change in an entity's tax status becomes effective after year-end in Year 2 but before the financial statements for Year 1 are issued or are available to be issued (as discussed in Section 855-10-25), the entity's financial statements for Year 1 shall disclose the change in the entity's tax status for Year 2 and the effects of that change, if material.

740-10-50-6

A **public entity** shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances).

740-10-50-8

A **nonpublic entity** shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type.

740-10-50-14

If not otherwise evident from the disclosures required by this Section, all entities shall disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented.

740-10-50-16

A public entity that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the entity's assets and liabilities.

740-10-50-17

An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

740-10-50-17A

An entity that is both not subject to tax and disregarded by the taxing authority that elects to include the allocated amount of current and deferred tax expense in its separately issued financial statements in accordance with paragraph 740-10-30-27A shall disclose that fact and provide the disclosures required by paragraph 740-10-50-17.

ASC Master Glossary

Public Entity

An entity that meets any of the following criteria:

a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).

b. It is a conduit bond obligor for **conduit debt securities** that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Nonpublic Entity

An entity that does not meet any of the following criteria:

a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).

b. It is a conduit bond obligor for **conduit debt securities** that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Income Taxes — Other Considerations or Special Areas

Disclosure

740-30-50-2

All of the following information shall be disclosed whenever a **deferred tax liability** is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable

b. The cumulative amount of each type of **temporary difference**

c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable. While paragraph 740-30-25-14 prohibits recognition of a tax **benefit** for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized, favorable tax treatment would be reflected in measuring that unrecognized deferred tax liability for disclosure purposes.

d. The amount of the deferred tax liability for temporary differences other than those in (c) (that is, undistributed domestic earnings) that is not recognized in accordance with the provisions of paragraph 740-30-25-18.

Financial Services-Depository and Lending — Income Taxes

Disclosure

942-740-50-1

All of the following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to a savings and loan association's bad-debt reserve for financial reporting:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable

b. The cumulative amount of each type of temporary difference

c. The amount of the deferred tax liability for temporary differences (that is, the bad-debt reserve for tax purposes of a U.S. savings and loan association or other qualified thrift lender) that is not recognized in accordance with the provisions of paragraphs 740-10-25-3, 740-30-25-5, 740-30-25-18, and 942-740-25-1 through 25-3.

942-740-50-2

The disclosure requirements set forth in the preceding paragraph also apply to a parent entity of a savings and loan association accounting for that investment either through consolidation or by the equity method.

Financial Services-Insurance — Income Taxes

Disclosure

944-740-50-1

The following information shall be disclosed if a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Section 740-10-25:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable

b. The cumulative amount of each type of temporary difference

c. The amount of the deferred tax liability for temporary differences other than the policyholders' surplus of a **life insurance entity** that is not recognized in accordance with the provisions of paragraph 740-10-25-3.

Income Statement — Reporting Comprehensive Income — Overall

Disclosure

General

Certain Income Tax Effects within Accumulated Other Comprehensive Income

220-10-50-1

An entity shall disclose a description of the accounting policy for releasing income tax effects from accumulated other comprehensive income.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 105-10-65-6

Editor's Note: The heading preceding paragraph 220-10-50-1 will be amended upon transition as noted below. The content of the paragraph will not change.

> Disclosing Changes and Certain Income Tax Effects within Accumulated Other Comprehensive Income

An entity shall disclose a description of the accounting policy for releasing income tax effects from accumulated other comprehensive income.

220-10-50-2

An entity that elects to reclassify the income tax effects of H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act), in accordance with paragraph 220-10-45-12A shall disclose in the period of adoption both of the following:

a. A statement that an election was made to reclassify the income tax effects of the Tax Cuts and Jobs Act from accumulated other comprehensive income to retained earnings

b. A description of other income tax effects related to the application of the Tax Cuts and Jobs Act that are reclassified from accumulated other comprehensive income to retained earnings, if any (see paragraph 220-10-45-12A(b)).

> *220-10-50-3*
>
> An entity that does not elect to reclassify the income tax effects of the Tax Cuts and Jobs Act in accordance with paragraph 220-10-45-12A shall disclose in the period of adoption a statement that an election was not made to reclassify the income tax effects of the Tax Cuts and Jobs Act from accumulated other comprehensive income to retained earnings.

ASC 740 requires the following disclosures about deferred tax balance sheet accounts:

- The total of all deferred tax liabilities, the total of all deferred tax assets, total valuation allowance recognized for deferred tax assets, and the net change during the year in the valuation allowance (ASC 740-10-50-2).
- Temporary differences and carryforwards that give rise to significant portions of a deferred tax liability or asset in a nonpublic entity (ASC 740-10-50-8).
- A public company should disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and assets (before allocation of valuation allowance). Separate disclosure of those tax effects for each major tax jurisdiction is encouraged but not required (ASC 740-10-50-6).
- The amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes (ASC 740-10-50-3). We believe companies also should disclose the nature and potential effects of any tax law provisions that might limit the availability or utilization of those carryforward amounts (e.g., separate-return limitations, limitations caused by changes in ownership).
- Any portion of the valuation allowance for deferred tax assets that is allocated to contributed capital if the future tax benefits that may be subsequently recognized will be credited directly to contributed capital (i.e., by elimination of the valuation allowance) (ASC 740-10-50-3).
- Information about temporary differences for which a deferred tax liability has not been recognized because of the "indefinite reversal criteria" in ASC 740-30 (ASC 740-30-50-2).
- If not otherwise evident from the disclosures made, companies should disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented (ASC 740-10-50-14).

See chapter 19, *Accounting for uncertainty in income taxes*, for additional disclosure related to uncertain tax positions.

18.2.1 Components of balance sheet deferred tax amounts

ASC 740-10-50 requires disclosure by all companies of the types of temporary differences that give rise to significant portions of the deferred tax asset or liability balances. Companies generally will be able to readily determine the types of temporary differences that give rise to significant portions of the deferred tax asset or liability balances from the listing of temporary differences underlying the ASC 740 deferred tax calculations. Public companies should disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and assets (before allocation of valuation allowance). Separate disclosure of those tax effects for each major tax jurisdiction is encouraged but not required. Public companies are also required to address uncertainties that might exist relating to the realization of deferred tax assets in their MD&A. Disclosure of the amounts of temporary differences is *not* required for nonpublic companies. However, a brief narrative disclosure of the types of items creating temporary differences is required. For example, a nonpublic company might indicate deferred tax assets relate to nondeductible warranty accruals and deferred tax liabilities relate to the use of accelerated depreciation for tax purposes.

18.2.2 Net operating loss and tax credit carryforwards

ASC 740-10-50-3 requires companies to disclose amounts and expiration dates of operating loss and tax credit carryforwards for income tax purposes. Those carryforwards are the amounts determined under the applicable tax law that are available to reduce taxes payable in future-year tax returns.

18.2.3 Subsequent recognition of tax benefits

As explained in section 11.11, *Valuation allowance in a business combination*, the tax benefits of an acquired company's deductible temporary differences, net operating losses and tax credit carryforwards could be offset by a valuation allowance at the acquisition date in the event management believed that it was more likely than not that the related tax benefits would not be realized. In those cases, the subsequent recognition of the acquired tax benefits that occurred within the measurement period that result from new information about the facts and circumstances that existed at the acquisition date are recognized through an adjustment to goodwill. Once goodwill is reduced to zero, any additional decrease in the valuation allowance should be reported as a bargain purchase (i.e., as a gain attributable to the acquirer). Effects of changes outside of the measurement period to the valuation allowance established in acquisition accounting or changes during the measurement period that do not relate to facts and circumstances that existed at the acquisition date are reported directly as a reduction of income tax expense.

Likewise, as discussed in section 15.3, *Items charged or credited directly to shareholders' equity*, the subsequent recognition of tax benefits (by a reduction or elimination of a valuation allowance) that were initially recorded with a valuation allowance as a direct benefit to shareholders' equity may be credited directly to shareholders' equity as opposed to being included in the income statement depending on the nature of the change of the valuation allowance. In this regard, ASC 740-10-50-3 requires disclosure of any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be directly credited to shareholders' equity.

18.2.4 Indefinite reversal and other exceptions

ASC 740-30-50-2 (also ASC 942-740-50-1 and ASC 944-740-50-1) requires additional disclosures whenever a deferred tax liability has not been recognized for temporary differences because an exception has been met, for example, the indefinite reversal criteria of ASC 740-30. The temporary differences covered by ASC 740-30 include undistributed earnings of domestic and foreign subsidiaries, bad debt reserves of savings and loan institutions, and policyholders' surplus of stock life insurance companies. The following should be disclosed whenever a deferred tax liability is not recognized for taxable temporary differences because of the exception allowed under ASC 740-30:

- A description of the nature of the temporary differences and the types of events that would cause them to become taxable
- The cumulative amount of each type of temporary difference
- The amount of unrecognized deferred tax liabilities for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration, if determining that amount is practicable, or a statement that determination of that amount is not practicable
- The amount of unrecognized deferred tax liabilities for taxable temporary differences related to undistributed earnings of domestic subsidiaries, policyholders' surplus of stock life insurance companies and bad debt reserves of a savings and loan association that is not recognized in accordance with the provisions of ASC 740-10-25-3, ASC 740-30-25-5, ASC 740-30-25-18, and ASC 942-740-25-1 through ASC 942-740-25-3.

18.2.5 Income taxes refundable or payable

Although not specifically required by ASC 740, public companies are required to disclose material amounts (i.e., greater than 5% of current assets or liabilities) of refundable income taxes or taxes currently payable in accordance with SEC requirements.

18.3 Disclosures about income statement accounts

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Disclosure

740-10-50-9

The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

a. **Current tax expense (or benefit)**

b. **Deferred tax expense (or benefit)** (exclusive of the effects of other components listed below)

c. Investment tax credits

d. Government grants (to the extent recognized as a reduction of income tax expense)

e. The benefits of operating loss carryforwards

f. Tax expense that results from allocating certain tax benefits directly to contributed capital

g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the entity

h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related **deferred tax asset** in future years. For example, any acquisition-date income tax benefits or expenses recognized from changes in the acquirer's valuation allowance for its previously existing deferred tax assets as a result of a business combination (see paragraph 805-740-30-3).

740-10-50-10

The amount of **income tax expense (or benefit)** allocated to continuing operations and the amounts separately allocated to other items (in accordance with the intraperiod tax allocation provisions of paragraphs 740-20-45-2 through 45-14 and 852-740-45-3) shall be disclosed for each year for which those items are presented.

SEC Materials

740-10-S99-1

3. Net of Tax Presentation

Question: What disclosure is required when an item is reported on a net of tax basis (e. g., extraordinary items, discontinued operations, or cumulative adjustment related to accounting change)?

Interpretive Response: When an item is reported on a net of tax basis, additional disclosure of the nature of the tax component should be provided by reconciling the tax component associated with the item to the applicable statutory Federal income tax rate or rates.

ASC 740-10-50-10 requires disclosure of the amount of income tax expense or benefit allocated to continuing operations, discontinued operations, other comprehensive income, the cumulative effect of accounting changes, prior period adjustments and other items charged or credited directly to shareholders' equity. The allocation of income tax expense or benefit between continuing operations and other items should include deferred taxes.

The significant components of income tax expense or benefit attributable to continuing operations for each year presented also are to be disclosed in the financial statements or notes thereto (ASC 740-10-50-9). These include:

- Current tax expense or benefit
- Deferred tax expense or benefit, exclusive of the effects of other components listed below
- Investment tax credits
- Government grants (to the extent recognized as a reduction of income tax expense)
- Benefits of operating loss carryforwards
- Tax expense that results from allocating certain tax benefits directly to contributed capital
- Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates, or a change in the tax status of an entity (e.g., a change from partnership status to regular corporate tax status)
- Adjustments to the beginning-of-the-year balance of a valuation allowance because of changes in circumstances that cause changes in judgments about the realizability of deferred tax assets in future years

ASC 740 requires, for disclosure purposes, that the sum of the above tax components relating to continuing operations equal the amount of income tax expense or benefit reported in the income statement for continuing operations. In other words, insignificant components should be aggregated and included as one amount in the disclosure. In the case of tax benefits first recognized in the income statement for the utilization of operating loss carryforwards, tax credits and tax credit carryforwards, the FASB required separate disclosure of those amounts. The separate disclosure of such amounts is made "in the year recognized" for financial reporting purposes. Accordingly, disclosure is not required in the year an operating loss or tax credit carryforward is realized in the income tax return if it previously had been recognized in the income statement as part of the deferred tax provision; however, separate disclosure would have been required in that previous year if the item was an operating loss carryforward, tax credit or tax credit carryforward at that time.

18.3.1 SEC staff position

See section 17.2, *SEC staff position on determining income taxes in separate financial statements*, for discussion related to the separate financial statements of a subsidiary that is included in the parent company's consolidated tax return.

18.4 Disclosure of changes in tax laws or rates

For financial reporting purposes, ASC 740 requires disclosure of the effect of adjustments to deferred tax amounts for enacted changes in tax laws or rates as well as, for interim periods, the effect of the change in the estimated annual effective tax rate. We suggest the following disclosure to be included in interim financial statements for periods that include the effects of enacted changes in tax laws and/or rates.

Illustration 18-2: Example interim disclosure in a period with enacted changes in tax rate

In the third quarter of 20X1, the Company revised its estimated annual effective tax rate to reflect a change in the federal statutory rate from 21% to 30%, effective 1 January 20X1, resulting from legislation that was enacted on 15 September 20X1. As a result, income tax expense reported for the first six months was adjusted to reflect the effects of the change in the tax law and resulted in an increase in income tax expense of $330,000 during the third quarter. This amount is comprised of $200,000 of additional income tax for the six-month period ended 30 June 20X1 and $130,000 from the application of the newly enacted rates to existing deferred balances.

18.5 Interest and penalties due to taxing authorities

As discussed in section 19.9.2, *Accounting policy election — classification of interest and penalties*, the classification of interest and penalties due to taxing authorities as either income taxes or interest expense is an accounting policy election that must be consistently applied. ASC 740-10-50-19 requires that an entity disclose its policy on classification of interest and penalties due to taxing authorities in the notes to the financial statements. In addition, ASC 740-10-50-15(c) requires that all entities disclose the total amounts of the interest and penalties related to tax positions recognized in the statement of operations and in the statement of financial position.

Refer to section 19.10, *Disclosures*, for details on these required disclosures.

18.6 Professional fees

Questions have arisen regarding the appropriateness of including fees incurred to implement tax strategies, resolve tax contingencies or defend tax structures as a component of income tax expense. Typically, such fees include amounts paid to attorneys, accountants and underwriters.

Although ASC 740 does not provide specific guidance on the classification of fees and costs incurred related to complying with income tax reporting, implementing tax strategies or defending positions taken in income tax returns as filed, we believe that professional fees and any other costs incurred that do not represent amounts that will be payable to, or refundable from, a taxing authority based solely on income should not be included as a component of income tax expense based on ASC 740's definition of income tax expense. Regulation S-X, Rule 5-03(b)(11) specifies what items public companies may include under the caption income tax expense.

18.7 Reconciliation to statutory rate

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Disclosure

740-10-50-12

A public entity shall disclose a reconciliation using percentages or dollar amounts of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The statutory tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed.

740-10-50-13

A nonpublic entity shall disclose the nature of significant reconciling items but may omit a numerical reconciliation.

ASC 740-10-50-12 requires public companies to reconcile the income tax expense (benefit) from continuing operations with the amount that would result from applying the domestic federal statutory rate to pretax income (loss) from continuing operations. The statutory rate is the regular tax rate if an alternative tax system is used (the US corporate alternative minimum tax). While the disclosure rules require public companies to present the nature and amount (using percentages or dollar amounts) of each significant reconciling item (Regulation S-X, Rule 4-08(h)(2)), nonpublic companies only need to explain major reconciling items and may omit a numerical reconciliation. In applying that rule, if no individual reconciling item amounts to more than 5% of the amount computed by multiplying the income before tax by the applicable statutory federal income tax rate, and the total difference to be reconciled is less than 5% of such computed amount, no reconciliation need be provided unless it would be significant in appraising the trend of earnings. Reconciling items that are individually less than 5% of the computed amount may be aggregated in the reconciliation.

The reconciliation may be presented in percentages rather than in dollar amounts. Where the reporting person is a foreign entity, the income tax rate in that person's country of domicile should normally be used in making the above computation, but different rates should not be used for subsidiaries or other segments of a reporting entity. When the rate used by a reporting person is other than the United States federal corporate income tax rate, the rate used and basis for using such rate shall be disclosed. Nonetheless, nonpublic companies also may wish to include an effective tax rate reconciliation to assist users of the financial statements in understanding their tax situation.

Companies also are required to disclose the nature and effect of any significant matters affecting comparability of information for all periods presented, if not evident from the other disclosures (ASC 740-10-50-14).

In addition to the disclosure requirements of ASC 740, the SEC requires separate disclosure of the foreign and federal components of income before income tax as well as amounts of US, foreign and other income taxes.

Some of the typical reconciling items between recorded tax expense and income tax expense computed at the statutory rate are:

- Effects of enacted tax law and tax rate changes on existing temporary differences
- Effects of differences between the enacted tax rate for the current year for net originating temporary differences and enacted tax rates in future periods (or rates used in carryback computations)
- Effects of permanent differences on the current and deferred provisions (e.g., nondeductible items, tax-exempt interest income, investment tax credits)
- Effects of valuation allowances on deferred tax assets
- Effects of differing tax rates in effect in different jurisdictions or for different types of income

An analysis of factors included in a rate reconciliation will serve as a final check on computations made and often will help management explain effects of the liability method computations to others.

18.8 Illustrative financial statement note disclosure

The following example illustrates ASC 740 financial statement note disclosures for a PBE.

Illustration 18-3: Example footnote disclosure for a PBE

Note 2. Summary of Significant Accounting Policies

Income Taxes

The Company provides for income taxes and the related accounts under the asset and liability method. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates expected to be in effect during the year in which the basis differences reverse. Valuation allowances are established when management determines it is more likely than not that some portion, or all, of the deferred tax assets will not be realized.

Note 10. Income Taxes

The provision (benefit) for income taxes comprises:

	Year ended 31 December		
	20X2	**20X1**	**20X0**
		(in thousands)	
Current federal	$ 2,250	$ 1,575	$ 950
Current state	1,225	850	425
Deferred federal	4,350	725	650
Deferred state	675	400	225
Provision for income tax expense (benefit)	$ 8,500	$ 3,550	$ 2,250

The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate to income before the provision for income taxes.

The sources and tax effects of the differences are as follows:

	Year ended 31 December		
	20X2	**20X1**	**20X0**
		(in thousands)	
Income tax (provision) benefit at the federal statutory rate of 21%	$ 5,885	$ 2,610	$ 1,580
Permanent differences, net	(230)	175	150
State income (tax) benefit, net of federal benefit	1,235	350	240
Nondeductible charge for purchased research and development activities	650	–	–
Nondeductible charge for merger-related expenses	35	–	5
Benefit of DRD	(55)	(10)	–
Valuation allowance changes affecting the provision for income taxes	1,000	500	250
Other	(20)	(75)	25
	$ 8,500	$ 3,550	$ 2,250

As of 31 December 20X2, the Company has net operating loss carryforwards of approximately $29.4 million for tax purposes, which will be available to offset future taxable income. If not used, these carryforwards will expire between 20X3 and 20Z0.

The Company's income tax provision was computed based on the federal statutory rate and the average state statutory rates, net of the related federal benefit.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

Significant components of the Company's deferred tax assets and liabilities are as follows:

	Year ended 31 December	
	20X2	**20X1**
	(in thousands)	
Deferred tax assets:		
Allowance for credit losses/Bad debt reserve	$ 1,000	$ –
Deferred revenue	500	250
Accrued expenses and other	250	125
Restructuring reserve	2,600	2,750
Net operating loss carryforwards	9,000	9,000
Deferred revenue	850	1,750
OPEB obligation	900	650
Other	250	200
	15,350	14,725
Valuation allowance	(5,500)	(4,500)
Net deferred tax assets	9,850	10,225
Deferred tax liabilities:		
Capitalized software costs	600	750
Unrealized gain on available-for-sale debt securities	9,600	5,700
Unremitted earnings of foreign subsidiaries	2,200	1,500
Depreciation	850	650
Total tax liabilities	13,250	8,600
Net noncurrent deferred tax asset (liability)	$ (3,400)	$ 1,625

Undistributed earnings of certain of the Company's foreign subsidiaries amounted to approximately $5 million at 31 December 20X2. Those earnings are considered to be indefinitely reinvested; accordingly, no provision for state, local and foreign withholding income taxes has been provided thereon. Upon repatriation of those earnings, in the form of dividends or otherwise, the Company would be subject to state and local taxes, and withholding taxes payable to the various foreign countries. The Company expects to be able to take a 100% dividend received deduction to offset any US federal income tax liability on the undistributed earnings. Determination of the amount of unrecognized state and local deferred income tax liability is not practicable due to the complexities associated with its hypothetical calculation. Withholding taxes of approximately $400,000 would be payable upon remittance of all previously unremitted earnings at 31 December 20X2.

Note: *This illustration assumes that the Company is a US corporation and that there are no federal income tax consequences for the undistributed foreign earnings as the Company expects its undistributed earnings to be subject to the 100% dividend received deduction, are considered previously taxed (for example, under the Section 965 transition tax inclusion, the GILTI provisions or Subpart F) and the amount of unrecognized tax liabilities related to investments in the foreign subsidiaries or undistributed earnings of domestic subsidiaries is not material. If unrecognized tax liabilities related to investments in foreign subsidiaries or domestic subsidiaries were material, they would need to be disclosed unless it is not practicable to determine the related deferred tax liabilities.*

18.9 Management's discussion and analysis — SEC staff positions

The SEC staff routinely requests disclosures be included in MD&A relative to uncertainties that might exist with respect to the realization of deferred tax assets that are not offset by deferred tax liabilities. For deferred tax assets that can be realized through carrybacks and reversals of existing taxable temporary differences (essentially those deferred tax assets that are not dependent upon future events) disclosure generally could be limited to discussion of the basis by which management determined that it was *more likely than not* the deferred tax asset would be realized. In instances where the implementation of tax-planning strategies is the basis for not recognizing a valuation allowance for all or some portion of the deferred tax asset, the SEC staff requires that disclosures include a discussion of the uncertainties that might impact the realization of deferred tax assets, as well as the factors that led management to conclude that it was *more likely than not* the deferred tax asset would be realized.

If a material net deferred tax asset's realization is dependent on significant improvements over present levels of consolidated pretax income, changes in the present relationship between income reported for financial and tax purposes, or asset sales or other nonroutine transactions, a description of these assumed future events, quantified to the extent practicable, should be included in MD&A. For example, the minimum annualized rate by which taxable income must increase during the tax NOL carryforward period should be disclosed if realization of the benefit is dependent on taxable income higher than currently reported. In addition, if significant objective negative evidence indicates uncertainty regarding realization of the deferred asset, the countervailing positive evidence relied upon by management in its decision not to establish a full allowance against the asset should be identified. Significant changes in the valuation allowance for a deferred tax asset from one period to the next should also be fully explained in MD&A, highlighting changes in assumptions and environmental factors that necessitated the change.

Conversely, a valuation allowance for the deferred tax asset is not appropriate unless it is *more likely than not* that the asset will not be realized. If the company has a history of earning pretax income but has provided a valuation allowance for deferred tax assets, the negative factors supporting such a conclusion should be discussed (e.g., continuing losses by foreign subsidiary). The SEC staff has challenged companies that establish a significant allowance but whose disclosures regarding current and expected operating results appear inconsistent with management's view regarding realization of the deferred tax asset. In those circumstances, the SEC staff has questioned whether the narrative disclosures are unreasonably optimistic or whether the valuation allowance is unreasonably pessimistic, and revisions to the financial statements or the narrative have typically been required to reconcile the apparent inconsistency. Companies should also consider the consistency of assumptions used to determine the need for a valuation allowance under ASC 740 as compared to other cash flow projections (i.e., acquisitions and divestitures, impairments of long-lived assets and others). The SEC staff has objected to the use of inconsistent assumptions in cash flow projections developed for ASC 360 and ASC 740.

The SEC staff's basis for requesting such disclosure is Financial Reporting Release 36, which states, "Disclosure (should be made) of known trends or uncertainties that the registrant reasonably expects will have a material impact on net sales, revenues, or income from continuing operations … MD&A shall focus on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."

Comment letters issued by the SEC staff indicate the staff is interpreting the phrase *reasonably expects* to mean "expects to have a reasonable chance to occur." Disclosures of forward-looking information made regarding uncertainties would be covered by the rules establishing a safe harbor for "forward-looking statements" in MD&A.

18.9.1 Management's discussion and analysis disclosure requirements

The SEC staff has requested that registrants include the following types of disclosure in their MD&A:

- Disclosure of the basis for management's determination that it is more likely than not that the net deferred tax asset will be realized.
- Disclosure of the types of uncertainties that may affect the ultimate realization of deferred tax assets.
- Disclosure of the registrant's intention to evaluate the realizability of the deferred tax asset quarterly by assessing the need for a valuation allowance.

Examples of uncertainties relating to future taxable income may include:

- Possible declines in sales, margins and revenues stemming from a variety of sources, such as loss of market share, technological obsolescence or increased competition.
- The amount of expected future taxable income that would have to be generated to realize the deferred tax assets, and whether the existing levels of pretax earnings for financial reporting purposes are sufficient to generate that minimum amount of future taxable income.
- The period that future taxable income would have to be earned to realize the deferred tax asset.
- Whether the source of the expected future taxable income will stem from ordinary and recurring operations or whether sales of operating assets will be necessary to achieve the required levels of income. If the source of the expected future taxable income is from other than ordinary and recurring operations, the amount of taxable income that could be generated from those transactions should be disclosed along with a discussion of how management plans to consummate those transactions and material uncertainties, if any, that could affect those transactions.

18.10 Entities not subject to income taxes

Some entities are not taxed on their earnings because their income is taxed directly to the owners or shareholders of the entity (e.g., S corporations, limited liability companies, partnerships, joint ventures). ASC 740-10-50-16 requires public entities not subject to income tax to disclose that fact and the difference between financial reporting and tax bases of assets and liabilities.

18.11 Disclosures of separately issued financial statements of members of a consolidated tax return

For separately issued financial statements of a member of a group that files a consolidated tax return, ASC 740-10-50-17 requires the company to disclose:

- The amount of any tax-related balances due to or from affiliates as of each balance sheet date
- The amount of current and deferred tax expense for each income statement presented
- The method of allocating consolidated current and deferred tax expense to members of the group and the effect of any changes in that method during the years presented

Additionally, after the adoption of ASU 2019-12, paragraph ASC 740-10-50-17A requires an entity that is (1) both not subject to tax and disregarded by the taxing authority and (2) that elects to include the allocated amount of current and deferred tax expense in its separately issued financial statements under ASC 740-10-30-27A to disclose that fact and provide the disclosures required by paragraph ASC 740-10-50-17 (as discussed above).

See chapter 17, *Separate financial statements of a subsidiary*, for details. In addition, see section 17.2, *SEC staff position on determining income taxes in separate financial statements*, for additional SEC pro forma disclosure if the financial statements are not prepared on a separate return basis.

19 Accounting for uncertainty in income taxes

19.1 Introduction

Uncertainty can arise from the nature, amount or timing of a tax position. The guidance for accounting for uncertainty in income taxes in ASC 740 applies to all income tax positions related to income taxes subject to ASC 740, including those considered to be "routine" and those with a high degree of uncertainty. The guidance for accounting for uncertainty in income taxes in ASC 740 is also applicable to pass-through entities, nontaxable entities and entities whose tax liability is subject to a 100% credit for dividends paid (e.g., real estate investment companies, registered investment companies). As a reminder, ASC 450 does not apply to income taxes.

The guidance requires entities to perform a two-step approach for evaluating tax positions:

Recognition	Recognize the tax position if more likely than not to be sustained upon examination.
Measurement	Measure the largest amount of benefit more likely than not to be realized.

In step 1 (recognition), an entity determines whether a tax position, based solely on its technical merits, is more likely than not to be sustained upon examination. This is the threshold for recognition. In step 2 (measurement), which is performed only if the recognition threshold is met (i.e., the position is more likely than not to be sustained), the entity measures the tax benefit as the largest amount of benefit, determined on a cumulative probability basis, that is more likely than not to be realized upon settlement.

Tax positions that fail to qualify for initial recognition are recognized in the first subsequent interim period they meet the more-likely-than-not threshold, they are resolved through negotiation or litigation with the taxing authority, or the statute of limitations expires. Derecognition of a tax position that was previously recognized occurs when a company subsequently determines that a tax position no longer meets the more-likely-than-not threshold. The guidance for accounting for uncertainty in income taxes prohibits the use of a valuation allowance as a substitute for derecognition of tax positions.

As noted in ASC 740-10-25-16, the amount of benefit recognized for a tax position in the balance sheet may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability results from an unrecognized tax benefit when it represents an entity's potential future obligation to the taxing authority for that tax position not recognized in the financial statements. Because the guidance applies to *all* tax positions, both negative and positive, in some cases, the unrecognized tax benefit could represent an entity's potential for a future tax refund.

In addition, a tax position recognized in the financial statements may also affect the tax bases of assets or liabilities and, thereby, change or create temporary differences. A taxable and deductible temporary difference is recorded for the difference between the reported amount of an item in the financial statements and the tax basis of that item determined by applying the recognition threshold and measurement provisions for tax positions described above.

The disclosure requirements in ASC 740 require public entities to provide a tabular rollforward of the beginning and ending aggregate unrecognized tax benefits. All entities must provide specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within 12 months. These disclosures are required at each annual reporting period and in an interim period if a significant change occurs.

Standard setting

The FASB issued a proposed Accounting Standards Update to ASC 740, *Improvements to Income Tax Disclosures*, to improve the transparency and decision usefulness of income tax disclosures. The proposal addresses investor requests for more transparency about income tax information, particularly by jurisdiction. It would require more details in the rate reconciliation and the disclosure about income tax paid. The proposal would also eliminate the requirement in ASC 740-10-50-15(d) for all entities to (1) disclose the nature and estimate of the range of reasonably possible change in unrecognized tax benefits balance in the next 12 months or (2) make a statement that an estimate of the range cannot be made, among other things. In addition, the proposal would eliminate the requirement to disclose the cumulative amount of each type of temporary difference when a deferred tax liability is not recognized because of a recognition exception (e.g., indefinite reinvestment exception) related to deferred taxes for subsidiaries and corporate joint ventures.

See our To the Point: ***FASB proposes improvements to income tax disclosures***. Readers should monitor developments.

19.2 Scope

Excerpt from Accounting Standards Codification

ASC Master Glossary

Tax Position

A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term tax position also encompasses, but is not limited to:

a. A decision not to file a tax return

b. An allocation or a shift of income between jurisdictions

c. The characterization of income or a decision to exclude reporting taxable income in a tax return

d. A decision to classify a transaction, entity, or other position in a tax return as tax exempt

e. An entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity.

Income Taxes — Overall

Scope and Scope Exceptions

740-10-15-2AA

The guidance in this Subtopic relating to accounting for uncertainty in income taxes applies to all entities, including tax-exempt not-for-profit entities, pass-through entities, and entities that are taxed in a manner similar to pass-through entities such as real estate investment trusts and registered investment companies.

19.2.1 Taxes within scope

The guidance for accounting for uncertainty in income taxes in ASC 740 applies to ***all*** tax positions (i.e., tax positions that increase or decrease taxable income) accounted for in accordance with ASC 740, including tax positions considered to be "routine" as well as those with a high degree of uncertainty, such as tax-advantaged transactions. It does not, however, apply to taxes that are not within the scope of ASC 740, such as sales and use, value-added, and other taxes that are not based substantially on income. See section 2.1, *General*, for further details.

19.2.2 Entities within scope

ASC 740 applies to all entities because, while accounting for income taxes is primarily an issue for business entities, the requirements also apply in assessing the exemption from income taxes of other entities. This includes pass-through entities, nontaxable entities and entities whose tax liability is subject to a 100% credit for dividends paid (e.g., real estate investment trusts and registered investment companies) (ASC 740-10-15-2AA).

19.3 Unit of account

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-13

The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account to be used shall consider the manner in which the entity prepares and supports its income tax return and the approach the entity anticipates the taxing authority will take during an examination. Because the individual facts and circumstances of a tax position and of an entity taking that position will determine the appropriate unit of account, a single defined unit of account would not be applicable to all situations.

19.3.1 Unit of account

ASC 740-10-25-13 provides that the unit of account is based on the level at which an entity prepares and supports the amounts claimed in the tax return and considers the approach the entity anticipates the taxing authority will take in an examination. Both of these factors will vary depending on the facts and circumstances related to each individual tax position. Consequently, ASC 740-10-25-13 does not provide a "bright line" or significance test to determine what constitutes an appropriate unit of account. Instead, judgment is required. The selection of the unit of account can have a significant effect on the financial statement reporting of a given tax position, because Step 1's more-likely-than-not recognition threshold is applied at the unit of account level. Thus, if a tax position as a whole is not more likely than not to be sustained, an entity is prohibited from recording any amount of benefit from that position.

The following example from ASC 740 highlights how an entity might go about evaluating the unit of account.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-83

An entity anticipates claiming a $1 million research and experimentation credit on its tax return for the current fiscal year. The credit comprises equal spending on 4 separate projects (that is, $250,000 of tax credit per project). The entity expects to have sufficient taxable income in the current year to fully utilize the $1 million credit. Upon review of the supporting documentation, management believes it is more likely than not that the entity will ultimately sustain a benefit of approximately $650,000. The anticipated benefit consists of approximately $200,000 per project for the first 3 projects and $50,000 for the fourth project.

740-10-55-84

This Case illustrates an entity's initial determination of the unit of account for a tax position.

740-10-55-85

In its evaluation of the appropriate amount to recognize, management first determines the appropriate unit of account for the tax position. Because of the magnitude of expenditures in each project, management concludes that the appropriate unit of account is each individual research project. In reaching this conclusion, management considers both the level at which it accumulates information to support the tax return and the level at which it anticipates addressing the issue with taxing authorities. In this Case, upon review of the four projects including the magnitude of expenditures, management determines that it accumulates information at the project level. Management also anticipates the taxing authority will address the issues during an examination at the level of individual projects.

740-10-55-86

In evaluating the projects for recognition, management determines that three projects meet the more-likely-than-not recognition threshold. However, due to the nature of the activities that constitute the fourth project, it is uncertain that the tax benefit related to this project will be allowed. Because the tax benefit related to that fourth project does not meet the more-likely-than-not recognition threshold, it should not be recognized in the financial statements, even though tax positions associated with that project will be included in the tax return. The entity would recognize a $600,000 financial statement benefit related to the first 3 projects but would not recognize a financial statement benefit related to the fourth project.

It is noteworthy that, in situations similar to the example presented above, companies will often determine the appropriate unit of account based on a subset of accumulated costs for each project, rather than at the project level, because this is typically how an entity prepares and supports its income tax return, and how it will be viewed by the taxing authority in an examination. If in the example above, the company had determined that its unit of account for the $1 million research and development credit was at the cost level (e.g., separate cost accumulation pools within each project) rather than at the project level, it is possible that a portion of the costs in the fourth project related to one or more cost accumulation pools may have qualified for recognition.

19.3.2 Consistency

Once an entity establishes a unit of account for a particular tax position, the entity applies that unit of account consistently from period to period unless a change in facts and circumstances indicates that a different unit of account is more appropriate. Changes in judgment regarding the appropriate unit of account are applied prospectively because they must be driven by changes in facts and circumstances. That is, an entity cannot make an accounting policy election to change the unit of account. Once the unit of account is selected to evaluate a tax position for recognition, that same unit of account must be used to measure the tax position. An entity cannot use one unit of account for recognition and a different unit of account for measurement.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

Case B: Change in the Unit of Account

740-10-55-87

This Case illustrates a change in an entity's initial determination of the unit of account for a tax position.

740-10-55-88

In Year 2, the entity increases its spending on research and experimentation projects and anticipates claiming significantly larger research credits in its Year 2 tax return. In light of the significant increase in expenditures, management reconsiders the appropriateness of the unit of account and concludes that the project level is no longer the appropriate unit of account for research credits. This conclusion is based on the magnitude of spending and anticipated claimed credits and on previous experience and is consistent with the advice of external tax advisors. Management anticipates the taxing authority will focus the examination on functional expenditures when examining the Year 2 return and thus needs to evaluate whether it can change the unit of account in subsequent years' tax returns.

740-10-55-89

Determining the unit of account requires evaluation of the entity's facts and circumstances. In making that determination, management evaluates the manner in which it prepares and supports its income tax return and the manner in which it anticipates addressing issues with taxing authorities during an examination. The unit of account should be consistently applied to similar positions from period to period unless a change in facts and circumstances indicates that a different unit of account is more appropriate. Because of the significant change in the tax position in Year 2, management's conclusion that the taxing authority will likely examine tax credits in the Year 2 tax return at a more detailed level than the individual project is reasonable and appropriate. Accordingly, the entity should reevaluate the unit of account for the Year 2 financial statements based on the new facts and circumstances.

19.3.3 Attribution of income taxes to the entity or its owners

Entities should attribute income taxes to either the entity or its owners based on how the tax laws and regulations of each jurisdiction attribute income taxes, rather than based on who pays the income taxes. The following examples from ASC 740-10-55-226 through 740-10-55-228 illustrate the attribution of income taxes to the entity or its owners. ASC 740-10-55-229 illustrates the financial statement presentation for a group of related entities.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-226

Entity A, a partnership with two partners — Partner 1 and Partner 2 — has nexus in Jurisdiction J. Jurisdiction J assesses an income tax on Entity A and allows Partners 1 and 2 to file a tax return and use their pro rata share of Entity A's income tax payment as a credit (that is, payment against the tax liability of the owners). Because the owners may file a tax return and utilize Entity A's payment as a payment against their personal income tax, the income tax would be attributed to the owners by Jurisdiction J's laws whether or not the owners file an income tax return. Because the income tax has been attributed to the owners, payments to Jurisdiction J for income taxes should be treated as a transaction with the owners. The result would not change even if there were an agreement between Entity A and its two partners requiring Entity A to reimburse Partners 1 and 2 for any taxes the partners may owe to Jurisdiction J. This is because attribution is based on the laws and regulations of the taxing authority rather than on obligations imposed by agreements between an entity and its owners.

740-10-55-227

If the fact pattern in paragraph 740-10-55-226 changed such that Jurisdiction J has no provision for the owners to file tax returns and the laws and regulations of Jurisdiction J do not indicate that the payments are made on behalf of Partners 1 and 2, income taxes are attributed to Entity A on the basis of Jurisdiction J's laws and are accounted for based on the guidance in this Subtopic.

740-10-55-228

Entity S, an S Corporation, files a tax return in Jurisdiction J. An analysis of the laws and regulations of Jurisdiction J indicates that Jurisdiction J can hold Entity S and its owners jointly and severally liable for payment of income taxes. The laws and regulations also indicate that if payment is made by Entity S, the payments are made on behalf of the owners. Because the laws and regulations attribute the income tax to the owners regardless of who pays the tax, any payments to Jurisdiction J for income taxes should be treated as a transaction with its owners.

740-10-55-229

Entity A, a partnership with 2 partners, owns a 100 percent interest in Entity B and is required to issue consolidated financial statements. Entity B is a taxable entity that has unrecognized tax positions and a related liability for unrecognized tax benefits. Because entities within a consolidated or combined group should consider the tax positions of all entities within the group regardless of the tax status of the reporting entity, Entity A should include in its financial statements the assets, liabilities, income, and expenses of both Entity A and Entity B, including those relating to the implementation of this Subtopic to Entity B. This is required even though Entity A is a pass-through entity.

19.3.4 Bipartisan Budget Act of 2015 — partnership audit regime

The Bipartisan Budget Act (BBA) of 2015 created an IRS centralized audit regime for entities treated as partnerships for US Federal income tax purposes and changed the income tax liability rules governing partners and partnerships.[56]

[56] A partnership may elect out of the centralized audit regime if it has less than 100 partners and all partners are "eligible partners" at all times during the tax year. Eligible partners are individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic, S corporations and estates of deceased partners.

Under the centralized partnership audit regime, an IRS audit takes place at the partnership level, and a designated partnership representative has sole authority to act on behalf of the partnership and its partners. Any adjustments related to a partnership's taxable income, deductions and credits are determined at the partnership level, and the IRS is no longer required to determine each partner's share of the adjustments to assess the correct tax due.

Taxes resulting from adjustments are assessed and collected at the partnership level (and referred to as an "imputed underpayment") unless the partnership elects to push out the adjustments to the partners. Any penalties or additional amounts relating to such adjustments are also determined at the partnership level.

Adjustments and penalties or additional amounts may be taken into account and paid by the partners if the partnership makes a push-out election and provides each partner with a statement showing the partner's share of the adjustment for the year under audit. Upon making this election, the partnership is no longer required to pay the imputed underpayment and the partners would take the adjustment into account on their respective returns in the year they receive a statement indicating their share of the adjustment.

Adjustments that do not result in an imputed underpayment (i.e., over-reporting of income) are taken into account by the partnership in the adjustment year. If the adjustment corrects an over-reporting of income, the partnership may not take the adjustment into account at the partnership level. This type of adjustment must be taken into account by the partners.

Tax accounting considerations for the partnership under audit

The following accounting discussion addresses the accounting in the standalone financial statements of the partnership under audit. That is, it does not address the accounting by the partner that, under US GAAP, may in some cases account for its interest on a consolidated, equity method or fair value (or a measurement alternative if fair value is not readily determinable), as discussed further below.

ASC 740 provides guidance that clarifies that entities should attribute income taxes to either the entity or its owners based on how the tax laws and regulations of each jurisdiction attribute income taxes, rather than based on who pays the income taxes. The implementation guidance in ASC 740-10-55-226 through 740-10-55-228 provides examples that illustrate the accounting for the attribution of income taxes to the entity or its owners (see section 19.3.3, *Attribution of income taxes to the entity or its owners*).

The BBA's centralized partnership audit regime has raised the question of whether the settlement of an imputed underpayment by the partnership is subject to the provisions under ASC 740 if the partnership does not elect to push out the imputed underpayment to the partners. That is, would the partnership's payment of the taxes resulting from adjustments to items under the regime require the partnership to apply ASC 740 to that liability?

We do not believe that the partnership would apply ASC 740 to the liability related to the imputed underpayment. Partnerships and other entities treated as partnerships for tax purposes (e.g., limited liability companies or subchapter S corporations) are not taxable entities. Instead, the tax consequences of transactions within the partnership flow through to the partners. If the partnership is paying an imputed underpayment, the liability assessed by the IRS and the payment of tax by the partnership is merely an administrative convenience to settle the imputed underpayment of income taxes of the partners (i.e., the partnership is paying the imputed underpayment for the benefit of the partners, not to settle its own tax liability). Accordingly, the income taxes paid by the partnership are attributed to the partners. Any payment from the partnership to the IRS would be treated as a distribution to the partners in a similar manner to a withholding payment.

Generally, the partnership would not recognize the obligation for the imputed underpayment until it is obligated to make the tax payment and can estimate the amount of the settlement, or the IRS has made notice of the amount of the adjustment. If the partnership has a contractual or legal obligation (including those imposed by the BBA rules) to settle the underpayment, the partnership may recognize the liability at a different time. The partnership will also need to consider the requirements under US GAAP to assess whether the partnership's commitment to make tax payments on behalf of its partners are required to be disclosed in the notes to its financial statements.

Tax accounting considerations for the partner

Under ASC 740, a corporate partner's future tax consequences of recovering the financial reporting basis of its investment in the partnership are recognized as deferred tax assets or liabilities. Deferred tax assets and liabilities are recognized for the difference between the financial reporting basis and tax basis of the investment in the partnership at the investor level.

The accounting for the settlement of the imputed underpayment of income taxes, whether pushed out to the partners or paid by the partnership, continues to be subject to the income tax accounting under ASC 740. The partner's accounting and presentation of income tax expense and the related liability will depend on whether the partner consolidates the partnership (including amounts allocated to any noncontrolling interest holders) or accounts for its investment under the equity method or at fair value (or elects to use a measurement alternative if fair value is not readily determinable) based on the guidance in ASC 321, *Investments-Equity Securities*. Based on the complexity of the partnership structure and the potential effect on the partner's tax basis related to the settlement of the imputed underpayment, corporate partners of affected audited partnerships should consider the potential effect on the carrying amount of their deferred tax assets or liabilities and/or any resulting uncertain tax positions.

19.3.4.1 State taxes for pass-through entities

A number of states have enacted laws allowing entities taxed as partnerships and other pass-through entities to pay state taxes at the entity level rather than at the individual owner level, commonly known as pass-through entity (PTE) taxes.

Electing to pay PTE taxes directly from the entity may allow the entity to deduct the taxes paid on its federal tax return. When the entity elects to pay the PTE taxes directly, the owners and the entity will need to determine whether the income taxes paid are attributed to the owners or the entity. The guidance in ASC 740-10-55-226 through 228 clarifies that entities should attribute taxes to either the entity or its owners based on how the tax laws and regulations of each jurisdiction attribute income taxes, rather than who pays the taxes.

If the income taxes are attributed to a liability of the owners, the offsetting amount would be treated as a distribution to the owners in a similar manner to a withholding payment. If the entity concludes that income taxes are entity-level taxes, the income tax expense would be recognized in the entity's financial statements and accounted for applying the guidance in ASC 740.

19.4 Recognition

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-6

An entity shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. The term *more likely than not* means a likelihood of more than 50 percent; the terms *examined* and *upon examination* also include resolution of the related appeals or litigation processes, if any. For example, if an entity determines that it is certain that the entire cost of an acquired asset is fully deductible, the more-likely-than-not recognition threshold has been met. The more-likely-than-not recognition threshold is a positive assertion that an entity believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date. The level of evidence that is necessary and appropriate to support an entity's assessment of the technical merits of a tax position is a matter of judgment that depends on all available information.

740-10-25-7

In making the required assessment of the more-likely-than-not criterion:

a. It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.

b. Technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities are widely understood, for example, by preparers, tax practitioners and auditors, those practices and precedents shall be taken into account.

c. Each tax position shall be evaluated without consideration of the possibility of offset or aggregation with other positions.

Implementation Guidance and Illustrations

740-10-55-3

The application of the requirements of this Subtopic related to tax positions requires a two-step process that separates recognition from measurement. The first step is determining whether a **tax position** has met the recognition threshold; the second step is measuring a tax position that meets the recognition threshold. The recognition threshold is met when the taxpayer (the reporting entity) concludes that, consistent with paragraphs 740-10-25-6 through 25-7 and 740-10-25-13, it is more likely than not that the taxpayer will sustain the benefit taken or expected to be taken in the tax return in a dispute with taxing authorities if the taxpayer takes the dispute to the court of last resort.

19.4.1 More likely than not

Under ASC 740-10-25-6, recognition and measurement are considered discrete events. That is, ASC 740 requires a two-step approach for evaluating a tax position, which separates recognition (Step 1) from measurement (Step 2). The recognition threshold is met when an entity concludes that a tax position (determined at the unit of account level), based solely on its technical merits, is more likely than not (i.e., a likelihood greater than 50%) to be sustained upon examination by the relevant taxing authority.

One of the more complicated issues regarding state and local tax positions relates to perceived conflicts between state and higher-level law. Numerous questions have arisen related to both the court of last resort under ASC 740-10-25-7 as well as the effect a US Supreme Court decision not to hear a case has on the evaluation of the technical merits of a tax position for purposes of applying ASC 740-10-25-7. The remainder of this section discusses some of those questions.

Questions and interpretative responses

Question 19-1 **Assume the court of last resort can choose not to hear a specific case without ruling on the issue of law (in the case of the US Supreme Court (USSC), many more cases are filed than could ever be granted certiorari (heard). The Supreme Court's website notes, "[t]he Justices must exercise considerable discretion in deciding which cases to hear, since more than 7,000 civil and criminal cases are filed in the Supreme Court each year from the various state and federal courts"). Does an entity have to factor in the likelihood such case would be heard by the court of last resort in applying the ASC 740-10-25-6 initial recognition threshold of more-likely-than-not?**

No, ASC 740 does *not* require an assessment of the likelihood that the court of last resort will ultimately decide the technical merits of the position. The likelihood of an appeal being accepted by the USSC is, however, a component of measurement of a recognized tax position where an entity is required to assess the various outcomes (e.g., litigation and settlement). As a result, the USSC declining to hear related cases and the resultant likelihood that the USSC would hear an entity's specific, or a similar case should be considered by entities in measurement of their recognized tax positions. While the USSC's recent denial of certiorari does not necessarily change the ASC 740-10-25-6 conclusion reached in the recognition step, measurement could be significantly affected.

Question 19-2 **What is the court of last resort as contemplated by ASC 740-10-55-3 when it comes to state tax matters?**

The court of last resort is the highest court that has discretion to hear the case. For questions about the constitutionality of enacted state law, the highest court, by default, is the US Supreme Court, which is the court of last resort on constitutional issues. ASC 740-10-25-6 states, "the terms *examined* and *upon examination* also include resolution of the related appeals or litigation processes, if any." Once the USSC denies certiorari, the lower court ruling is final, and that lower court becomes the court of last resort for the specific taxpayer that applied for certiorari. See Question 19-1 for assessing the effect on other entities (i.e., entities other than the taxpayer that was denied certiorari).

Question 19-3 **Can an entity factor in a law being overturned (i.e., the state tax law determined to be unconstitutional) as a basis for applying step 1 of the ASC 740-10-25-6 analysis?**

Yes, ASC 740-10-25-6 states: "[a]n entity shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. The term *more likely than not* means a likelihood of more than 50%; the terms *examined* and *upon examination* also include resolution of the related appeals or litigation processes, if any." Since the litigation process would include the ability to appeal whether a tax law is in conflict with higher-level law, that appeal and its outcome should be considered in assessing compliance with the more-likely-than-not threshold for initial recognition. In addition, ASC 740-10-55-3 states, "[t]he recognition threshold is met when the taxpayer (the reporting entity) concludes that, consistent with paragraphs 740-10-25-6 through 25-7 and 740-10-25-13, it is more likely than not that the taxpayer will sustain the benefit taken or expected to be taken in the tax return in a dispute with the taxing authorities if the taxpayer takes the dispute to the court of last resort."

19.4.2 Examination by the taxing authority

ASC 740-10-25-7 requires a company to assume, when assessing whether a tax position meets the requirements for initial recognition, that the tax position will be examined by the taxing authorities who will have access to all relevant facts and information (i.e., supporting schedules and workpapers, legal opinions from outside tax advisors and other information gathered by management or available in support of, or at variance with, its position). This requirement exists even if an entity believes the possibility of examination by a taxing authority or discovery of the related risk matters is remote, or where the entity has a long history of the taxing authority not performing an exam (e.g., certain state nexus issues) or overlooking an issue.

19.4.3 Evaluating the technical merits of individual tax positions

By their very nature, tax laws are often subject to interpretation. Further complicating matters is that in those cases where a tax position is open to interpretation, differences of opinion can result in differing conclusions as to the amount of tax basis of the assets or liabilities to be recognized. Consequently, the level of evidence and documentation necessary to support a position before recognizing and measuring it in the financial statements is a matter of judgment that depends on all available evidence.

When a position is subject to significant interpretation of the tax law or statutes, the use of a tax opinion by management may be one source of external evidence to support its conclusion regarding the sustainability of that position. The FASB acknowledged that while the term "more likely than not" is used in both financial reporting and tax law, it does not believe a tax opinion must be obtained to support a tax position. It did, however, recognize that an entity may use a tax opinion to support its accounting conclusion. It should be noted, however, that the FASB's view on tax opinions does not impact the audit guidance regarding an auditor's need to access and retain such opinions (see AICPA Professional Standards AU Section 9326, *Audit Evidence: Auditing Interpretations of Section 326*, or PCAOB Standards and Related Rules AU Section 9326, *Evidential Matter: Auditing Interpretations of Section 326,* Section 2*: The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals*). For additional discussion of tax opinions, see section 19.4.3.2, *Tax opinions and levels of authority for a tax position*.

19.4.3.1 Sources of authoritative tax laws

When evaluating whether a tax position meets the more-likely-than-not recognition threshold under ASC 740-10-25-6, a company should consider the sources of authorities in the tax law and other guidance and their applicability to the facts and circumstances of the tax position. Sources of authorities include laws and other guidance issued by a governmental authority and cases settled in a court of law that a taxpayer may use to support a tax position on a tax return, and later if the position is challenged by the taxing authority. These same sources of authorities are often used to evaluate the tax position for recognition under ASC 740 (see section 19.4, *Recognition*).

For US federal income tax purposes, authorities include (in no particular order):

- Tax laws, including the Internal Revenue Code and other statutes
- Regulations interpreting tax laws
- Temporary and proposed regulations interpreting tax laws
- Case law
- IRS rulings and official explanations — revenue rulings, revenue procedures, private letter rulings, technical advice memoranda, action on decisions, general counsel memoranda, press releases, notices, announcements and other guidance published in the Internal Revenue Bulletin
- Tax treaties, including regulations and other official explanations of the treaties

- Congressional intent as reflected in committee reports, joint explanatory statements and floor statements made by one of the bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book")

The authorities listed above don't all carry the same weight. The weight given to a tax authority depends on its relevance, persuasiveness and the type of document providing the authority. The relevance and persuasiveness of a document should be viewed in light of any developments that might limit the weight that should be placed on the guidance provided in that document. To illustrate these concepts, consider the following:

- **Relevance** — An authority that addresses a tax position taken by a different taxpayer with few facts in common with the entity's situation is not particularly relevant, and thus, the weight of this evidence is minimal.
- **Persuasiveness** — An authority that merely "states a conclusion" is less persuasive than one that reaches a conclusion by clearly relating the applicable law to pertinent facts. For example, an authority that draws conclusions on the taxation of a transaction without citing the basis for the taxation is less persuasive than one that does.
- **Type of document** — In the US, certain documents carry greater weight than others. For example, when evaluating sources of authorities, a revenue ruling is accorded greater weight than a private letter ruling. Also, recent guidance generally is favored over older guidance that could be superseded or otherwise dated.

It is noteworthy that conclusions reached in treatises, legal periodicals, legal opinions or opinions provided by tax professionals are not authorities. However, the authorities and analysis cited in those documents may support a tax position if it applies to the facts and circumstances of that position. Refer to section 19.4.3.2, *Tax opinions and levels of authority for a tax position*, for additional discussion of tax opinions.

The IRS may issue a ruling to a taxpayer concerning the treatment of a tax position that is binding only for that taxpayer. Because the IRS is required to treat similar facts and circumstances consistently among taxpayers, the ruling may support a tax position taken by another taxpayer if that taxpayer's facts and circumstances are substantially similar to those covered by the ruling and the law is unchanged. Examples of such rulings include private letter rulings, technical advice memoranda and competent authority (CA) resolution (see section 19.5.5, *Transfer pricing*, for additional discussion on competent authority).

Tax positions taken in state or foreign jurisdictions should be evaluated under the appropriate governmental authorities.

19.4.3.2 Tax opinions and levels of authority for a tax position

Types of tax opinions and levels of authority

Four common types of tax opinions include:

- **Substantial authority tax opinion** — There is "substantial authority" for a tax position only if the weight of the authorities supporting the position is substantial in relation to the weight of authorities supporting a contrary position. There may be substantial authority for more than one position with respect to the same item. A substantial authority tax opinion provides less support for a tax position than needed to reach the more-likely-than-not threshold for recognition in ASC 740.
- **More-likely-than-not tax opinion** — A tax position reaches the "more-likely-than-not" level when there is a greater than 50% chance of the position being sustained based on its technical merits if it is challenged.

- **Should tax opinion** — A tax position reaches the "should" level when it *should* be sustained based on its technical merits if it is challenged. A should tax opinion indicates stronger support for a tax position than a more-likely-than-not tax opinion. However, with a should tax opinion, there remains some uncertainty whether the tax position will be sustained based on its technical merits if it is challenged.
- **Will tax opinion** — A tax position reaches the "will" level when it *will* be sustained based on its technical merits if it is challenged. A will tax opinion indicates stronger support for a tax position than a should tax opinion.

It is noteworthy that the Internal Revenue Code and IRS regulations don't address the "should" and "will" levels of support. The highest level found in those authorities is "more likely than not." Treasury regulations, meanwhile, describe other levels of authority (e.g., realistic possibility of success, reasonable basis) that fall below the level of substantial authority.

It is important to note that the level of the tax opinion does not necessarily imply that the company's tax position could not have reached a higher level. That is, a company may receive a more-likely-than-not tax opinion. However, based on the tax technical analysis of the tax position, it is expected that the position *will* be sustained if it is challenged.

In some cases (e.g., tax planning), a company's tax position must reach the more-likely-than-not level for the company to avoid penalties. In other cases, the company can avoid a penalty if its tax position reaches the level of substantial authority or reasonable basis (i.e., 20% or greater chance that the company's tax position will be sustained based on its technical merits if it is challenged). For a given tax position, the IRS' provisions on penalties (or the applicable tax jurisdiction) should be evaluated carefully.

When a company receives a tax opinion for a particular tax position, it is incumbent on both the company and its auditors to make sure that the information used to form the basis of the opinion is consistent with the company's facts and circumstances. Additionally, the receipt of a tax opinion does not obviate the need for the company and its auditors to perform their own evaluations of the technical merits of the company's tax position (and any related penalties) for purposes of accounting for and auditing of the position.

Accounting implications

A tax position meets the recognition threshold in ASC 740-10-25-6 when it is more likely than not that the position will be sustained upon examination based on its technical merits (see section 19.4, *Recognition*, for additional discussion). The level of evidence that is necessary and appropriate to support a company's assessment of the technical merits of a tax position is a matter of judgment that depends on all available information. In some cases, a company may choose to obtain a tax opinion to support the recognition of a tax position. For an unrecognized tax position, a company may choose to obtain a tax opinion (e.g., substantial authority tax opinion) to avoid penalties. See section 19.8, *Interest and penalties*, for additional discussion of the accounting for penalties.

19.4.4 Administrative practices and precedents

ASC 740-10-25-7(b) introduces the concept of administrative practices and precedents of the taxing authority, meaning the prior practices of the authority are considered in dealing with a particular tax position. The administrative practices and precedents concept is intended to deal with *limited* technical violations of the tax law for which there is a broad understanding in practice that the taxing authority will not take issue with the entity's position or will limit the scope of the issue. The concept is not intended to apply to matters requiring significant judgment or interpretation. Instead, administrative practices and precedents are intended to deal with practice matters that are both prevalent and widely understood by tax practitioners and auditors.

ASC 740-10-55-91 through 55-92 and ASC 740-10-55-94 through 55-95 provide two examples of administrative practice exceptions. The first deals with asset capitalization while the second deals with state nexus. In both examples, it is emphasized that the entity has evidence that the taxing authority has a widely understood administrative practice.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-91

An entity has established a capitalization threshold of $2,000 for its tax return for routine property and equipment purchases. Assets purchased for less than $2,000 are claimed as expenses on the tax return in the period they are purchased. The tax law does not prescribe a capitalization threshold for individual assets, and there is no materiality provision in the tax law. The entity has not been previously examined. Management believes that based on previous experience at a similar entity and current discussions with its external tax advisors, the taxing authority will not disallow tax positions based on that capitalization policy and the taxing authority's historical administrative practices and precedents.

740-10-55-92

Some might deem the entity's capitalization policy a technical violation of the tax law, since that law does not prescribe capitalization thresholds. However, in this situation the entity has concluded that the capitalization policy is consistent with the demonstrated administrative practices and precedents of the taxing authority and the practices of other entities that are regularly examined by the taxing authority. Based on its previous experience with other entities and consultation with its external tax advisors, management believes the administrative practice is widely understood. Accordingly, because management expects the taxing authority to allow this position when and if examined, the more-likely-than-not recognition threshold has been met.

740-10-55-94

An entity has been incorporated in Jurisdiction A for 50 years; it has filed a tax return in Jurisdiction A in each of those 50 years. The entity has been doing business in Jurisdiction B for approximately 20 years and has filed a tax return in Jurisdiction B for each of those 20 years. However, the entity is not certain of the exact date it began doing business, or the date it first had nexus, in Jurisdiction B.

740-10-55-95

The entity understands that if a tax return is not filed, the statute of limitations never begins to run; accordingly, failure to file a tax return effectively means there is no statute of limitations. The entity has become familiar with the administrative practices and precedents of Jurisdiction B and understands that Jurisdiction B will look back only six years in determining if there is a tax return due and a deficiency owed. Because of the administrative practices of the taxing authority and the facts and circumstances, the entity believes it is more likely than not that a tax return is not required to be filed in Jurisdiction B at an earlier date and that a liability for tax exposures for those periods is not required.

19.4.4.1 Self-reporting obligation

An entity may consider certain administrative practices and precedents only if it self-reports a violation (i.e., under a voluntary disclosure program). In assessing whether an administrative practice can be considered, the key question is whether the administrative practice relief would be available to the entity if the taxing authority had discovered the issue (with full knowledge of when it had been previously identified by the entity and not self-reported). If the administrative practice relief would still be available, the relief is not contingent on self-reporting. If, however, relief provided by an administrative practice (including an amnesty program) is contingent on self-reporting, and the entity does not intend to self-report, any liability related to the uncertain tax position should not include the benefit of the administrative practice relief.

For example, assume that an entity has determined that, due to the presence of certain types of income, it no longer meets the requirements to preserve its special tax status wherein it is entitled to a tax credit equal to its income. In addition to owing current taxes, the entity will also recognize the tax effect of all of its temporary differences because it will no longer be eligible for the special status credit in future periods when those temporary differences reverse. If the entity were to self-report the violation, it could consider an administrative practice under which the taxing authority requires the entity, in this situation, to pay the current tax due (along with interest and penalties) but allows it to retain its special tax status. If, however, the entity does not intend to self-report and the consequence of discovery by the taxing authority is both the current liability (along with any related interest and penalties) and the loss of special tax status, on an ongoing basis the entity would be required to provide both the current amount due as well as recognize the tax effect of excluding the special status credit on all temporary differences.

19.4.5 Disaggregation

Each tax position being considered for recognition must stand on its own technical merits. That is, an entity may not consider one tax position to persuade the taxing authority to support another tax position. Likewise, an entity may not aggregate tax positions when considering whether the initial recognition and measurement thresholds have been met.

19.4.6 General reserves

The guidance in ASC 740 related to accounting for uncertainty in income taxes is a benefit recognition approach to accounting for income tax positions. That is, only income tax positions that qualify for initial recognition may be measured in the financial statements. This approach, which is applied at a unit-of-account level, results in individual tax positions being recognized and measured only when the recognition threshold is met. General or unallocated reserves are inconsistent with the ASC 740 accounting model. Instead, any recorded liability is expected to relate to unrecognized or partially recognized tax positions that are specifically identified.

19.4.7 Tax indemnification agreements

Tax indemnification agreements are common in a variety of transactions, including business combinations, spin-offs and management agreements. These negotiated agreements are designed to transfer certain tax risks to the indemnifying party. While an indemnification agreement is designed to transfer risk, accounting for these agreements is complicated by the different accounting requirements for tax uncertainties, guarantees, contingent receivables and contingent payables, and business combinations.

Entities should consider the following points when a transaction includes a tax indemnification agreement:

- **Uncertain tax positions** — Uncertain tax positions are accounted for under ASC 740. Only those tax positions for which the reporting entity is the primary obligor are evaluated and accounted for as uncertain tax positions under ASC 740.[57] Determining whether the reporting entity is the primary obligor to the taxing authority depends on the facts and circumstances of its relationship to the taxing authority.

[57] This limitation is not intended to address the accounting for a subsidiary or other carve-out on a standalone return basis.

- **Party providing the indemnity** — If a party is not the primary obligor to the taxing authority, the obligation is imposed under another agreement (e.g., shareholder, business combination, management agreement). The party providing the indemnity to the primary obligor would account for its obligation in accordance with ASC 460-10-55-13.[58]
- **Party receiving the indemnity** — The indemnified party would separately account for the tax uncertainty and any receivable under the indemnity in the balance sheet, income statement and statement of cash flows. That is, the primary obligor for the tax position would account for the uncertain tax position in accordance with ASC 740 without considering potential recoveries it might receive through an indemnification arrangement (i.e., potential recoveries are accounted for separately). This means the indemnified party will show any obligation related to the uncertain tax position and receivable on a gross basis and, while the obligation is accounted for as a tax obligation with offsets to tax expense,[59] the receivable under the indemnity would be separately displayed with activity recorded somewhere other than the tax line on a pretax basis (e.g., other income).

19.4.7.1 Tax indemnification agreements in a business combination

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-27

The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value.

805-20-25-28

In some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles. For example, an indemnification may relate to a contingency that is not recognized at the acquisition date because it does not satisfy the criteria for recognition in paragraphs 805-20-25-18A through 25-19 at that date. In those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

[58] ASC 460 applies unless one of the scope exceptions is met.

[59] Penalties and interest would be treated in accordance with the company's accounting policy election. See section 19.9.2, *Accounting policy election — classification of interest and penalties*, for further details.

Initial Measurement

805-20-30-18

Paragraph 805-20-25-27 requires that the acquirer recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. That paragraph also requires that, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value. For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectibility considerations are included in the fair value measure and a separate valuation allowance is not necessary, as noted in paragraph 805-20-30-4.

805-20-30-19

Paragraph 805-20-25-28 states that in some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles, and provides an example of an indemnification that may relate to a contingency that is not recognized at the acquisition date because it does not satisfy the criteria for recognition in paragraphs 805-20-25-18A through 25-19 at that date. Alternatively, an indemnification may relate to an asset or a liability, for example, one that results from an uncertain tax position that is measured on a basis other than acquisition-date fair value. (Paragraph 805-20-30-13 identifies the business-combination-related measurement requirements for income taxes.) Paragraph 805-20-25-28 establishes that in those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

Subsequent Measurement

805-20-35-4

At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized in accordance with paragraphs 805-20-25-27 through 25-28 at the **acquisition date** on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount, except as noted in paragraph 805-20-35-4B, and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset.

Derecognition

805-20-40-3

The acquirer shall derecognize an indemnification asset recognized in accordance with paragraphs 805-20-25-27 through 25-28 only when it collects the asset, sells it, or otherwise loses the right to it.

The recognition and measurement accounting for an acquired tax uncertainty, as discussed in section 11.12, *Changes in a tax uncertainty established at the acquisition date*, is not changed because an indemnity is provided by the seller. Instead, ASC 805 simply conforms (in many respects) the accounting for the indemnity to align it with the accounting for the tax uncertainty.

ASC 805-20-25-27 requires an indemnification asset for an uncertain tax position to be recognized and measured using the same recognition and measurement principles and assumptions that were used to measure the obligation related to the uncertain tax position under ASC 740. That is, an entity would use the amount recognized for the obligation, reduced for the effect of any contractual limitations (e.g., the indemnification asset is limited to a specific amount, or excludes interest) or collectibility issues. If there are no adjustments for contractual limitations or collectibility issues, the tax obligation associated with the tax uncertainty and indemnification asset should be equal.

After acquisition, indemnification assets should be measured using assumptions consistent with those used to measure the tax uncertainty after the acquisition date, subject to any contractual limitations on the indemnification amount and management's updated assessment of collectibility. As a result, barring contractual limitations or collectibility issues, the indemnification asset related to a tax uncertainty should move in parallel with the obligation associated with the tax uncertainty.

An acquirer is required to recognize an indemnification asset at the same time that it recognizes an obligation related to a tax uncertainty. If an obligation for a tax uncertainty is not recognized because it does not meet the criteria in ASC 740, the acquirer would not recognize an indemnification asset. If the tax uncertainty obligation under ASC 740 is recorded after the acquisition date (whether within or outside the measurement period), the acquirer would then be required to also recognize the indemnification asset. However, the indemnification asset would be subjected to any contractual limitations as well as an evaluation of collectibility.

The following illustration reflects the accounting for indemnification assets.

Illustration 19-1: Accounting for tax indemnification assets

Target is subject to a tax uncertainty at the acquisition date, and the former owners of Target agree to indemnify Acquirer for any losses that result from the tax uncertainty. Acquirer determines that an obligation associated with the tax uncertainty should be recorded under ASC 740 at the acquisition date and records that obligation in the business combination. Because Acquirer records the obligation for the tax uncertainty, it also recognizes an indemnification asset in the business combination using the same recognition and measurement principles and assumptions. Absent any contractual limitations or collectibility issues, the indemnification asset would be equal to the obligation for the tax uncertainty. Subsequent to the acquisition date, Acquirer determines there is new information related to the tax uncertainty indicating that the amount is higher than initially recognized.

The new information results in an increase to both the obligation and the indemnification asset. The increase to the indemnification asset should equal the increase to the obligation, assuming there are no contractual limitations or collectibility issues.

Alternatively, if Acquirer were to determine on the acquisition date that no obligation should be recorded under ASC 740, it wouldn't recognize a tax uncertainty obligation or an indemnification asset in the business combination. If Acquirer determines that the tax uncertainty needs to be recorded after the acquisition date, it would record an obligation pursuant to ASC 740, and the indemnification asset would be measured on the same basis (subject to contractual limitations and collectibility issues) as the obligation.

ASC 805-740 provides guidance on the recognition of subsequent adjustments to tax positions acquired in a business combination. In accordance with ASC 805-740-45-4, the effect of a change to an acquired tax position or a tax position that arises as a result of the acquisition that occurs within the measurement period and results from new information about the facts and circumstances that existed at the acquisition date should be recognized through an adjustment to goodwill. Once goodwill is reduced to zero, any additional decrease related to the tax uncertainty is reported as a bargain purchase (i.e., as a gain attributable to the acquirer). All other changes in acquired income tax positions are recognized the same as any other changes in income tax positions, within income tax expense as discrete items in the period in which the changes occur.

Because the accounting for the indemnity is intended to mirror the accounting for the tax uncertainty, we believe appropriate measurement period indemnification asset adjustments should follow the tax uncertainty adjustments (i.e., to goodwill and as an adjustment to the bargain purchase gain, as applicable). However, adjustments after the measurement period (as well as post-acquisition interest) would be reflected outside business combination accounting, which will result in income statement gross-up.

The following illustration reflects the accounting for indemnification assets that do not meet the recognition criteria as of the acquisition date.

Illustration 19-2: Accounting for indemnification assets not meeting the recognition criteria as of the acquisition date
Company A acquires all the outstanding common stock of Company B on 1 April 20X0. Company B is subject to tax uncertainty at the acquisition date, and the previous owner of Company B agrees to indemnify Company A for any losses up to $10 million. Company A does not recognize an obligation for the tax uncertainty as of the acquisition date because the tax position met the recognition criteria in ASC 740 as of the acquisition date. Subsequent to the acquisition date and after the end of the measurement period, Company A determines that an obligation for the tax uncertainty must be recorded and recognizes a liability of $15 million under ASC 740, through tax expense. We believe that the indemnification asset of $10 million (maximum amount Company B agreed to indemnify Company A) would also be recognized, albeit in pretax results, if collection of the amount is deemed probable. As such, there would be a net after tax-effect on current earnings of $5 million (presuming the indemnity is not taxable).

19.4.7.2 Tax indemnification agreements in a spin-off transaction

In a spin-off transaction, the company that is spun off may agree to indemnify or reimburse the spinnor (or vice versa) for uncertain tax positions that were taken prior to the spin-off and may be settled unfavorably with a tax authority at a later date.

In these situations, there are several accounting issues that need to be addressed in the standalone spinnee financial statements.

As noted in section 19.4.7, *Tax indemnification agreements*, only tax positions for which the reporting entity is the primary obligor are evaluated and accounted for as uncertain tax positions pursuant to ASC 740. The determination of whether the spinnee or spinnor is the primary obligor depends on the facts and circumstances. For instance, if the spinnee was previously included in the consolidated return of the spinnor and the taxing authority considers all entities in a consolidated return primarily obligated for the tax positions taken in a consolidated return, both the spinnee and spinnor would be primary obligors for the uncertain tax positions related to the spinnee's operations in tax returns prior to the spin-off transaction. However, if the spinnee filed a separate tax return from the spinnor in periods prior to the spin off transaction (e.g., if the spinnee operates in a foreign jurisdiction), the spinnee may be the only primary obligor for the uncertain tax positions taken in the spinnee's separate tax return. Only those tax positions to which the reporting entity is the primary obligor are evaluated and accounted for as uncertain tax positions pursuant to ASC 740.[60] Noteworthy is that applying the standalone return method of determining the spinnee's tax provision will generally produce the same result as the spinnee being primarily obligated for the tax uncertainties related to its operations.

If the spinnee is indemnified by the spinnor for its tax uncertainties, the indemnity receivable would not be within the scope of ASC 740. While a spin-off is not a business combination, we would accept accounting for the receivable by analogy to the guidance in business combinations post-measurement periods noted in section 19.4.7.1, *Tax indemnification agreements in a business combination*.[61]

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[60] While theoretically the spinnee could be primarily obligated for tax uncertainties of the spinnor unrelated to spinnee's operations, those obligations would not be accounted for in spinnee's separate financial statements under ASC 740. Instead, any exposure is generally accounted for under ASC 450.

[61] Alternatively, the receivable would be accounted for as a contingent gain under ASC 450.

In the spinnor's financial statements (after the spin-off transaction and presuming the spin-off results in deconsolidation), the obligation associated with an uncertain tax position would be accounted for under ASC 740 if the spinnor is the primary obligor for the tax period and ASC 460 (unless a scope exception is met) if the obligation results from an indemnity agreement.

At the 2007 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff made the following comments on the accounting by a parent for an indemnity provided to a former subsidiary that has been spun-off:

> *"We have considered a number of transactions where a parent provides an indemnity for certain lawsuits to its wholly owned subsidiary prior to a pro rata spin off. Since FIN 45 doesn't require guarantees issued between a parent and its subsidiaries to be recognized, registrants have concluded that subsequent to the spin-off the former parent doesn't need to recognize the guarantee. Registrants have noted that pro rata spin offs are recorded at the carrying amount of the net assets transferred after adjustment for any impairment and believe that this supports the view that no accounting should be required for the guarantee by the former parent. We do not believe that this conclusion is consistent with FIN 45. We believe that the FIN 45 parent-subsidiary scope exception applies only during a parent-subsidiary relationship since the guarantee is not relevant to the consolidated financial statements. Further, in a spin-off transaction the parent often has the ability to retain, modify or rescind the guarantee. The decision to retain any guarantee is the same as issuing a new guarantee at the date of the spin off when the parent-subsidiary relationship no longer exists. While the example that I just discussed related to an indemnification for legal settlements, we believe that other guarantees including **tax indemnities** should also be recognized by the guarantor."*

19.4.7.3 Other tax indemnification agreements

An advisor or manager that manages a fund may agree to indemnify or reimburse the fund for actions taken that have a negative tax effect on the fund. These indemnifications are typically put in place to protect the shareholders' value in the fund. Some have questioned whether such indemnification agreements with the advisor or manager could be recorded as an offset (i.e., an indemnification receivable and credit to income) against any potential liability related to the uncertain tax position that is recorded by the fund for tax positions failing to meet the initial recognition threshold. An indemnification receivable recorded as a result of a liability related to the uncertain tax position is not within the scope of ASC 740. Additionally, assuming that an indemnification receivable was deemed appropriate and recorded by the fund, the offset/credit would not be realized through the tax provision line, and both the receivable and payable should be presented on the balance sheet on a gross basis. That is, the tax uncertainty and the related indemnification would be presented gross in the balance sheet, income statement and statement of cash flows.

Another frequently asked question is whether the indemnified party's rights to receive the indemnification (i.e., a potential receivable up to the amount of the tax obligation recorded) should be accounted for under ASC 450-30 as a contingent gain. While we believe contingent gain accounting is appropriate, we would also accept, as an accounting policy election, accounting for the receivable by analogy to the guidance in business combinations post-measurement periods noted in section 19.4.7.1, *Tax indemnification agreements in a business combination*.

The SEC Division of Investment Management addressed this issue in response to comments from funds seeking further clarification on the implementation of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*:

Excerpt from 28 June 2007 letter from the SEC Division of Investment Management re: Implementation of FASB Interpretation No. 48

2. Clarification regarding past administrative practice

You state that in some cases where a fund may be required to accrue a tax liability under Interpretation 48, the fund advisor or another party may step in and agree to pay this tax liability, even though there may be no obligation to do so. You propose extension of the concept of past administrative practice, as described in paragraph 7(b) of Interpretation 48 and as clarified in the ICI Letter, to an advisor's (or other relevant party's) practice of making a fund whole for tax liabilities or other harm the fund has suffered as a result of the advisor's or other party's actions or inactions. Thus, to the extent an advisor or other party had a general disposition, upon discovery of an error or other issue, to make a fund whole, you propose the fund could consider this in determining whether to reduce its NAV.

We, however, note that the notion of past administrative practice in paragraph 7(b) of Interpretation 48 is limited to widely understood dealings with the taxing authority and should not be extended to an advisor's (or other relevant party's) practice of making a fund whole. Interpretation 48 solely addresses the accounting for tax uncertainties and should not be used as a basis for recognizing and measuring gain contingencies as they relate to indemnifications from advisors (or other relevant parties). Instead, funds should refer to the recognition criteria in other areas of GAAP when accounting for indemnification receivables. GAAP establishes a probable threshold with respect to the recognition of indemnification receivables, by analogy to EITF Issue No. 01-10, Accounting for the Impact of the Terrorist Attacks of September 11, 2001, which in turn refers to AICPA Statement of Position 96-1, Environmental Remediation Liabilities ("SOP 96-1"). This EITF Issue states:

> [SOP 96-1] generally requires that an asset relating to the insurance recovery should be recognized only when realization of the claim for recovery of a loss recognized in the financial statements is deemed probable[2] (as that term is used in Statement 5). In addition, under the requirements of paragraph 17 of Statement 5, a gain (that is, a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of a loss recognized in the financial statements) should not be recognized until any contingencies relating to the insurance claim have been resolved.
>
> [2] In accordance with paragraph 140 of SOP 96-1, if the claim is subject to litigation, a rebuttable presumption exists that realization of the claim is not probable.

Based on this guidance, we note that an advisor's (or other relevant party's) contractual obligation to indemnify uncertain tax positions generally would be sufficient in demonstrating that the likelihood of recovery is probable. The process of obtaining a contractual obligation to indemnify uncertain tax positions may occur simultaneously while the fund is gathering the relevant information to assess whether a liability should be recorded to NAV. In these circumstances, recognition of an indemnification receivable, to the extent of recovery of the tax accrual, generally would be acceptable practice. Subsequently, if the uncertain tax position is effectively settled,[5] both the tax accrual and any related indemnification receivable should be derecognized.

[5] "Effective settlement" is addressed in FASB Staff Position No. FIN 48-1, *Definition of Settlement in FASB Interpretation No. 48*.

19.4.8 Amended tax returns and tax refund claims

Amending tax returns to claim refunds

The process for amending a US federal tax return to claim a tax refund is described below. Similar considerations may apply in other jurisdictions.

Subsequent to filing a US federal tax return, a company may determine that it has overstated taxable income (e.g., it determines that it is entitled to a deduction that was not taken on the tax return). As a result, a company may amend its return to claim a tax refund. Before accepting an amended return with a refund claim, the US taxing authority establishes that an overpayment exists. If the US taxing authority previously examined the original return, filing an amended return generally results in the US taxing authority having the ability to examine any tax position that could affect the potential overpayment (i.e., the entire tax return is subject to re-examination).

To receive a refund, a company typically files an amended US federal tax return to claim the refund. However, not all US federal refunds are claimed via an amended return. For example, US federal refunds also may be claimed as follows:

- **Claims presented in an examination** — When a company has been selected for audit, it may present positions in its favor, along with those not in its favor, to the US taxing authority. These claims for a refund generally arise from new information that was not available when the original US federal tax return was filed. If the company successfully supports its claims for a refund during the examination, the US taxing authority will issue a refund or use the claim to offset other adjustments without requiring the company to file an amended return.
- **Protective claims** — If there is uncertainty about whether a refund will be due to a company and the uncertainty may not be resolved prior to the expiration of the refund statute of limitations, the company may file a protective claim on an amended US federal return. This gives the company more time to resolve the uncertainty. For example, companies commonly file a protective claim when they are involved in litigation with respect to a transaction and, depending on the outcome of the litigation, it may be entitled to a tax refund. Ultimately, the company must amend the return containing the protective claim to receive a refund.
- **Informal claims** — If a company has not filed a formal amended US federal return claiming a refund within the period prescribed by the refund statute of limitations, it may establish that it made a timely informal claim that should be honored. To be a valid informal claim, the claim must be in writing, request a refund, state the basis for the refund and be timely (i.e., submitted within the period prescribed by the refund statute of limitations). A company is not required to file an amended return to receive a refund through the informal claims process.

Additionally, the Joint Committee on Taxation is a part of Congress that must review and approve all refund claims in excess of $5 million. Refer to section 19.7.3.1, *Audit milestones*, for additional discussion.

Accounting considerations

Because the US taxing authority generally can examine any tax position included on the original or amended US federal tax return to claim a refund (even if the taxing authority previously examined the original return), a company may need to account for tax positions that were previously or would have otherwise been considered effectively settled (refer to section 19.7.1.1, *Effectively settled*, for additional discussion). Thus, a company should carefully review any related tax positions in accordance with the guidance on uncertainty in income taxes.

If a company determines that it will file an amended tax return to claim a refund but has not done so by the balance sheet date, the positions the company expects to take (i.e., the positions that would result in a refund) in the amended return as well as those that were or were not included on prior returns should also be evaluated in accordance with the guidance on uncertainty in income taxes.

19.5 Measurement of tax positions

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Initial Measurement

740-10-30-7

A **tax position** that meets the more-likely-than-not recognition threshold shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon settlement using the facts, circumstances, and information available at the reporting date. As used in this Subtopic, the term *reporting date* refers to the date of the entity's most recent statement of financial position. For further explanation and illustration, see Examples 5 through 10 (paragraphs 740-10-55-99 through 55-116).

Only tax positions that meet the more-likely-than-not threshold for recognition (Step 1) are measured in the financial statements (Step 2). If a tax position does not meet the more-likely-than-not initial recognition threshold, no benefit is recorded. In its discussion of the measurement of a tax position, ASC 740-10-30-7 refers to "cumulative probability." That is, it says a recognized tax position is measured at the largest amount of benefit that is more likely than not (determined by cumulative probability) to be realized upon ultimate settlement with the taxing authority.

For certain tax positions, the amount of the tax position is highly certain and measurement in the financial statements is clearly at the amount claimed, or expected to be claimed, in the tax return (see section 19.5.2, *Highly certain tax positions*, for further discussion on the evaluation of these types of positions). There may be tax positions for which one outcome is much more likely than all other possible outcomes (i.e., an individual outcome is more likely than not to occur), making the analysis of cumulative probability straightforward.

Other tax positions, however, will require more detailed consideration of the various potential measurement outcomes. As an example, assume that an entity claims a deduction in its current year tax return of $100 and determines that the tax position meets the recognition threshold (more likely than not). Since the initial recognition threshold is met (Step 1), the entity must move to Step 2 and measure the benefit. The estimated measurement (valuation) outcomes (bounded from below at zero and above by the amount taken or expected to be taken in the tax return) and individual probabilities of occurrence are as follows:

Possible outcome	Individual probability of occurring	Cumulative probability of occurring
$ 100	30%	30%
$ 80	20%	50%
$ 60	20%	70%
$ 40	20%	90%
$ 20	10%	100%

The entity has to analyze the outcomes and use the cumulative probability approach because no amount is individually more likely than not to be realized. In this example, the entity would recognize a $60 benefit in its financial statements because that is the largest amount (assuming the Step 1 recognition threshold is met) with a cumulative probability of occurrence in excess of 50%. The entity would not recognize the single most likely amount expected to occur ($100).

19.5.1 Binary tax positions

Some tax positions may not lend themselves to a negotiated settlement or compromise. That is, some tax positions, if challenged, will result in an "all-or-nothing" outcome (i.e., a binary outcome). Examples of these tax positions are those that involve an entity's tax status (i.e., taxable or nontaxable), tax elections and amounts that are of such significance the taxing authority will not compromise. Assuming the more-likely-than-not recognition threshold under ASC 740-10-25-6 has been met for such binary tax positions, the largest amount of tax benefit that is more than 50% likely to be realized is the entire benefit. Thus, ASC 740's measurement guidance results in 100% of the tax benefit being measured and recorded. Careful consideration may be necessary before concluding that a tax position, if challenged, has a binary outcome.

19.5.2 Highly certain tax positions

Not all tax positions meeting the recognition threshold will require a detailed scheduling or distribution of potential outcomes. For instance, there are a number of routine transactions for which the tax law is clear and unambiguous, and the deduction (i.e., timing, amount and jurisdiction) is highly certain. The following example from ASC 740 illustrates this type of position.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-100

An entity has taken a tax position that it believes is based on clear and unambiguous tax law for the payment of salaries and benefits to employees. The class of salaries being evaluated in this tax position is not subject to any limitations on deductibility (for example, executive salaries are not included), and none of the expenditures are required to be capitalized (for example, the expenditures do not pertain to the production of inventories); all amounts accrued at year-end were paid within the statutorily required time frame subsequent to the reporting date. Management concludes that the salaries are fully deductible.

740-10-55-101

All tax positions are subject to the requirements of this Subtopic. However, because the deduction is based on clear and unambiguous tax law, management has a high confidence level in the technical merits of this position. Accordingly, the tax position clearly meets the recognition criterion and should be evaluated for measurement. In determining the amount to measure, management is highly confident that the full amount of the deduction will be allowed and it is clear that it is greater than 50 percent likely that the full amount of the tax position will be ultimately realized. Accordingly, the entity would recognize the full amount of the tax position in the financial statements.

19.5.2.1 Documentation of highly certain tax positions

While the guidance in ASC 740 related to the accounting for uncertainty in income taxes applies to all tax positions, the level of documentation and support will vary based on the degree of uncertainty present within a tax position as well as the processes and systems a company has in place to address uncertainty. For instance, there are a number of routine transactions for which the tax law is clear and unambiguous, and in turn the deduction (i.e., timing, amount and jurisdiction) is highly certain. These are referred to in ASC 740 as "highly certain" tax positions. The level of effort and documentation surrounding the accounting for highly certain tax positions are expected to be significantly less than those for which greater uncertainty is present. There are two broad categories of highly certain tax positions, as described below.

Highly certain transactions where book and tax accounting are the same — Typically, these transactions are substantiated, both historically and under ASC 740, by reliance on the book accounting processes and controls, including processes and controls a company has in place to determine that book-tax differences do not exist and that recognition and measurement thresholds are met. We would often expect these positions to be documented by category or transaction class versus by position (e.g., sales department salaries as a whole rather than individual payments).

Highly certain transactions with different book and tax treatments — We would expect support and documentation to focus on the processes for identification of book-tax differences as well as the processes in place to substantiate the book accounting. We would also often expect these positions to be documented by category or transaction type rather than by position, as discussed above.

At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff discussed the documentation requirements of FIN 48 [ASC 740], saying "… some read FIN 48 to suggest that a detailed analysis and documentation is required to support even the most obvious tax position, such as a deduction for depreciation or charitable contributions, and that, in the absence of such detailed documentation, it would be improper under the Interpretation for the company to record the benefit of such a deduction. This is just wrong. FIN 48 doesn't require a significant amount of documentation and analysis to support obvious positions — it is written for those positions for which there is uncertainty. And FIN 48 also doesn't have a default provision that suggests that no position may be recognized until sufficient documentation is prepared."

We believe our discussion of processes for identifying uncertainty and documentation of highly certain tax positions is consistent with the SEC's view that ASC 740 does not require a significant amount of documentation and analysis to support obvious tax positions.

19.5.3 Measurement of a tax position after an audit settlement

A company may also consider its likelihood of realizing the tax benefit of a position upon ultimate settlement in light of recent audits that addressed the prospective treatment of such positions as illustrated by the following example from ASC 740.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-109

In applying the recognition criterion of this Subtopic for tax positions, an entity has determined that a tax position resulting in a benefit of $100 qualifies for recognition and should be measured. In a recent settlement with the taxing authority, the entity has agreed to the treatment for that position for current and future years. There are no recently issued relevant sources of tax law that would affect the entity's assessment. The entity has not changed any assumptions or computations, and the current tax position is consistent with the position that was recently settled. In this case, the entity would have a very high confidence level about the amount that will be ultimately realized and little information about other possible outcomes. Management will not need to evaluate other possible outcomes because it can be confident of the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement without that evaluation.

The above example presumes that the company does not change any assumptions or computations and that the tax position being evaluated is consistent with the tax position that was settled with the taxing authority. Also important in arriving at this conclusion is that the taxing authority agreed to the treatment for future years, as well as the year under examination. Additionally, the position should be continually reevaluated in light of any recently issued guidance (e.g., changes in the tax law, regulations, rulings governing the position) that might impact the company's assessment of the applicability of the prior settlement. See section 19.7.2, *Effect of completion of an audit on change in measurement*, for further discussion of the effect of an audit on initial recognition and measurement in accordance with the guidance in ASC 740 related to accounting for uncertainty in income taxes.

19.5.4 Differences related to timing

Often the deductibility of a particular tax position is not in question; rather, the issue relates to the timing in which the position is reflected. For instance, when an entity purchases and capitalizes fixed assets, it is generally considered the owner of the assets for income tax purposes and thereby receives depreciation deductions. Consequently, the deduction of the acquired cost is often not in question, but the rate of annual tax deduction is.

For those tax positions where the only question relates to the timing of the deduction, some have questioned whether a tax position must meet the recognition criteria of ASC 740-10-25-6 for the particular period in which the deduction is taken, before it can be measured. For example, if an entity takes a deduction in its current year tax return that may not be allowed currently, but clearly would be allowed in the following year, what is the accounting in that first year when it is claimed (i.e., is there any "measurement" or is it simply all "unrecognizable")?

We have discussed this situation with the FASB staff members, who noted that if the deductibility was not in question, the recognition threshold in ASC 740-10-25-6 would be met and the amount of benefit to be recorded should be dealt with through measurement. That is, in the example above, the recognition threshold would have been met in the first year. As such, assuming measurement in year one is zero, a liability related to the uncertain tax position would be established in year one for the full amount of the deduction taken in the tax return, while a corresponding deferred tax asset would be recognized. In explaining their view, the FASB staff referred to ASC 740-10-55-110 through ASC 740-10-55-116.

The following examples from ASC 740 illustrate how such tax positions should be evaluated and measured in the financial statements.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation

740-10-55-110

This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on the timing of the deduction.

740-10-55-111

In Year 1, an entity acquired a separately identifiable intangible asset for $15 million that has an indefinite life for financial statement purposes and is, therefore, not subject to amortization. Based on some uncertainty in the tax code, the entity decides for tax purposes to deduct the entire cost of the asset in Year 1. While the entity is certain that the full amount of the intangible is ultimately deductible for tax purposes, the timing of deductibility is uncertain under the tax code. In applying the recognition criterion of this Subtopic for tax positions, the entity has determined that the tax position qualifies for recognition and should be measured. The entity believes it is 25 percent likely it would be able to realize immediate deduction upon settlement, and it is certain it could sustain a 15-year amortization for tax purposes. Thus, the largest Year 1 benefit that is greater than 50 percent likely of being realized upon settlement is the tax effect of $1 million (the Year 1 deduction from straight-line amortization of the asset over 15 years).

740-10-55-112

At the end of Year 1, the entity should reflect a deferred tax liability for the tax effect of the temporary difference created by the difference between the financial statement basis of the asset ($15 million) and the tax basis of the asset computed in accordance with the guidance in this Subtopic for tax positions ($14 million, the cost of the asset reduced by $1 million of amortization). The entity also should reflect a tax liability for the tax-effected difference between the as-filed tax position ($15 million deduction) and the amount of the deduction that is considered more likely than not of being sustained ($1 million). The entity should evaluate the tax position for accrual of statutory penalties as well as interest expense on the difference between the amounts reported in the financial statements and the tax position taken in the tax return.

740-10-55-113

This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on a change in timing of deductibility.

740-10-55-114

In 20X1 an entity took a tax position in which it amortizes the cost of an acquired asset on a straight-line basis over three years, while the amortization period for financial reporting purposes is seven years. After one year, the entity has deducted one-third of the cost of the asset in its income tax return and one-seventh of the cost in the financial statements and, consequently, has a deferred tax liability for the difference between the financial reporting and tax bases of the asset.

740-10-55-115

In accordance with the requirements of this Subtopic, the entity evaluates the tax position as of the reporting date of the financial statements. In 20X2, the entity determines that it is still certain that the entire cost of the acquired asset is fully deductible, so the more-likely-than-not recognition threshold has been met according to paragraph 740-10-25-6. However, in 20X2, the entity now believes based on new information that the largest benefit that is greater than 50 percent likely of being realized upon settlement is straight-line amortization over 7 years.

740-10-55-116

In this Example, the entity would recognize a liability for unrecognized tax benefits based on the difference between the three and seven-year amortization. In 20X2, no deferred tax liability should be recognized, as there is no longer a temporary difference between the financial statement carrying value of the asset and the tax basis of the asset based on this Subtopic's measurement requirements for tax positions. Additionally, the entity should evaluate the need to accrue interest and penalties, if applicable under the tax law.

19.5.5 Transfer pricing

Tax positions associated with intercompany transactions are subject to the more-likely-than-not recognition threshold described in section 19.4, *Recognition*. In some intercompany transactions, it may be clear that the recognition threshold is met as a result of payments made from one consolidated entity to another for items such as assets, services, licenses or interest. However, uncertainty often exists related to the measurement of those tax positions. Oftentimes, the inherent subjectivity in pricing intercompany transactions gives rise to the measurement uncertainty. Refer to section 3.2.2, *Intercompany transactions*, for unique considerations for an intercompany sale or transfers of inventory, including related uncertain tax positions. Under that guidance, no tax effects are recognized in earnings due to an intercompany sale or transfer of inventory among members of its consolidated group, including the tax effects of uncertain tax positions related to an intercompany sale or transfer of inventory (see section 3.2.2.5, *Uncertain tax position considerations for intercompany sales or transfers of inventory*).

ASC 740 requires (for purposes of measuring and recognizing a tax position) a company to determine the largest amount of tax benefit that is more likely than not to be realized upon ultimate settlement (refer to section 19.5, *Measurement of tax positions*). Management should consider all information (e.g., the facts and circumstances of the transaction, transfer pricing studies, a taxing authority's position with respect to comparable transactions, tax treaties) in making this determination.

In measuring a tax position that meets the more-likely-than-not recognition threshold, a company must consider the amounts and probabilities of outcomes that could be realized upon settlement using the facts, circumstances and information available at the reporting date. Because a transfer pricing analysis might produce a number of different outcomes or a range of outcomes in arriving at the transfer price (e.g., the price that would be charged in an arm's-length transaction), measurement of tax positions associated with an intercompany transaction often requires careful consideration.

In many cases, the deduction taken by one party to an intercompany transaction results in taxable income to the other party. However, depending on the agreements between tax jurisdictions, the buyer's and seller's accounting for uncertain tax positions may not be similar, which could result in one party to the transaction recognizing taxable income without an offsetting deduction being recorded by the other party. Additionally, any liability for unrecognized tax benefits in one tax-paying component cannot be offset against an asset for overpayment of taxes in another tax-paying component (i.e., it is inappropriate to offset tax receivables and payables in different jurisdictions). Interest and penalties should also be determined separately for each tax-paying component.

Advance pricing agreement

A company may limit the measurement uncertainty of a transfer pricing arrangement by obtaining an advance pricing agreement (APA), in which a taxing authority agrees to a company's transfer price for a period of time. In the absence of such documentation from a taxing authority accepting the company's transfer pricing arrangement or its equivalent, a company would look at how comparable transfer pricing uncertainties have been resolved for the company or others. Because information about how comparable uncertainties were resolved may not be available, it may be challenging for a company to develop a probability assessment of outcomes.

Documentation

Many taxing authorities require a company to document that its transfer pricing is at arm's length. The existence of contemporaneous documentation may help a company avoid transfer pricing penalties under the tax law. However, the mere existence of contemporaneous documentation is not sufficient to conclude that a company's tax position should be measured, for accounting purposes, at the amount included or expected to be included in the company's tax return. That is, the contemporaneous documentation for tax purposes is not a substitute for evaluating the measurement guidance on uncertain tax positions, because the documentation is not designed to determine the largest amount of benefit that is more likely than not to be realized upon ultimate settlement with the taxing authority. A company should measure its transfer pricing uncertain tax positions considering the amounts and probabilities of the outcomes (e.g., alternative transfer pricing methods) that could be realized upon settlement consistent with the guidance in ASC 740.

Competent authority

Consider the following scenario. Company XYZ has two subsidiaries — Subsidiary A and Subsidiary B — that are domiciled in different tax jurisdictions. In a given year, Subsidiary A sells services to Subsidiary B for $100. Upon audit, Subsidiary A's taxing authority concludes that Subsidiary A should have charged Subsidiary B $120 for those services. Thus, Subsidiary A's taxable income increases by $20. Absent a commensurate increase in the tax deduction by Subsidiary B, Company XYZ is subject to incremental tax on the intercompany service transaction.

To address this issue, taxing authorities in many countries have entered into agreements detailing how such conflicts will be resolved. The taxing authorities agree to adjust pricing on both sides of a transaction if one of the party's tax positions is not sustained. This mechanism is commonly referred to as CA resolution. A company that seeks to resolve a potential transfer pricing issue may only seek CA resolution if a bilateral income tax treaty exists between the particular taxing authorities and the treaty provides for mutual agreement procedures (MAP).

A company can request the CA resolution process when it believes, among other things, that the actions of the taxing authorities create a tax situation that was not intended by a treaty (e.g., double taxation). CA resolution is based on a company's specific facts and circumstances. See section 19.4.3.1, *Sources of authoritative tax laws*, for additional discussion of CA resolution.

19.6 Tax-planning strategies

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Initial Measurement

740-10-30-19

In some circumstances, there are actions (including elections for tax purposes) that:

a. Are prudent and feasible

b. An entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused

c Would result in realization of deferred tax assets.

This Subtopic refers to those actions as tax-planning strategies. An entity shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a **tax-planning strategy** or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. See paragraphs 740-10-55-39 through 55-48 for additional guidance. Implementation of the tax-planning strategy shall be primarily within the control of management but need not be within the unilateral control of management.

740-10-30-20

When a tax-planning strategy is contemplated as a source of future taxable income to support the realizability of a deferred tax asset, the recognition and measurement requirements for tax positions in paragraphs 740-10-25-6 through 25-7; 740-10-25-13; and 740-10-30-7 shall be applied in determining the amount of available future taxable income.

The guidance in ASC 740 related to accounting for uncertain tax positions does not change the requirement in ASC 740 to evaluate the realizability of deferred tax assets (i.e., the need for a valuation allowance). However, ASC 740 provided little in the way of guidance on how management might evaluate the sustainability of tax-planning strategies as a source of income other than to note the tax-planning strategy must: (1) be prudent and feasible; (2) be steps management might not otherwise take, but would take to prevent the expiration of operating loss carryforwards or other tax credit carryforwards, and (3) result in realization of the deferred tax asset. A qualifying tax-planning strategy is subject to the same recognition and measurement criteria (i.e., more likely than not) as all other tax positions, in addition to the requirements in ASC 740-10-30-19. That is, when evaluating a tax-planning strategy as a source of potential future taxable income, a company must first determine that the strategy meets the more-likely-than-not-recognition threshold and the "largest amount more likely than not to be sustained" measurement criteria prior to being considered. See chapter 6, *Valuation allowances*, for further discussions of the realizability of deferred tax assets.

19.7 Subsequent recognition, derecognition and measurement

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-8

If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an entity shall recognize the benefit of the tax position in the first interim period that meets any one of the following conditions:

a. The more-likely-than-not recognition threshold is met by the reporting date.

b. The tax position is effectively settled through examination, negotiation or litigation.

c. The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

Accordingly, a change in facts after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) shall be recognized in the period in which the change in facts occurs.

740-10-25-9

A tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an entity shall make the assessment on a position-by-position basis, but an entity could conclude that all positions in a particular tax year are effectively settled.

740-10-25-10

As required by paragraph 740-10-25-8(b) an entity shall recognize the benefit of a tax position when it is effectively settled. An entity shall evaluate all of the following conditions when determining effective settlement:

a. The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position.

b. The entity does not intend to appeal or litigate any aspect of the tax position included in the completed examination.

c. It is remote that the taxing authority would examine or reexamine any aspect of the tax position. In making this assessment management shall consider the taxing authority's policy on reopening closed examinations and the specific facts and circumstances of the tax position. Management shall presume the relevant taxing authority has full knowledge of all relevant information in making the assessment on whether the taxing authority would reopen a previously closed examination.

740-10-25-11

In the tax years under examination, a tax position does not need to be specifically reviewed or examined by the taxing authority to be considered effectively settled through examination. Effective settlement of a position subject to an examination does not result in effective settlement of similar or identical tax positions in periods that have not been examined.

740-10-25-12

An entity may obtain information during the examination process that enables that entity to change its assessment of the technical merits of a tax position or of similar tax positions taken in other periods. However, the effectively settled conditions in paragraph 740-10-25-10 do not provide any basis for the entity to change its assessment of the technical merits of any tax position in other periods.

740-10-25-14

Subsequent recognition shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. A tax position need not be legally extinguished and its resolution need not be certain to subsequently recognize the position. Subsequent changes in judgment that lead to changes in recognition shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period. See Sections 740-10-35 and 740-10-40 for guidance on changes in judgment leading to derecognition of and measurement changes for a tax position.

740-10-25-15

A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs. Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.

Subsequent Measurement

740-10-35-2

Subsequent measurement of a **tax position** meeting the recognition requirements of paragraph 740-10-25-6 shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Paragraph 740-10-30-7 explains that the reporting date is the date of the entity's most recent statement of financial position. A tax position need not be legally extinguished and its resolution need not be certain to subsequently measure the position. Subsequent changes in judgment that lead to changes in measurement shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.

Derecognition

740-10-40-2

An entity shall derecognize a previously recognized **tax position** in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination. Use of a **valuation allowance** is not a permitted substitute for derecognizing the benefit of a tax position when the more-likely-than-not recognition threshold is no longer met. Derecognition shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Paragraph 740-10-30-7 explains that the reporting date is the date of the entity's most recent statement of financial position. Subsequent changes in judgment that lead to derecognition shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.

740-10-40-3

If an entity that had previously considered a tax position effectively settled becomes aware that the taxing authority may examine or reexamine the tax position or intends to appeal or litigate any aspect of the tax position, the tax position is no longer considered effectively settled and the entity shall reevaluate the tax position in accordance with the requirements of this Subtopic for tax positions.

Income Taxes — Interim Reporting

Subsequent Measurement

740-270-35-6

A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a **tax position** taken in a prior interim period within the same fiscal year is an integral part of an annual period and, consequently, shall be reflected as such under the requirements of this Subtopic. This requirement differs from the requirement in paragraph 740-10-25-15 applicable to a change in judgment that results in subsequent recognition, derecognition, or a change in measurement of a tax position taken in a prior annual period, which requires that the change (including any related interest and penalties) be recognized as a discrete item in the period in which the change occurs.

19.7.1 Subsequent recognition

Recognition of tax positions can occur at any point prior to or after the tax position is reported to the taxing authority in a tax return. If the more-likely-than-not recognition threshold is not met in the period the tax position is taken or expected to be taken, an entity should recognize the benefit of the tax position in the first interim reporting period in which:

- The more-likely-than-not recognition threshold is met by the reporting date.
- The tax position is effectively settled through examination, negotiation or litigation.
- The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

See section 19.7.8, *Subsequent events*, for further discussion of changes that occur subsequent to the reporting date (i.e., balance sheet date).

19.7.1.1 Effectively settled

ASC 740-10-25-8 requires a tax position to be recognized if it is effectively settled through examination, negotiation or litigation. A tax position is deemed to have been effectively settled through examination when the taxing authority has completed all its required or expected examination procedures, the entity does not intend to appeal or litigate any aspect of the tax position, and the chance is considered "remote" that the taxing authority would reexamine the tax position based on a full knowledge of all relevant information related to the tax position. The term "remote" has the same meaning as used in ASC 450 (i.e., the chance of the event or events occurring is slight).

Completion of an audit

Assessing whether the completion of an audit by the taxing authority should affect recognition (i.e., determining whether a tax position is effectively settled by examination) begins with an assessment of the taxing authority's ability to reopen the applicable years and reach a conclusion that is unfavorable to the taxpayer related to the tax position.

For example, under Revenue Procedure 2005-32, 2005-23 IRB 1 (20 May 2005), the IRS will not reopen a case closed after examination (assuming a Closing Agreement is not issued) to make an adjustment unfavorable to the taxpayer unless one of the following conditions exist:

- There is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of material fact.
- The closed case involved a clearly defined, substantial error based on an established service position existing at the time of the examination.
- Other circumstances exist indicating that a failure to reopen the case would be a serious administrative omission.

Under the IRS rule, other circumstances indicating that a failure to reopen a case would be a serious administrative omission include cases with items or transactions that present significant potential for abuse for which a limited examination was performed. If the taxing authority, by the terms of its administrative procedures, is unable to reopen a given tax year, the tax position has been effectively settled. If the taxing authority is able to reopen the tax year (or position taken in the year), a company would have to perform further analysis to assess the likelihood that the taxing authority would reopen the tax year. Because taxing authorities often exercise significant judgment in deciding whether to reopen a case (i.e., a tax year), an assessment of the likelihood that they would take such an action is generally necessary. Factors that may affect the likelihood of the taxing authority reexamining or examining a given tax position include the nature of the position and its significance. In its assessment of both the ability and likelihood that the taxing authority would reopen a given tax position, the entity must also assume that the taxing authority has full knowledge of all relevant information related to the tax position (i.e., the same information management has relevant to the tax position).

19.7.1.2 Change in assessment of technical merits

If as a result of the audit process the entity changes its determination of the technical merits of the position and now believes that it is more likely than not that the position will be sustained upon examination by the relevant taxing authority, the position would qualify for recognition. If neither the more-likely-than-not criterion nor the "effectively settled" criterion are met on completion of the audit, the tax position would not be recognized until either the technical merits are reevaluated as more likely than not, the effectively settled criteria are met or the statute of limitations expires.

19.7.1.3 Changes in tax rates

Liabilities for tax uncertainties may exist for taxes that would be due for prior tax periods. In addition, a tax uncertainty may affect a recorded temporary difference. The tax rate to be applied to a tax uncertainty after a tax rate change is determined based on the nature of the tax uncertainty and the period to which it relates. For example, prior to a change in tax law a company recorded a liability for a tax uncertainty that, if the company does not prevail in its tax position, would result in an increase in its tax liability for a tax return related to periods prior to the change in tax law. That tax liability would be measured at the enacted rate effective for the related year (i.e., the rate in effect prior to the change in tax law). Alternatively, if the uncertainty affects the measurement of a temporary difference that existed as of the enactment date, and it is expected to reverse in subsequent years (i.e., it's expected to affect taxes payable in a future period), that tax uncertainty is reflected in the related temporary difference measured at the new tax rate.

The following illustrations show the UTP accounting considerations when there is a change in tax rates.

Illustration 19-3: UTP related to a permanent difference

The company recorded in its 20X5 tax return a $1 million tax deduction for federal income tax purposes. The tax position did not meet the more-likely-than-not recognition criteria in ASC 740-10-25-6. As a result, the company recorded a liability for the unrecognized tax benefit of $350,000 ($1 million x 35%). For illustration purposes, penalties and interest are ignored, and the tax position is assumed to be a permanent difference. The company did not have NOLs (carryforwards or carrybacks) available as of 31 December 20X5 to offset the unrecognized tax benefit.

During 20X6, the company generated a $1 million taxable loss and recognized a deferred tax asset of $350,000 for the related NOL carryforward. On 31 December 20X6, the company, based on the guidance in ASC 740-10-45-10A, offset the $350,000 unrecognized tax benefit with the NOL as permitted under the tax law. The company intends to carry back the loss to offset the tax position if the outcome of the settlement of the uncertain tax position is unfavorable to the company.

In December 20X7, the corporate tax rate is reduced to 21% from 35%. If the tax position is not settled in its favor, the company will be required to pay additional federal income taxes of $350,000 (before penalties and interest) since that was the amount of the unrecognized tax benefit from the $1 million deduction it realized on its 20X5 tax return. Since the tax law permits the 20X6 NOL to be carried back, and the company intends to use the NOL to offset this amount, the company should continue to measure the NOL at $350,000 after the enactment date.

Assume in 20X9, the unrecognized tax position settled in the company's favor. As a result, the company recognizes a tax benefit of $350,000. Further, since the company will no longer need the NOL carryback to offset the unrecognized tax benefit and there are no other carryback periods available, the NOL is available to be carried forward to offset future taxable income (assuming it cannot be used to satisfy a liability that will be settled at the old tax rate). In the period the uncertain tax position is settled, the company remeasures the NOL at the current corporate tax rate and reduces the deferred tax asset from $350,000 to $210,000 ($1 million x 21%). The company recognizes a net tax benefit of $210,000 and records the following journal entries in 20X9:

Journal entry to recognize tax benefit from the favorable settlement of the uncertain tax position:

Unrecognized tax benefit	$ 350,000	
Current tax benefit		$ 350,000

Journal entry to remeasure the NOL carryforward at the new 21% corporate tax rate based on planned usage after the favorable resolution of the uncertain tax position:

Deferred tax expense	$ 140,000	
Deferred tax asset (NOL carryforward)		$ 140,000

If the uncertain tax position is resolved during an interim reporting period, the income tax effects should be treated as a discrete item in the period in which a change in judgment occurred or the uncertain tax position is settled.

Illustration 19-4: UTP related to differences in timing

On 1 January 20X6, Company SBS acquired a separately identifiable intangible asset for $15 million that has an indefinite life for financial reporting purposes and is not subject to amortization. Company SBS deducted the entire cost of the asset in 20X6. Based on its interpretation of the tax code, the company is certain that the full value of the intangible asset is deductible for tax purposes and only the timing of deductibility is uncertain. The company determined that the tax position qualifies for recognition and determined it could sustain a 15-year amortization for tax purposes (under the ASC 740-10-30-7 measurement principles). On the date the intangible asset is acquired, the tax rate is 35%.

At the end of 20X6, the company recognized a deferred tax liability of $350,000, representing the tax effect of the temporary difference created by the difference between the financial statement basis of the asset ($15 million) and the tax basis of the asset computed in accordance with ASC 740-10-30-7 ($14 million, representing the cost of the asset reduced by $1 million of amortization). The entity recorded a liability for the unrecognized tax benefit of $4.9 million ($14 million x 35%), the tax effect of the difference between the as-filed tax position ($15 million) and the deduction that is considered more likely than not to be sustained ($1 million).

On 31 December 20X7, the corporate tax rate is reduced to 21% from 35%. On the enactment date, the company estimated the deferred tax liability and unrecognized tax benefit based on the temporary difference between the financial statement basis of the asset ($15 million) and the tax basis of the asset computed in accordance with ASC 740 ($13 million, which is the cost of the asset reduced by $2 million of accumulated amortization through the enactment date). As a result, the company estimated its deferred tax liability to be $420,000 ($2 million x 21%). The company continues to measure the unrecognized tax benefit using the tax rate related to the period in which the uncertainty originated. Therefore, the company recorded a liability of $4.55 million ($13 million x 35%).

Note: *For simplicity purposes, the illustration ignores possible interest and penalties.*

Illustration 19-5: UTP related to differences in timing — Company offsets UTP with available NOLs

Assume the same facts as in the previous example except that Company SBS has sufficient NOL carryforwards to offset the tax position if the outcome is unfavorable to the company. Further, the company intends to and is permitted under the law to use the NOLs. Since the tax law permits the NOLs to be carried forward, and the company intends to use the NOL to offset this amount, the company continues to measure the portion of its NOL carryforward that would be used to settle the tax liability associated with the uncertain tax position for 20X6 and 20X7 based on the 35% tax rate or $4.55 million (NOLs of $13 million x 35%).

At 31 December 20X8, the tax position remains uncertain. The company updated its analysis to reflect an additional year of amortization for tax purposes. The company estimated the deferred tax liability and unrecognized tax benefit based on the temporary difference between the financial statement basis of the asset ($15 million) and the tax basis of the asset computed in accordance with ASC 740 ($12 million, which is the cost of the asset reduced by $3 million of amortization recognized through 20X8). As a result, the company estimated its deferred tax liability to be $630,000 ($3 million x 21%). The company continued to measure the unrecognized tax benefit using the tax rate related to the period in which the uncertainty originated. Therefore, the company recorded a liability of $4.2 million ($12 million x 35%).

At 31 December 20X8, the company recorded the following entries:

Journal entry to record the tax effects from $1 million of additional tax amortization at 21%:

Deferred tax expense	$	210,000		
Deferred tax liability			$	210,000

Journal entry to adjust the UTP for the additional benefit from the additional tax amortization of $1 million at 35%:

Unrecognized tax benefit	$	350,000		
Current tax benefit			$	350,000

Journal entry to remeasure the NOL carryforward from 35% to 21% based on planned usage after the partial resolution of the uncertain tax position ($1 million x (35% – 21%)):

Deferred tax expense	$	140,000		
Deferred tax asset (NOL carryforward)			$	140,000

Note: For simplicity purposes, these entries ignore possible interest and penalties.

A company presenting the tabular reconciliation required by ASC 740-10-50-15A would reflect the unrecognized tax benefits at the amounts consistent with the examples above and disclose the effect on the effective tax rate if the uncertain tax position settled in each subsequent year until the UTP is resolved.

19.7.2 Effect of completion of an audit on change in measurement

Only those tax positions meeting the recognition criteria (Step 1) should be measured within the financial statements (Step 2). If a tax position does not meet the recognition threshold, measurement is not applicable — that is, no benefit is recorded. In measuring a recognized tax position, a benefit is recorded at the largest amount of benefit that is more likely than not (determined by cumulative probability) of being realized upon settlement with the taxing authority. If an audit has been completed, but the taxing authority has the ability to reopen that year, it may be appropriate to adjust the measurement of a recognized tax position (i.e., a tax position that met the Step 1 recognition threshold). When evaluating whether a change in measurement is appropriate, an entity assumes that the taxing authority is aware of all relevant facts. If the taxing authority would not reopen the audit for that matter, it would be viewed as a change in estimate of the amount that is more than 50% likely of being sustained on settlement resulting in a change in measurement (i.e., record the full benefit).

19.7.3 Examples — various stages of an audit on recognition and measurement

The following examples illustrate how the various stages of the audit process can affect recognition and measurement. While these examples focus on the US audit process and related rules, similar conclusions could result in other countries, depending on the local tax law and the assessment of the likelihood the taxing authority would reopen the matter. Each of these examples assumes nothing occurs during the tax authority audit or at completion of the audit that would lead the taxpayer to conclude that the technical merits of a tax position have changed. These also assume the statute of limitations has not expired.

	Step 1 initial recognition[62]	Step 2 measurement[63]	Status of examination (presume this is the only new information available to management that could change its conclusion on recognition and measurement)[64]	Subsequent recognition or change in measurement of a tax position[65]
Example 1	Yes	Partial	Audit closed (RAR/Form 870 issued). However, the tax position was not examined.	A
Example 2	Yes	Partial	Audit closed (RAR/Form 870 issued). The tax position was examined and not objected to.	A
Example 3	No	N/A	Audit closed (RAR/Form 870 issued). The tax position was not examined.	B
Example 4	No	N/A	Audit closed (RAR/Form 870 issued). Tax position was examined by a field agent of the taxing authority.	B
Example 5	No	N/A	Audit closed. Tax position was examined by the appeals division of the taxing authority (i.e., a more senior tax person within the taxing authority who possesses the ability to negotiate a settlement) and a Form 870-AD related specifically to the position was issued.	B
Example 6	Yes	Partial	Entity is under a life exam, whereby the scope of the examination is agreed to in advance with the taxing authority. The tax position in question is not included within scope of the examination.	A

A. The evaluation of whether a change in measurement (Step 2) is appropriate should be based on an assumption that the taxing authority is aware of all relevant facts. If the taxing authority would not reopen the audit for that matter, it would be viewed as a change in estimate of the amount that is more than 50% likely to be sustained on ultimate settlement, resulting in a change in measurement. Example 2 may provide the entity with more information to conclude measurement should be adjusted, versus Example 1.

B. The closing of the audit would not, in and of itself, affect the technical merits of the tax position (Step 1). However, because the audit is considered closed (i.e., RAR 870 or 870 AD was received) management would evaluate the tax position under the "effectively settled" criteria in ASC 740-10-25-10. The tax position is considered effectively settled when the taxing authority has completed all its required or expected examination procedures, the entity does not intend to appeal or litigate any aspect of the tax position, and the chance that the taxing authority would reexamine the tax position is considered remote. If the tax position is considered effectively settled, recognition is met, and the company would evaluate the tax position for measurement.

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62 Tax position evaluated using the more-likely-than-not recognition threshold based solely on its technical merits.

63 Assuming the recognition threshold in Step 1 was achieved (indicated by a Yes under Step 1) partial measurement of the tax position was considered to have occurred for financial reporting purposes.

64 Indicates the stage of an IRS examination and notes whether the tax position in question was specifically examined. See section 19.7.3.1, *Audit milestones*, for further details. While the audit is closed, barring a formal Closing Agreement, the US taxing authority can reopen an audit subject to Revenue Procedure 2005-32, 2005-23 IRB 1.

65 Based on the status of examination noted, should the tax position be considered for subsequent recognition or, for those positions which met the initial recognition threshold but were measured at less than 100% of the amount claimed in the tax return, be able to be remeasured under either ASC 740-10-25-8 or ASC 740-10-25-14.

19.7.3.1 Audit milestones

Questions have arisen with respect to ongoing or anticipated IRS examinations and what milestones may occur in the audit process (e.g., notification of audit, Notice of Program Adjustments, receipt of a Closing Agreement or Pre-Filing Agreement).

In order to more carefully evaluate tax positions in light of the recognition criteria as well as subsequent changes in judgment that may occur during the course of an audit by the IRS and/or agreements that a company may reach with the IRS, we describe some of the more common audit steps and milestones that a company may encounter along the way with respect to tax positions or tax years with the IRS.

Closing Agreement — A Closing Agreement resolves a tax position of contention and is final with respect to the specific matters, unless the facts have been misrepresented or there is fraud. A Closing Agreement may relate to multiple issues in a single tax year or to one tax position in multiple years.

Pre-filing Agreement — A Pre-filing Agreement (PFA) is an agreement with the IRS with respect to a specific item, such as:

- Research and development credits
- Deductibility and fair market value of donated property
- Worthless securities and bad debts/credit losses
- Fair market value of stock exchanged
- Cost segregation for asset class and recovery periods
- Treatment of license fee income
- Deductibility of fines and penalties
- Various international tax issues

The PFA process calls for a Closing Agreement in the initial PFA year and a PFA Methodology Agreement in years subsequent to the initial PFA year.

Advanced Pricing Agreement — An APA is similar to a PFA, except it involves transfer pricing issues. The APA is reached prior to the filing of the position in the tax return.

Private Letter Ruling — A Private Letter Ruling (PLR) is a ruling by the IRS regarding the correct tax treatment for an item or transaction. For instance, a tax-exempt entity may wish to obtain a PLR from the IRS prior to entering into a transaction with a taxable entity to make sure that the transaction will not violate or cause the entity to lose its tax-exempt status. A PLR applies only to the taxpayer requesting the ruling. The IRS may examine the facts, but absent a misrepresentation of the facts in the ruling request, the IRS should not propose an adjustment.

PLRs are published (without identifying the taxpayer) and present all relevant facts and circumstances and the conclusions reached by the IRS with respect to the tax position. A PLR is usually fairly narrow in scope and relates to the facts and circumstances of the company requesting it. As a result, other entities should use caution in relying on another entity's PLR to provide evidence or support for their conclusions about meeting the recognition or measurement criteria in ASC 740's guidance on accounting for uncertainty in income taxes.

Notice of Proposed Adjustment — A Notice of Proposed Adjustment (NOPA) is usually issued by the IRS during the course of its field audit and provides the entity with the IRS's position, for a proposed adjustment amount reflected as additional or reduced tax. A NOPA is generated for each issue that the IRS field agent has concluded on. The entity is required to respond to the NOPA, either agreeing or disagreeing with the IRS's adjustment. The entity's response details its position (assuming the entity disagrees with the adjustment) with all relevant facts, circumstances and other evidence accumulated by management in support of its position (e.g., legal opinion from its tax advisors).

Technical Advice Memorandum — A Technical Advice Memorandum (TAM) is generated as a result of a field agent's inquiry to the IRS National Office asking for guidance on a specific tax position. TAMs normally deal with a very narrow set of facts and circumstances but are, nevertheless, published and, therefore, available to the public for review.

Form 870 — Form 870 is the IRS agent's write-up of all proposed adjustments. A company's signing of the Form 870 is evidence of agreement with the adjustments. However, the signing of the Form 870 does not preclude the IRS from reopening the tax year, including examination of the items that were adjusted. That is, until the statute of limitations on assessments expires, there is always a possibility that the tax year or tax positions may be reexamined (see prior section on the completion of the audit for further details). For instance, the IRS may reopen a tax year or revisit a prior adjustment of a tax position as a result of newspaper articles citing the tax matter or whistleblower allegations. Also, a claim for refund or tentative claim for refund filed by the taxpayer may reopen the case and could result in an adjustment to the issue, unless the issue was subject to a Closing Agreement (see discussion above regarding Closing Agreements). Additionally, the company may sign the Form 870, pay the additional tax resulting from the adjustment and then file a claim for refund and contest the adjustment through litigation.

If the company elects to appeal one or more proposed adjustments, it may do so by indicating this on the Form 870. Appeals would be reviewed by a senior IRS agent and, upon resolution, would result in the issuance of Form 870-AD. The Form 870-AD is an appeals determination related to one or more proposed adjustments from the Form 870. It should be noted that taxpayers have litigated to determine whether the issuance of the Form 870-AD results in the final resolution of the matter and the courts have sided with the taxpayer indicating that the Form 870-AD does not rise to the same level as a Closing Agreement.

Joint Committee on Taxation — The Joint Committee on Taxation is a part of Congress that must review and approve all refund claims in excess of $5 million. There is no requirement that the IRS wait for a ruling from the Joint Committee before issuing a refund, only that it wait 30 days after a submission to the Joint Committee. However, practically speaking, it is rare that a refund would be issued before approval by the Joint Committee. In general, the technical aspects of the position have been resolved by the IRS before being presented to the Joint Committee.

Litigation — Litigation may occur in Tax Court, a Court of Claims or District Court, and decisions can be appealed to a Circuit Court and ultimately to the Supreme Court. A tax position being litigated is considered "not yet resolved." Interestingly though, even if the courts side with the taxpayer on a particular tax position, the IRS still maintains the ability to audit the underlying data or calculations used in determining the amount of the benefit and thus may still adjust the amount of the tax position.

19.7.3.2 Payment of taxes as prerequisite to petition a court

In some jurisdictions, courts require a company to pay a tax assessment as a prerequisite to petitioning the court to contest the tax assessment. If the tax is an income tax, the potential recovery of the amounts paid should be accounted for in accordance with ASC 740 rather than the gain contingencies guidance in ASC 450. If the company's income tax position meets the recognition and measurement threshold in ASC 740, the payment should be considered a prepaid asset (or potentially a reduction to taxes payable, if appropriate), and the company should potentially accrue interest income, depending on the jurisdiction. The payment should not be considered a deferred tax.

19.7.4 Derecognition of a tax position

A previously recognized tax position is derecognized in the first interim period the tax position no longer meets the more-likely-than-not threshold or the tax position is no longer considered effectively settled. Derecognition occurs by recording a tax liability or reducing a deferred tax asset and recording a corresponding cumulative catch-up adjustment for interest and penalties. ASC 740-10-40-2 specifically prohibits the use of a valuation account or valuation allowance as a substitute for derecognition of a tax position.

19.7.5 New information versus new evaluation

ASC 740-10-25-14 emphasizes that a change in judgment about recognition or measurement is to be based on new information rather than a change in interpretation or evaluation of previous information. As a result, changes related to recognition and measurements are expected to be supported by triggering events in the form of new information. See section 19.7.8, *Subsequent events*, for an example.

19.7.6 Changes in judgment

Changes in judgment that result in the subsequent recognition, derecognition or changes in measurement of a tax position that was previously recognized in an annual period (including any interest and penalties) are considered discrete events and are recognized in earnings in the period (interim as well as annual) in which the change occurs. A change in judgment related to a tax position taken in prior interim periods of the current year is an integral part of an annual period and should be accounted for pursuant to the guidance on interim reporting in ASC 740. See section 19.7.9, *Interim reporting*, for further discussion.

19.7.7 Intraperiod tax allocation

Excerpt from Accounting Standards Codification

Presentation of Financial Statements — Discontinued Operations

Other Presentation Matters

205-20-45-4

Adjustments to amounts previously reported in discontinued operations in a prior period shall be presented separately in the current period in the discontinued operations section of the statement where net income is reported.

The initial recognition and derecognition of a tax position and any change in the measurement of a tax position are subject to the intraperiod tax allocation requirements (i.e., income statement classification) in ASC 740-20. Questions have arisen regarding when "backward tracing" would be permitted or required for the resolution of tax uncertainties that arose in a prior year and were related to activity initially recorded outside of the income tax expense/benefit allocated to continuing operations. Uncertain tax positions initially related to discontinued operations and items accounted for in equity are often the subject of these questions.

Discontinued operations

As an example, assume an entity records a liability related to an uncertain tax position associated with a disposed component and an offsetting entry in discontinued operations. In a subsequent year, the tax uncertainty is resolved, and the benefit can be recognized for financial statement purposes. To determine where in the financial statements to reflect the benefit (reversal), some believe it is appropriate to follow ASC 740-20-45-8, while others look to ASC 205-20-45-4.

ASC 740-20-45-8 provides for income tax expense or benefit to be allocated to continuing operations based on the pretax income or loss that *occurred during the current year*. The remaining amounts, if any, are allocated in accordance with ASC 740-20-45-12 and ASC 740-20-45-14 and are based on an allocation of taxes in relation to pretax activity. If the entity in question only had income or loss from continuing operations in the year the tax uncertainty is resolved, the reversal of the tax uncertainty would have to be allocated to continuing operations (i.e., it couldn't be backward traced through discontinued operations).

ASC 205-20-45-4 provides that adjustments to amounts reported in discontinued operations in a prior period are to be presented separately in the period in discontinued operations (i.e., the income tax position is "backward traced").

In our discussion with the FASB staff about this situation, the staff acknowledged the diversity in practice and said that an entity would make an accounting policy election for the intraperiod tax allocation associated with the resolution of tax uncertainties related to a discontinued operation and could follow either ASC 740-20-45-8 or ASC 205-20-45-4.

Equity

ASC 740 also does not specifically address the application of intraperiod allocation guidance to changes in uncertain tax positions that are accounted for in equity. Questions have arisen regarding whether "backward tracing" to equity is permissible for tax uncertainties accounted for in equity in a prior annual period as a result of intraperiod allocation requirements.

Two common approaches seen in practice are noted below.

Approach A: No backward tracing

ASC 740-20-45-8 requires income tax expense or benefit to be allocated to continuing operations based on the pretax income or loss that *occurred during the current year*. Such a model is often applied to changes in uncertain tax positions (i.e., no backward tracing).

ASC 740-20-45-8 provides that the amount of income tax expense or benefit to be allocated to continuing operations is based on the pretax income or loss that occurred during the current year. If there is only one item other than continuing operations (such as a discontinued operation), the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that one item.

For example, consider an entity that previously recorded a liability for an uncertain tax position related to an item accounted for in OCI. The expense associated with the liability for the uncertain tax position also was included in OCI. In the year the uncertain tax position is resolved and the position meets the recognition threshold, the entity only had income or loss from continuing operations. The reversal of the tax uncertainty and the related tax effect is recognized in continuing operations because the entity only has income from continuing operations in the current annual period.

Approach B: Limited equity backward tracing

The intraperiod allocation guidance in ASC 740-10-45-20 related to changes in valuation allowances also provides a model that can be applied to changes in uncertain tax positions. ASC 740-10-45-20 provides that the initial recognition (that is, by elimination of the valuation allowance) of tax benefits related to the items specified in 740-20-45-11(c) and (f) is included in shareholders' equity. Such items include:

- Increases or decreases in contributed capital (for example, deductible expenses reported as a reduction of the proceeds from issuing capital stock) (ASC 740-20-45-11(c))
- Deductible temporary differences and carryforwards that existed at the date of a quasi-reorganization (ASC 740-20-45-11(f))

Under this model, a liability for an uncertain tax position related to the items listed above that was originally established through equity would be reversed through equity.

An entity should select an accounting policy related to the intraperiod tax allocation associated with changes in tax uncertainties related to equity and consistently apply the policy.

19.7.8 Subsequent events

Subsequent recognition, derecognition and measurement of tax positions should be based on management's best judgment, given the facts, information and circumstances that exist as of the balance sheet date. ASC 740 does not permit a tax position to be recognized, derecognized or remeasured due to changes after the balance sheet date but before the issuance of the financial statements. Rather, these changes are recorded in the period in which the change in judgment occurs (based on new information) with appropriate disclosure of the subsequent events, if significant.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-117

Paragraphs 740-10-25-6 and 740-10-25-8 require that tax positions be recognized and measured based on information available at the reporting date. This Example demonstrates the effect of information becoming available after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).

740-10-55-118

Entity A has evaluated a tax position at its most recent reporting date and has concluded that the position meets the more-likely-than-not recognition threshold. In evaluating the tax position for recognition, Entity A considered all relevant sources of tax law, including a court case in which the taxing authority has fully disallowed a similar tax position with an unrelated entity (Entity B). The taxing authority and Entity B are aggressively litigating the matter. Although Entity A was aware of that court case at the recent reporting date, management determined that the more-likely-than not recognition threshold had been met. After the reporting date, but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the taxing authority prevailed in its litigation with Entity B, and Entity A concludes that it is no longer more likely than not that it will sustain the position.

740-10-55-119

Paragraph 740-10-40-2 provides the guidance that an entity shall derecognize a previously recognized tax position in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination, and paragraphs 740-10-25-14; 740-10-35-2; and 740-10-40-2 establish that subsequent recognition, derecognition, and measurement shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Because the resolution of Entity B's litigation with the taxing authority is the information that caused Entity A to change its judgment about the sustainability of the position and that information was not available at the reporting date, the change in judgment would be recognized in the first quarter of the current fiscal year.

19.7.9 Interim reporting

A change in judgment (recognition, derecognition or measurement) about a tax position taken in a previous annual period should be treated as a discrete item in the period in which the change in judgment occurs. Changes in judgment (recognition, derecognition and measurement) about tax positions reflected in a prior interim period within the same fiscal year should be reflected in accordance with the interim reporting guidance in ASC 740-270-35-6. See section 20.4, *Computation of interim period tax (or benefit)*, for further details.

19.8 Interest and penalties

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-56

When the tax law requires interest to be paid on an underpayment of income taxes, an entity shall begin recognizing interest expense in the first period the interest would begin accruing according to the provisions of the relevant tax law.

740-10-25-57

If a tax position does not meet the minimum statutory threshold to avoid payment of penalties (considering the factors in paragraph 740-10-25-7), an entity shall recognize an expense for the amount of the statutory penalty in the period in which the entity claims or expects to claim the position in the tax return. If penalties were not recognized when the position was initially taken, the expense shall be recognized in the period in which the entity's judgment about meeting the minimum statutory threshold changes.

Initial Measurement

740-10-30-29

Paragraph 740-10-25-56 establishes the requirements under which an entity shall accrue interest on an underpayment of income taxes. The amount of interest expense to be recognized shall be computed by applying the applicable statutory rate of interest to the difference between the tax position recognized in accordance with the requirements of this Subtopic for tax positions and the amount previously taken or expected to be taken in a tax return.

Derecognition

740-10-40-5

A tax position that did not meet the recognition requirements of paragraph 740-10-25-6 may have resulted in the accrual of interest and penalties under the requirements of paragraphs 740-10-25-56 through 25-57. Previously recognized interest and penalties associated with tax positions that subsequently meet one of the conditions in paragraph 740-10-25-8 shall be derecognized in the period that condition is met.

19.8.1 Interest

Interest expense is initially recognized by applying the statutory rate of interest in effect at that time to the difference between the amount reported in the financial statements and the amount claimed, or expected to be claimed, in the tax return. Interest will accrue on a tax position over time, beginning when the accrual would start under the applicable tax law and continuing until the position is ultimately settled.

Accordingly, for each period prior to effective settlement of a tax position, additional accruals will be required for interest expense. It is not appropriate to pre-accrue interest for the future years the tax position is anticipated to be outstanding or unresolved. Interest payable to a taxing authority is not eligible for capitalization under ASC 835.

ASC 740-10-25-6 only discusses the requirement to accrue interest expense on tax positions failing to meet the initial recognition threshold, or on those tax positions that are measured at less than 100% of the benefit claimed or expected to be claimed in the tax return. As a result, questions have arisen about whether it is appropriate to also recognize interest income on tax positions (presuming the tax law provides for such interest in the specific situation) accounted for in accordance with the guidance in ASC 740 related to accounting for uncertainty in income taxes, or whether the entity must evaluate the recognition of interest income using a higher threshold, such as the gain contingency threshold in ASC 450.

For example, consider an entity with a tax position relating to transfer pricing in two jurisdictions that doesn't meet the initial recognition or full measurement criteria in ASC 740 related to accounting for uncertainty in income taxes. This situation will result in the accrual of interest expense in one jurisdiction under the guidance in ASC 740 related to accounting for uncertainty in income taxes but would presumably create interest income in the other jurisdiction, assuming it is appropriate under the tax law. We believe that to the extent interest income (i.e., a recovery) is applicable under the tax law, interest income should be recognized using the same model as described in the guidance in ASC 740 related to accounting for uncertainty in income taxes (i.e., recognized as it accrues under the tax law for a given receivable).

19.8.2 Penalties

The tax law in many jurisdictions requires the payment of penalties when a specified threshold (i.e., minimum statutory threshold) is not met. A tax position must have substantial authority based on its technical merits and must be adequately disclosed in the tax return or it fails to meet the minimum statutory threshold to avoid the payment of penalties. If a penalty applies, a company recognizes an accrual in the financial statements in the period in which the entity claims, or expects to claim, the position within its tax return (assuming the deduction triggers the penalty).

If an entity changes its assessment about a particular tax position and determines it no longer meets the minimum threshold to avoid a penalty, the entity would recognize the penalty in the period it changed its assessment. As discussed previously, interest is recognized at the applicable statutory rate in effect for that period and accrues over the period that the position remains unresolved with the taxing authority. Any additional amount above the statutory interest rate is considered "penalty interest" and should be accrued in the period in which the entity claims or expects to claim the position in the tax return (based on when the accrual would start under applicable tax law) and increases as the penalty liability accrues (either as a lump sum or over time, depending on the nature of penalty).

19.9 Classification

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Recognition

740-10-25-16

The amount of benefit recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability is created (or the amount of a net operating loss carryforward or amount refundable is reduced) for an **unrecognized tax benefit** because it represents an entity's potential future obligation to the taxing authority for a tax position that was not recognized under the requirements of this Subtopic.

740-10-25-17

A tax position recognized in the financial statements may also affect the tax bases of assets or liabilities and thereby change or create **temporary differences**. A **taxable** and **deductible temporary difference** is a difference between the reported amount of an item in the financial statements and the tax basis of an item as determined by applying this Subtopic's recognition threshold and measurement provisions for tax positions. See paragraph 740-10-30-7 for measurement requirements.

Other Presentation

740-10-45-11

An entity that presents a classified statement of financial position shall classify an unrecognized tax benefit that is presented as a liability in accordance with paragraphs 740-10-45-10A through 45-10B as a current liability to the extent the entity anticipates payment (or receipt) of cash within one year or the operating cycle, if longer.

740-10-45-12

An unrecognized tax benefit presented as a liability shall not be classified as a deferred tax liability unless it arises from a **taxable temporary difference**. Paragraph 740-10-25-17 explains how the recognition and measurement of a **tax position** may affect the calculation of a temporary difference.

740-10-45-25

Interest recognized in accordance with paragraph 740-10-25-56 may be classified in the financial statements as either **income taxes** or interest expense, based on the accounting policy election of the entity. Penalties recognized in accordance with paragraph 740-10-25-57 may be classified in the financial statements as either income taxes or another expense classification, based on the accounting policy election of the entity. Those elections shall be consistently applied.

As noted in ASC 740-10-25-16, the amount of benefit recognized for a tax position in the balance sheet may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability results from an unrecognized tax benefit when it represents an entity's potential future obligation to the taxing authority for that tax position not recognized in the financial statements. Because the guidance applies to *all* tax positions, both negative and positive, in some cases the unrecognized tax benefit could represent an entity's potential for a future tax refund.

In addition, a tax position recognized in the financial statements may also affect the tax bases of assets or liabilities and, thereby, change or create temporary differences. A taxable and deductible temporary difference is recorded for the difference between the reported amount of an item in the financial statements and the tax basis of that item determined by applying the recognition threshold and measurement provisions for tax positions as described in this section. Refer to Chapter 5, *Recognition and measurement*, for further discussion of how to measure temporary differences.

Refer to Illustration 19-4, *UTP related to differences in timing*, for an example of an uncertain tax position related to a timing difference.

19.9.1 Classification as current or noncurrent

ASC 740-10-45-11 requires that an unrecognized tax benefit that is presented as a liability be classified as current to the extent the entity expects payment within a year. That is, only the portion of the liability that is expected to be paid in the next year (or operating cycle, if longer) is classified as a current liability. As a result, an unrecognized tax benefit that is presented as a liability and is expected to be resolved without a payment of cash (e.g., resolution of an unrecognized tax benefit due to the expiration of the statute of limitations) should not be classified as current. The FASB departed from the presumed liability approach in ASC 740 related to accounting for income taxes for unrecognized positions as current or long term because FASB members believed management's assessment of the timing of payment was the most representationally faithful classification.

19.9.2 Accounting policy election — classification of interest and penalties

ASC 740-10-45-25 requires an entity to make an accounting policy election to classify interest due to the taxing authority on unrecognized tax positions as either interest expense or income taxes. While ASC 740 does not specifically discuss interest due from a taxing authority, we believe the interest due from the taxing authority should be classified in income taxes or interest income following an accounting policy that is consistent with an entity's policy for interest due to a taxing authority related to uncertain tax positions.

Similarly, entities are required to make an accounting policy election to classify penalties as either other expense or income taxes. A company need not have the same policy for classification of interest and penalties. Entities should disclose its policy elections, if significant, in the notes to the financial statements (ASC 740-10-50-19).

Any change in classification would be treated as a change in accounting principle subject to the requirements of ASC 250 and, for public companies, would require an auditor to issue a preferability letter.

Refer to section 19.10, *Disclosures*, for details on these required disclosures.

19.9.3 Presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Other Presentation Matters

740-10-45-10A

Except as indicated in paragraphs 740-10-45-10B and 740-10-45-12, an **unrecognized tax benefit**, or a portion of an unrecognized tax benefit, shall be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward.

740-10-45-10B

To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit shall be presented in the financial statements as a liability and shall not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and shall be made presuming disallowance of the tax position at the reporting date.

ASC 740-10-45-10A and 740-10-45-10B require that a liability related to an unrecognized tax benefit be offset against a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward if such a settlement would be required or expected in the event the tax position is disallowed. In that case, the liability associated with the unrecognized tax benefit is presented in the financial statements as a reduction to the related deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward.

If a net operating loss carryforward, a similar tax loss or a tax credit carryforward is not available at the reporting date under the tax law of the jurisdiction or the tax law of the jurisdiction does not require, and the entity does not intend to use, the deferred tax asset for this purpose, the unrecognized tax benefit would be presented in the financial statements as a liability and would not be combined with deferred tax assets. That is, gross presentation of the unrecognized tax benefit and deferred tax asset would be required in the following circumstances:

- A deferred tax asset is not available under the tax law to settle any additional income taxes that would result from the disallowance of the tax position at the reporting date. For example, an entity may have net operating losses and unrecognized tax benefits related to different tax jurisdictions. If the net operating losses from one tax jurisdiction could not be used to settle the unrecognized tax benefits of another tax jurisdiction, these amounts would be presented gross in the financial statements. Additionally, a jurisdiction may limit the amount of net operating loss used in a particular year, which could limit the net operating losses available to settle the unrecognized tax benefit.
- The tax law allows an entity to elect the manner of settlement of unrecognized tax benefits and the entity does not intend to use its existing deferred tax assets for such a settlement. For example, if an entity may be permitted to settle an unrecognized tax benefit (assuming settlement at the reporting date) with cash and may expect to do so, even if it has deferred tax assets available for a settlement.

Companies that operate in multiple jurisdictions will need to track unrecognized tax benefits by jurisdiction and determine whether each jurisdiction requires or permits settlement of unrecognized tax benefits with a net operating loss, similar tax loss or tax credit carryforward. An entity also would need to consider limitations on the use of deferred tax assets as of the reporting date (e.g., limitations on the use of a net operating loss).

The determination of whether a deferred tax asset is available is based on the unrecognized tax benefit and the deferred tax asset that exist at the reporting date and presumes that the tax position is disallowed at the reporting date. Accordingly, an entity should not consider future events when making its presentation assessment. For example, an entity should not evaluate whether a deferred tax asset is expected to expire before the statute of limitations on the tax position.

Other considerations

ASC 740-10-45-10A and 740-10-45-10B were added to the Codification to prevent diversity in practice in the presentation of unrecognized tax benefits when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists. This presentation guidance does not otherwise change the way in which an entity accounts for unrecognized tax benefits or deferred tax assets (i.e., there were no changes to the recognition, measurement or disclosure requirements as a result of codifying ASC 740-10-45-10A and 740-10-45-10B).

In its deliberations, the Emerging Issues Task Force clarified the following:

- The presentation of unrecognized tax benefits as a reduction of a deferred tax asset is consistent with an entity's analysis of the realizability of its deferred tax assets and, as a result, is not expected to change an entity's assessment of realizability. See section 6.2.2, *Liabilities for uncertain tax positions as a source of taxable income*, for further discussion.
- The gross presentation in the rollforward of unrecognized tax benefits in the notes to the financial statements is still required. See section 19.10.1, *Disclosures under ASC 740 for uncertain tax positions*, for further discussion.

While not specifically addressed in ASC 740-10-45-10A and 740-10-45-10B, we believe that deferred tax asset balances that are disclosed in the notes to the financial statements should reconcile to the net deferred tax asset balances that are presented in the balance sheet. That is, if an unrecognized tax position has been presented as a reduction to a deferred tax asset, a company should capture that reduction in its disclosures that include the same deferred tax asset.

19.10 Disclosures

An entity is required to make disclosures in the notes to the financial statements that assist the user in evaluating the entity's tax uncertainties. Public entities are required to make incremental disclosures, as discussed below.

Standard setting

The FASB issued a proposed Accounting Standards Update to ASC 740, *Improvements to Income Tax Disclosures*, to improve the transparency and decision usefulness of income tax disclosures. The proposal addresses investor requests for more transparency about income tax information, particularly by jurisdiction. It would require more details in the rate reconciliation and the disclosure about income tax paid. The proposal would also eliminate the requirement in ASC 740-10-50-15(d) for all entities to (1) disclose the nature and estimate of the range of reasonably possible change in unrecognized tax benefits balance in the next 12 months or (2) make a statement that an estimate of the range cannot be made, among other things. In addition, the proposal would eliminate the requirement to disclose the cumulative amount of each type of temporary difference when a deferred tax liability is not recognized because of a recognition exception (e.g., indefinite reinvestment exception) related to deferred taxes for subsidiaries and corporate joint ventures.

See our To the Point: ***FASB proposes improvements to income tax disclosures***. Readers should monitor developments.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Disclosure

740-10-50-15

All entities shall disclose all of the following at the end of each annual reporting period presented:

a. Subparagraph superseded by Accounting Standards Update No. 2009-06

b. Subparagraph superseded by Accounting Standards Update No. 2009-06

c. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position

d. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:

   1. The nature of the uncertainty
   2. The nature of the event that could occur in the next 12 months that would cause the change
   3. An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.

e. A description of tax years that remain subject to examination by major tax jurisdictions.

740-10-50-15A

Public entities shall disclose both of the following at the end of each annual reporting period presented:

a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:
    1. The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period
    2. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period
    3. The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities
    4. Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

See Example 30 (paragraph 740-10-55-217) for an illustration of disclosures about uncertainty in income taxes.

740-10-50-19

An entity shall disclose its policy on classification of interest and penalties in accordance with the alternatives permitted in paragraph 740-10-45-25 in the notes to the financial statements.

19.10.1 Disclosures under ASC 740 for uncertain tax positions

The following summarizes the key aspects related to required disclosures under ASC 740.

ASC 740-10-50-15A(a) — The tabular rollforward (public entities)

The following are the required captions in the tabular rollforward public companies are required to provide and our understanding of the information to be included within each category:

- The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period — This disclosure is intended to address changes (increases and decreases) in the amount of unrecognized tax benefits related to prior annual periods. It would include changes in the recognition or measurement of prior year tax positions as a result of new information (excluding cash payments, use of an existing deferred tax asset or a lapse in the statute of limitations). Entities are required to disclose both the gross increases and gross decreases in prior year tax positions.
- The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period — This disclosure is intended to address changes in the amount of current period unrecognized tax benefits. Because this disclosure is an annual rollforward of unrecognized tax benefits, there cannot be "decreases" in this category. That is, this disclosure will address current year increases in unrecognized tax benefits. However, material changes in unrecognized tax benefits (including decreases), which occur in an interim period, should be disclosed in interim financial statements.
- The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities — This disclosure addresses decreases due to cash payments made to the taxing authority or the use of a related deferred tax asset. It does not include changes in an estimate or changes related to other means of resolution of tax positions (e.g., negotiation (ASC 740-10-50-15A(a1)), litigation (ASC 740-10-50-15A(a1)), lapse of the statute of limitations (ASC 740-10-50-15A(a4))). We believe an entity that makes an advance deposit with taxing authorities to stop the accrual of penalty interest on tax uncertainties or as a condition for appealing a tax position in court would disclose these amounts once they are applied to a particular position in settlement.

- Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations — This disclosure addresses tax positions ultimately settled through the expiration of the statute of limitations.

Interest and penalties should not be included in the tabular rollforward.

ASC 740-10-50-15A(b) — Effective tax rate (public entities)

The term "effective tax rate" in ASC 740-10-50-15A(b) should be interpreted as the percentage derived by dividing (1) income tax expense allocated to continuing operations by (2) pretax income from continuing operations. The resolution of some tax uncertainties will not affect the effective tax rate as discussed in ASC 740 (e.g., resolutions related to business combinations that occurred during the measurement period, additional paid-in capital). However, we believe supplemental disclosure should be encouraged for resolution of tax uncertainties that do not affect the effective tax rate.

ASC 740-10-50-15(c) — Interest and penalties (all entities)

All entities are required to disclose the total amounts of interest and penalties recognized in the statement of operations and the statement of financial position as required by ASC 740-10-50-15(c). This would include increases and decreases in such amounts.

ASC 740-10-50-15(d) and (e) — Other disclosures (all entities)

For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date, entities are required to disclose (1) the nature of the uncertainty, (2) the nature of the event that could occur in the next 12 months that would cause the change and (3) an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.

Entities are also required to disclose a description of tax years that remain subject to examination by major tax jurisdictions.

Effect of full valuation allowance on disclosures (public entities)

ASC 740-10-50-15A(a) requires that an entity disclose, in a tabular reconciliation, the total amounts of unrecognized tax benefits at the beginning and end of the period. Some have questioned whether this requirement applies to unrecognized tax benefits that result in a deferred tax asset that, if recognized, would require a full valuation allowance. We believe that the tabular rollforward requirement is independent of the need for a valuation allowance. As a result, the rollforward should be presented with the gross amounts of unrecognized tax benefits, regardless of the presentation in the balance sheet (i.e., valuation allowance).

ASC 740-10-50-15A(b) requires disclosure of the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. In the case of an unrecognized tax benefit that, if recognized, would result in a deferred tax asset and corresponding increase in the entity's valuation allowance, such unrecognized tax benefit would not affect the effective rate if recognized. As a result, because the benefit would be offset by an increase in the valuation allowance, there would be no effect on the effective tax rate.

Federal benefits and other indirect effects

Many tax positions have an indirect effect on other tax positions in different tax jurisdictions. For example, state taxes often have an indirect effect on federal taxes because state taxes are deductible in the federal return. We believe the tabular rollforward described in ASC 740-10-50-15A(a) is intended to address only the unrecognized tax position. That is, the unrecognized position (the state tax deduction) would be included in the tabular rollforward of unrecognized tax benefits, and the amount disclosed would not reflect the indirect benefits it would trigger if disallowed. In other words, the federal benefit would be considered "recognized" because ASC 740 is applied by jurisdiction and that benefit should not be included in the tabular rollforward of unrecognized tax benefits. However, the indirect effects should be included in describing the effect on the effective tax rate as provided for in ASC 740-10-50-15A(b).

The following illustration reflects the interaction between an uncertain tax position and the indirect effect on the uncertain tax position in a different tax jurisdiction.

Illustration 19-6: Interaction between an uncertain tax position and the indirect effect of the undertain tax position in a different tax jurisdiction

Assume Company A records a $100 deduction for state purposes. The position does not meet the recognition threshold of being more likely than not to be sustained upon examination. As a result, under ASC 740, Company A has an unrecognized tax benefit of $9 ($100 at the state rate of 9%).

Because the benefit of the deduction for state tax purposes does not meet the recognition threshold, Company A will be entitled to an indirect federal benefit of $2 ($9 deduction at 21%) related to the additional state taxes accrued for the uncertain tax position. In accounting for this tax position under ASC 740, Company A would accrue a $9 liability to the state government for the uncertain tax position and record a corresponding deferred tax asset related to the federal deduction of $2.

Only the gross $9 unrecognized state tax position is included in the tabular rollforward pursuant to ASC 740-10-50-15A(a). However, Company A would disclose $7 ($9 less $2) of unrecognized tax benefits that, if recognized, would affect the effective tax rate pursuant to ASC 740-10-50-15A(b).

<u>Balance sheet presentation</u>		
Liability for uncertain tax positions	$	9
Deferred tax asset for federal tax deduction on state taxes	$	2
<u>Disclosure for uncertain tax positions</u>		
Unrecognized tax benefits	$	9
Amount of unrecognized tax benefits expected to impact the effective tax rate	$	7

19.10.2 Disclosure example

Standard setting

The FASB issued a proposed Accounting Standards Update to ASC 740, *Improvements to Income Tax Disclosures*, to improve the transparency and decision usefulness of income tax disclosures. The proposal addresses investor requests for more transparency about income tax information, particularly by jurisdiction. It would require more details in the rate reconciliation and the disclosure about income tax paid. The proposal would also eliminate the requirement in ASC 740-10-50-15(d) for all entities to (1) disclose the nature and estimate of the range of reasonably possible change in unrecognized tax benefits balance in the next 12 months or (2) make a statement that an estimate of the range cannot be made, among other things. In addition, the proposal would eliminate the requirement to disclose the cumulative amount of each type of temporary difference when a deferred tax liability is not recognized because of a recognition exception (e.g., indefinite reinvestment exception) related to deferred taxes for subsidiaries and corporate joint ventures.

See our To the Point: ***<u>FASB proposes improvements to income tax disclosures</u>***. Readers should monitor developments.

The following is an example disclosure from ASC 740.

Excerpt from Accounting Standards Codification

Income Taxes — Overall

Implementation Guidance and Illustrations

740-10-55-217

This Example illustrates the guidance in paragraph 740-10-50-15 for disclosures about uncertainty in income taxes.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 20X1. The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X2 through 20X4 in the first quarter of 20X7 that is anticipated to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant adjustments to the Company's transfer pricing and research credits tax positions. Management is currently evaluating those proposed adjustments to determine if it agrees, but if accepted, the Company does not anticipate the adjustments would result in a material change to its financial position. However, the Company anticipates that it is reasonably possible that an additional payment in the range of $80 to $100 million will be made by the end of 20X8. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows.

	20X7	20X6	20X5
		(In thousands)	
Balance at January 1	$ 370,000	$ 380,000	$ 415,000
Additions based on tax positions related to the current year	10,000	5,000	10,000
Additions for tax positions of prior years	30,000	10,000	5,000
Reductions for tax positions of prior years	(60,000)	(20,000)	(30,000)
Settlements	(40,000)	(5,000)	(20,000)
Balance at December 31	$ 310,000	$ 370,000	$ 380,000

At December 31, 20X7, 20X6, and 20X5, there are $60, $55, and $40 million of unrecognized tax benefits that if recognized would affect the annual effective tax rate.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended December 31, 20X7, 20X6, and 20X5, the Company recognized approximately $10, $11, and $12 million in interest and penalties. The Company had approximately $60 and $50 million for the payment of interest and penalties accrued at December 31, 20X7, and 20X6, respectively.

19.10.3 Interim reporting

Public companies are required by Item 303(b)(3) of Regulation S-K to make disclosures related to the estimation uncertainty in their income tax accounts, if such estimates are designated as critical accounting estimates, in the MD&A - Critical Accounting Estimates section of their annual report on Form 10-K. In their interim reports on Form 10-Q, public companies are required by Item 303(c) to discuss both:

1. Material changes in their income tax critical accounting estimates since year-end and the events or changes in assumptions that led to such material changes and

2. Events and changes in assumptions that are reasonably likely to lead to a material change in the income tax critical accounting estimates, results of operations and financial condition of the company.

Article 10 of Regulation S-X requires that the condensed interim financial information include sufficient disclosures in order to avoid the presentation of misleading information. Footnote disclosures that would substantially duplicate the disclosures in the most recent annual report (e.g., summary of significant accounting policies, account balances that have not changed significantly in amount or composition since the most recently completed fiscal year, other disclosures required by Rule 4-08 of Regulation S-X) may be omitted from the condensed interim financial statements. However, registrants must disclose events subsequent to the most recent fiscal year that have had a material impact on the registrant. This requirement would include any significant changes in ASC 740 disclosures related to uncertainty in income taxes.

20 Interim reporting

ASC 740-270 provides guidance on accounting for income taxes in interim periods. One of the principal concepts of interim reporting is that the tax provision for the year is the same whether a company only prepares annual financial statements or prepares interim (i.e., quarterly or monthly) financial statements in addition to the annual financial statements.

20.1 Estimated annual effective tax rate

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Recognition

740-270-25-1

This guidance addresses the issue of how and when **income tax expense (or benefit)** is recognized in interim periods and distinguishes between elements that are recognized through the use of an estimated annual effective tax rate applied to measures of year-to-date operating results, referred to as **ordinary income (or loss)**, and specific events that are discretely recognized as they occur.

740-270-25-2

The **tax (or benefit)** related to ordinary income (or loss) shall be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items shall be individually computed and recognized when the items occur.

Glossary

Ordinary Income (or Loss)

Ordinary income (or loss) refers to income (or loss) from continuing operations before income taxes (or benefits) excluding significant unusual or infrequently occurring items. Discontinued operations and cumulative effects of changes in accounting principles are also excluded from this term. The term is not used in the income tax context of ordinary income versus capital gain. The meaning of unusual or infrequently occurring items is consistent with their use in the definitions of the terms **unusual nature** and **infrequency of occurrence**.

Initial Measurement

740-270-30-5

The estimated annual effective tax rate, described in paragraphs 740-270-30-6 through 30-8, shall be applied to the year-to-date ordinary income (or loss) at the end of each interim period to compute the year-to-date tax (or benefit) applicable to ordinary income (or loss).

740-270-30-6

At the end of each interim period the entity shall make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. In some cases, the estimated annual effective tax rate will be the statutory rate modified as may be appropriate in particular circumstances. In other cases, the rate will be the entity's estimate of the tax (or benefit) that will be provided for the fiscal year, stated as a percentage of its estimated ordinary income (or loss) for the fiscal year (see paragraphs 740-270-30-30 through 30-34 if an ordinary loss is anticipated for the fiscal year).

740-270-30-7

The tax effect of a **valuation allowance** expected to be necessary for a **deferred tax asset** at the end of the year for originating deductible temporary differences and **carryforwards** during the year shall be included in the effective tax rate.

740-270-30-8

The estimated effective tax rate also shall reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this estimated effective tax rate, no effect shall be included for the tax related to an employee share-based payment award within the scope of Topic 718 when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes, significant unusual or infrequently occurring items that will be reported separately, or for items that will be reported net of their related tax effect in reports for the interim period or for the fiscal year. The rate so determined shall be used in providing for income taxes on a current year-to-date basis.

740-270-30-14

Certain investment tax credits may be excluded from the estimated annual effective tax rate. If an entity includes allowable investment tax credits as part of its provision for income taxes over the productive life of acquired property and not entirely in the year the property is placed in service, amortization of deferred investment tax credits need not be taken into account in estimating the annual effective tax rate; however, if the investment tax credits are taken into account in the estimated annual effective tax rate, the amount taken into account shall be the amount of amortization that is anticipated to be included in income in the current year (see paragraphs 740-10-25-46 and 740-10-45-28).

740-270-30-15

Further, paragraphs 840-30-30-14 and 840-30-35-34 through 35-35 require that investment tax credits related to leases that are accounted for as leveraged leases shall be deferred and accounted for as return on the net investment in the leveraged leases in the years in which the net investment is positive and explains that the use of the term *years* is not intended to preclude application of the accounting described to shorter periods. If an entity accounts for investment tax credits related to leveraged leases in accordance with those paragraphs for interim periods, those investment tax credits shall not be taken into account in estimating the annual effective tax rate.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* **| Transition Guidance:** 842-10-65-1

Further, paragraphs 842-50-30-1 and 842-50-35-3 through 35-4 require that investment tax credits related to leases that are accounted for as **leveraged leases** shall be deferred and accounted for as return on the net investment in the leveraged leases in the years in which the net investment is positive and explains that the use of the term *years* is not intended to preclude application of the accounting described to shorter periods. If an entity accounts for investment tax credits related to leveraged leases in accordance with those paragraphs for interim periods, those investment tax credits shall not be taken into account in estimating the annual effective tax rate.

740-270-30-16

This guidance addresses the consequences of an entity's inability to reliably estimate some or all of the information which is ordinarily required to determine the annual effective tax rate in interim financial information.

740-270-30-17

Paragraph 740-270-25-3 requires that if an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated be reported in the interim period in which the item is reported.

Subsequent Measurement

740-270-35-3

As indicated in paragraph 740-270-30-6, at the end of each successive interim period the entity shall make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. As indicated in paragraph 740-270-30-8, the rate so determined shall be used in providing for **income taxes** on a current year-to-date basis. The rate shall be revised, if necessary, as of the end of each successive interim period during the fiscal year to the entity's best current estimate of its annual effective tax rate.

Disclosure

740-270-50-1

Application of the requirements for accounting for **income taxes** in interim periods may result in a significant variation in the customary relationship between income tax expense and pretax accounting income. The reasons for significant variations in the customary relationship between income tax expense and pretax accounting income shall be disclosed in the interim period financial statements if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

Implementation Guidance and Illustrations

Case B2: Year-to-Date Ordinary Losses, Realization More Likely Than Not

740-270-55-7

The entity has ordinary income and losses in interim periods, and there is an ordinary loss for the year to date at the end of an interim period. Established seasonal patterns provide evidence that realization in the current year of the tax **benefit** of the year-to-date loss and of anticipated tax credits is more likely than not. Quarterly tax computations are as follows.

	Ordinary Income (Loss)		Estimated	Tax (or Benefit)		
Reporting Period	Reporting Period	Year-to-Date	Annual Effective Tax Rate	Year-to-Date	Less Previously Provided	Reporting Period
First quarter	$ (20,000)	$ (20,000)	40%	$ (8,000)	$ -	$ (8,000)
Second quarter	10,000	(10,000)	40%	(4,000)	(8,000)	4,000
Third quarter	15,000	5,000	40%	2,000	(4,000)	6,000
Fourth quarter	95,000	100,000	40%	40,000	2,000	38,000
Fiscal year	$ 100,000					$ 40,000

Case B3: Year-to-Date Ordinary Losses, Realization Not More Likely Than Not

740-270-55-8

The entity has ordinary income and losses in interim periods, and there is a year-to-date ordinary loss during the year. There is no established seasonal pattern and it is more likely than not that the tax benefit of the year-to-date loss and the anticipated tax credits will not be realized in the current or future years. Quarterly tax computations are as follows.

	Ordinary Income (Loss)		Estimated		Tax		
Reporting Period	Reporting Period	Year-to-Date	Annual Effective Tax Rate		Year-to-Date	Less Previously Provided	Reporting Period
First quarter	$ (20,000)	$ (20,000)	–	(a)	$ –	$ –	$ –
Second quarter	10,000	(10,000)	–	(a)	–	–	–
Third quarter	15,000	5,000	40%		2,000	–	2,000
Fourth quarter	95,000	100,00	40%		40,000	2,000	38,000
Fiscal year	$ 100,000						$ 40,000

(a) No benefit is recognized because the tax benefit of the year-to-date loss is not expected to be realized during the current year or recognizable as a deferred tax asset at the end of the current year in accordance with the provisions of Subtopic 740-10.

Under ASC 740-270, each interim period is considered an integral part of the annual period, and tax expense is measured using an estimated annual effective rate. A company is required, at the end of each interim reporting period, to make its best estimate of the annual effective tax rate for the full fiscal year and use that rate to provide for income taxes on a current year-to-date basis. The estimated effective tax rate should reflect enacted federal, state and local income tax rates, foreign tax rates and credits, percentage depletion, capital gains rates, other taxes and credits and available tax-planning alternatives.

Also, under ASC 740, companies are required to project the deferred tax effects of expected year-end temporary differences. In this regard, ASC 740-270-30-7 requires that the tax effect of a valuation allowance expected to be necessary at the end of the year for deferred tax assets related to deductible temporary differences and carryforwards originating during the year be included in the effective tax rate. However, in determining the effective tax rate, no effect should be included for the tax related to an employee share-based payment award within the scope of Topic 718 when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes, significant unusual or infrequently occurring items that would be reported separately or for items that will be reported net of their related tax effect for interim or annual reporting purposes (ASC 740-270-30-8).

Once the total estimated tax provision (current and deferred) is computed, an effective tax rate would be determined by dividing the total estimated provision by the estimated annual pretax "ordinary income." The effective tax rate would then be used for computing the interim tax provision. Because the timing of recognition of tax consequences related to items included in ordinary income may differ from the timing of recognition of tax consequences from transactions or events not included in ordinary income, it is important to understand how ASC 740-270 defines ordinary income (or loss).

Ordinary income (or loss) in the context of US GAAP refers to income (or loss) from continuing operations before income tax, without reference to the characterization of that income under any particular tax laws (i.e., US taxable ordinary income versus capital gains), and excludes the following items:

- Unusual items — Events or transactions that possess a high degree of abnormality and are of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates
- Infrequently occurring items — Events or transactions that are not reasonably expected to recur in the foreseeable future, taking into account the environment in which the entity operates

- Discontinued operations
- Cumulative effects of changes in accounting principles

20.1.1 Non-recognized subsequent events

As part of the annual effective tax rate estimation process, a company is required, at the end of each reporting period, to make its best estimate of pretax ordinary income for the full fiscal year. In estimating pretax ordinary income for the full fiscal year, questions often arise as to how to consider events (specifically, non-recognized subsequent events) that occur after the interim balance sheet date (i.e., events that occur after the most recent quarter end but within the same fiscal year), but before the interim financial statements are issued. As noted in ASC 855, non-recognized subsequent events provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date. Those events are recognized in the financial statements in the period in which they occur.

When a company estimates its annual effective tax rate, the estimate of pretax ordinary income includes only items that are expected to be included in pretax ordinary income for the year. ASC 740 identifies certain events that are recognized in the period in which they occur:

- Changes in tax laws or rates (see section 20.3, *Effect of new tax legislation (before the adoption of ASU 2019-12)*, or section 20.3A, *Effect of new tax legislation (after the adoption of ASU 2019-12)*)
- Changes in the recognition or measurement of uncertain tax positions for changes subsequent to the balance sheet date (see section 19.7.8, *Subsequent events*)

Also, we do not believe that a company should anticipate obtaining control of a business for purposes of income tax accounting (i.e., the income tax effects of a business combination should be reflected in the period in which it occurs). However, see section 11.13.4, *Assertion regarding indefinite reinvestment*, for considerations with respect to a company's indefinite reinvestment assertion prior to a potential business combination.

ASC 740 and ASC 855 do not address how a company should consider non-recognized subsequent events that would be considered a component of pretax ordinary income but were not included in the estimate of ordinary income for the full fiscal year and occur after an interim balance sheet date when estimating the annual effective tax rate to apply in the interim financial statements. Because the pretax effects of non-recognized subsequent events are recorded in the period in which they occur, we believe that it is most appropriate to exclude those events from the estimate of pretax ordinary income (to the extent they were not previously included in the estimate) prior to the events occurring for purposes of determining the effective tax rate.

20.2 Operations taxable in multiple jurisdictions

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Initial Measurement

740-270-30-19

The effect of translating foreign currency financial statements may make it difficult to estimate an annual effective foreign currency tax rate in dollars. For example, in some cases depreciation is translated at historical exchange rates, whereas many transactions included in income are translated at current period average exchange rates. If depreciation is large in relation to earnings, a change in the estimated ordinary income that does not change the effective foreign currency tax rate can change the effective tax rate in the dollar financial statements. This result can occur with no change in exchange rates during the current year if there have been exchange rate changes in past years. If the entity is unable to estimate its annual effective tax rate in dollars or is otherwise unable to make a reliable estimate of its ordinary income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the tax (or benefit) applicable to ordinary income (or loss) in that jurisdiction shall be recognized in the interim period in which the ordinary income (or loss) is reported.

740-270-30-36

If an entity that is subject to tax in multiple jurisdictions pays taxes based on identified income in one or more individual jurisdictions, interim period tax (or benefit) related to consolidated ordinary income (or loss) for the year to date shall be computed in accordance with the requirements of this Subtopic using one overall estimated annual effective tax rate with the following exceptions:

a. If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with paragraphs 740-270-30-30 through 30-33, no tax benefit can be recognized, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). A separate estimated annual effective tax rate shall be computed for that jurisdiction and applied to ordinary income (or loss) in that jurisdiction in accordance with the methodology otherwise required by this Subtopic.

b. If an entity is unable to estimate an annual effective tax rate in a foreign jurisdiction in dollars or is otherwise unable to make a reliable estimate of its ordinary income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). The tax (or benefit) related to ordinary income (or loss) in that jurisdiction shall be recognized in the interim period in which the ordinary income (or loss) is reported. The tax (or benefit) related to ordinary income (or loss) in a jurisdiction may not be limited to tax (or benefit) in that jurisdiction. It might also include tax (or benefit) in another jurisdiction that results from providing taxes on unremitted earnings, foreign tax credits, and so forth.

See Example 5, Cases A; B; and C (paragraphs 740-270-55-39 through 55-43) for illustrations of accounting for income taxes applicable to ordinary income if an entity is subject to tax in multiple jurisdictions.

When a company is subject to tax in one or more individual jurisdictions, ASC 740-270-30-36 indicates that one overall estimated annual effective tax rate should be used to determine the interim period tax (benefit) related to the entity's consolidated ordinary income (loss) for the year-to-date period, except as follows:

- If, in a separate jurisdiction, the company anticipates an ordinary loss for the fiscal year or incurs an ordinary loss for the year-to-date period for which a tax benefit cannot be realized in accordance with ASC 740, the company should exclude the ordinary income (loss) in that jurisdiction and the related tax (benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (benefit). The company must compute a separate estimated annual effective tax rate for this jurisdiction, which would be applied to the ordinary income (loss) in that jurisdiction.
- If a company is unable to estimate the annual effective tax rate in a foreign jurisdiction in dollars (e.g., depreciation in a foreign jurisdiction may be significant and foreign exchange rates have historically fluctuated) or is otherwise unable to make a reliable estimate of the foreign jurisdiction's ordinary income (loss) or the related tax (benefit) for the fiscal year, the company should exclude the ordinary income (loss) in that jurisdiction and the related tax (benefit) from the overall computations

of the estimated annual effective tax rate and interim period tax (benefit). The company must compute separately the interim tax (benefit) for this jurisdiction as the jurisdiction reports ordinary income (loss) in an interim period (ASC 740-270-30-19).

20.2.1 Consideration when a company is subject to GILTI and has a loss in a foreign jurisdiction

ASC 740-270-30-36 indicates if an entity anticipates an ordinary loss for the fiscal year or incurs an ordinary loss for the year-to-date period for which a tax benefit cannot be realized in accordance with ASC 740, the entity should exclude the ordinary income (loss) in that jurisdiction and the related tax (benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (benefit).

We have received questions on whether entities should continue to include the loss from a foreign subsidiary in the overall computation of the estimated annual effective tax rate if it is more likely than not that the tax benefit of the loss will provide a US tax benefit by reducing the US entity's GILTI inclusion. While the US tax benefit of the loss should be included in the overall computation of the estimated tax expense of the US jurisdiction, we believe that a company should continue to exclude the ordinary loss in the foreign jurisdiction from the computation of the estimated annual effective tax rate (EAETR) if the tax benefit of the loss cannot be realized in the foreign jurisdiction. GILTI is an element included in the computation of the income tax expense of the US tax jurisdiction and not a tax of the separate foreign tax jurisdiction that incurred the loss.

20.2.2 Income tax effects of a change in an indefinite reinvestment assertion

The income tax effects of a company changing its indefinite reinvestment assertion for a foreign subsidiary should be recorded in the interim reporting period when the change in assertion occurs either as a discrete charge to income tax expense for the deferred tax effects of undistributed earnings from prior years or as an adjustment to the estimated annual effective tax rate for undistributed earnings related to the current year. Generally, a change in assertion of indefinite reinvestment during the year should result in the same reporting for the annual period as if the change in assertion occurred at the beginning of the year. That is, despite reporting on an interim basis, the results of a change in an indefinite reinvestment assertion during the year should not be presented any differently in the annual financial statements than if the entity solely reported on an annual basis.

The deferred income tax effects of undistributed earnings related to prior years, including any deferred income tax effects of the beginning-of-the-year cumulative translation adjustment related to the investment (i.e., the outside basis difference on the company's investment in a foreign subsidiary as of the beginning of the year), should be reported in continuing operations as a discrete charge to income tax expense in the period in which the change in assertion occurs. The backward tracing of the tax effects of the beginning-of-the-year cumulative translation adjustment to accumulated other comprehensive income would not be appropriate (see section 15.4, *Operating loss tax benefit — backward tracing prohibited*, for further discussion on the general prohibition in ASC 740 on backward tracing). The tax effects of undistributed earnings, including translation adjustments related to the current year (i.e., the outside basis difference related to the current reporting year), would be recognized as an adjustment to the estimated annual effective tax rate in the period in which the change in assertion occurs. The deferred tax effects of the translation adjustment related to the current period should be reported in other comprehensive income in accordance with ASC 740-20-45-11. See chapter 14, *Foreign and domestic subsidiaries*, for further discussion on accounting for investments in foreign subsidiaries that are essentially permanent in duration.

20.2.3 Zero-rate jurisdictions

As discussed in section 20.2, *Operations taxable in multiple jurisdictions*, one overall estimated annual effective tax rate should be used to determine the interim period tax (benefit) related to a company's consolidated ordinary income (loss) for the year-to-date period unless one of two exceptions discussed in section 20.2, *Operations taxable in multiple jurisdictions*, is met (ASC 740-270-30-36). While an entity may have taxable income (or loss) in a jurisdiction, the tax rate applicable[66] to the taxable income (or loss) may be zero (e.g., Bermuda).

Unless one of the two exceptions in ASC 740-270-30-36 are met, we generally believe that entities subject to tax in one or more jurisdictions should include the ordinary income (or loss) from all jurisdictions (including those from zero-rate jurisdictions) and the related tax expense or benefit (which can be zero for certain tax jurisdictions imposing a zero rate) in the overall estimated annual effective tax rate computation.

However, we are aware that in practice alternative views exist that provide for the ordinary income in a zero-rate jurisdiction to be excluded from the estimated annual effective tax rate. In particular, ASC 740-270-30-36(a) provides that if, in a separate jurisdiction, the company anticipates an ordinary loss for the fiscal year or incurs an ordinary loss for the year-to-date periods for which a tax benefit cannot be realized in accordance with ASC 740, the company should exclude the ordinary income (loss) in that jurisdiction and the related tax (benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (benefit). When a company experiences a loss in a zero-rate jurisdiction, there is no benefit to those losses and as such some believe ASC 740-270-30-36(a) is applicable. However, we generally believe that ASC 740-270-30-36(a) is referring to facts and circumstances that require losses to be evaluated for realizability (i.e., whether a deferred tax asset is more likely than not to be realizable) rather than losses that simply don't result in a tax because the jurisdictional rate is zero.

20.2.4 Effects of deferred tax liabilities related to indefinite-lived intangible assets on the estimated annual effective tax rate

As discussed in section 11.3.4, *Tax-deductible goodwill*, in tax jurisdictions where amortization of goodwill is deductible for tax purposes, ASC 805-740-25-8 requires that the amount of goodwill reported for financial reporting and the tax basis of goodwill each be separated into two components as of the acquisition date for purposes of computing deferred taxes. The first component of goodwill equals the lesser of goodwill for financial reporting or tax-deductible goodwill. The second component of goodwill equals the remainder, if any, of (1) goodwill for financial reporting over tax-deductible goodwill or (2) tax-deductible goodwill over goodwill for financial reporting. As a result, when deductions are taken on a tax return for tax-deductible goodwill, a deferred tax liability can arise. As discussed in section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*, the reversal of taxable temporary differences with respect to indefinite-lived intangible assets and tax-deductible goodwill should not be considered a source of future taxable income in accordance with ASC 740 when assessing the realizability of deferred tax assets unless the deferred tax assets or net operating loss carryforwards do not expire, the deferred tax assets upon reversal are expected to generate net operating losses that do not expire or the tax-deductible goodwill is accounted for under the goodwill alternative for companies that are not PBEs.

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[66] A tax rate may be effectively zero for a period of time. Careful consideration of the facts and circumstances may be necessary to determine whether the jurisdiction's tax rate is zero or a tax holiday exists. See section 5.4, *Tax holidays*, for further discussion of the applicable tax rate to measure deductible and taxable temporary differences expected to reverse during a tax holiday period.

An entity with tax basis in indefinite-lived intangible assets (e.g., tax-deductible goodwill for a PBE or a nonpublic business entity that does not elect the goodwill alternative) may be incurring losses and have a full valuation allowance on deferred tax assets that are not more likely than not to be realized. As a result of deducting amortization expense for the indefinite-lived asset (including tax-deductible goodwill) on the entity's tax return, an entity increases its net operating loss (DTA), increases its valuation allowance and increases the taxable temporary difference associated with the indefinite-lived intangible asset.

The entity's estimated annual effective tax rate should include the increase to the deferred tax liability associated with the increase in the taxable temporary difference resulting from the annual tax amortization deduction. That is, while an entity may have a full valuation allowance resulting in an expectation of a zero estimated annual effective tax rate, the amortization deduction that results in an increase to the deferred tax liability is recognized in the annual effective tax rate because a deferred tax asset cannot benefit from the taxable income associated with the indefinite-lived intangible asset's taxable temporary difference and a valuation allowance is required unless the related deferred tax asset or net operating loss carryforward does not expire and is in the same jurisdiction and of the same character. Inclusion of the deferred tax liability in the estimated annual effective tax rate applies whether one overall estimated annual effective rate is used or if an entity is computing a separate estimated annual effective tax rate for a particular jurisdiction. See section 20.4.2, *Ability to estimate the annual effective tax rate*, for further discussion when an entity cannot estimate an annual effective tax rate and section 20.2, *Operations taxable in multiple jurisdictions*, for discussion of excluding a separate jurisdiction from the overall effective tax rate.

20.3 Effect of new tax legislation (before the adoption of ASU 2019-12)

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Recognition

740-270-25-5

The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be recorded after the effective dates prescribed in the statutes and reflected in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a **deferred tax liability** or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate.

740-270-25-6

The tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year shall be recognized as of the enactment date of the change as tax expense (benefit) for the current year. See Example 6 (paragraph 740-270-55-44) for illustrations of accounting for changes caused by new tax legislation.

Initial Measurement

740-270-30-11

The effects of changes in judgment about beginning-of-year valuation allowances and effects of changes in tax laws or rates shall be excluded from the estimated annual effective tax rate calculation. See paragraph 740-270-25-5 for requirements related to when the estimated annual effective tax rate shall be adjusted to reflect changes in tax laws and rates that affect current year taxes payable or refundable.

Income Taxes — Interim Reporting

Implementation Guidance and Illustrations

Example 6: Effect of New Tax Legislation

740-270-55-44

The following Cases illustrate the guidance in paragraphs 740-270-25-5 through 25-6 for accounting in interim periods for the effect of new tax legislation on income taxes:

a. Legislation effective in a future interim period (Case A)

b. Effective date of new legislation (Case B).

Case A: Legislation Effective in a Future Interim Period

740-270-55-45

The assumed facts applicable to this Case follow.

740-270-55-46

For the full fiscal year, an entity anticipates ordinary income of $100,000. All income is taxable in one jurisdiction at a 50 percent rate. Anticipated tax credits for the fiscal year total $10,000. No events that do not have tax consequences are anticipated.

740-270-55-47

Computation of the estimated annual effective tax rate applicable to ordinary income is as follows.

Tax at statutory rate ($100,000 at 50%)	$ 50,000
Less anticipated tax credits	(10,000)
Net tax to be provided	$ 40,000
Estimated annual effective tax rate ($40,000 ÷ $100,000)	40%

740-270-55-48

Further, assume that new legislation creating additional tax credits is enacted during the second quarter of the entity's fiscal year. The new legislation is effective on the first day of the third quarter. As a result of the estimated effect of the new legislation, the entity revises its estimate of its annual effective tax rate to the following.

Tax at statutory rate ($100,000 at 50%)	$ 50,000
Less anticipated tax credits	(12,000)
Net tax to be provided	$ 38,000
Estimated annual effective tax rate ($38,000 ÷ $100,000)	38%

740-270-55-49

The effect of the new legislation shall not be reflected until it is effective or administratively effective. Accordingly, quarterly tax computations are as follows.

	Ordinary Income		Estimated Annual Effective Tax Rate	Tax		
Reporting Period	Reporting Period	Year-to-Date		Year-to-Date	Less Previously Provided	Reporting Period
First quarter	$ 20,000	$ 20,000	40%	$ 8,000	$ -	$ 8,000
Second quarter	20,000	40,000	40%	16,000	8,000	8,000
Third quarter	20,000	60,000	38%	22,800	16,000	6,800
Fourth quarter	40,000	100,000	38%	38,000	22,800	15,200
Fiscal year	$ 100,000					$ 38,000

Case B: Effective Date of New Legislation

740-270-55-50

Legislation generally becomes effective on the date prescribed in the statutes. However, tax legislation may prescribe changes that become effective during an entity's fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. For example, if the statutory tax rate applicable to calendar-year corporations were increased from 48 to 52 percent, effective January 1, the increased statutory rate might be administratively applied to a corporation with a fiscal year ending at June 30 in the year of the change by applying a 50 percent rate to its **taxable income** for the fiscal year, rather than 48 percent for the first 6 months and 52 percent for the last 6 months. In that case the legislation becomes effective for that entity at the beginning of the entity's fiscal year.

740-270-55-51

Applying this to specific legislation, an entity with a fiscal year other than a calendar year would account during interim periods for the reduction in the corporate tax rate resulting from the Revenue Act of 1978 through a revised annual effective tax rate calculation in the same way that the change will be applied to the entity's taxable income for the year. The revised annual effective tax rate would then be applied to pretax income for the year to date at the end of the current interim period.

ASC 740-10-45-15 requires that when deferred tax balances are adjusted for the effect of a change in tax laws or rates, as required by 740-10-35-4, the effects of such adjustments should be included in income from continuing operations in the period in which the new legislation is enacted. The effects of new tax legislation should not be recognized prior to enactment. In the case of US federal income taxes, the enactment date is the date the bill becomes law, even if the change in the tax law or rate is retroactive to an earlier date. In addition, for tax laws or rates that are changed retroactively by new tax legislation, entities should not restate prior interim periods for the retroactive tax legislation. The enactment date may not be near the beginning or end of a reporting period. Entities will need to estimate temporary differences as of the enactment date (i.e., estimate temporary differences (to the extent significant) using a short-period cut-off approach, estimate that temporary differences are generated and reverse ratably or estimate that temporary differences are generated in the same period as the financial reporting income occurs during the year).

ASC 740-270-25-5 says "[t]he tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be recorded after the effective dates prescribed in the statutes and reflected in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation." In most instances, a change in tax law is effective as of the beginning of a company's fiscal year (e.g., 1 January for a calendar-year company). When a change in tax laws or rates is enacted within a company's fiscal year and is effective in a subsequent interim period in that fiscal year, complexity is added to the determination of the effects of the change on a company's estimated annual effective tax rate. ASC 740-270-55-49 provides an example showing that a new law's effect on taxes currently payable is not reflected until the effective date when the change in tax law is enacted but becomes effective in a future interim period. While there may be other acceptable views, based on this example in ASC 740, we believe that it is most appropriate for a company's estimate of the payable for the current year to be included in the calculation of its estimated annual effective tax rate beginning on the effective date.

The effect of a change in tax laws or rates on deferred tax assets or liabilities should be recognized as a discrete event as of the enactment date and should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate. Similarly, the effects of a change in tax laws or rates on taxes currently payable or refundable for a prior year should be recognized as of the enactment date as a discrete event and not included in the estimated annual effective tax rate.

In some jurisdictions, tax legislation may prescribe changes that become effective during an entity's fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. In these cases, an entity may need to use a blended tax rate when determining its current year tax payable. To compute the blended rate, a company calculates the weighted average tax rate based on the ratio of days in the fiscal year prior to and after the enactment date. The following illustration demonstrates the effects of a rate change on the estimated annual effective tax rate when a change in tax rate is administratively effective to the beginning of an entity's fiscal year.

Illustration 20-1: Effects of a rate change on the estimated annual effective tax rate when a change in tax rate is administratively effective to the beginning of the fiscal year

Facts

Assume for the full fiscal year, an entity with a 30 June year-end anticipates ordinary taxable income of $100,000. All income is taxable in one jurisdiction at a 35% rate. All anticipated transactions will have tax consequences.

New legislation enacted on the last day of the entity's second quarter reduces the tax rate to 21%. The new tax rate is administratively effective as of the beginning of the company's fiscal year. The new legislation is administratively implemented by applying a portion of the change to the full fiscal year.

Analysis

The entity revises its EAETR computation using a blended tax rate of 28.0% (the weighted average of the 35% rate for the first half of the year and 21% rate for second half of the year):

Tax at statutory rate ($100,000 at 28.0%)	$	28,000

The effect of the new legislation is not reflected until it is effective or administratively effective. Accordingly, quarterly tax computations are as follows:

	Ordinary income		**Tax**			
Reporting period	**Quarter**	**Year to date**	**EAETR**	**Year to date**	**Less previously reported**	**Reporting period**
Q1	$ 20,000	$ 20,000	35.00%	$ 7,000	$ -	$ 7,000
Q2	20,000	40,000	28.00%	11,200	7,000	4,200
Q3	20,000	60,000	28.00%	16,800	11,200	5,600
Q4	40,000	100,000	28.00%	28,000	16,800	11,200
	$ 100,000					$ 28,000

See chapter 8, *An enacted change in tax laws or rates*, for further discussion on accounting for changes in tax laws or rates in the period of enactment.

20.3A Effect of new tax legislation (after the adoption of ASU 2019-12)

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12, which simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the existing guidance to promote more consistency. The amendments require an entity to reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the first interim period that includes the enactment date of the new legislation.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Non-PBEs may early adopt the guidance in interim or annual periods for which financial statements have not yet been made available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply this amendment prospectively.

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Recognition

General Recognition Approach

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

740-270-25-5

The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be reflected in the computation of the annual effective tax rate beginning in the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a **deferred tax liability** or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate.

740-270-25-6

The tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year shall be recognized as of the enactment date of the change as tax expense (benefit) for the current year. See Example 6 (paragraph 740-270-55-44) for illustrations of accounting for changes caused by new tax legislation.

Initial Measurement

Items Always Excluded from Estimated Annual Effective Tax Rate

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

740-270-30-11

The effects of changes in judgment about beginning-of-year valuation allowances and effects of changes in tax laws or rates on deferred tax assets or liabilities and taxes payable or refundable for prior years (in the case of a retroactive change) shall be excluded from the estimated annual effective tax rate calculation.

Income Taxes — Interim Reporting

Implementation Guidance and Illustrations

Example 6: Effect of New Tax Legislation

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

740-270-55-44

The following Example illustrates the guidance in paragraphs 740-270-25-5 through 25-6 for accounting in interim periods for the effect of new tax legislation on income taxes when legislation is effective in a future interim period.

a. Subparagraph superseded by Accounting Standards Update No. 2019-12.

b. Subparagraph superseded by Accounting Standards Update No. 2019-12.

Case A: Legislation Effective in a Future Interim Period

740-270-55-45

Editor's Note: Paragraph 740-270-55-45 will be amended upon transition, together with its heading:

> Legislation Effective in a Future Interim Period

The assumed facts applicable to this Example follow.

740-270-55-46

For the full fiscal year, an entity anticipates ordinary income of $100,000. All income is taxable in one jurisdiction at a 50 percent rate. Anticipated tax credits for the fiscal year total $10,000. No events that do not have tax consequences are anticipated.

740-270-55-47

Computation of the estimated annual effective tax rate applicable to ordinary income is as follows.

Tax at statutory rate ($100,000 at 50%)	$ 50,000
Less anticipated tax credits	(10,000)
Net tax to be provided	$ 40,000
Estimated annual effective tax rate ($40,000 ÷ $100,000)	40%

740-270-55-48

Further, assume that new legislation creating additional tax credits is enacted during the second quarter of the entity's fiscal year. The new legislation is effective on the first day of the third quarter. As a result of the estimated effect of the new legislation, the entity revises its estimate of its annual effective tax rate to the following.

Tax at statutory rate ($100,000 at 50%)	$ 50,000
Less anticipated tax credits	(12,000)
Net tax to be provided	$ 38,000
Estimated annual effective tax rate ($38,000 ÷ $100,000)	38%

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

740-270-55-49

The effect of the new legislation shall be reflected in the computation of the annual effective tax rate beginning in the first interim period that includes the enactment date of the new legislation. Accordingly, quarterly tax computations are as follows.

	Ordinary Income		Estimated Annual Effective Tax Rate	Tax		
Reporting Period	Reporting Period	Year-to-Date		Year-to-Date	Less Previously Provided	Reporting Period
First quarter	$ 20,000	$ 20,000	40%	$ 8,000	$ -	$ 8,000
Second quarter	20,000	40,000	38%	15,200	8,000	7,200
Third quarter	20,000	60,000	38%	22,800	15,200	7,600
Fourth quarter	40,000	100,000	38%	38,000	22,800	15,200
Fiscal year	$ 100,000					$ 38,000

ASC 740-10-45-15 states that when deferred tax balances are adjusted for the effect of a change in tax laws or rates, as required by 740-10-35-4, the effects of such adjustments must be included in income from continuing operations in the period in which the new legislation is enacted. In addition, ASC 740-270-25-6 indicates that the tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year should be recognized as of the enactment date of the change as tax expense (benefit) for the current year. However, ASC 740-270-25-5 states "[t]he tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be reflected in the computation of the annual effective tax rate beginning in the first interim period that includes the enactment date of the new legislation." ASC 740-270-55-45 through -49 provides an example showing a new law's effect reflected in the computation of the annual effective tax rate beginning in the first period that includes the enactment date of the new legislation.

In most instances, a change in tax law is effective as of the beginning of a company's fiscal year (e.g., 1 January for a calendar-year company). The effects of new tax legislation should not be recognized prior to enactment. In the case of US federal income taxes, the enactment date is the date the bill becomes law, even if the change in the tax law or rate is retroactive to an earlier date. In addition, for tax laws or rates that are changed retroactively by new tax legislation, entities should not restate prior interim periods for the retroactive tax legislation. If the enactment date is not near the beginning or end of a reporting period, entities will need to estimate temporary differences as of the enactment date (i.e., estimate temporary differences, to the extent significant, using a short-period cut-off approach, estimate that temporary differences are generated and reverse ratably or estimate that temporary differences are generated in the same period as the financial reporting income occurs during the year).

The effect of a change in tax laws or rates on deferred tax assets or liabilities should be recognized as a discrete event as of the enactment date and should not be allocated to subsequent interim periods by adjusting the estimated annual effective tax rate. Similarly, the effects of a change in tax laws or rates on taxes currently payable or refundable for a prior year should also be recognized as of the enactment date as a discrete event and not be included in the estimated annual effective tax rate.

In some jurisdictions, tax legislation may prescribe changes that become effective during an entity's fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. In these cases, an entity may need to use a blended tax rate when determining its current year tax payable. To compute the blended rate, a company calculates the weighted average tax rate based on the ratio of days in the fiscal year before and after the enactment date. The following illustration demonstrates the effects of a rate change on the estimated annual effective tax rate when a change in tax rate is administratively effective to the beginning of an entity's fiscal year.

Illustration 20-1A: Effects of a rate change on the estimated annual effective tax rate when a change in tax rate is administratively effective to the beginning of the fiscal year

Facts

Assume for the full fiscal year, an entity with a 30 June year end anticipates ordinary taxable income of $100,000. All income is taxable in one jurisdiction at a 35% rate. All anticipated transactions will have tax consequences.

New legislation enacted on the last day of the entity's second quarter reduces the tax rate to 21%. The new tax rate is administratively effective as of the beginning of the company's fiscal year. The new legislation is administratively implemented by applying a portion of the change to the full fiscal year.

Analysis

The entity revises its estimated annual effective tax rate (EAETR) computation using a blended tax rate of 28.0% (the weighted average of the 35% rate for the first half of the year and 21% rate for second half of the year):

Tax at statutory rate ($100,000 at 28.0%)	$	28,000

The effect of the new legislation is not reflected until it is effective or administratively effective. Accordingly, quarterly tax computations are as follows:

	Ordinary income		**Tax**			
Reporting period	**Quarter**	**Year to date**	**EAETR**	**Year to date**	**Less previously reported**	**Reporting period**
Q1	$ 20,000	$ 20,000	35.00%	$ 7,000	$ -	$ 7,000
Q2	20,000	40,000	28.00%	11,200	7,000	4,200
Q3	20,000	60,000	28.00%	16,800	11,200	5,600
Q4	40,000	100,000	28.00%	28,000	16,800	11,200
	$ 100,000					$ 28,000

See chapter 8, *An enacted change in tax laws or rates*, for more details.

20.4 Computation of interim period tax (or benefit)

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12, which simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the legacy guidance to promote more consistency. The amendments eliminate a legacy exception to the guidance on accounting for income taxes for interim periods. Under the new guidance, an entity would no longer limit the tax benefit recognized in an interim period if it expects to realize a tax benefit for the entire amount of the anticipated year-to-date and full-year ordinary loss.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Non-PBEs may early adopt the guidance in interim or annual periods for which financial statements have not yet been made available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply this amendment prospectively.

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Recognition

740-270-25-7

The effect of a change in the beginning-of-the-year balance of a **valuation allowance** as a result of a change in judgment about the realizability of the related deferred tax asset in future years shall not be apportioned among interim periods through an adjustment of the effective tax rate but shall be recognized in the interim period in which the change occurs.

740-270-25-8

This guidance establishes requirements for considering whether the amount of income tax benefit recognized in an interim period shall be limited due to interim period losses.

740-270-25-9

The tax effects of losses that arise in the early portion of a fiscal year shall be recognized only when the tax benefits are expected to be either:

a. Realized during the year.

b. Recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Subtopic 740-10.

740-270-25-10

An established seasonal pattern of loss in early interim periods offset by income in later interim periods shall constitute evidence that realization is more likely than not, unless other evidence indicates the established seasonal pattern will not prevail.

740-270-25-11

The tax effects of losses incurred in early interim periods may be recognized in a later interim period of a fiscal year if their realization, although initially uncertain, later becomes more likely than not. When the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision shall be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized.

Initial Measurement

740-270-30-5

The estimated annual effective tax rate, described in paragraphs 740-270-30-6 through 30-8, shall be applied to the year-to-date ordinary income (or loss) at the end of each interim period to compute the year-to-date tax (or benefit) applicable to ordinary income (or loss).

740-270-30-22

If an entity has ordinary income for the year to date at the end of an interim period and anticipates ordinary income for the fiscal year, the interim period tax shall be computed in accordance with paragraph 740-270-30-5.

740-270-30-23

See Example 1, Cases A and B1 (paragraphs **740-270-55-4 through 55-6**) for illustrations of the application of these requirements.

740-270-30-24

If an entity has an ordinary loss for the year to date at the end of an interim period and anticipates ordinary income for the fiscal year, the interim period tax benefit shall be computed in accordance with paragraph 740-270-30-5, except that the year-to-date tax benefit recognized shall be limited to the amount determined in accordance with paragraphs 740-270-30-30 through 30-33.

740-270-30-25

See Example 1, Cases B2 and B3 (paragraphs **740-270-55-7 through 55-8)** for illustrations of the application of these requirements.

740-270-30-26

If an entity has ordinary income for the year to date at the end of an interim period and anticipates an ordinary loss for the fiscal year, the interim period tax shall be computed in accordance with paragraph 740-270-30-5. The estimated tax benefit for the fiscal year, used to determine the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8, shall not exceed the tax benefit determined in accordance with paragraphs 740-270-30-30 through 30-33.

740-270-30-27

See Example 2, Cases A2 and C2 (paragraphs **740-270-55-16** and **740-270-55-20**) for illustrations of the application of these requirements.

740-270-30-28

If an entity has an ordinary loss for the year to date at the end of an interim period and anticipates an ordinary loss for the fiscal year, the interim period tax benefit shall be computed in accordance with paragraph 740-270-30-5. The estimated tax benefit for the fiscal year, used to determine the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8, shall not exceed the tax benefit determined in accordance with paragraphs 740-270-30-30 through 30-33. In addition to that limitation in the effective rate computation, if the year-to-date ordinary loss exceeds the anticipated ordinary loss for the fiscal year, the tax benefit recognized for the year to date shall not exceed the tax benefit determined, based on the year-to-date ordinary loss, in accordance with paragraphs 740-270-30-30 through 30-33.

Pending Content:

Transition Date: *(P) December 16, 2020; (N) December 16, 2021* | **Transition Guidance:** 740-10-65-8

If an entity has an ordinary loss for the year to date at the end of an interim period and anticipates an ordinary loss for the fiscal year, the interim period tax benefit shall be computed in accordance with paragraph 740-270-30-5. The estimated tax benefit for the fiscal year, used to determine the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8, shall not exceed the tax benefit determined in accordance with paragraphs 740-270-30-30 through 30-33.

740-270-30-29

See Example 2 Cases A1, B, and C1 (paragraphs **740-270-55-15**, **740-270-55-17**, and **740-270-55-19**) for illustrations of the application of these requirements.

740-270-30-30

Paragraph 740-270-25-9 provides that a tax benefit shall be recognized for a loss that arises early in a fiscal year if the tax benefits are expected to be either of the following:

a. Realized during the year

b. Recognizable as a deferred tax asset at the end of the year in accordance with the requirements established in Subtopic 740-10. Paragraph 740-10-30-5(e) requires that a valuation allowance be recognized if it is more likely than not that the tax benefit of some portion or all of a deferred tax asset will not be realized.

740-270-30-31

The limitations described in the preceding paragraph shall be applied in determining the estimated tax benefit of an ordinary loss for the fiscal year, used to determine the estimated annual effective tax rate and the year-to-date tax benefit of a loss.

740-270-30-33

If the tax benefit relates to an estimated ordinary loss for the fiscal year, it shall be considered in determining the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8. If the tax benefit relates to a year-to-date ordinary loss, it shall be considered in computing the maximum tax benefit that shall be recognized for the year to date.

Subsequent Measurement

740-270-35-4

As indicated in paragraph 740-270-30-5, the estimated annual effective tax rate shall be applied to the year-to-date **ordinary income (or loss)** at the end of each interim period to compute the year-to-date **tax (or benefit)** applicable to ordinary income (or loss). The interim period tax (or benefit) related to ordinary income (or loss) shall be the difference between the amount so computed and the amounts reported for previous interim periods of the fiscal year.

> *740-270-35-5*
>
> One result of the year-to-date computation is that, if the tax benefit of an ordinary loss that occurs in the early portions of the fiscal year is not recognized because it is more likely than not that the tax benefit will not be realized, tax is not provided for subsequent ordinary income until the **unrecognized tax benefit** of the earlier ordinary loss is offset (see paragraphs 740-270-25-9 through 25-11). As indicated in paragraph 740-270-30-31, the limitations described in paragraph 740-270-25-9 shall be applied in determining the estimated tax benefit of an ordinary loss for the fiscal year, used to determine the estimated annual effective tax rate, and the year-to-date tax benefit of a loss. As indicated in paragraph 740-270-30-33, if the tax benefit relates to an estimated ordinary loss for the fiscal year, it shall be considered in determining the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8. If the tax benefit relates to a year-to-date ordinary loss, it shall be considered in computing the maximum tax benefit that shall be recognized for the year to date.
>
> *Other Presentation Matters*
>
> *740-270-45-5*
>
> Paragraph 740-270-25-11 establishes the requirement that when the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision shall be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized.

Although ASC 270 rejects the discrete approach to interim reporting (i.e., each interim period determined as if the interim period were an annual period), ASC 740 is based on a discrete approach that measures a deferred tax liability or asset as of a given point in time. ASC 740 requires the recognition of a deferred tax asset for deductible temporary differences and carryforwards. A valuation allowance is required if it is more likely than not that some portion, or all, of the deferred tax asset will not be realized. ASC 740-270-25-7 through ASC 740-270-25-11 discusses how a tax benefit related to current year or prior year operating losses should be treated in the estimated annual effective tax rate computation.

For operating losses that originated in the current year, the estimated annual effective tax rate computation should include the tax benefit of those losses if the losses are expected to be (1) realized during the current fiscal year or (2) recognizable as a deferred tax asset at the end of the fiscal year. However, the expected benefit would be limited to the estimated net deferred tax asset associated with the current operating losses (i.e., the expected tax benefit should be reduced by any estimated valuation allowance if it is more likely than not that some portion or all of a resulting deferred tax asset will not be realized). That is, the excess tax benefits are not recognized in the interim period if the tax benefit attributable to the company's year-to-date operating loss exceeds either of the following amounts:

- The amount that will be offset by anticipated operating income in subsequent interim periods in the current year (of sufficient reliability in accordance with the more-likely-than-not standard)
- The amount that will qualify for recognition as a deferred tax asset without a valuation allowance at year end (or as a receivable if a carryback in a prior period is available)

Further, before the adoption of ASU 2019-12, if an entity has a year-to-date ordinary loss that exceeds the anticipated ordinary loss for the year and the entity expects to realize a tax benefit for the anticipated ordinary loss for the year, the exception in ASC 740-270-30-28 limits the income tax benefit recognized in the year-to-date interim period to the amount of the tax benefit determined on the basis of the year-to-date ordinary loss. That is, an entity is not permitted to recognize tax benefits in excess of the amount that would be recognized if its year-to-date ordinary loss were the anticipated ordinary loss for the year. The limitations discussed above should also apply when differences in tax rates exist that would increase the effective benefit rate during periods of loss. ASU 2019-12 removes this exception so that, after adoption, an entity would no longer limit the tax benefit recognized in an interim period if it expects to realize a tax benefit in accordance with ASC 740-270-30-30.

See section 20.8.2, *Accounting for income taxes if an 'ordinary' loss is anticipated for the fiscal year*, for examples.

For operating losses that originated in the prior year(s) (e.g., a deferred tax asset existed at the end of the prior fiscal year) for which a full or partial valuation allowance was provided, the effective tax rate computation should include the tax benefit of those losses if the tax benefit is expected to be realized as a result of ordinary income in the current year. Otherwise, the tax benefit should be recognized in the current interim period to the extent that ordinary or "other" income in the current interim period is available to realize the operating loss carryforward, and the tax benefit should not be allocated to subsequent interim periods by an adjustment to the estimated annual effective tax rate. Similarly, the effect of a change in a valuation allowance that results from a change in judgment about the realizability of the related deferred tax asset in future years should be recognized as a discrete event in the interim period that the change in judgment is made and not apportioned to other interim periods.

Therefore, for current year changes in a valuation allowance for deferred tax assets as of the beginning of the fiscal year, the treatment for interim financial reporting purposes is dependent on whether the benefit is expected to be realized because of current year ordinary income or "other" income, or alternatively, because of expectations about future years' income. If the benefit is expected to be realized because of both current year ordinary income and future years' income (of any type), the benefit would be allocated between the interim period that includes the date of the change in judgment (for the future-year effect) and inclusion in the annual effective rate (for the current year effect). In addition, if the benefit is expected to be realized because of current year income other than ordinary income, the effect of the change would be included in the interim period that includes the "other" income.

20.4.1 Exception to the general principle of allocating income tax expense (benefit) to continuing operations (before the adoption of ASU 2019-12)

Standard setting

In December 2019, as part of its broader simplification initiative, the FASB issued ASU 2019-12, which simplifies the accounting for income taxes by eliminating some exceptions to the general approach in ASC 740 and clarifying certain aspects of the legacy guidance to promote more consistency. The amendments eliminate the exception in ASC 740-20-45-7 to the general guidance on how to allocate income tax expense or benefit for the year to continuing operations, discontinued operations, other comprehensive income and other changes or credits recorded directly to shareholder's equity.

For PBEs, the guidance was effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022.

Non-PBEs may early adopt the guidance in interim or annual periods for which financial statements have not yet been made available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect to early adopt must adopt all the amendments in the same period.

Entities must apply this amendment prospectively.

The exception to the general principle of intraperiod tax allocations described in ASC 740-20-45-7 also applies to interim periods if a company anticipates having an ordinary loss from continuing operations for the full fiscal year. This exception requires that all items (i.e., discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations that should be allocated to continuing operations. The exception in ASC 740-20-45-7 applies in all situations in which there is a loss from continuing operations while there is income from other items outside of continuing operations, even if a company has recorded a full valuation allowance at the beginning and end of the reporting period and the overall tax provision for the year is zero (i.e., a benefit would be recognized in continuing operations even though the loss from continuing operations does not provide a current period incremental tax benefit). For further discussion on applying this exception to the general principle, see section 15.2.1.1, *Exception to general principle of allocation to continuing operations (before the adoption of ASU 2019-12)*.

Provided a loss from continuing operations is anticipated for the full fiscal year, a company should apply the exception in ASC 740-20-45-7 for interim reporting if there is income from other items outside of continuing operations that has been recognized in an interim reporting period. This would include situations in which a company has recorded a full valuation allowance at the beginning and end of the period and the overall tax provision for the year is expected to be zero (i.e., a benefit would be recognized in continuing operations even though the loss from continuing operations does not provide a current period incremental tax benefit). This exception only relates to the allocation of the current period tax provision and does not change a company's overall tax provision. The following example illustrates how to apply the exception provided in ASC 740-20-45-7 to interim reporting periods.

Illustration 20-2: Quarterly computation of tax expense when the exception in ASC 740-20-45-7 applies

Facts

Assume Company A anticipates an ordinary loss of $100 million for fiscal year 20X9 or $25 million each quarter. In addition, assume that in the first quarter of 20X9 Company A disposed of one of its divisions and recognized income from discontinued operations of $40 million. Further, assume the following:

- A full valuation allowance exists at the beginning and end of the year.
- There are no permanent differences.
- There are no changes in other temporary differences during the year.
- The statutory tax rate is 40%.
- Actual results equal anticipated results.

Analysis (before adoption of ASU 2019-12)

When the guidance in ASC 740-20-45-7 is applied to interim reporting periods, the estimated effective tax rate should be recomputed at the end of each reporting period using current estimates of the ordinary loss expected for the fiscal year and year-to-date amounts already incurred for all other items (i.e., significant unusual or infrequently occurring items, or discontinued operations). It should be noted that significant unusual or infrequently occurring items, or discontinued operations cannot be anticipated in setting the effective tax rate. In this example, Company A's estimated effective tax rate prior to disposing of one of its divisions is 0% because an ordinary loss is expected for the full fiscal year and it is not more likely than not that Company A will be able to realize any tax benefits resulting from the ordinary loss (i.e., a full valuation allowance exists at the beginning and end of the year).

The intraperiod allocation provisions in ASC 740 allow Company A to report a tax benefit of $16 million ($40 million of realizable ordinary loss x 40% statutory tax rate) for the fiscal year on the ordinary loss from continuing operations because of the $40 million of income recognized from discontinued operations in Q1. Therefore, Company A recomputed its estimated effective tax rate at the end of Q1 to be 16% ($16 million tax benefit / $100 million anticipated ordinary loss for fiscal year 20X9). As no other taxable income or change in valuation allowance is assumed to occur during the year, the recomputed estimated effective tax rate is applied to the year-to-date ordinary income (or loss) at the end of each interim reporting period to compute the year-to-date tax expense (or benefit) related to the ordinary income (or loss). The interim reporting period tax expense (or benefit) is the difference between the current period year-to-date calculated amount and the previous interim period year-to-date amount.

The quarterly computation of tax expense or (benefit) attributable to the ordinary loss from continuing operations and the income from discontinued operations using the provisions in ASC 740-20-45-7 is as follows (in thousands):

	Tax (benefit) attributable to ordinary loss from continuing operations			Tax expense attributable to income from discontinued operations	
Quarter	**Computed year to date[(a)]**	**Less previously provided**	**Reporting period**	**Year-to-date[(b)]**	**Reporting period**
First quarter	$(4,000)	$ –	$ (4,000)	$ 16,000	$16,000
Second quarter	(8,000)	(4,000)	(4,000)	16,000	–
Third quarter	(12,000)	(8,000)	(4,000)	16,000	–
Fourth quarter	(16,000)	(12,000)	(4,000)	16,000	–
Fiscal year			$(16,000)		$16,000

(a) Amount represents the year-to-date ordinary loss from continuing operations for each quarter multiplied by the adjusted estimated annual effective tax rate of 16%. The tax benefit that can be recognized for the year-to-date period is limited to the $16 million of tax expense on discontinued operations.

(b) Amount represents the $40 million of income from discontinued operations multiplied by the statutory tax rate of 40%.

As noted above, although the overall tax provision for the year will be zero, the tax provision for each quarter is not zero because the tax effect on ordinary income from continuing operations is computed using the estimated annual effective tax rate, considering the income from discontinued operations, while the tax effect on income from discontinued operations is treated as a discrete event in the period it occurs.

Analysis (after adoption of ASU 2019-12)

After the adoption of ASU 2019-12, Company A will no longer consider the tax effects of the income from discontinued operations when determining the amount of tax benefit from the loss in continuing operations to be recognized. Because Company A does not expect to realize a tax benefit for the current year losses that exceed income from discontinued operations, Company A will reflect a tax provision of zero.

The following illustrates how the effective annual tax rate will be determined to allocate income tax expense to continuing operations after the adoption of ASU 2019-06 (in thousands):

Forecasted loss from continuing operations:	$ (100,000)
Income from discontinued operations:	40,000
Net loss before taxes	$ (60,000)
Tax rate	40%
Tax benefit	$ (24,000)
Valuation allowance	24,000
Tax expense (benefit)	$ –
Effective tax rate:	0%

Because Company A no longer considers income from other items in determining the amount of tax benefit to allocate to continuing operations and the losses require a full valuation allowance, the estimated annual effective tax rate for the year is zero percent. Because the overall tax expense for the year and the amount allocated to continuing operations are zero, no income tax expense or benefit is allocated to discontinued operations. Therefore, the tax provision in this illustration allocated to continuing operations and discontinued operations for each quarter would be zero.

20.4.2 Ability to estimate the annual effective tax rate

Under ASC 740-270, each interim period is considered an integral part of the annual period, and tax expense is measured using an estimated annual effective rate. A company is required, at the end of each interim reporting period, to make its best estimate of the annual effective tax rate for the full fiscal year and use that rate to provide for income taxes on a current year-to-date basis. The estimated effective tax rate should reflect enacted federal, state and local income tax rates; foreign tax rates and credits; percentage depletion; capital gains rates; other taxes and credits; and available tax-planning alternatives. The rate should be revised, if necessary, as of the end of each successive interim period during the fiscal year to the company's best current estimate of its annual effective tax rate.

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Recognition

740-270-25-3

If an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

Initial Measurement

740-270-30-18

Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on evaluations of possible future events and transactions and may be subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate.

ASC 740-270-25-3 addresses the consequences of a company's inability to reliably estimate some or all the information that is ordinarily required to determine the annual effective tax rate in the financial statements for an interim period. When a company is unable to estimate a part of its ordinary income (loss) or the related tax expense (benefit) but is able to make a reliable estimate of its annual effective tax rate, the tax expense (benefit) applicable to the item that cannot be estimated should be reported in the interim period in which the item is reported.

In some cases, minor changes in estimated ordinary income can have a significant effect on the estimated annual effective rate. A common example of this is when a company is estimating that its operating results will be at or about break even or when events without tax consequences (i.e., permanent differences) are significant as compared to estimated income. The FASB specifically addressed this concern as part of its deliberations on FIN 18 and noted the following:

Non-authoritative literature

FIN 18: FASB Interpretation No. 18: Accounting for Income Taxes in Interim Periods an interpretation of APB Opinion No. 28

82. Several respondents recommended that an estimated annual effective tax rate not be applied in various specific circumstances. Circumstances mentioned included (a) if the rate is extremely high or low, (b) if an "ordinary" loss is expected for the year, and (c) if an enterprise has a year-to-date "ordinary" income and anticipates an "ordinary" loss for the year. An example cited was an enterprise that experienced "ordinary" income in an early part of the year and anticipated offsetting "ordinary" losses in the balance of the year, resulting in zero estimated "ordinary" income and no tax (or benefit). Such unusual circumstances may result in significant variations in the customary relationship between income tax expense and pretax accounting income in interim periods and footnote 2 to paragraph 19 of Opinion No. 28 requires disclosure of the reasons for those variations. Footnote 7 to paragraph 8 of this Interpretation states that if a reliable estimate cannot be made the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. What is and what is not a "reliable estimate" is a matter of judgment. In the break-even situation cited above, a small change in the enterprise's estimated "ordinary" income could produce a large change in the estimated annual effective tax rate. In those circumstances, a break-even estimate would not be reliable if a small change in the estimated "ordinary" income were considered likely to occur.

Therefore, companies in situations in which minor changes in estimated annual ordinary income can have significant effects on the estimated annual effective tax rate need to consider whether a reliable estimate of the annual effective tax rate can be made. If a reliable estimate of the annual effective tax rate cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate.

20.5 Reversal of taxable temporary differences

ASC 740-270-30-32 addresses the reversal of existing taxable temporary differences when it is a source of evidence for recognition of tax benefits.

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Initial Measurement

740-270-30-32

The reversal of existing taxable temporary differences may be a source of evidence in determining whether a tax benefit requires limitation. A **deferred tax liability** related to existing taxable temporary differences is a source of evidence for recognition of a tax benefit when all of the following conditions exist:

a. An entity anticipates an ordinary loss for the fiscal year or has a year-to-date ordinary loss in excess of the anticipated ordinary loss for the fiscal year.

b. The tax benefit of that loss is not expected to be realized during the year.

c. Recognition of a deferred tax asset for that loss at the end of the fiscal year is expected to depend on **taxable income** from the reversal of existing taxable temporary differences (that is, a higher deferred tax asset valuation allowance would be necessary absent the existing taxable temporary differences).

The requirement to consider the reversal of existing taxable temporary differences is illustrated in Example 2, Case D (see paragraph 740-270-55-21).

Implementation Guidance and Illustrations

Case D: Reversal of Net Deferred Tax Credits

740-270-55-21

The entity anticipates a fiscal year ordinary loss. The loss cannot be carried back, and future profits exclusive of reversing temporary differences are unlikely. Net deferred tax liabilities arising from existing net taxable temporary differences are present. A portion of the existing net taxable temporary differences relating to those liabilities will reverse within the loss carryforward period. Computation of the estimated annual effective tax rate to be used (see paragraphs 740-270-30-32 through 30-33) is as follows.

Estimated fiscal year ordinary loss		$ (100,000)
The tax benefit to be recognized is the lesser of:		
Tax effect of the loss carryforward ($100,000 at 50% statutory rate)	$ 50,000	
Amount of the net deferred tax liabilities that would otherwise have been settled during the carry-forward period	$ 24,000	
Estimated annual effective tax rate ($24,000 ÷ $100,000)		24%

740-270-55-22

Quarterly tax computations are as follows.

	Ordinary Loss			Tax Benefit		
Reporting Period	Reporting Period	Year-to-Date	Estimated Annual Effective Tax Rate	Year-to-Date	Less Previously Provided	Reporting Period
First quarter	$ (20,000)	$ (20,000)	24%	$ (4,800)	$ -	$ (4,800)
Second quarter	(20,000)	(40,000)	24%	(9,600)	(4,800)	(4,800)
Third quarter	(20,000)	(60,000)	24%	(14,400)	(9,600)	(4,800)
Fourth quarter	(40,000)	(100,000)	24%	(24,000)	(14,400)	(9,600)
Fiscal year	$ (100,000)					$ (24,000)

740-270-55-23

Note that changes in the timing of the loss by quarter would not change this computation.

20.6 Tax (or benefit) applicable to significant unusual or infrequently occurring items, or discontinued operations

20.6.1 Basis of tax provision

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Recognition

740-270-25-12

If an entity has a significant unusual or infrequently occurring loss or a loss from discontinued operations, the tax benefit of that loss shall be recognized in an interim period when the tax benefit of the loss is expected to be either:

a. Realized during the year

b. Recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Subtopic 740-10.

Realization would appear to be more likely than not if future **taxable income** from (ordinary) income during the current year is expected based on an established seasonal pattern of loss in early interim periods offset by income in later interim periods. The guidance in this paragraph also applies to a tax benefit resulting from an employee share-based payment award within the scope of Topic 718 on stock compensation when the deduction for the award for tax purposes is greater than the cumulative cost of the award recognized for financial reporting purposes.

740-270-25-13

See Example 3, Cases A and B (paragraphs **740-270-55-26 through 55-28**) for example computations involving unusual or infrequently occurring losses.

740-270-25-14

If recognition of a deferred tax asset at the end of the fiscal year for all or a portion of the tax benefit of the loss depends on taxable income from the reversal of existing taxable temporary differences, see paragraphs 740-270-30-32 through 30-33 for guidance. If all or a part of the tax benefit is not realized and future realization is not more likely than not in the interim period of occurrence but becomes more likely than not in a subsequent interim period of the same fiscal year, the previously **unrecognized tax benefit** shall be reported that subsequent interim period in the same manner that it would have been reported if realization had been more likely than not in the interim period of occurrence, that is, as a tax benefit relating to continuing operations or discontinued operations. See Subtopic 740-20 for the requirements to allocate total income tax expense (or benefit).

Initial Measurement

740-270-30-12

Taxes related to an employee share-based payment award within the scope of Topic 718 when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes, significant unusual or infrequently occurring items that will be reported separately or items that will be reported net of their related tax effect shall be excluded from the estimated annual effective tax rate calculation.

Other Presentation Matters

740-270-45-3

Discontinued operations that will be presented net of related tax effects in the financial statements for the fiscal year shall be presented net of related tax effects in interim financial statements. Unusual or infrequently occurring items that will be separately disclosed in the financial statements for the fiscal year shall be separately disclosed as a component of pretax income from continuing operations, and the **tax (or benefit)** related to those items shall be included in the tax (or benefit) related to continuing operations. See paragraphs 740-270-25-12 through 25-14 for interim period recognition guidance when an entity has a significant unusual or infrequently occurring loss or a loss from discontinued operations. See paragraphs 740-270-45-7 through 45-8 for the application of interim period allocation requirements to recognized income tax expense (or benefit) and discontinued operations. See Example 7 (paragraph 740-270-55-52) for an illustration of the income statement display of these items.

Implementation Guidance and Illustrations

Example 3: Accounting for Income Taxes Applicable to Unusual or Infrequently Occurring Items 740-270-55-24

The following Cases illustrate accounting for income taxes applicable to unusual or infrequently occurring items when ordinary income is expected for the fiscal year:

a. Realization of the tax benefit is more likely than not at date of occurrence (Case A)

b. Realization of the tax benefit not more likely than not at date of occurrence (Case B).

740-270-55-25

Cases A and B illustrate the computation of the tax (or benefit) applicable to unusual or infrequently occurring items when ordinary income is anticipated for the fiscal year. These Cases are based on the assumptions and computations presented in paragraph 740-270-55-3 and Example 1, Cases A and B (see paragraphs 740-270-55-4 through 55-8), plus additional information supplied in Cases A and B of this Example. The computation of the tax (or benefit) applicable to the ordinary income is not affected by the occurrence of an unusual or infrequently occurring item; therefore, each Case refers to one or more of the illustrations of that computation in Example 1, Cases A and B (see paragraphs 740-270-55-4 through 55-8), and does not reproduce the computation and the assumptions. The income statement display for tax (or benefit) applicable to unusual or infrequently occurring items is illustrated in Example 7 (see paragraph 740-270-55-52).

Case A: Realization of the Tax Benefit Is More Likely Than Not at Date of Occurrence

740-270-55-26

As explained in paragraph 740-270-55-25, this Case is based on the computations of tax applicable to ordinary income that are illustrated in Example 1, Case A (see paragraph 740-270-55-4). In addition, the entity experiences a tax-deductible unusual or infrequently occurring loss of $50,000 (tax benefit $25,000) in the second quarter. Because the loss can be carried back, it is more likely than not that the tax benefit will be realized at the time of occurrence. Quarterly tax provisions are as follows.

			Tax (or Benefit) Applicable to	
Reporting Period	Ordinary Income	Unusual or Infrequently Occurring	Ordinary Income	Unusual or Infrequently Occurring
First quarter	$ 20,000		$ 8,000	
Second quarter	20,000	$ (50,000)	8,000	$ (25,000)
Third quarter	20,000		8,000	
Fourth quarter	40,000		16,000	
Fiscal year	$ 100,000	$ (50,000)	$ 40,000	$ (25,000)

740-270-55-27

Note that changes in assumptions would not change the timing of the recognition of the tax benefit applicable to the unusual or infrequently occurring item as long as realization is more likely than not.

Case B: Realization of the Tax Benefit Not More Likely Than Not at Date of Occurrence

740-270-55-28

As explained in paragraph 740-270-55-25, this Case is based on the computations of tax applicable to ordinary income that are illustrated in Example 1, Cases A and B1 (see paragraphs 740-270-55-4 through 55-6). In addition, the entity experiences a tax-deductible unusual or infrequently occurring loss of $50,000 (potential benefit $25,000) in the second quarter. The loss cannot be carried back, and available evidence indicates that a **valuation allowance** is needed for all of the deferred tax asset. As a result, the tax benefit of the unusual or infrequently occurring loss is recognized only to the extent of offsetting ordinary income for the year to date. Quarterly tax provisions under two different assumptions for the occurrence of ordinary income are as follows.

			Tax (or Benefit) Applicable to				
			Ordinary Income (Loss)		Unusual or Infrequently Occurring Loss		
Assumptions and Reporting Period	Ordinary Income (Loss)	Unusual or Infrequently Occurring Loss	Reporting Period	Year-to-Date	Year-to-Date	Less Previously Provided	Reporting Period
Income in all quarters:							
First quarter	$ 20,000		$ 8,000	$ 8,000			
Second quarter	20,000	$ (50,000)	8,000	16,000	$ (16,000)	$ -	$ (16,000)
Third quarter	20,000		8,000	24,000	(24,000)	(16,000)	(8,000)
Fourth quarter	40,000		16,000	40,000	(25,000)	(24,000)	(1,000)
Fiscal year	$ 100,000	$ (50,000)	$ 40,000				$ (25,000)
Income and loss quarters:							
First quarter	$ 40,000		$ 16,000	$ 16,000			
Second quarter	40,000	$ (50,000)	16,000	32,000	$ (25,000)	$ -	$ (25,000)
Third quarter	(20,000)		(8,000)	24,000	(24,000)	(25,000)	1,000
Fourth quarter	40,000		16,000	40,000	(25,000)	(24,000)	(1,000)
Fiscal year	$ 100,000	$ (50,000)	$ 40,000				$ (25,000)

A company is required, at the end of each interim reporting period, to make its best estimate of the annual effective tax rate for the full fiscal year and use that rate to provide for income taxes on a current year-to-date basis. The annual effective tax rate is applied to ordinary income. A frequently asked question is whether the tax effects of a transaction should be reported as a discrete event in the provision or considered in the annual effective tax rate when reporting that event in interim financial statements. An initial step in evaluating whether the tax effects of a transaction should be reported as a discrete event in the provision or in the annual effective tax rate is determining whether the transaction or event would be included in ordinary income. That is, is the item (before considering related income tax effects) included in ordinary income?

The ASC Master Glossary defines "ordinary income (or loss)" and the terms unusual or infrequently occurring as follows:

> Ordinary income (or loss) refers to income (or loss) from continuing operations before income taxes (or benefits) excluding significant unusual or infrequently occurring items. Discontinued operations and cumulative effects of changes in accounting principles are also excluded from this term. The term is not used in the income tax context of ordinary income versus capital gain. The meaning of unusual or infrequently occurring items is consistent with their use in the definition of the term **unusual nature** and **infrequency of occurrence**.

The following are excerpts from the ASC Master Glossary definition of unusual nature and infrequency of occurrence as it relates to unusual and infrequent:

> **Unusual nature** — The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates (see ASC 220-20-60-1).
>
> **Infrequency of occurrence** — The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates (see ASC 220-20-60-1).

Income taxes related to an employee share-based payment award within the scope of ASC 718, when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes, as well as significant unusual items or infrequently occurring items, are reported as discrete events (i.e., not included in the annual effective tax rate) when the transaction itself is separately reported or reported net of the related tax effects (i.e., discontinued operations). This description of unusual or infrequently occurring includes the following:

- Unusual items
- Infrequently occurring items
- Discontinued operations (see section 20.6.2, *Discontinued operations*)

In addition to being unusual or infrequently occurring, a transaction also must be significant to be excluded from ordinary income (and therefore excluded from the effective tax rate calculation). That is, the tax effects of a transaction generally are reported discretely when the transaction is both significant *and* either unusual or infrequently occurring (as those terms are discussed in ASC 220). Significance generally does not, in and of itself, allow for a transaction to be recognized discretely. The tax effects of discontinued operations are always excluded from the annual effective tax rate calculation.

Deciding whether significant events should be considered unusual or infrequently occurring items can be challenging. For example, we often receive questions regarding whether a significant impairment of nondeductible goodwill would be considered an unusual or infrequently occurring item that requires discrete treatment, or should it be considered a component of the estimated annual effective tax rate. We have found that the determination of whether a nondeductible goodwill impairment should be classified as an unusual or infrequently occurring item requires careful consideration of the relevant facts and circumstances as well as expectations of the future. The definition of unusual nature provides that the transaction or event is highly abnormal historically and unrelated to the ordinary and typical activities of the entity. Similarly, the definition of infrequency of occurrence provides that the transaction or event is not expected to recur in the future based on the operating environment of the entity.

A history of goodwill impairments or a reasonable expectation that there will be impairment in the future likely indicates that goodwill impairment is not unusual or infrequently occurring. In these situations, the income tax effects of the goodwill impairment would be included in the estimated annual effective tax rate. Conversely, in circumstances where there has been no history of goodwill impairments and there is presently no reasonable expectation of goodwill impairments in the future, the income tax effect of the goodwill impairment may be recognized as a discrete item in the period in which the impairment is recorded.

In some instances, an event may not be infrequent or unusual but may change the ordinary income projections so significantly that it calls into question a company's ability to estimate its ordinary income. See discussion in section 20.4.2, *Ability to estimate the annual effective tax rate*, for further details.

Additionally, to the extent that a transaction reported outside of continuing operations (i.e., gain from discontinued operations) results in taxable income that provides for the reversal of a beginning-of-the-year valuation allowance, the intraperiod allocation guidance may require that the effect of a change in the valuation allowance is not reported in income from continuing operations. See section 15.2.2.2, *Changes in the valuation allowance*, for additional discussion. Refer to section 15.2.1.1, *Exception to the general principle of allocation to continuing operations (before the adoption of ASU 2019-12)*, for guidance when an entity has a loss in continuing operations and income reported outside of continuing operations.

20.6.2 Discontinued operations

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Other Presentation Matters

740-270-45-7

When an entity reports discontinued operations, the computations described in paragraphs 740-270-25-12 through 25-14, 740-270-30-11 through 30-13, and 740-270-45-2 through 45-3 shall be the basis for the tax (or benefit) related to the income (or loss) from operations of the discontinued operation before the date on which the criteria in paragraph 205-20-45-1E are met.

740-270-45-8

Income (or loss) from operations of the discontinued operation, prior to the interim period in which the date on which the criteria in paragraph 205-20-45-1E are met occurs, will have been included in **ordinary income (or loss)** of prior periods and thus will have been included in the estimated annual effective tax rate and tax (or benefit) calculations described in Sections 740-270-30 and 740-270-35 applicable to ordinary income. The total tax (or benefit) provided in the prior interim periods shall not be recomputed but shall be divided into two components, applicable to the remaining ordinary income (or loss) and to the income (or loss) from operations of the discontinued operation as follows. A revised estimated annual effective tax rate and resulting tax (or benefit) shall be computed, in accordance with Sections 740-270-30 and 740-270-35 applicable to ordinary income, for the remaining ordinary income (or loss), on the basis of the estimates applicable to such operations used in the original calculations for each prior interim period. The tax (or benefit) related to the operations of the discontinued operation shall be the total of:

a. The difference between the tax (or benefit) originally computed for ordinary income (or loss) and the recomputed amount for the remaining ordinary income (or loss)

b. The tax computed in accordance with paragraphs 740-270-25-12 through 25-14; 740-270-30-11 through 30-13; and 740-270-45-2 through 45-3 for any unusual or infrequently occurring items of the discontinued operation.

See Example 4 (paragraph 740-270-55-29) for an illustration of accounting for income taxes applicable to income or (loss) from discontinued operations at an interim date.

Operations may meet the criteria to be reported as discontinued operations in an interim reporting period. In this situation, two items occur:

- First, the total tax reported in prior interim periods is divided between the remaining ordinary income (or loss) and the operations of the discontinued components.
- Second, the annual effective tax rate is revised. See section 15.2.1, *Allocation of the tax effect of pretax income from continuing operations*, section 15.2.1.1, *Exception to general principle of allocation to continuing operations (before the adoption of ASU 2019-12)*, and section 20.4.1, *Exception to the general principle of allocating income tax expense (benefit) to continuing operations (before the adoption of ASU 2019-12)*, for additional discussion.

Prior interim periods total tax provision

The results of the operations that are now presented for all periods reported as discontinued operations were previously included in ordinary income and considered in the computation of the entity's annual effective tax rate. Therefore, the total tax related to the discontinued operations provided in prior interim periods (and included in the income tax provision for continuing operations) must now be divided between:

- The remaining ordinary income (or loss)
- The operations of the discontinued component

The total tax (benefit) related to discontinued operations in the prior periods is:

- The difference between the tax (benefit) originally computed for ordinary income (loss) and the recomputed amount for the remaining ordinary income (loss)
- The tax computed for the unusual or infrequently occurring items of the discontinued operations

Revised estimated annual effective tax rate for remainder of current year

In the first interim period that includes reporting discontinued operations, an entity should revise its estimated annual effective tax rate applied to income from continuing operations in the current period (see section 20.6.3, *Gain from the disposal of a component of an entity*). Revising the estimated annual effective tax rate applied to income from continuing operations in the current period is necessary even if an entity anticipates no overall tax expense or benefit (i.e., a full valuation allowance is expected).

Illustration 20-3: Revising the estimated annual effective tax rate applied to loss from continuing operations when discontinued operations arise (before the adoption of ASU 2019-12)

Note: This illustration shows Company A considering the income from the discontinued operations in determining the amount of tax benefit allocated to continuing operations. However, after the adoption of ASU 2019-12, Company A would no longer consider the income from the discontinued operations in determining the amount of tax benefit allocated to continuing operations. After the adoption of ASU 2019-12, because Company A is not expected to realize the benefit of the loss, it would recognize a full valuation allowance and no income tax benefit would be recognized in continuing operations. Additionally, because the overall income tax provision in this example would still be zero, no income tax expense would be allocated to discontinued operations.

Assume at the beginning of fiscal 20X1, Company A anticipated a full-year ordinary loss of $80 million, or $20 million each quarter, as follows (in thousands):

	Anticipated ordinary loss	
Quarter	**Reporting period**	**Year-to-date**
First quarter	$ (20,000)	$ (20,000)
Second quarter	(20,000)	(40,000)
Third quarter	(20,000)	(60,000)
Fourth quarter	(20,000)	(80,000)

This anticipated full-year ordinary loss did not contemplate a sale of discontinued operations. Further, Company A had a full valuation allowance at the beginning of the year and anticipates a full valuation allowance at the end of the year. At the beginning of 20X1 Company A believed it was not more likely than not that it would be able to realize any tax benefits resulting from the anticipated full-year loss for 20X1. Therefore, the Company calculated an estimated annual effective tax rate of zero at the beginning of 20X1.

In the third quarter, one of the Company's components met the held-for-sale criteria. On the final day of the third quarter the Company sold the component and recognized income from discontinued operations of $40 million on the disposal transaction. Prior to its disposal, the discontinued component generated income of $15 million, or $5 million each quarter, which had been included in the Company's anticipated full-year ordinary loss at the beginning of 20X1 ($80 million).

As a result of the discontinued operations, at the end of the third quarter, the Company revised its estimate of the ordinary loss in 20X1. The revised estimates for ordinary losses and actual income from discontinued operations (including the disposal), are shown below (in thousands):

	Revised ordinary loss from continuing operations		**Income from discontinued operations**	
Quarter	**Reporting period**	**Year-to-date**	**Reporting period**	**Year-to-date**
First quarter [a]	$ (25,000)	$ (25,000)	$ 5,000	$ 5,000
Second quarter [a]	(25,000)	(50,000)	5,000	10,000
Third quarter [a]	(25,000)	(75,000)	45,000[c]	55,000
Fourth quarter [b]	(25,000)	(100,000)	–	55,000

(a) Amounts represent actual results.

(b) Amounts represent anticipated results for the fourth quarter as estimated at the end of the third quarter. Note that the total loss expected for the year for continuing operations reflects none of the income from discontinued operations that was initially anticipated ($20 million).

(c) Third-quarter (reporting period) income from discontinued operations is comprised of a $40 million gain from the sale of the discontinued component and $5 million of income from the operations of the discontinued component (prior to the disposal).

Further, assume the following:

- There are no permanent differences.
- There are no changes in other temporary differences during the year.
- The statutory tax rate is 40%.
- In the first quarter and second quarter, the Company reported a tax provision (total) of $0.
- Actual results equal anticipated results.
- The change in the valuation allowance needed for current year loss from continuing operations is solely as a result of income in the current year from the discontinued operation.[67]
- The gain on the sale of the discontinued component is ordinary in nature (i.e., it is of the same character as the ordinary loss from continuing operations).

When applying the guidance in ASC 740-20-45-8 to interim reporting periods, the estimated effective tax rate should be recomputed at the end of each reporting period using current estimates of the ordinary loss expected for the fiscal year and year-to-date amounts already incurred for all other items (i.e., significant unusual or infrequently occurring items or discontinued operations). Noteworthy is that significant unusual or infrequently occurring items or discontinued operations cannot be anticipated in setting the effective tax rate. In this example, Company A's estimated annual effective tax rate prior to selling the component is 0% because an ordinary loss is expected for the full fiscal year and it is not more likely than not that the Company will be able to realize any tax benefits resulting from the ordinary loss (i.e., a full valuation allowance exists at the beginning and end of the year).

[67] Changes in the beginning-of-the-year valuation allowance (except for certain changes related to a business combination or the initial recognition of tax benefits for certain equity related items) that are attributed to, and only as a result of, income or loss recognized in a category other than income from continuing operations generally are allocated to that other item. See section 15.2.2.2, *Changes in the valuation allowance*.

Recompute prior interim period(s) tax provision (benefit)

Company A will begin reporting discontinued operations in the third quarter. Prior to disposal, the results of the component's operations were included in the ordinary loss and considered in the computation of the Company's annual effective tax rate of 0%. Company A applied the guidance in ASC 740-270-45-8 to divide the total tax provision reported in prior 20X1 interim periods (i.e., first and second quarter 20X1) between:

- The remaining ordinary loss (i.e., prior quarters' estimates of annual ordinary loss, exclusive of estimates of income from operations of the discontinued component)
- Income from the operations of the discontinued component.

For purposes of allocating the previously reported first and second quarter (and year-to-date six-month periods) 20X1 tax provisions between continuing and discontinued operations, Company A recomputed an estimated annual effective tax rate (recomputed rate) in accordance with ASC 740-270-30 and 740-270-35. The recomputed rate is not used to revise the total provision or benefit for the prior 20X1 interim periods. The recomputed rate is calculated based on the estimates used in the original calculation as they apply to the remaining ordinary loss.

(amounts in thousands)		
Estimated annual income from discontinued component (before consideration of gain on sale)	$	15,000
Statutory tax rate		40%
Estimated annual tax provision on discontinued operations	$	6,000
Estimated remaining annual ordinary loss from continuing operations	$	100,000
Recomputed estimated annual effective tax rate		6.0%

Company A determined the prior 20X1 interim period tax provision related to discontinued operations was $1.5 million in the first quarter (6% x $25 million YTD ordinary loss) and $1.5 million in the second quarter (6% x $50 million YTD ordinary loss, less tax provided in prior 20X1 interim periods).

For purposes of comparative prior year interim periods (e.g., 20X0 interim periods), Company A applies the same process to allocate the previously reported 20X0 interim period tax provisions between continuing and discontinued operations.

Current interim period tax provision (benefit)

Because of the $55 million of income recognized from discontinued operations for the year, the intraperiod allocation provisions in ASC 740 result in Company A reporting a tax benefit of $22 million ($55 million of realizable ordinary loss x 40% statutory tax rate) for the fiscal year on the ordinary loss from continuing operations. Because the third quarter is the first interim period that includes reporting of discontinued operations, Company A determined its revised estimated annual effective tax rate at the end of Q3, as follows:

(amounts in thousands)		
Estimated annual income from discontinued component	$	15,000
Gain on disposal		40,000
Total estimated annual income from discontinued operations		55,000
Statutory tax rate		40%
Estimated annual tax provision on discontinued operations	$	22,000

Estimated annual benefit to continuing operations	$	22,000
Estimated remaining annual ordinary loss from continuing operations		100,000
Revised estimated annual effective tax rate		22.0%

The revised estimated annual effective tax rate of 22% will be applied to the year-to-date loss from continuing operations in the third and fourth quarters (i.e., the current interim period and subsequent interim periods of the same year, respectively). Although the overall tax provision (benefit) for the full year will still be zero, the Company will report a total tax provision of $5.5 million in the third quarter (reporting period and year-to-date period) and a total tax benefit of $5.5 million in the fourth quarter (reporting period). The third and fourth quarterly tax amounts are not zero because the tax benefit on the ordinary loss from continuing operations is computed using the revised estimated annual effective tax rate, whereas the tax provision on the income from discontinued operations is recognized in the third quarter because it is treated as a discrete event. The recognition of the full tax benefit on continuing operations in the third quarter (less amounts previously recognized in prior interim periods of the same year) would only be appropriate if the Company was unable to estimate its annual effective tax rate and was recognizing its provision on a discrete basis (e.g., in the case of near-breakeven results) (see section 20.4.2, *Ability to estimate the annual effective tax rate*).

The quarterly computation of the tax benefit attributable to the ordinary loss from continuing operations and the tax provision on income from discontinued operations under the provisions of ASC 740-20-45-7 and 740-270-45-8 is as follows (in thousands):

	Benefit attributable to ordinary loss from continuing operations			**Tax expense attributable to income from discontinued operations**	
Quarter	**Computed year-to-date**	**Less previously provided**	**Reporting period**	**Year-to-date**	**Reporting period**
First quarter [(a)]	$ (1,500)	$ –	$ (1,500)	$ 1,500	$ 1,500
Second quarter [(a)]	(3,000)	(1,500)	(1,500)	3,000	1,500
Third quarter [(b)]	(16,500)	(3,000)	(13,500)	22,000	19,000
Fourth quarter [(c)]	(22,000)	(16,500)	(5,500)	22,000	–
Fiscal year			$(22,000)		$22,000

(a) Represents allocation of previously reported 20X1 interim period total tax provision (zero) between the benefit on the ordinary loss from continuing operations and the provision on income from discontinued operations. The year-to-date benefit to continuing operations is calculated using the recomputed EAETR of 6% (for allocation purposes) and the year-to-date ordinary loss from continuing operations; the reporting period benefit represents the year-to-date benefit, less amounts previously recognized in prior 20X1 interim periods. No unusual or infrequent items occurred which would impact the provision allocated to discontinued operations.

(b) The third-quarter year-to-date benefit from continuing operations is calculated using the revised EAETR of 22% and the $75 million year-to-date ordinary loss from continuing operations; the reporting period benefit represents the year-to-date benefit, less amounts previously recognized in prior 20X1 interim periods. The third-quarter year-to-date provision for discontinued operations is calculated based on the $55 million year-to-date income from discontinued operations and the statutory tax rate of 40%; the reporting period provision represents the year-to-date provision, less amounts previously recognized in prior 20X1 interim periods.

(c) The fourth-quarter year-to-date benefit from continuing operations is calculated using the revised EAETR of 22% and the $100 million year-to-date ordinary loss from continuing operations; the reporting period benefit represents the year-to-date benefit, less amounts previously recognized in prior 20X1 interim periods. There was no fourth-quarter activity related to discontinued operations because of the disposal in the third quarter.

Example 4 (paragraphs 740-270-55-29 through 36) also provides an illustration of accounting for income taxes applicable to income or (loss) from discontinued operations at an interim date.

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Other Presentation Matters

740-270-55-29

This Example illustrates the guidance in paragraph 740-270-45-7. An entity anticipates ordinary income for the year of $100,000 and tax credits of $10,000. The entity has ordinary income in all interim periods. The estimated annual effective tax rate is 40 percent, computed as follows.

Estimated pretax income:	$ 100,000
Tax at 50% statutory rate	$ 50,000
Less anticipated credits	(10,000)
Net tax to be provided	$ 40,000
Estimated annual effective tax rate	40%

740-270-55-30

Quarterly tax computations for the first two quarters are as follows.

	Ordinary Income		Estimated	Tax		
Reporting Period	Reporting Period	Year-to-Date	Annual Effective Tax Rate	Year-to-Date	Less Previously Provided	Reporting Period
First quarter	$ 20,000	$ 20,000	40%	$ 8,000	$ -	$ 8,000
Second quarter	25,000	45,000	40%	18,000	8,000	10,000

740-270-55-31

In the third quarter a decision is made to discontinue the operations of Division X, a segment of the business that has recently operated at a loss (before income taxes). The pretax income (and losses) of the continuing operations of the entity and of Division X through the third quarter and the estimated fourth quarter results are as follows.

			Division X	
Reporting Period	Revised Ordinary Income from Continuing Operations		Loss from Operations	Provision for Loss on Disposal
First quarter	$ 25,000		$ (5,000)	
Second quarter	35,000		(10,000)	
Third quarter	50,000		(10,000)	$ (55,000)
Fourth quarter	50,000	[a]	-	-
Fiscal year	$ 160,000		$ (25,000)	$ (55,000)

[a] Estimated

740-270-55-32

No changes have occurred in continuing operations that would affect the estimated annual effective tax rate. Anticipated annual tax credits of $10,000 included $2,000 of credits related to the operations of Division X. The revised estimated annual effective tax rate applicable to ordinary income from continuing operations is 45 percent, computed as follows.

Estimated ordinary income from continuing operations:	$ 160,000
Tax at 50% statutory rate	80,000
Less anticipated tax credits applicable to continuing operations	(8,000)
Net tax to be provided	$ 72,000
Estimated annual effective tax rate	45%

740-270-55-33

Quarterly computations of tax applicable to ordinary income from continuing operations are as follows.

Reporting Period	Ordinary Income Reporting Period	Ordinary Income Year-to-Date	Estimated Annual Effective Tax Rate	Tax Year-to-Date	Tax Less Previously Provided	Tax Reporting Period
First quarter	$ 25,000	$ 25,000	45%	$ 11,250	$ -	$ 11,250
Second quarter	35,000	60,000	45%	27,000	11,250	15,750
Third quarter	50,000	110,000	45%	49,500	27,000	22,500
Fourth quarter	50,000	160,000	45%	72,000	49,500	22,500
Fiscal year	$ 160,000					$ 72,000

740-270-55-34

Tax benefit applicable to Division X for the first two quarters is computed as follows.

Reporting Period	Tax Applicable to Ordinary Income: Previously Reported (A)	Tax Applicable to Ordinary Income: Recomputed (Above) (B)	Tax Benefit Applicable to Division X (A-B)
First quarter	$ 8,000	$ 11,250	$ (3,250)
Second quarter	10,000	15,750	(5,750)
			$ (9,000)

740-270-55-35

The third quarter tax benefits applicable to both the loss from operations and the provision for loss on disposal of Division X are computed based on estimated annual income with and without the effects of the Division X losses. Current year tax credits related to the operations of Division X have not been recognized. It is assumed that the tax benefit of those credits will not be realized because of the discontinuance of Division X operations. Any reduction in tax benefits resulting from recapture of previously recognized tax credits resulting from discontinuance or current year tax credits applicable to the discontinued operations would be reflected in the tax benefit recognized for the loss on disposal or loss from operations as appropriate. If, because of capital gains and losses, and so forth, the individually computed tax effects of the items do not equal the aggregate tax effects of the items, the aggregate tax effects are allocated to the individual items in the same manner that they will be allocated in the annual financial statements. The computations are as follows.

	Loss from Operations Division X	Provision for Loss on Disposal
Estimated annual income from continuing operations	$ 160,000	$ 160,000
Loss from Division X operations	(25,000)	
Provision for loss on disposal of Division X		(55,000)
Total	$ 135,000	$ 105,000

Tax at 50% statutory rate	$ 67,500	$ 52,500
Anticipated credits from continuing operations	(8,000)	(8,000)
Tax credits of Division X and recapture of previously recognized tax credits resulting from discontinuance	-	-
Taxes on income after effect of Division X losses	59,500	44,500
Taxes on income before effect of Division X losses — see computation above	72,000	72,000
Tax benefit applicable to the losses of Division X	(12,500)	(27,500)
Amounts previously recognized — see computation above	(9,000)	-
Tax benefit recognized in third quarter	$ (3,500)	$ (27,500)

740-270-55-36

The resulting revised quarterly tax provisions are summarized as follows.

	Pretax Income (Loss)			Tax (or Benefit) Applicable to		
Reporting Period	**Continuing Operations**	**Operations of Division X**	**Provisions for Loss on Disposal**	**Continuing Operations**	**Operations of Division X**	**Provisions for Loss on Disposal**
First quarter	$ 25,000	$ (5,000)		$ 11,250	$ (3,250)	
Second quarter	35,000	(10,000)		15,750	(5,750)	
Third quarter	50,000	(10,000)	$(55,000)	22,500	(3,500)	$ (27,500)
Fourth quarter	50,000	-		22,500		-
Fiscal year	$ 160,000	$ (25,000)	$(55,000)	$ 72,000	$ (12,500)	$ (27,500)

20.6.3 Gain from the disposal of a component of an entity

Disposals of a component of an entity may result in a gain that would allow for the realization of deferred tax assets. Gains from the disposal of a component of an entity are likely not ordinary income. To the extent that the change in realizability of the prior year deferred tax assets relates to current year income that is not ordinary (e.g., the gain from disposition is included in discontinued operations), the benefit is presented discretely in the period in which the gain on disposal is presented (to the extent that income from continuing operations in the current year or the other sources of taxable income discussed in section 6.2, *Sources of taxable income*, do not support the realizability of the deferred tax assets).

If, however, expected gains from the future disposal of a component of an entity (in a subsequent year) are considered a change in estimate of *future years'* income and can be used as a source of income to realize existing deferred tax assets, the benefit associated with the reversal of a valuation allowance is presented discretely in the period in which the change in judgment occurs (generally an annual period prior to the period in which the gain on disposal is presented).

Refer to section 6.11, *A change in valuation allowance*, for additional discussion of the effect of a change in the beginning-of-the-year balance of a valuation allowance that result from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. Additionally, refer to sections 15.2.1, *Allocation of the tax effect of pretax income from continuing operations*, and 15.2.2.2, *Changes in the valuation allowance*, for intraperiod allocation considerations when a change in valuation allowance is due to taxable income from sources outside of continuing operations.

20.7 Using a prior year operating loss carryforward

Excerpt from Accounting Standards Codification

Income Taxes — Interim Reporting

Recognition

740-270-25-4

The tax benefit of an operating loss carryforward from prior years shall be included in the effective tax rate computation if the tax benefit is expected to be realized as a result of ordinary income in the current year. Otherwise, the tax benefit shall be recognized in the manner described in paragraph 740-270-45-4 in each interim period to the extent that income in the period and for the year to date is available to offset the operating loss carryforward or, in the case of a change in judgment about realizability of the related **deferred tax asset** in future years, the effect shall be recognized in the interim period in which the change occurs.

Other Presentation Matters

740-270-45-4

Paragraph 740-20-45-3 requires that the manner of reporting the tax benefit of an operating loss carryforward recognized in a subsequent year generally is determined by the source of the income in that year and not by the source of the operating loss carryforward or the source of expected future income that will result in realization of a **deferred tax asset** for the operating loss carryforward. The tax benefit is allocated first to reduce tax expense from continuing operations to zero with any excess allocated to the other source(s) of income that provides the means of realization, for example, discontinued operations, other comprehensive income and so forth. That requirement also pertains to reporting the tax benefit of an operating loss carryforward in interim periods.

Although ASC 270 rejects the discrete approach to interim reporting (i.e., each interim period determined as if the interim period were an annual period), ASC 740 is based on a discrete approach that measures a deferred tax liability or asset as of a given point in time. Under ASC 740, a change in circumstances can cause a change in judgment about the future realizability of a deferred tax asset and result in a revision to the valuation allowance. In those instances, ASC 740 requires that the effect of the change to the valuation allowance be recognized in the period in which the change occurs.

Therefore, the manner in which the effect of a change in the valuation allowance that results from a change in circumstances is treated for interim financial reporting purposes is dependent on whether the benefit is expected to be realized because of current year ordinary income or, alternatively, because of expectations about future years' income.

If the benefit is expected to be realized because of current year ordinary income and future years' income, the effect of the change would be allocated between the interim period that includes the date of the change (for the future year effect) and inclusion in the annual effective rate (for the current year effect). In addition, if the benefit is expected to be realized because of current year income other than ordinary income, the effect of the change would be included in the interim period that includes the other income.

The following table summarizes the interim financial reporting considerations when prior year(s) deferred tax assets are now realizable (i.e., the reversal of a valuation allowance on a beginning-of-the-year valuation allowance):

Determine why the benefit of deferred tax assets that originated in prior year(s) are now realizable	Include in the estimated annual effective tax rate (EAETR)?	
	Yes	No
As a result of current year ordinary income	Yes — include in EAETR for remaining periods	
As a result of a change in expectations of future years' income (i.e., income subsequent to the current year)		No — include in interim period of change in judgment (not in EAETR)
As a result of both a change in current year ordinary income and change in expectations of future years' income	Yes — allocate between the interim period that includes the date of change in judgment (future year effect) and EAETR (current year ordinary income effect)	No — allocate between interim period that includes the date of change in judgment (future year effect) and EAETR (current year ordinary income effect)
As a result of current year net income other than ordinary income		No — include in interim period that includes the other income (not in EAETR)

See section 6.6.1, *Period covered by projections of future income*, for discussion of accounting for revisions in the valuation allowance based on the ability to rely on additional periods of future taxable income.

20.8 Illustrations

The illustrations below demonstrate the guidance on accounting for income taxes in interim periods. Specifically, the illustrations relate to (1) the estimated annual effective tax rate computation and the effect of new tax legislation, (2) the accounting for income taxes if an ordinary loss is anticipated for the fiscal year and (3) the accounting for income taxes upon the use of prior year net operating loss carryforwards.

20.8.1 Estimated annual effective tax rate computation and effect of new tax legislation

20.8.1.1 Calculation of first-quarter income tax expense

Illustration 20-4: Calculation of first-quarter income tax expense

Facts

Assume the following about Company A:

- The following tax rates apply to all years: federal = 40%, foreign = 45%, state = 7.5%
- At 31 December 20X3, Company A:
  - Identifies a taxable temporary difference of $31 million related to equipment, and a deductible temporary difference of $10 million related to a warranty accrual
  - Recognizes a federal deferred tax liability of $12.4 million ($31 million x 40%) for the taxable temporary difference and a federal deferred tax asset of $4 million ($10 million x 40%) for the deductible temporary difference
  - Concludes that no valuation allowance is necessary for the deferred tax asset
  - Records a net federal deferred tax liability of $8.4 million

- For the year ending 31 December 20X4, Company A:
  - Projects that the taxable temporary difference as of 31 December 20X4 will be $35 million and the deductible temporary difference will remain at $10 million
  - Projects a federal deferred tax liability of $14 million ($35 million x 40%) and a federal deferred tax asset of $4 million ($10 million x 40%)
  - Concludes that no valuation allowance will be necessary for the deferred tax asset at 31 December 20X4
  - Projects a net federal deferred tax liability of $10 million at 31 December 20X4
  - Projects the federal deferred tax expense for 20X4 would be $1.6 million ($10 million – $8.4 million)

Analysis

	(In thousands)	
Estimated annual pretax income before items listed below (including $2 million of foreign income – with no temporary differences)		$ 50,000
Less:		
State income tax ([$48,000 - $4,000] * 7.5%)	$ 3,300	
Dividend received deduction	50	
Effect of tax-exempt interest income	600	(3,950)
		46,050
Increase in excess accumulated tax depreciation over book ($35 – $31 million)		(4,000)
Estimated taxable income		42,050
Estimated taxable income		42,050
Statutory federal income tax rate		40%
Estimated current income taxes payable		16,820
Estimated federal deferred tax expense, less benefit of state deferred taxes ([$4,000 increase in taxable temporary difference – ($4,000 * 7.5%) state deferred taxes on increase in taxable temporary difference] x 40%)		1,480
		18,300
Less research and development credit		(2,160)
Add effect of higher tax rates on foreign income ($2 million x 5%)		100
Add state income tax ($3,300 current state income tax + [$4,000 * 7.5%] deferred state income taxes)		3,600
Estimated full-year income tax provision		$ 19,840
Estimated annual effective tax rate ($19,840 ÷ $50,000)		39.68%
Application of effective tax rate to first quarter:		
First-quarter pretax income		$ 10,000
Estimated full-year effective income tax rate		39.68%
Income tax provision – first quarter		$ 3,968

20.8.1.2 Calculation of second-quarter income tax expense when a change in tax rates occurs

Illustration 20-5: Calculation of second-quarter income tax expense

Assume the same facts as in Illustration 20-4, except that an increase from 40% to 42% in the federal tax rate was enacted on 30 June 20X4, retroactive to the beginning of the year. The effect of the change would be reflected in income tax expense for the three and six months ended 30 June 20X4 as follows:

	(In thousands)	
Estimated annual pretax income before items listed below (including $2 million of foreign income — with no temporary differences)		$ 50,000
Less:		
State income tax ([$48,000 - $4,000] * 7.5%)	$ 3,300	
Dividend received deduction	50	
Effect of tax-exempt interest income	600	(3,950)
		46,050
Increase in excess accumulated tax depreciation over book ($35 million — $31 million)		(4,000)
Estimated taxable income		42,050
Estimated taxable income		42,050
Statutory federal income tax rate		42%
Estimated current income taxes payable		17,661
Estimated federal deferred tax expense ([$4,000 increase in taxable temporary difference — ($4,000 * 7.5%) state deferred taxes on increase in taxable temporary difference] x 42%)		1,554
		19,215
Less research and development credit		(2,160)
Add effect of higher tax rates on foreign income ($2,000 x 3%)		60
Add state income tax ($3,300 current state income tax + [$4,000 * 7.5%] deferred state income taxes)		3,600
Estimated full-year income tax provision		$ 20,715
Estimated annual effective tax rate ($20,715 ÷ $50,000)		41.43%

Application of effective tax rate to year-to-date second quarter:

	(In thousands)	
Pretax income:		
First quarter	$ 10,000	
Second quarter	15,000	25,000
Revised estimated tax rate		41.43%
Revised estimated income tax provision		$ 10,358
Year-to-date estimated income tax provision	$ 10,358	
First-quarter income tax provision	(3,968)	
Second-quarter income tax provision		$ 6,390
Adjustment to 31 December 20X3 deferred tax balances:(a)		
Deferred tax liability ($31,000 x 1.85% [42% - 40% - (7.5% x 2%))](b)	574	
Deferred tax asset ($10,000 x 1.85% [42% - 40% - (7.5% x 2%))](b)	(185)	
Net increase in income tax expense		389
Total second-quarter tax expense ($6,390 + $389)		$ 6,779
Total six-months tax expense ($10,358 + $389)		$ 10,747

(a) For simplicity, it is assumed that there is no net change in the temporary differences and related deferred tax balances between 31 December 20X3 and immediately prior to the change in tax rate enactment date (i.e., 30 June 20X4).

(b) The (7.5% x 2%) represents the federal benefit of state income taxes.

A reconciliation of the second-quarter income tax expense of $6,779 (in thousands) is as follows:

Second-quarter tax expense at old effective tax rate ($15,000 x 39.68%)	$ 5,952
Adjustment to second-quarter tax expense at new effective tax rate ($15,000 x [41.43% − 39.68%])	263
Adjustment to first-quarter tax expense at new effective tax rate ($10,000 x [41.43% − 39.68%])	175
Adjustment to 31 December 20X3 deferred tax liability	389
Total second-quarter tax expense	$ 6,779

Thus, the total income tax provision for the second quarter of $6,779 includes (1) estimated second-quarter tax provision of $6,390 (inclusive of the $438 cumulative catch-up for the increased tax rates on year-to-date income) plus (2) the effect of the change in the federal tax rate on deferred tax balances as of 31 December 20X3 of $389. Therefore, the increase in the federal tax rate results in an increase in tax expense for the second quarter of $827 ($438 resulting from the increase in the annual estimated effective tax rate on year-to-date 20X4 pretax earnings and $389 resulting from the adjustment to the deferred tax balances at 31 December 20X3).

An alternative calculation (that only addresses the impact of the change in tax rates through the prior interim period because subsequent activity is insignificant) is presented in section 8.4, *Retroactive change in enacted tax rates*.

The following disclosure would be appropriate for a change in tax rates in an interim period.

Illustration 20-6: Disclosure for a change in tax rates in an interim period

In the second quarter of 20X4, the Company revised its estimated annual effective tax rate to reflect a change in the enacted federal statutory rate from 40% to 42%, effective retroactive to 1 January 20X4. The effect of the change in the estimated annual effective tax rate was to increase income tax expense for the quarterly and six-month period ended 30 June 20X4 by $827, of which $175 related to the first quarter, and $389 was a result of applying the newly enacted tax rates to the deferred tax balances as of 31 December 20X3.

20.8.2 Accounting for income taxes if an ‘ordinary’ loss is anticipated for the fiscal year

20.8.2.1 Realization of the full tax benefit of losses when company has ‘ordinary’ losses in all interim periods

Illustration 20-7: Realization of the full tax benefit of losses when company has ordinary losses in all interim periods

Facts

Assume for the full 20X4 fiscal year, Company A anticipates an ordinary loss of $20 million. Assume that losses are generated evenly over the four quarters. Company A operates in only one jurisdiction. The tax rate for all future years is 25%. Assume further that anticipated tax credits for the fiscal year total $1 million. No other permanent differences or temporary differences exist. The company determined that it is more likely than not that the tax benefit of the loss and the tax benefit of tax credits are expected to be recognizable as a deferred tax asset at the end of the current year; therefore, no valuation allowance is needed.

Analysis

The estimated annual effective tax rate calculation is the following (in thousands):

Tax benefit of the loss at statutory rate	$ 5,000	($20,000 x 25%)
Tax benefit of tax credits for the year	1,000	
Net tax benefit	6,000	
Estimated annual effective tax rate	30%	($6,000/$20,000)

The quarterly income tax computations are as follows (in thousands):

	Ordinary loss			Tax benefit			
Quarter	Reporting period	Year-to-date	Estimated annual effective tax rate	Year-to-date	Less previously provided	Reporting period	Effective tax rate quarterly/ Y-T-D
First quarter	$ (5,000)	$ (5,000)	30%	$ (1,500)	$ –	$ (1,500)	30%/30%
Second quarter	(5,000)	(10,000)	30%	(3,000)	(1,500)	(1,500)	30%/30%
Third quarter	(5,000)	(15,000)	30%	(4,500)	(3,000)	(1,500)	30%/30%
Fourth quarter	(5,000)	(20,000)	30%	(6,000)	(4,500)	(1,500)	30%/30%
Fiscal year	$(20,000)					$ (6,000)	

20.8.2.2 Realization of the full tax benefit of losses when company has 'ordinary' income and losses in interim periods and for the year-to-date period (before the adoption of ASU 2019-12)

Illustration 20-8: Realization of the full tax benefit of losses when company has ordinary income and losses in interim periods and for the year-to-date period

Assume the same facts provided in Illustration 20-7, in which case the estimated annual effective tax rate remains the same. However, Company A has the following pattern of ordinary income and losses in the interim periods:

Quarter 1:	($15) million	Quarter 3:	($20) million
Quarter 2:	$5 million	Quarter 4:	$10 million

The quarterly income tax computations are as follows (in thousands):

	Ordinary income/(loss)			Tax benefit				
Quarter	Reporting period	Year-to-date	Estimated annual effective tax rate	Year-to-date	Limited to[(a)]	Less previously provided	Reporting period	Effective tax rate qtrly/ Y-T-D
First quarter	$ (15,000)	$(15,000)	30%	$ (4,500)	$ –	$ –	$ (4,500)	30%/30%
Second quarter	5,000	(10,000)	30%	(3,000)		(4,500)	1,500	30%/30%
Third quarter	(20,000)	(30,000)	30%	(9,000)	(8,500)	(3,000)	(5,500)	28%/28%
Fourth quarter	10,000	(20,000)	30%	(6,000)		(8,500)	2,500	25%/30%
Fiscal year	$ (20,000)						$ (6,000)	

(a) Because the year-to-date ordinary loss of $30,000 exceeds the anticipated ordinary loss of $20,000 for the fiscal year, ASC 740 limits the tax benefit recognized for the year-to-date period to the amount that would be recognized if the year-to-date ordinary loss were the anticipated ordinary loss for the fiscal year. The limitation is computed as follows:

	(in thousands)
Year-to-date ordinary loss at statutory rate ($30,000 x 25%)	$ 7,500
Estimated tax credits for the year	1,000
Year-to-date benefit limited to	$ 8,500

Note: *If neither the anticipated loss for the fiscal year nor anticipated tax credits were recognizable pursuant to ASC 740 (i.e., a full valuation allowance is expected to be established at 31 December 20X4 related to the deferred tax assets), the estimated annual effective tax rate for the year would be zero and no tax (or benefit) would be recognized in any quarter.*

20.8.2.2A Realization of the full tax benefit of losses when a company has 'ordinary' income and losses in interim periods and in the year-to-date period (after the adoption of ASU 2019-12)

ASU 2019-12 eliminates the exception in ASC 740-270-30-28 that limits the income tax benefit an entity can recognize in an interim period when the year-to-date ordinary loss exceeds the anticipated ordinary loss for the full year and the entity expects to realize a tax benefit for the anticipated ordinary loss for the full year. The following illustration presents the same fact pattern as Illustration 20-8 to compare how the outcome under ASU 2019-12 differs from the legacy guidance. After adoption of ASU 2019-12, assuming a company would be able to recognize the benefit of the loss, the amount of benefit recognized in an interim period is no longer limited.

Illustration 20-8A: Realization of the full tax benefit of losses when company has ordinary income and losses in interim periods and for the year-to-date period

Assume the same facts as in Illustration 20-7, in which case the estimated annual effective tax rate remains the same. However, assume that Company A has the following pattern of ordinary income and losses in the interim periods:

Quarter 1:	($15) million	Quarter 3:	($20) million
Quarter 2:	$5 million	Quarter 4:	$10 million

The quarterly income tax computations are as follows (in thousands):

	Ordinary income/(loss)			Tax benefit			
Quarter	Reporting period	Year-to-date	Estimated annual effective tax rate	Year-to-date	Less previously provided	Reporting period	Effective tax rate qtrly/ Y-T-D
First quarter	$ (15,000)	$ (15,000)	30%	$ (4,500)	$ –	$ (4,500)	30%/30%
Second quarter	5,000	(10,000)	30%	(3,000)	(4,500)	1,500	30%/30%
Third quarter	(20,000)	(30,000)	30%	(9,000)[(a)]	(3,000)	(6,000)	30%/30%
Fourth quarter	10,000	(20,000)	30%	(6,000)	(9,000)	3,000	30%/30%
Fiscal year	$ (20,000)					$ (6,000)	

[(a)] After the adoption of ASU 2019-12, ASC 740 no longer limits the tax benefits that can be recognized for the year-to-date period based on the amount of anticipated ordinary loss for the fiscal year. Therefore, Company A can recognize the $9 million tax benefit of the year-to-date loss. However, Company A must also determine that it will be able to realize the $9 million tax benefit either through anticipated taxable income in subsequent interim periods in the current year (of sufficient reliability in accordance with the more-likely-than-not standard) or as a deferred tax asset without a valuation allowance at the end of the year.

Note: *If neither the anticipated loss for the fiscal year nor anticipated tax credits were recognizable pursuant to ASC 740 (i.e., a full valuation allowance is expected to be established at 31 December 20X4 related to the deferred tax assets), the estimated annual effective tax rate for the year would be zero and no tax (or benefit) would be recognized in any quarter.*

20.8.2.3 Partial realization of the tax benefit of losses when company has 'ordinary' losses in all interim periods

Illustration 20-9: Partial realization of the tax benefit of losses when company has ordinary losses in all interim periods

Assume the same facts stated in Illustration 20-7 except that it is more likely than not that any tax benefit of the anticipated loss in excess of $15,000 of prior income available to be offset by carryback will not be realized. In addition, no tax credits will be realized for the year. Therefore, a valuation allowance will be recognized for the portion of the tax benefit that is not more likely than not to be realized.

The estimated annual effective tax rate calculation is the following (in thousands):

Tax benefit of the loss at statutory rate expected to be realized	$ 3,800 [(a)]	($15,000 x 25%)
Tax benefit of tax credits for the year	–	
Net tax benefit	$ 3,800[(a)]	
Estimated annual effective tax rate	19%[(a)]	($3,800/$20,000)

The quarterly income tax computations are as follows (in thousands):

	Ordinary loss		Estimated	Tax benefit			Effective tax
Quarter	Reporting period	Year-to-date	annual effective tax rate	Year-to-date	Less previously provided	Reporting period	rate quarterly/ Y-T-D
First quarter	$ (5,000)	$ (5,000)	19%	$ (950)	$ –	$ (950)	19%/19%
Second quarter	(5,000)	(10,000)	19%	(1,900)	(950)	(950)	19%/19%
Third quarter	(5,000)	(15,000)	19%	(2,850)	(1,900)	(950)	19%/19%
Fourth quarter	(5,000)	(20,000)	19%	(3,800)	(2,850)	(950)	19%/19%
Fiscal year	$ (20,000)					$ (3,800)	

(a) Rounded

20.8.2.4 Partial realization of the tax benefit of losses when company has 'ordinary' income and losses in interim periods and for the year-to-date period

Illustration 20-10: Partial realization of the tax benefit of losses when company has ordinary income and losses in interim periods and for the year-to-date period

Assume the same facts as in Illustration 20-9, in which case the estimated annual effective tax rate remains the same. However, assume that Company A has the pattern of ordinary income and losses as provided in Illustration 20-8.

The quarterly income tax computations are as follows (in thousands):

	Ordinary income/(loss)		Estimated	Tax benefit				Effective
Quarter	Reporting period	Year-to-date	annual effective tax rate	Year-to-date	Limited to[(a)]	Less previously provided	Reporting period	tax rate qtrly/ Y-T-D
First quarter	$ (15,000)	$ (15,000)	19%	$ (2,850)	$ –	$ –	$ (2,850)	19%/19%
Second quarter	5,000	(10,000)	19%	(1,900)		(2,850)	950	19%/19%
Third quarter	(20,000)	(30,000)	19%	(5,700)	(3,800)	(1,900)	(1,900)	10%/13%
Fourth quarter	10,000	(20,000)	19%	(3,800)		(3,800)	0	–%/19%
Fiscal year	$ (20,000)						$ (3,800)	

(a) ASC 740-270-30-30 limits the tax benefits from a loss that arises early in a fiscal year to the tax benefits that are expected to be (1) realized during the year or (2) recognizable as a DTA at the end of the year and it is more likely than not the tax benefit (or some portion of it) can be realized. Because Company A has determined that it is more likely than not that any tax benefit of the anticipated loss in excess of $15,000 will not be realized, the year-to-date tax benefit is limited to $3,800 ($15,000 x 25%) (rounded).

Illustration 20-11: Partial realization of the tax benefit of losses when company has ordinary losses in some interim periods

Assume the same facts as in Illustration 20-9, in which case the estimated annual effective tax rate remains the same. However, assume that Company A has the following pattern of ordinary income and losses in the interim periods (income in first quarter):

Quarter 1:	$5 million	Quarter 3:	($20) million
Quarter 2:	($15) million	Quarter 4:	$10 million

The quarterly income tax computations are as follows (in thousands):

	Ordinary income/(loss)		Estimated	Tax benefit				Effective
Quarter	Reporting period	Year-to-date	annual effective tax rate	Year-to-date	Limited to[(a)]	Less previously provided	Reporting period	tax rate qtrly/ Y-T-D
First	$ 5,000	$ 5,000	19%	$ 950		$ –	$ 950	19%/19%
Second	(15,000)	(10,000)	19%	(1,900)		950	(2,850)	19%/19%
Third	(20,000)	(30,000)	19%	(5,700)	$ (3,800)	(1,900)	(1,900)	10%/13%
Fourth	10,000	(20,000)	19%	(3,800)		(3,800)	–	– %/19%
Fiscal year	$ (20,000)						$ (3,800)	

(a) ASC 740-270-30-30 limits the tax benefits from a loss that arises early in a fiscal year to the tax benefits that are expected to be (1) realized during the year or (2) recognizable as a DTA at the end of the year and it is more likely than not the tax benefit (or some portion of it) can be realized. Because it is more likely than not that any tax benefit of the anticipated loss in excess of $15,000 will not be realized, the year-to-date tax benefit is limited to $3,800 ($15,000 x 25%) (rounded).

20.8.3 Accounting for income taxes upon the use of prior year net operating loss carryforwards

20.8.3.1 Reversal of valuation allowance because of current year 'ordinary' income

Illustration 20-12: Reversal of valuation allowance because of current year ordinary income

Facts

Assume that after finalizing the 20X3 financial statements, in the first quarter of the 20X4 fiscal year, an unexpected change in circumstances causes a change in judgment about the realizability of Company A's deferred tax asset relating to its $10 million in net operating losses available from prior years. At the beginning of fiscal year 20X4, the deferred tax asset was fully offset by a valuation allowance. Assume further that Company A estimates ordinary income of $20 million, which is generated evenly over the four quarters and that Company A operates in only one jurisdiction. The tax rate for the current and future years is 25%. No other permanent or temporary differences exist.

Analysis

The estimated annual effective tax rate calculation is the following (in thousands):

Tax expense on ordinary income at statutory rate ($20,000 x 25%)	$ (5,000)
Tax benefit of loss carryforward for the year ($10,000 x 25%)	2,500
Net current tax benefit (expense)	$ (2,500)
Reversal of deferred tax asset for the use of operating loss carryforward	$ (2,500)
Reversal of valuation allowance because of current year ordinary income	2,500
Net deferred tax benefit/(expense)	$ –
Net tax benefit/(expense)	$ (2,500)
Estimated annual effective tax rate ($2,500/$20,000)	12.5%

The quarterly income tax computations are as follows (in thousands):

Quarter	Ordinary income: Reporting period	Ordinary income: Year-to-date	Estimated annual effective tax rate	Estimated tax expense: Year-to-date	Estimated tax expense: Less previously provided	Reporting period	Effective tax rate quarterly/ Y-T-D
First quarter	$ 5,000	$ 5,000	12.5%	$ 625	$ –	$ 625	12.5%/12.5%
Second quarter	5,000	10,000	12.5%	1,250	625	625	12.5%/12.5%
Third quarter	5,000	15,000	12.5%	1,875	1,250	625	12.5%/12.5%
Fourth quarter	5,000	20,000	12.5%	2,500	1,875	625	12.5%/12.5%
Fiscal year	$20,000					$ 2,500	

Note: *In this example, the realization of an operating loss carryforward that is attributable to losses in prior years is expected because of estimated ordinary income in the current year. The benefit from the reversal of the valuation allowance recorded as of the beginning of the year is included in the computation of the estimated annual effective tax rate.*

20.8.3.2 Reversal of valuation allowance because of estimated 'ordinary' income in the current year and in future years

Illustration 20-13: Reversal of valuation allowance because of estimated ordinary income in the current year and in future years

Facts

Assume Company B has a net operating loss carryforward of $30 million at the end of 20X3, for which the related deferred tax asset was fully offset by a valuation allowance. Assume further that Company B estimates ordinary income of $20 million in 20X4, which is generated evenly over the four quarters. In the first quarter of 20X4, Company B determines that it is more likely than not that it will realize $20 million of its net operating loss carryforward through current-year ordinary income. Furthermore, in the second quarter of 20X4, based on income projections for future years, Company B believes that it is more likely than not that the excess $10 million operating loss carryforward over current year ordinary income will be realized. Company B operates in only one jurisdiction. The tax rate for the current and future years is 25%. No other permanent or temporary differences exist.

Analysis

The estimated annual effective tax rate calculation is the following (in thousands):

Tax expense on ordinary income at statutory rate ($20,000 x 25%)	$(5,000)
Tax benefit of loss carryforward for the year ($20,000 x 25%)	5,000
Net current tax benefit (expense)	$ –
Reversal of deferred tax asset for the use of operating loss carryforward	$(5,000)
Reversal of valuation allowance because of current year ordinary income	5,000
Net deferred tax benefit/(expense)	$ –
Net tax benefit/(expense)	$ –
Estimated annual effective tax rate ($0/$20,000)	0%

Note: *In this example, the benefit from the NOL carryforward is expected to be realized because of current year ordinary income and future years' income. Therefore, the effect of the change in the valuation allowance is allocated between the interim period that includes the date of the change (for the future-year effect) and inclusion in the annual effective rate (for the current year effect).*

- *Because $20 million of the NOL carryforward will be realized from current-year ordinary income, the benefit from the reversal of the valuation allowance in the first quarter as a result of the change in judgment based on current-year income is included in the estimated annual effective tax rate, as demonstrated above.*
- *Because the remaining $10 million of the NOL carryforward will be realized with future years' ordinary income, the tax benefit of $2,500 ($10 million x 25%) from the reversal of the valuation allowance in the second quarter as a result of the change in judgment based on future years' income is recorded as a discrete item in the second quarter and not allocated to subsequent interim periods by an adjustment to the estimated annual effective tax rate.*

The quarterly income tax computations are as follows (in thousands):

	Ordinary income/(loss)		Estimated annual effective tax rate	Tax benefit				Effective tax rate qtrly/ Y-T-D
Quarter	**Reporting period**	**Year-to-date**		**Year-to-date**	**Limited to**	**Less previously provided**	**Reporting period**	
First quarter	$ 5,000	$ 5,000	0%	$ –	$ –	$ –	$ –	0%/0%
Second quarter	5,000	10,000	0%	(2,500)	–	–	(2,500)	50%/25%%
Third quarter	5,000	15,000	0%	(2,500)	(2,500)	(2,500)	–	0%/17%
Fourth quarter	5,000	20,000	0%	(2,500)	(2,500)	(2,500)	–	0%/13%
Fiscal year	$ 20,000						$ (2,500)	

21 Share-based payments to employees

21.1 ASC 718 overview

ASC 718, *Compensation-Stock Compensation* requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement using a fair-value-based measure.[68] ASC 718 not only addresses the accounting for employee share-based compensation but also incorporates the accounting for employee stock ownership plans previously addressed in AICPA Statement of Position 93-6, *Accounting for Employee Stock Ownership Plans*, as well as the accounting for share-based payment awards issued to nonemployees. Please refer to our FRD, ***Share-based payment***, for further details including general application guidance and our observations on the application of ASC 718.

The objective of ASC 718 is to recognize goods or services received in exchange for equity instruments granted or liabilities incurred and the related cost to the entity as those goods or services are received. The accounting for share-based payments under ASC 718 depends on whether an instrument is classified as an equity or a liability award.

The objective of accounting for equity instruments granted to employees is to measure the cost of employee services received (compensation cost) in exchange for an award of equity instruments, based on the fair value of the award on the grant date, and to recognize that measured compensation cost in the financial statements over the requisite service period.

ASC 718 requires that certain types of employee awards be classified as liabilities (e.g., instruments that are required to be cash-settled). The measurement objective for liability awards is the same as for equity awards. However, ASC 718 requires that public entities measure share-based awards classified as liabilities at fair value at each reporting date. Nonpublic entities may elect to account for liability awards using:

(1) the fair value method (or a calculated-value method using an appropriate industry sector index to estimate volatility, if the company cannot reasonably estimate its own volatility) or

(2) the intrinsic-value method.

Regardless of the measurement method used, the liability award must be remeasured at each reporting date until the award is settled.

ASC 718 provides specific guidance on income tax accounting and clarifies how ASC 740 should be applied to share-based payments. Guidance also has been provided by the FAS 123(R) Resource Group (the Resource Group), an advisory group that was created after the issuance of FAS 123(R) (the predecessor to ASC 718) to discuss specific implementation issues. Such guidance, while not authoritative, has been included within as the FASB staff has stated publicly that it would not expect diversity in practice to develop related to an issue if the Resource Group was able to reach a consensus on that issue.

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[68] ASC 718 refers to the required measurement basis as the fair-value-based method because the measurement method described in the standard conceptually is not fair value. However, ASC 718 and chapter 21 of this publication refer to the required measurement as fair value, both for convenience and to distinguish it from other measurements, such as intrinsic value and calculated value.

The accounting for the income tax effects of share-based payments is one of the most complex aspects of ASC 718, particularly for multinational companies that grant share-based payments to employees in numerous jurisdictions. Accounting for awards under ASC 718 typically requires the use of sophisticated award and tax-benefit tracking systems for companies that make significant use of share-based payments to compensate employees.

Under ASC 718, the income tax effects of share-based payments are recognized for financial reporting purposes only if such awards are structured to result in deductions on the company's income tax return.

Determining whether a share-based payment will result in a future tax deduction depends on the type of award. Under current US federal income tax law, employee stock options are treated as either statutory (e.g., incentive) stock options or nonstatutory (e.g., non-qualified) stock options. Nonstatutory options are discussed in section 21.2, *Tax effects of awards that normally result in a tax deduction*. Statutory options are discussed further in section 21.6, *Tax effects of awards that normally do not result in a tax deduction*.

21.2 Tax effects of awards that normally result in a tax deduction

Excerpt from Accounting Standards Codification

Income Taxes — Compensation — Stock Compensation

Overview and Background

718-740-05-4

Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under tax law, allowable tax deductions may be measured as the **intrinsic value** of an instrument on a specified date. The **time value** component, if any, of the **fair value** of an instrument generally may not be tax deductible. Therefore, tax deductions may arise in different amounts and in different periods from compensation cost recognized in financial statements. Similarly, the amount of expense reported for an employee stock ownership plan during a period may differ from the amount of the related income tax deduction prescribed by income tax rules and regulations.

Under a non-qualified stock option plan, an employer generally receives a US tax deduction in an amount equal to the excess of the market price of the stock on the date of exercise over the exercise price (i.e., the intrinsic value). Nonvested stock is treated similarly to non-qualified stock options under current US federal income tax law in that the employer generally receives a tax deduction equal to the market value of the stock on the date the restrictions lapse (usually the vesting date), less any amounts paid by the employee.

The fair value method of ASC 718 results in compensation cost being recognized in the financial statements in different amounts and in different periods than the related income tax deductions.

21.2.1 Measuring deferred taxes for deductible awards

Excerpt from Accounting Standards Codification

Income Taxes — Compensation — Stock Compensation

Recognition

718-740-25-2

The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a **deductible temporary difference** in applying the requirements of Subtopic 740-10. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

718-740-25-3

Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future **event** can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

718-740-25-4

The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes.

Initial Measurement

718-740-30-1

The **deferred tax benefit (or expense)** that results from increases (or decreases) in the recognized share-based payment **temporary difference**, for example, an increase that results as additional service is rendered and the related cost is recognized or a decrease that results from forfeiture of an **award**, shall be recognized in the income statement.

Temporary differences arise under ASC 718 for both equity and liability awards that would result in a future tax deduction under existing tax law. These temporary differences will result in the recognition of deferred tax benefits with a corresponding increase to a deferred tax asset. Those deferred tax assets generally are calculated as the amount of compensation cost recognized for financial reporting purposes multiplied by the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax assets are expected to be realized. Refer to chapter 5, *Recognition and measurement*, for further discussion of the applicable tax rates to use when measuring deferred taxes. An example of the calculation of deferred tax benefits is provided in section 21.5.1, *Tax deduction differs from the amount of cumulative compensation cost recognized*.

21.2.2 The effect on deferred tax assets of the IRC Section 162(m) limitation

Section 162(m) of the Internal Revenue Code generally limits a publicly held corporation's federal tax deduction for compensation paid to "covered employees" to $1 million per year (non-performance and performance based). Covered employees include (1) individuals who serve as a company's chief executive officer or chief financial officer at any time during the taxable year and (2) the next three most highly compensated officers. Once an individual is a covered employee, the deduction limitation applies to compensation paid to that individual at any point in the future, including after a separation from service. Thus, any individual who is a covered employee for a tax year after 31 December 2016 will remain a covered employee for all future years.

The Section 162(m) provisions discussed above generally apply to taxable years beginning after 31 December 2017. However, the TCJA provided transition rules for compensation paid pursuant to a written binding contract that was in effect on 2 November 2017 if the contract has not been materially modified since that date. Companies should carefully review the terms of their compensation plans and agreements to assess whether they are considered to be written binding contracts in effect on 2 November 2017 to determine whether pre- or post-TCJA Section 162(m) rules apply.

The American Rescue Plan Act (ARPA), which was enacted on 11 March 2021, expands the scope of covered employees to include the five highest compensated employees (not limited to officers) that are not already treated as covered employees under (1) or (2) above. Unlike the individuals covered under (1) and (2) above, this new group of covered employees will not permanently retain that status for subsequent tax years. This provision of the ARPA is effective for tax years beginning after 31 December 2026. Because of the additional limitation imposed by ARPA, entities should continually determine if a portion of existing deferred tax assets related to share-based compensation and pertaining to the expanded group of employees is expected to reverse after the effective date of ARPA provisions and therefore, is no longer expected to be realized.

21.2.2.1 Section 162(m) limitations accounting implications

An issue arises as to whether and how the Section 162(m) limitation should affect the recognition of a tax benefit and a corresponding deferred tax asset as compensation cost is recognized over the requisite service period. Consider the following example:

- Base salary for a particular executive is expected to be $1 million for each year.
- 100,000 shares of nonvested stock are granted on 1 January 2005.
- The fair value of stock on date of grant is $10 per share (total fair value of award is $1 million).
- All 100,000 shares cliff vest on 1 January 2007 provided the employee continues to provide service through that date.
- The fair value of stock remains constant for all periods.
- Excluding executive compensation, pretax loss (income) is $0.
- The combined federal and state statutory tax rate is 40%.[69]

The Resource Group discussed the above example at its 13 September 2005 meeting and agreed that, in many cases, tax strategies (e.g., compensation deferral) can be utilized to avoid the Section 162(m) limitation. The Resource Group agreed that if the company expected to utilize alternatives that would avoid the Section 162(m) limitation and realize a tax benefit, it would recognize a tax benefit and a deferred tax asset as the compensation cost of the award is recognized (i.e., the Section 162(m) limitation would not affect the accounting for the deferred tax asset).

The Resource Group concluded that if the use of the tax strategies is not within the control of the employer (e.g., if the employee must make an election to defer compensation and had not yet done so), it would be inappropriate in the above example to recognize a tax benefit and a deferred tax asset in full for the award of nonvested stock. In that case, it would be acceptable to recognize a tax benefit for the share-based payment as compensation cost under one of two approaches:

1. Pro rata — Under this approach, the employer would estimate the employee's anticipated total taxable compensation subject to the Section 162(m) limitation in the year that the share-based payment would result in a tax deduction, based on the current estimate of the fair value of the award and the estimate of other compensation that would be paid to the employee during the year the award becomes taxable to the employee. The proportion of the expected deduction for the share-based payment to the total expected compensation deduction for that individual during that tax year (without consideration of the Section 162(m) limitation) would be multiplied by the deferred tax benefit that would be recognized during that year considering the Section 162(m) limitation. In the previous example, the employer expects $1 million in cash compensation and $1 million of nonvested stock (based on a current estimate

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[69] The combined federal and state statutory tax rate is 40% as that was the combined blended federal and state rate at the time of the 13 September 2005 Resource Group meeting.

of the fair value of the stock) to become deductible during 2007. The share-based payment represents 50% of the compensation deduction during the year. Because the total deduction is limited to $1 million, deferred taxes for the share-based payment would be recognized on only 50% of the recognized compensation cost, or $500,000. As a result, the employer would recognize a deferred tax benefit of $100,000 in each of the two years during the vesting period with respect to the grant of nonvested stock.

2. Share-based payment last — Under this approach, the employer would estimate the employee's total taxable compensation subject to the Section 162(m) limitation in the year that the share-based payment would result in a tax deduction as described above. The expected deduction would be allocated first to compensation other than share-based payments. Any remaining deductible amounts would be allocated to share-based payments on a pro rata basis based on the percentage of the award that is expected to become deductible. In the previous example, the employer expects $1 million in cash compensation and $1 million of nonvested stock (based on a current estimate of the fair value of the stock) to become deductible during 2007. Because the Section 162(m) limitation is fully absorbed by the cash compensation expected to be paid during that year, no deferred tax asset will ever be recognized for the nonvested stock.

In addition, we are aware that a third approach, known as the share-based payment first approach, is also applied in practice.

Any accounting policy election must be applied consistently to the recognition of deferred tax assets for all share-based payments subject to the potential limitations (whether they become subject to the limitations on the grant date or a later date).

21.2.2.2 Section 162(m)(6) limitations for certain health insurance providers

Section 162(m) (6) of the Internal Revenue Code limits to $500,000 the deduction for compensation earned by all officers, employees, directors and other workers or service providers (collectively, "employees") who provide services for a covered health insurance provider without regard to whether such compensation is paid during the taxable year or a subsequent taxable year (the "Section 162(m)(6) limitation").

Unlike the general limitation on deductibility in Section 162(m) discussed above, there are no exceptions as to the group of employees affected (or the type of compensation included for compensation arrangements entered into before 2 November 2017) by the Section 162(m)(6) limitation. In addition, the limitation under Section 162(m)(6) is determined based upon the year in which services are provided, rather than the year in which compensation is paid, as is the case under Section 162(m).

Under Section 162(m)(6), all compensation arrangements earned by the employee in a taxable year are included in the calculation of the $500,000 deduction limitation. All compensation includes compensation that may not be deductible in the year it is earned (e.g., share-based compensation or deferred compensation arrangements). That is, the deduction for share-based compensation or deferred compensation arrangements is based on the amount of the compensation earned by an employee in the year(s) when the services are performed, rather than the compensation paid to the employee in the year when the deduction occurs.

For tax purposes, the employer's share-based compensation deduction is determined in the year the compensation is included in the employee's tax return (e.g., the year in which stock options are exercised or restricted stock grants vest). For Section 162(m)(6) limitation purposes, this deduction is then allocated ratably to the periods the compensation was earned. Following this allocation, if the sum of the allocated share-based compensation plus other forms of compensation (e.g., cash salary) attributable to each period exceeds the Section 162(m)(6) limitation ($500,000), the share-based compensation deduction is limited. The Section 162(m)(6) limitation is effective for compensation paid in tax years beginning after 31 December 2012 for services performed in tax years beginning after 31 December 2009.

We expect an entity that is subject to the Section 162(m) limitations in general to apply existing accounting policy elections in accounting for limitations of compensation deductions. However, with respect to the Section 162(m)(6) limitations, additional complexities arise for share-based compensation arrangements that are earned during a taxable year but are deductible in a later year.

Due to the lower compensation deduction limits and the expanded scope of the Section 162(m)(6) limitation, tax planning may not be available. Additionally, if the use of tax planning is not within the control of the employer (e.g., if the employee must make an election to defer compensation and has not yet done so), we believe it would be inappropriate to recognize a tax benefit and a deferred tax asset in full for share-based payment arrangements as if they were not limited.

Because of the mechanics of the Section 162(m)(6) limitation and the requirement to maximize a deduction in the year in which the deduction is available,[70] we believe the share-based payment last method described above for general Section 162(m) limitations is the most appropriate way for a covered health insurance provider to determine the income tax effects of share-based compensation subject to the Section 162(m)(6) limitation. That is, because the Section 162(m)(6) limitation is first absorbed by the cash compensation paid during a particular year, the share-based compensation that may become deductible in a future period generally is ordered last, resulting in the recognition of a deferred tax asset consistent with this approach.

Any accounting policy election must be applied consistently to the recognition of deferred tax assets for all share-based payments subject to the potential limitations (whether they become subject to the limitations on the grant date or a later date).

21.3 Valuation allowances on deferred tax assets

Excerpt from Accounting Standards Codification

Income Taxes — Compensation — Stock Compensation

Initial Measurement

718-740-30-2

Subtopic 740-10 requires a **deferred tax asset** to be evaluated for future realization and to be reduced by a **valuation allowance** if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between the **deductible temporary difference** computed pursuant to paragraphs 718-740-25-2 through 25-3 and the tax deduction that would result based on the current **fair value** of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under these requirements.

Once the deferred tax asset is recognized pursuant to the preceding section, consideration must be given to whether the deferred tax asset is realizable.

ASC 740-10-30-5(e) requires companies to evaluate deferred tax assets on a gross basis (i.e., before consideration of deferred tax liabilities) to determine whether it is more likely than not that the future tax benefits represented by the deferred tax assets will be realized. As discussed in chapter 6, *Valuation allowances*, if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized, a valuation allowance is recognized to reduce the net carrying amount of the deferred tax asset to an amount that is more likely than not to be realized.

[70] A taxpayer cannot choose to limit the deduction of cash compensation in a period to allow for a larger deduction for share-based compensation earned in the same period but deductible in a future period.

When considering the need for, or amount of, a valuation allowance for deferred tax assets recognized as a result of share-based payments, companies should consider whether future taxable income will be sufficient to recover the deferred tax assets (as originally measured) in the periods in which the deduction would otherwise be recognized for tax purposes. Deferred tax assets recognized as a result of share-based payments are considered together with the company's other deferred tax assets in this analysis. A valuation allowance should be established only if the company believes, based on the weight of all available evidence, that it is more likely than not that future taxable income will not be sufficient to realize all or a portion of the deferred tax assets.

Changes in the intrinsic value of the award after the grant date should not be considered in determining the need for, or amount of, a valuation allowance. For example, assume an at-the-money option was granted with a fair value of $100 and, based on the employer's combined statutory tax rate, the employer recognized a deferred tax asset of $25. Further, assume that the underlying stock price declines after the grant date and remains well below the exercise price of the option for the entire term of the option. Despite the fact that the award is not expected to result in any tax deduction at current stock-price levels, this factor is not considered in the recognition of the deferred tax asset or in determining the need for a valuation allowance. If the company expects to have sufficient taxable income to result in realization of the $25 tax benefit, no valuation allowance would be recognized. However, if the option expires unexercised, the tax benefit would be written off as discussed in section 21.4.1, *Tax deduction differs from compensation cost*, which addresses circumstances in which recognized compensation cost for an award is different from the realized tax deduction. For additional discussion on evaluating whether a valuation allowance is necessary, see chapter 6, *Valuation allowances*.

While a valuation allowance is not recognized solely because the intrinsic value of the award is less than the grant date fair value of the award, we believe that in some circumstances it may be appropriate to disclose the potential write-off of the deferred tax asset as a significant risk or uncertainty pursuant to ASC 275-10. For example, if the employer has outstanding a significant number of deeply out-of-the-money options that are approaching contractual expiration and the write-off of the related deferred tax asset would be material to the employer's financial position or results of operations, we believe disclosure of the possible write-off and the factors that may contribute to such a write-off would be appropriate.

21.4 Realization of tax benefits

ASC 718 provides that, after all compensation cost has been recognized over the vesting period, a company does not adjust the deferred tax asset[71] until an option is exercised, expires or is forfeited, a restricted share vests or is forfeited, or an award is settled or is modified (as discussed in chapter 8, *Modifications, exchanges and settlements*, of our FRD, ***Share-based payment***).

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[71] The deferred tax asset would be adjusted if the applicable income tax rate changes. In that circumstance, the deferred tax asset would be recomputed based on the compensation cost recognized to date multiplied by the new tax rate, with any adjustment to the deferred tax asset recognized in income tax expense from continuing operations during the period of the tax rate change. See chapter 8, *An enacted change in tax laws or rates*, for additional guidance on accounting for changes in income tax rates.

21.4.1 Tax deduction differs from compensation cost

Excerpt from Accounting Standards Codification

Income Taxes — Compensation — Stock Compensation

Subsequent Measurement

718-740-35-2

This Section addresses the accounting required in a period when the deduction for compensation expense to be recognized in a tax return for **share-based payment arrangements** differs in amounts and timing from the compensation cost recorded in the financial statements. The tax effect of the difference, if any, between the cumulative compensation cost of an **award** recognized for financial reporting purposes and the deduction for an award for tax purposes shall be recognized as income tax expense or benefit in the income statement. The tax effect shall be recognized in the income statement in the period in which the amount of the deduction is determined, which typically is when an award is exercised or expires, in the case of share options, or vests, in the case of nonvested stock awards. The appropriate period depends on the type of award and the incremental guidance under the requirements of Subtopic 740-270 on income taxes—interim reporting.

A difference in amount or timing may exist related to compensation expense recognized by an entity for share-based payment arrangements on its tax return and its financial statements. The tax effect of such a difference is recognized as income tax expense or benefit in the income statement. That is, ASC 718 provides that:

- if a tax deduction taken on the company's income tax return for the award exceeds the cumulative amount of compensation cost recognized in the financial statements for that award, the company would recognize the excess tax benefit (or "windfall") in operations (income tax benefit).
- if the tax deduction reported in the tax return for an individual award is less than the cumulative compensation cost recognized for financial reporting purposes for that award, the write-off of the related deferred tax asset in excess of the tax benefits of the tax deduction (or "shortfall") is recognized in operations (income tax expense).
- if a vested option expires unexercised — thus yielding no tax deduction, any deferred tax asset would be written off to operations (income tax expense) in the period of expiry.

For interim reporting purposes, companies account for excess tax benefits and tax deficiencies as discrete items in the period in which they occur (i.e., they will be excluded from a company's estimated annual effective tax rate). See section 20.6.1, *Basis of tax provision*, within the interim reporting chapter, for further detail.

Companies present excess tax benefits as an operating activity on the statement of cash flows rather than as a financing activity.

21.4.2 Other realization considerations

21.4.2.1 Sale of a subsidiary

We believe that the excess tax benefits recognized before the sale of a subsidiary that result from share-based payments granted by entities currently in the consolidated group to employees of former subsidiaries previously sold should remain within the consolidated group and should be recognized through the income statement. Excess tax benefits from awards granted by the sold subsidiary (i.e., in the equity of the sold subsidiary before the sale but recognized after the sale) should not be included in the former parent's income statement.

21.4.2.2 Identifying and measuring excess tax benefits in foreign jurisdictions

US companies generally do not receive a tax deduction on their US income tax return for share-based payments granted to employees of a foreign subsidiary. The foreign subsidiary generally will not receive a deduction on its foreign income tax return unless it is charged for the benefit by the parent. To obtain a deduction in the foreign jurisdiction, the parent company may institute a management charge to the foreign subsidiary equal to the intrinsic value of the share-based payment on exercise of an option or vesting of a share. Generally, no US taxes are owed on the payment because the payment is for the purpose of purchasing the US company's shares. Related entities may also enter into cost-sharing agreements, which generally include the sharing of stock-based compensation costs for tax purposes (as specified by US tax regulations). Refer to section 21.7.2, *Impact of research and development cost-sharing arrangements on deferred taxes*, for further discussion regarding the income tax effects of stock-based compensation on cost-sharing arrangements (CSAs).

At its 21 July 2005 meeting, the Resource Group discussed how companies should determine when excess tax benefits from options granted to employees of foreign subsidiaries have been realized and how to measure those excess tax benefits. The Resource Group agreed that the tax benefit that should be accounted for under the share-based payment model is limited to the actual benefit of the tax deduction taken on the local income tax return. As such, deferred taxes and any excess or deficient tax benefit should be measured at the local statutory income tax rate. Any benefit from the ability to repatriate earnings from the foreign jurisdiction to the parent's home jurisdiction (assuming such earnings are not indefinitely reinvested) would be recognized as a consequence of accounting for any outside basis difference under ASC 740-30.

Illustration 21-1: Identifying and measuring excess tax benefits in foreign jurisdictions

Facts

Assume a US parent company grants options to employees of a subsidiary in Country X with a grant-date fair value of $1,000. The US parent is subject to a US statutory income tax rate of 21%. The subsidiary in Country X is subject to a local statutory tax rate of 15% and, because the parent will charge the subsidiary for the shares delivered under the options, the subsidiary will take an income tax deduction for the intrinsic value of the options at exercise in its income tax return filed in Country X.

Analysis

The company would recognize in its consolidated financial statements $1,000 of compensation cost and a related deferred tax benefit (and deferred tax asset) of $150 for the options granted to employees of the subsidiary. If the intrinsic value of the options at exercise is $1,500 and that tax deduction is realized on the subsidiary's tax return, the parent company would also record in income an excess tax benefit of $75 (($1,500 − 1,000) × 15%) in its consolidated financial statements. Any additional benefit from the parent's ability to remit $1,500 without paying income tax would be recognized pursuant to ASC 740-30.

21.4.2.3 Realization of tax benefits on awards subject to graded vesting

As discussed in section 4.4.1.4, *Accounting for awards subject to graded vesting*, of our FRD, ***Share-based payment***, some share-based payments are subject to graded vesting. For example, an employer may grant employee stock options on 400 shares, 100 of which vest and become exercisable at the end of each year through year four. As discussed in section 7.3.2.3, *Expected term of awards with graded vesting*, of our FRD, ***Share-based payment***, the fair value of such an award may be estimated based on the values of four separate awards (each with a different vesting period and, most likely, a different expected term). Alternatively, fair value may be estimated for the award as a whole using an expected term based on the average of the expected terms of each vesting tranche.

While the former approach will most likely result in a better estimate of fair value, it complicates the accounting because each vesting tranche will have a different fair value (detailed examples of the accelerated and straight-line attribution models are provided in section 4.4.1.6, *Comprehensive examples of the* *accounting for awards subject to service vesting*, of our FRD, ***Share-based payment***), and a different resulting tax benefit. The FASB addressed the income tax accounting for share-based payments subject to graded vesting in ASC 718-20-55-34. However, the FASB staff has confirmed that this guidance only applies when the company has valued the award by treating the individual vesting tranches as separate awards and is using the accelerated attribution model described in section 4.4.1.4 of our FRD, ***Share-based payment***.

Excerpt from Accounting Standards Codification

Compensation — Stock Compensation — Awards Classified as Equity

Implementation Guidance and Illustrations

718-20-55-34

Accounting for the tax effects of awards with graded vesting follows the same pattern illustrated in paragraphs 718-20-55-20 through 55-23. However, unless Entity T identifies and tracks the specific tranche from which share options are exercised, it would not know the recognized compensation cost that corresponds to exercised share options for purposes of calculating the tax effects resulting from that exercise. If an entity does not know the specific tranche from which share options are exercised, it should assume that options are exercised on a first-vested, first-exercised basis (which works in the same manner as the first-in, first-out [FIFO] basis for inventory costing).

The earlier vesting tranches, generally with lower fair values (and lower tax benefits) because of the use of a shorter expected term, should be assumed to be exercised first.

If the award is valued as a single award with a single average expected term, the instruments in each vesting tranche would have the same fair value and the tracking issue described in ASC 718-20-55-34 would not arise. Additionally, for awards that are valued as separate awards but the company then recognizes the aggregate fair value of all tranches using the straight-line method as if they were a single award, the FASB staff believes that the separate values for each tranche are no longer meaningful from an attribution or tax standpoint. For these awards (i.e., any award subject to graded vesting for which compensation cost is being attributed using the straight-line method), the realization of tax benefits would be based on ASC 718-740-25-2 which states, in part, "[t]he deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes."

That is, the tax deductions that arise from the different vested tranches for an award measured as a single award would be indistinguishable from the others, despite the fact that the options are subject to graded vesting. Accordingly, deferred taxes would be allocated to exercised options on a pro rata basis (i.e., the deferred tax asset for each underlying share would be the same for all options granted at the same time with the same exercise price).

21.4.2.4 Tax effects of liability awards and Section 83(b) elections

In certain cases, the tax benefit recognized in the financial statements and reported on the tax return will be equal. This generally will occur whenever the measurement dates for the compensation cost recognized for financial reporting purposes corresponds to the date that the employer's tax benefit is measured. We believe that there are at least two circumstances in which this likely will be the case:

1. **Liability awards** — As discussed in chapter 5, *Accounting for liability instruments*, of our FRD, ***Share-based payment***, the final measurement of compensation cost for a liability award (e.g., a cash-settled stock appreciation right) is made on the settlement date. This generally is the date that the employee's taxable income and the employer's tax deduction are measured. Although the total amount of the tax deduction and the cumulative amount recognized for financial reporting purposes for liability-classified awards may be the same, the time period in which those amounts are reported for tax purposes as compared to financial reporting purposes may differ.

2. **Section 83(b) elections on nonvested stock** — Under Internal Revenue Code Section 83(b), an employee who receives nonvested stock (and certain other types of "property") is allowed to make an election to accelerate the inclusion of the value of the stock (measured on the grant date) in his or her ordinary income. The benefit of making the Section 83(b) election is that any subsequent appreciation in the value of the stock is treated as a capital gain, rather than ordinary income. However, the election generally cannot be revoked and, therefore, if the stock is worth less on the vesting date than on the grant date, the employee cannot adjust the amount originally included on his or her tax return for the year the award was granted (if the employee ultimately sells the shares for less than his or her basis in the shares determined on the date of the Section 83(b) election, the employee will receive a deduction for a capital loss). Assuming the grant of nonvested stock is accounted for as an equity award under ASC 718, both the compensation cost and the tax deduction are measured on the grant date. At its 21 July 2005 meeting, the Resource Group concluded that on the grant date, the employer recognizes a deferred tax liability (for the difference between the financial reporting basis and tax basis of the recognized compensation cost) as well as a reduction in taxes payable (the employer has recognized a tax deduction before it has recognized compensation cost in the financial statements). The company reduces the deferred tax liability as it recognizes compensation cost and a corresponding tax benefit over the requisite service period.

21.5 Examples of the accounting for the tax consequences of non-qualified stock options

21.5.1 Tax deduction differs from the amount of cumulative compensation cost recognized

Illustration 21-2: Excess tax benefit

Assumptions:

- Date of grant: 31 December 20X0
- Award: 3,000 non-qualified stock options
- Expected forfeitures: 0
- Market value of stock at date of grant: $10
- Option exercise price: $10
- Fair value of option at date of grant: $3
- Vesting: 100% at the end of three years — three years is the requisite service period.
- Tax rate: 21%
- Date of exercise: 31 December 20X5
- Market value of stock at the exercise date: $15

The compensation cost to be recognized over the vesting period of the options is $9,000 (3,000 options × $3), or $3,000 per year for three years. The deferred tax benefit recognized would be $630 per year ($3,000 × 21%).

The journal entries to be recorded through the exercise date (assuming the compensation cost is recognized as compensation expense, rather than capitalized) are as follows:

Annual entry — years 1-3

Compensation expense	$ 3,000	
Additional paid-in capital		$ 3,000

To recognize compensation expense over the requisite service period.

Deferred tax asset	$ 630	
Deferred income tax benefit		$ 630

To recognize the related deferred tax asset over the requisite service period. At the end of the vesting period the deferred tax asset totals $1,890 based on $9,000 of cumulative compensation expense.

On exercise

Cash	$ 30,000	
Additional paid-in capital	9,000	
Common stock and additional paid-in capital		$ 39,000

To recognize the cash proceeds and issuance of stock on exercise of 3,000 options.

Deferred income tax expense	$ 1,890	
Deferred tax asset		$ 1,890
Current income tax payable	$ 1,890	
Current income tax benefit		$ 1,890

To reverse the deferred tax asset accumulated over the vesting period and record the corresponding current tax benefit.

Current income tax payable	$ 1,260	
Current income tax benefit (income statement)		$ 1,260

To record the income statement impact of the excess tax benefits.

Number of options	3,000
Intrinsic value per share	$5
Total intrinsic value	$15,000
Tax rate	21%
Current year tax benefit	$3,150
Less amount previously recognized	(1,890)
Excess tax benefit realized in current period	$1,260

For illustrative purposes, the above entries, and those in the following example, assume that current taxes payable originally were recorded ignoring the effect of the tax deduction associated with the option exercise. As such, the journal entries to recognize the tax effects of option exercise reflect the incremental tax benefits resulting from the option exercise.

Summary:

	20X1	**20X2**	**20X3**	**20X5**	**Cumulative**
Compensation expense	$ 3,000	$ 3,000	$ 3,000	$ -	$ 9,000
Deferred tax expense (benefit)	(630)	(630)	(630)	1,890	-
Current tax benefit	-	-	-	(3,150)	(3,150)
Net impact on earnings	$ 2,370	$ 2,370	$ 2,370	$(1,260)	$ 5,850

Illustration 21-3: Tax shortfall

Assume the same facts as in Illustration 21-2, except that the market price of the stock on exercise is $11. The accounting and recognition of compensation expense and the deferred tax asset would be identical to that in Illustration 21-2 at the grant date and interim reporting dates, but would differ at exercise as the deferred tax asset at the date of exercise of $1,890 is not fully recoverable from the tax benefit of the actual tax deduction.

Because the tax deduction on exercise of $3,000 (3,000 options × $1 per share appreciation) is less than the cumulative compensation expense of $9,000 recognized for financial reporting purposes a tax shortfall exists ($9,000 – $3,000 = $6,000 shortfall). As a result, only a portion of the related deferred tax asset will reverse from the exercise of the option and the remaining portion of the deferred tax asset must be written off. The company will realize a benefit of only $630 (based on a deduction of $3,000 × 21% tax rate), but it previously recognized a deferred tax asset of $1,890 (based on $9,000 of compensation expense × 21% tax rate). The excess recorded deferred tax asset of $1,260 ($1,890 – $630) must be written off in the tax provision included in the income statement.

Exercise date (31 December 20X5)

Current income tax payable	$ 630	
Deferred income tax expense	630	
Deferred tax asset		$ 630
Current income tax benefit		630

To record the current tax benefit from the exercise of the options and the reversal of the related deferred tax asset.

Deferred income tax expense	$ 1,260	
Deferred tax asset		$ 1,260

To write off the remaining deferred tax asset due to tax shortfall on exercise of the options.

Summary:

	20X1	**20X2**	**20X3**	**20X5**	**Cumulative**
Compensation expense	$ 3,000	$ 3,000	$ 3,000	$ -	$ 9,000
Deferred tax expense (benefit)	(630)	(630)	(630)	1,890	-
Current tax benefit	-	-	-	(630)	(630)
Net impact on earnings	$ 2,370	$ 2,370	$ 2,370	$ 1,260	$ 8,370

In this example, while compensation expense in each of the vesting years is presented net of a 21% income tax benefit, the effective income tax rate in the year of exercise will be impacted by the $1,260 in additional income tax expense. This example also demonstrates the consequences of ASC 718's requirement to ignore subsequent changes in the market price of the stock in evaluating the need for a valuation allowance.

In each of these examples, it was assumed that a valuation allowance for the deferred tax asset was not required under ASC 740 for reasons unrelated to stock options (e.g., taxable income in the carryback (if permitted) or carryforward period). In addition, other aspects of ASC 740 that may affect the deferred tax accounting for share-based payments are not illustrated in the above examples (such as its provisions on accounting for changes in tax rates and laws).

21.6 Tax effects of awards that normally do not result in a tax deduction

Excerpt from Accounting Standards Codification

Income Taxes — Compensation — Stock Compensation — Overall

Recognition

718-740-25-2

The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a **deductible temporary difference** in applying the requirements of Subtopic 740-10. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

718-740-25-3

Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future **event** can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

Initial Measurement

718-740-30-1

The **deferred tax benefit (or expense)** that results from increases (or decreases) in the recognized share-based payment **temporary difference**, for example, an increase that results as additional service is rendered and the related cost is recognized or a decrease that results from forfeiture of an **award**, shall be recognized in the income statement.

One type of statutory stock option is an incentive stock option (ISO). The employer generally does not receive a tax deduction on employee exercise of an ISO. Similarly, an Internal Revenue Code Section 423 qualified employee stock purchase plan (ESPP) (see chapter 12, *Employee stock purchase plans*, of our FRD, ***Share-based payment***) normally does not provide a tax deduction for the employer. In addition, options exercised in some foreign jurisdictions may not result in any tax benefits.

The financial statement recognition of compensation cost for share-based payments for an arrangement that is not ordinarily deductible for tax purposes does not create deductible temporary differences under ASC 740. Temporary differences are described in ASC 740-10-05-10 as events recognized in earnings that, based on provisions in the tax law, result in taxable or deductible amounts in future periods even though identifiable assets or liabilities are not recognized for financial reporting purposes related to those events. Accordingly, if future tax deductions are ordinarily not available to the employer based on current tax law and the nature of the stock-based compensation arrangement (e.g., an ISO or qualified ESPP), a temporary difference is not created by the recognition of stock-based compensation in earnings and, accordingly, deferred taxes are not recognized for financial reporting purposes. Thus, neither a company's income tax expense nor its deferred tax accounts are impacted by incentive stock options, statutory ESPPs and similar arrangements that do not ordinarily result in tax deductions. Refer to chapter 4, *Temporary differences*, for further discussion.

21.6.1 Accounting for a change in the tax status of an award (e.g., disqualifying disposition)

A future event can give rise to an employer's tax deduction for an award that ordinarily does not result in a tax deduction for the employer (e.g., an employee's disqualifying disposition[72] of stock granted under an ISO, ESPP or a qualifying stock formula plan). Although many companies with ISOs, ESPPs and similar qualified plans have sufficient history of employee actions to reasonably estimate the level of disqualifying dispositions in future periods, ASC 718-740-25-3 precludes companies from anticipating disqualifying dispositions by employees. In other words, the tax benefits from disqualifying dispositions are required to be recognized in the period in which the employee makes the disqualifying disposition. On the occurrence of the future event that converts nondeductible awards into deductible awards (e.g., disqualifying dispositions), the tax benefit recognized in earnings is equal to the lesser of (1) the actual benefit of the tax deduction or (2) the cumulative compensation cost previously recognized in the financial statements for the disqualified award multiplied by the statutory tax rate (this accounting was confirmed by the Resource Group at its 21 July 2005 meeting). Any excess benefit should be recognized as an increase to income tax benefit in a manner similar to that discussed in section 21.4.1, *Tax deduction differs from compensation cost*.

21.6.1.1 Modifications of incentive stock options

A modification (e.g., an acceleration of vesting) may cause the disqualification of an ISO. If ISO status is disallowed because of a disqualifying modification, then the award should be treated as if it had been a non-qualified option from its grant date. That is, deferred taxes should be recognized on all compensation cost previously recognized for the award on the date of the modification. Thereafter, the tax effect of the award would be accounted for the same as any other non-qualified award.

21.7 Other issues

21.7.1 Income tax effects of replacement awards classified as equity issued in a business combination

ASC 805 requires that deferred taxes, if any, related to the cost of replacement awards classified as equity issued in a business combination and considered part of consideration transferred be accounted for as an element of consideration transferred in the business combination if the replacement award is expected to result in a future tax deduction under existing tax law. To the extent that the cost of replacement awards classified as equity is recognized as post-combination compensation cost, a deferred tax asset would generally be established (through income tax expense) as that compensation cost is recognized. However, any eventual tax benefit associated with the replacement share-based payment awards (i.e., the excess or deficiency) is accounted for without regard to whether the benefit is related to (sourced from) consideration transferred in the business combination or post-combination compensation cost.

Any difference between the eventual tax benefit received and the amount of deferred tax asset associated with a replacement award should be recognized in the income tax provision in the income statement.

ASC 805 also states that an acquirer should not recognize a deferred tax asset for the portion of a replacement award that is attributed to past service if the replacement award would not result in a future tax deduction under current tax law. However, a future event, such as a disqualifying disposition, may result in a tax deduction for an award that ordinarily does not qualify for a tax deduction. For further discussion on the application of this accounting requirement, see section 11.14, *Income tax effects of replacement awards classified as equity issued in a business combination*.

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[72] Tax regulations require that an employee hold the shares purchased through an ESPP or the shares obtained on exercise of an ISO for a specified period of time in order to achieve the beneficial tax treatment associated with such plans. Any sale of shares before the end of the required holding period is considered a disqualifying disposition. A disqualifying disposition generally results in adverse tax consequences for the employee and allows the employer to take a tax deduction relating to a share-based payment award that would not otherwise result in a tax deduction.

21.7.2 Impact of research and development cost-sharing arrangements on deferred taxes

Related companies that plan to share the cost of developing intangible property may choose to enter into what is commonly characterized as a "cost-sharing arrangement" whereby two related companies agree to share the costs of developing intangible assets. US tax regulations specify the expenses that must be included in a pool of shared costs; such expenses include costs related to share-based payments granted in tax years beginning after 26 August 2003.[73] The tax regulations provide two methods for determining the amount and timing of stock-based compensation that is to be included in the pool of shared costs: the "exercise method" and the "grant method." Under the exercise method, the timing and amount of the allocated expense is based on the intrinsic value of the award on the exercise date. Companies that elect to follow the grant method allocate expense based on the grant-date fair values that are to be included in a pool of shared costs. Under the grant method, companies must include such costs in US taxable income regardless of whether the options are ultimately exercised by the holder and result in an actual US tax deduction.

The impact of R&D CSAs was discussed by the Resource Group at its 21 July 2005 meeting. The Resource Group concluded that companies should consider the impact of CSAs when measuring the deferred tax assets and excess tax benefits resulting from share-based payments based on the tax election they have made or plan to make. The following example illustrates how those arrangements would be considered in the tax accounting for share-based payments.

Illustration 21-4: Impact of research and development cost-sharing arrangements on deferred taxes

Assume that Company A, located in the United States, enters into a cost-sharing arrangement with its subsidiary, Company B, which is located in Switzerland. Under the arrangement, the two companies share costs associated with the research and development of certain technology. Company B reimburses Company A for 30% of the research and development costs incurred by Company A. The US tax rate is 25%. Cumulative compensation cost recognized for financial reporting purposes for a fully vested option is $1,000 for the year ending on 31 December 2006. The award is exercised during 2007, when the intrinsic value of the option is $1,500.

Exercise method

If Company A uses the exercise method to determine the cost of share-based payments to be included in the cost-sharing pool, on 31 December 2006, it records $175 as the deferred tax asset related to the option ($1,000 [GAAP compensation expense] x 70% [percentage not subject to reimbursement] x 25% [tax rate]). When, in 2007, the option is exercised, any net tax benefit that exceeds the deferred tax asset is an excess tax benefit and credited to income tax benefit in the income statement. The company is entitled to a US tax deduction (net of the inclusion) of $263 ($1,500 [intrinsic value when the option is exercised] x 70% [percentage not reimbursed] x 25%). Accordingly, $88 ($263 − $175) would be recognized in income tax benefit in the income statement.

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[73] On 27 July 2015, the US Tax Court decided that a 2003 Treasury Department regulation that requires multinational companies that share the costs associated with the joint development of intangible property pursuant to a CSA between operations in the US and other countries to include stock-based compensation in the pool of shared costs is invalid. On 7 June 2019, the Ninth Circuit Court issued its final opinion reversing the US Tax Court's 2003 holding and upholding the 2003 IRS regulations that required participants in a cost-sharing arrangement to treat stock-based compensation costs as compensable. On 22 June 2020, the Supreme Court of the United States announced that it was denying the taxpayer's petition for certiorari and will not review an appeals court decision in the case. Each of these developments represents new information that should be considered in evaluating accounting conclusions regarding the recognition and measurement of related tax matters. The Tax Court's, Ninth Circuit Court's and Supreme Court's actions and any subsequent developments should be evaluated in the context of the income tax accounting guidance for uncertain tax positions (see chapter 19, *Accounting for uncertainty in income taxes*).

Grant method

If Company A uses the grant method to determine the cost of share-based payments to be included in the cost-sharing pool, the tax impact of the cost-sharing agreement is an increase in currently payable US taxes each period. However, in contrast to the exercise method, the cost-sharing method should have no direct impact on the carrying amount of the US deferred tax asset related to share-based compensation. If there was $1,000 of stock-based compensation during 2006, the impact of the cost sharing arrangement on the 2006 current tax provision would be $75 ($1,000 [book compensation expense] x 30% [percentage reimbursed] x 25%). If the stock-based charge under ASC 718 is considered a deductible temporary difference, a deferred tax asset also should be recognized in 2006 for the financial statement expense, in the amount of $250 ($1,000 [GAAP compensation expense] x 25%). The net impact on the 2006 income statement is a tax benefit of $175 ($250 — $75). At settlement, the excess tax deduction of $125 ($500 x 25%) would be recognized in income tax benefit in the income statement.

21.7.3 Accounting for income tax benefits of dividends on share-based payments

Excerpt from Accounting Standards Codification

Income Taxes — Compensation — Stock Compensation

Other Presentation Matters

Tax Benefits of Dividends on Share-Based Payment Awards

718-740-45-8

An income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to grantees for any of the following equity classified awards shall be recognized as income tax expense or benefit in the income statement:

a. Nonvested equity shares

b. Nonvested equity share units

c. Outstanding equity share options.

In some cases, grantees may receive, as part of a share-based payment arrangement, dividend payments from the date the award is granted even though the award is subject to vesting requirements. As discussed further in section 3.6.1, *Dividends or dividend equivalents paid on equity instruments prior to vesting*, of our FRD, ***Share-based payment***, if an entity has elected to estimate forfeitures, ASC 718-10-55-45 requires that non-forfeitable dividend payments on employee awards are charged to retained earnings if the award is expected to vest; however, dividend payments on awards that are not expected to vest are recognized as compensation expense. Dividends and dividend equivalents are reclassified between retained earnings and compensation cost when the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates). If an entity has elected to account for forfeitures as they occur, non-forfeitable dividend payments and dividend equivalents paid on employee awards will initially be recorded to retained earnings. Amounts previously charged to retained earnings are reclassified to compensation cost in the period the award is forfeited.

In some cases, the payment of non-forfeitable dividends or dividend equivalents on nonvested shares (or nonvested share units) and unexercised options is treated as deductible compensation for income tax purposes. ASC 718-740-45-8 says that an income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for nonvested share-based payments should be recognized as a reduction of income tax expense (or increase an income tax benefit) in the income statement.

21.7.4 Accounting for payroll taxes on share-based payments (not subject to ASC 740)

Excerpt from Accounting Standards Codification

Compensation — Stock Compensation — Overall

Recognition

718-10-25-22

A liability for employee payroll taxes on employee stock compensation shall be recognized on the date of the event triggering the measurement and payment of the tax to the taxing authority (for a nonqualified option in the United States, generally the exercise date).

718-10-25-23

Payroll taxes, even though directly related to the appreciation on stock options, are operating expenses and shall be reflected as such in the statement of operations.

When an employee exercises a non-qualified stock option, the difference between the exercise price paid and the fair value of the acquired stock on the exercise date (the intrinsic value) is considered ordinary income for purposes of determining the employee's federal income taxes. Similar tax treatment results from the exercise of qualified stock options that are subsequently disqualified. In the period in which the option is exercised or the disqualifying disposition occurs, the employer is entitled to a federal income tax deduction in an amount equal to the employee's ordinary income. Because the intrinsic value of exercised options is considered the equivalent of compensation paid directly to the employee, the employer must pay payroll-related taxes (e.g., Medicare taxes, perhaps FICA taxes depending on the employee's aggregate compensation level). These payroll related taxes are not income taxes and are not subject to ASC 740. Refer to the EY Accounting Manual chapter A2, *Accrued liabilities and accounts payable*, for a general discussion regarding the accounting for accrued payroll taxes.

In addition, when an employee receives stock for services, the excess of the fair value of the stock over the purchase price is taxed currently as ordinary income. However, if the stock is subject to a "substantial risk of forfeiture" and is nontransferable, taxation is deferred until the risk of forfeiture lapses or the stock becomes transferable. In the period that the employee recognizes ordinary income, the employer is entitled to a corresponding deduction and the employer must pay any applicable payroll related taxes.

ASC 718-10-25-22 states that the liability for employee payroll taxes on employee share-based payment arrangements should be recognized on the date of the event that triggers measurement and payment of the payroll tax to the taxing authority. As a result, no liability should be recognized until that event occurs. For example, in the US the obligating event for the payroll tax liability associated with a non-qualified stock option generally is the stock option exercise date.

ASC 718-10-25-23 states that employer-paid payroll taxes associated with stock option exercises are operating expenses and should be reflected as such in the statement of operations.

21.8 Presentation of excess tax benefits and tax deficiencies in the statement of cash flows

Excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) are recognized as income tax expense or benefit in the income statement and, therefore, should be classified as operating activities in the statement of cash flows (ASC 230-10-45-17(c)).

A Abbreviations used in this publication

Abbreviation	FASB Accounting Standards Codification
ASC 205	Presentation of Financial Statements
ASC 210	Balance Sheet
ASC 220	Income Statement — Reporting Comprehensive Income
ASC 225	Income Statement
ASC 235	Notes to Financial Statements
ASC 250	Accounting Changes and Error Corrections
ASC 255	Changing Prices
ASC 270	Interim Reporting
ASC 275	Risks and Uncertainties
ASC 310	Receivables
ASC 320	Investments — Debt Securities
ASC 321	Investments — Equity Securities
ASC 323	Investments — Equity Method and Joint Ventures
ASC 326	Financial Instruments — Credit Losses
ASC 330	Inventory
ASC 350	Intangibles — Goodwill and Other
ASC 360	Property, Plant and Equipment
ASC 405	Liabilities
ASC 410	Asset Retirement and Environmental Obligations
ASC 450	Contingencies
ASC 460	Guarantees
ASC 470	Debt
ASC 606	Revenue from Contracts with Customers
ASC 610	Other Income
ASC 715	Compensation — Retirement Benefits
ASC 718	Compensation — Stock Compensation
ASC 740	Income Taxes
ASC 805	Business Combinations
ASC 810	Consolidation
ASC 815	Derivatives and Hedging
ASC 830	Foreign Currency Matters
ASC 835	Interest
ASC 840	Leases
ASC 842	Leases
ASC 852	Reorganizations
ASC 855	Subsequent Events
ASC 860	Transfers and Servicing
ASC 942	Financial Services — Depository and Lending
ASC 944	Financial Services — Insurance

Abbreviation	FASB Accounting Standards Codification
ASC 970	Real Estate — General
ASC 980	Regulated Operations
ASU 2014-01	Accounting for Investments in Qualified Affordable Housing Projects
ASU 2014-02	Accounting for Goodwill
ASU 2016-01	Recognition and Measurement of Financial Assets and Financial Liabilities
ASU 2016-13	Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments
ASU 2017-04	Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment
ASU 2018-02	Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income
ASU 2019-12	Income Taxes (Topic 740) — Simplifying the Accounting for Income Taxes
ASU 2020-06	Debt-Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging-Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity
ASU 2023-02	*Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*

Abbreviation	Other authoritative standards
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
SAB 5.S	Quasi-Reorganization
SAB 118	Income Tax Accounting Implications of the Tax Cuts and Jobs Act
SAB 121	Accounting for Obligations to Safeguard Crypto-Assets an Entity Holds for its Platform Users

Abbreviation	Non-authoritative standards
Statement 5	Accounting for Contingencies
Statement 109	Accounting for Income Taxes
Statement 141	Business Combinations
Statement 141(R)	Business Combinations
FSP FAS 109-2	Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004
FIN 18	Accounting for Income Taxes in Interim Periods
FIN 45	Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others
FIN 48	Accounting for Uncertainty in Income Taxes, an interpretation of Statement No. 109
APB 16	Business Combinations
APB 23	Accounting for Income Taxes — Special Areas
SOP 93-6	Employers' Accounting for Employee Stock Ownership Plans
SOP 96-1	Environmental Remediation Liabilities
EITF 94-10	Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109
EITF 00-23	Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44

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740-270-45-7 through 45-8	20.6.2	Discontinued operations
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830-10-45-15	3.3	Remeasurement in highly inflationary economies
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830-740-25-5	3.3.2	General price-level changes — restatement of financial statements
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C Non-authoritative guidance

The following guidance represents non-authoritative literature. We have decided to maintain the guidance for those companies that have not adopted the FASB Accounting Standards Codification and the Accounting Standards Updates.

C1 (Non-authoritative) Business combinations — before the adoption of Statement 141(R)

This chapter discusses the income tax effects of business combinations prior to the adoption of Statement 141(R). Refer to Chapter 11 for the accounting for the tax effects of business combinations upon the adoption of Statement 141(R).

In December 2007, the FASB issued Statement 141(R), which amends the accounting guidance in Statement 109 and FIN 48. These amendments are effective upon the adoption of Statement 141(R). Accordingly, the guidance in this section will no longer apply once a company adopts Statement 141(R), which must be adopted for an entity's fiscal year beginning after 15 December 2008 (fiscal year 2009 for a calendar year-end company).

Non-authoritative literature

Excerpt from Statement 109, prior to the adoption of Statement **141(R)**

30. A deferred tax liability or asset shall be recognized in accordance with the requirements of this Statement for differences between the assigned values and the tax bases of the assets and liabilities (except the portion of goodwill for which amortization is not deductible for tax purposes, unallocated excess over cost (also referred to as negative goodwill), leveraged leases, and acquired Opinion 23 differences[8]) recognized in a purchase business combination (refer to paragraphs 259-272 for additional guidance). If a valuation allowance is recognized for the deferred tax asset for an acquired entity's deductible temporary differences or operating loss or tax credit carryforwards at the acquisition date, the tax benefits for those items that are first recognized (that is, by elimination of that valuation allowance) in financial statements after the acquisition date shall be applied (a) first to reduce to zero any goodwill related to the acquisition, (b) second to reduce to zero other noncurrent intangible assets related to the acquisition, and (c) third to reduce income tax expense.

[8] Acquired Opinion 23 differences are accounted for in accordance with the requirements of Opinion 23, as amended by this Statement.

C1.1 General — before the adoption of Statement 141(R)

In June 2001, the FASB issued Statement No. 141, *Business Combinations* (Statement 141), and Statement 142. The issuance of Statement 141 and Statement 142 drastically changed the accounting for business combinations, goodwill and intangible assets. The effect of these Statements is far reaching, impacting not only those companies completing business combinations in the future but also any company with unamortized balances of acquired goodwill or intangible assets from past acquisitions. The key provisions of Statement 141 include: eliminating the pooling of interests method of accounting for business combinations initiated on or after 1 July 2001; requiring intangible assets to be recorded apart from goodwill if they meet certain criteria; and significantly increasing the disclosures about business combinations. Certain purchase accounting guidance in APB Opinion No. 16, *Business Combinations* (APB 16), as well as certain of its amendments and interpretations, have been carried forward to

Statement 141 without reconsideration. The key provisions of Statement 142 include: replacing amortization of goodwill and indefinite-lived intangible assets with annual impairment reviews (or more frequently when indicators of impairment exist); requiring intangible assets (other than indefinite-lived intangibles) to be amortized using a method that reflects the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up; providing a model and methodology to test for and measure goodwill impairment to be applied by both public and nonpublic companies; guidance to test intangible assets that are not amortizable for impairment, creating what is essentially a lower of cost or fair value model for these assets; and increasing disclosure requirements. See our FRD, ***Business combinations***, for additional information.

Statement 141 and Statement 142 did not amend the requirements of Statement 109 for recognition of deferred taxes in a business combination. As a result, in taxable business combinations that yield tax-deductible goodwill, application of Statement 142 will result in the accumulation of significant deferred tax liabilities over time as goodwill is deducted on tax returns but not amortized for financial reporting. The same situation will arise for indefinite-lived intangible assets that are not amortized for financial reporting purposes but are deductible for tax purposes. These deferred tax liabilities will reverse as impairment charges are recognized or when the businesses to which the goodwill or the intangible assets relate are disposed of through sale or otherwise. See section 6.4.4, *Limitations on taxable temporary differences related to indefinite-lived assets as a source of future taxable income*, for issues associated with limitations on the ability to use the reversal of such deferred tax liabilities in assessing the need for, and amount of, a valuation allowance.

C1.2 Tax effects of basis differences — before the adoption of Statement 141(R)

Statement 109.30 requires the recognition of deferred tax assets and liabilities for the tax effects of differences between assigned values in the purchase price allocation and tax bases of assets acquired and liabilities assumed in a purchase business combination (except for the portion of goodwill that is not deductible for tax purposes, unallocated "negative goodwill," leveraged leases and acquired APB 23 differences). Acquired APB 23 differences are accounted for in accordance with APB 23, as amended by Statement 109 (see section C1.3.9.3, *Assertion regarding indefinite reinvestment — before the adoption of Statement 141(R)*, for a further discussion). The provisions of Statement 109 apply to basis differences that arise in both taxable and nontaxable business combinations.

Illustration C1-1

Assume that at the beginning of 20X0, a company acquires another company for $60 million in a tax-free business combination. The only book/tax basis difference relates to depreciable property and equipment with a fair value of $50 million and a zero tax basis. The fair values of other identifiable assets acquired and liabilities assumed net to zero. The tax rate is 40%, no future tax rate changes have been enacted, and the amortization of goodwill is not deductible for tax purposes. The purchase price allocation (in millions) under Statements 109 and 141 is as follows:

Property and equipment	$	50	
Deferred tax liability		(20)	(Basis difference of $50 million x 40%)
Goodwill		30	(Derived)
Purchase price		60	

Assume for 20X0 the company has consolidated pretax income of $10 million exclusive of charges for depreciation related to the acquired company. Assuming no other book-taxable income differences, taxes currently payable would be $4 million ($10 million times 40%). Property and equipment acquired in the business combination are depreciated over 10 years. Goodwill, which is not tax-deductible, is not amortized for book purposes (and not impaired) in this example. Income statement reporting under Statement 109 (in millions) would be as follows:

Pretax income before adjustments	$ 10
Acquired-company charges:	
Depreciation	(5)
Pretax income	$ 5
Income taxes:	
Current payable	(4)
Deferred benefit	2
Total income taxes	(2)
Net income	$ 3

C1.3 Identifiable intangible assets and goodwill — before the adoption of Statement 141(R)

Statement 141.35 requires companies to allocate the purchase price in a business combination to the individual assets acquired and liabilities assumed based on the estimated fair values of the acquired assets and assumed liabilities at the acquisition date. Individual assets include tangible assets (e.g., inventories and property), financial assets (e.g., accounts and notes receivable, marketable and nonmarketable securities, and derivative contracts) and identifiable intangible assets (e.g., patents, franchises, and trademarks). For income tax purposes, amounts assigned to particular assets acquired and liabilities assumed may be different from amounts used for financial reporting. The differences in assigned values for financial reporting and tax purposes result in temporary differences. In applying Statement 109, companies are required to recognize the tax effects of temporary differences related to all assets and liabilities, including identifiable intangible assets, except goodwill that is not tax-deductible, unallocated "negative goodwill," leveraged leases, and acquired APB 23 differences.

C1.3.1 Nondeductible goodwill — before the adoption of Statement 141(R)

Goodwill arises in business combinations when the purchase price exceeds the assigned values of tangible and identifiable intangible assets acquired less liabilities assumed. Conceptually, the difference between the book basis and tax basis of goodwill constitutes a temporary difference and deferred taxes should be recognized. However, the requirements of Statement 109 differ depending on whether goodwill can be amortized as a deduction for tax purposes. Statement 109.9(d) prohibits recognition of a deferred tax asset or liability for goodwill temporary differences if goodwill is not amortizable and deductible for tax purposes.

When the amortization of goodwill is not deductible for tax purposes, recognition of deferred taxes for the future tax effects of recovering goodwill would result in a deferred tax liability that would further increase both goodwill *and* deferred tax liabilities because goodwill and the related deferred tax liability are mutually dependent on each other in the mechanics of recording the purchase transaction. The FASB concluded that adjusting goodwill by an amount equal to the deferred tax liability to reflect the future tax effects of recovering goodwill would not provide information that was particularly relevant and the computation of that adjustment would oftentimes be complex. Thus, the FASB concluded deferred tax liabilities should not be recognized for goodwill temporary differences if goodwill is not tax-deductible.

C1.3.2 Nondeductible identified intangible assets — before the adoption of Statement 141(R)

All basis differences related to identified intangible assets are temporary differences for which deferred tax assets and liabilities should be recognized. Although some believe identified intangible assets that are not deductible for tax purposes are essentially the same as goodwill and the accounting for the income tax effects of those intangible assets should be the same as nondeductible goodwill, the FASB disagreed with that approach because they believe goodwill is different from other types of intangible assets. The FASB believes goodwill is a residual — it is the excess of the purchase price over the assigned values of the net assets acquired. In the FASB's view, other types of intangibles are not residuals and the computation of the required deferred tax adjustment would not be complex.

C1.3.3 Purchase price allocation differences — before the adoption of Statement 141(R)

In a taxable business combination, the purchase price is assigned to the assets acquired and the liabilities assumed for tax purposes as well as for financial reporting purposes. However, the amounts assigned to particular assets and liabilities may differ for financial reporting and tax purposes. Statement 109 requires deferred tax liabilities and assets to be recognized for the deferred tax consequences of those temporary differences. For example, a portion of the amount of goodwill recorded for financial reporting purposes may be allocated to other assets for income tax purposes, and amortization of that other asset may be deductible for tax purposes. If a valuation allowance is recognized for a portion, or all, of that deductible temporary difference (i.e., deferred tax asset) at the acquisition date, Statement 109.261 requires the initial recognition of those tax benefits (i.e., the reduction of the valuation allowance) to be applied first to reduce goodwill related to that acquisition to zero, then to reduce other noncurrent intangible assets related to that acquisition to zero, and any remaining benefits recognized as a reduction of income tax expense.

Illustration C1-2

Assume that $1 million of the purchase price of a business combination was allocated to goodwill for financial reporting purposes; however, for tax purposes the $1 million was allocated to an intangible asset, the amortization of which is deductible for tax purposes. Also, assume that the tax rate is 40%. The purchase price accounting would include a deferred tax asset of $400,000 ($1,000,000 x 40%) related to the amortizable intangible asset recognized for tax purposes. If a valuation allowance is recognized at the acquisition date for the $400,000 deferred tax asset, subsequent recognition of that tax benefit would reduce the recorded amount of goodwill related to the acquisition.

C1.3.4 Tax-deductible goodwill — before the adoption of Statement 141(R)

In tax jurisdictions where amortization of goodwill is deductible for tax purposes, Statement 109.262 requires that the reported amount of goodwill and the tax basis of goodwill each be separated into two components as of the business combination date for purposes of computing deferred taxes. This analysis should include all goodwill recorded as a result of the business combination, including goodwill previously recorded by the acquired company that has been assumed by the acquiring company. The first component of each equals the lesser of goodwill for financial reporting or tax-deductible goodwill. The second component of each equals the remainder of each, that is, (1) the remainder, if any, of goodwill for financial reporting over tax-deductible goodwill or (2) the remainder, if any, of tax-deductible goodwill over goodwill recorded for financial reporting. Deferred taxes are recognized for any differences that arise in the future between the book basis and tax basis of the first component of goodwill. Deferred taxes are not recognized for the second component of goodwill. If the second component is an excess of tax-deductible goodwill over the reported amount of goodwill, the tax benefit for that excess is recognized when realized on the tax return. That tax benefit is applied first to reduce goodwill and then other noncurrent intangible assets related to that acquisition to zero and any remainder is recognized as a reduction of income tax expense. The following example, which has been adapted from Statement 109.263, illustrates the accounting for tax-deductible goodwill in a taxable business combination.

Illustration C1-3

Assume, at the combination date, the reported amount and tax basis of goodwill are $600 and $800, respectively. In addition, for tax purposes, amortization of goodwill will result in tax deductions of $400 in each of years 1 and 2. Those deductions result in a current tax benefit in years 1 and 2. Further, assume goodwill has not been impaired for financial reporting purposes.

For purposes of simplification, the consequences of other temporary differences are ignored for years 1 through 4, the tax rate is 40% for all years and income before income taxes in each of years 1 through 4 is $1,000.

Income taxes payable for years 1 through 4 are:

	Year 1	**Year 2**	**Year 3**	**Year 4**
Pretax book income	$ 1,000	$ 1,000	$ 1,000	$ 1,000
Tax deduction for goodwill amortization for tax purposes	(400)	(400)	–	–
Taxable income	$ 600	$ 600	$ 1,000	$ 1,000
Income taxes payable (40% of taxable income)	$ 240	$ 240	$ 400	$ 400

At the combination date, goodwill is separated into two components as follows:

	Reported amount	**Tax basis**
First component (lesser of goodwill for financial reporting or tax-deductible goodwill)	$ 600	$ 600
Second component (remainder)	–	200
Total goodwill	$ 600	$ 800

A deferred tax liability is recognized at the end of each year for the excess of the reported amount over the tax basis of the first component of goodwill (Note: goodwill for financial reporting purposes remains unchanged at $600 until it is impaired or disposed through sale or otherwise). A deferred tax asset is not recognized for the second component of goodwill; the tax benefit is allocated to reduce goodwill when realized on the tax returns for years 1 and 2.

The second component of goodwill is deductible $100 per year in years 1 and 2. Those tax deductions provide $40 ($100 at 40%) of tax benefits that are realized in each of years 1 and 2. Allocation of those realized tax benefits to reduce the first component of goodwill produces a deferred tax benefit by reducing the taxable temporary difference related to that component of goodwill. Thus, the total tax benefit allocated to reduce the first component of goodwill in each of years 1 and 2 is the sum of (1) the $40 realized tax benefit allocated to reduce goodwill and (2) the deferred tax benefit from reducing the deferred tax liability related to goodwill. That total tax benefit (TTB) is determined as follows:

TTB = Realized tax benefit + (Tax rate x TTB)
TTB = $40 + (.40 x TTB)
TTB -.4TTB = $40
0.6TTB = $40
TTB = $40 / 0.6
TTB = $67

Goodwill for financial reporting purposes remains unchanged at $600 until it is impaired or disposed through sale or otherwise. Accordingly, the deferred tax liability for the first component of goodwill and the related amount of deferred tax expense (benefit) for years 1 through 4 are:

	Year 1	Year 2	Year 3	Year 4
Reported amount of goodwill at end of year	$ 533 (a)	$ 466 (c)	$ 466	$ 466
Tax basis of goodwill (first component)	300 (b)	– (d)	–	–
Taxable temporary difference	$ 233	$ 466	$ 466	$ 466

(a) Original book goodwill of $600 reduced by $67 tax benefit realized in year 1 recognized as a reduction in book goodwill

(b) Computed as first component of goodwill ($600) less first-year amortization ($300).

(c) Original book goodwill of $600 reduced by $67 tax benefit realized in years 1 and 2 recognized as a reduction in book goodwill.

(d) Computed as first component of goodwill ($600) less first- and second- year tax amortization ($300 + $300).

	Year 1	Year 2	Year 3	Year 4
Deferred tax liability:				
At end of year (40%)	$ 93.2	$ 186.4	$ 186.4	$ 186.4
At beginning of year	(–)	(93.2)	(186.4)	(186.4)
Deferred tax expense (benefit) for the year	$ 93.2	$ 93.2	$ –	$ –

Income for financial reporting for years 1 through 4 is:

	Year 1	Year 2	Year 3	Year 4
Income before income taxes	$ 1,000.0	$ 1,000.0	$ 1,000.0	$ 1,000.0
Income tax expense (benefit):				
Current	240.0	240.0	400.0	400.0
Deferred	93.2	93.2	–	–
Benefit applied to reduce goodwill	67.0	67.0	–	–
Income tax expense	400.2	400.2	400.0	400.0
Net income	$ 599.8	$ 599.8	$ 600.0	$ 600.0

C1.3.5 Immediate recognition of tax benefits in a business combination — before the adoption of Statement 141(R)

Questions have arisen regarding the appropriateness of the immediate recognition in earnings of the tax benefits associated with costs incurred in a business combination that are deductible for tax purposes in the period in which the business combination is consummated but treated as part of the cost/purchase price allocation for financial reporting purposes. We believe the tax benefits related to costs that are included in the acquisition cost/purchase price allocation should also be recognized as a component of the acquisition (i.e., included in the purchase price allocation) rather than immediately recognized in earnings.

Illustration C1-4

Assume Company LMS acquires Company CS is a nontaxable transaction that results in nondeductible goodwill of $50. Further, assume that Company LMS incurs $10 of professional fees that, based on existing tax laws and regulations, are deductible when incurred but included as a component of the purchase price for book purposes.

Although Company LMS will receive an immediate tax deduction for the professional fees, the immediate recognition of those tax benefits in earnings while the underlying cost is included in nondeductible goodwill for financial reporting purposes would result in an inappropriate gain upon consummation of the business combination. Instead, $4 ($10 x 40%) of the goodwill recognized by Company LMS attributable to the acquisition is considered tax-deductible goodwill and deferred taxes would be required.

C1.3.6 Negative goodwill — before the adoption of Statement 141(R)

In a business combination in which the fair value of the identifiable net assets acquired exceeds the cost of the acquired business, Statement 141.44 requires the excess over cost (i.e., negative goodwill) to reduce, on a pro rata basis, amounts assigned to all of the acquired assets, including purchased research and development assets required to be written off in accordance with FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method — an interpretation of FASB Statement No. 2* (FIN 4), with the exception of financial assets (other than investments accounted for by the equity method), assets to be disposed by sale, deferred tax assets, prepaid assets related to postretirement benefit plans, and any other current assets (ARB No. 43, Chapter 3, *Working Capital*, provides guidance on determining current assets).

If any excess remains after reducing to zero the amounts that would have been assigned to the assets acquired (which the FASB believes will be rare), that excess should be recognized as an extraordinary gain as described in APB Opinion No. 30, *Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (APB 30). The extraordinary gain should be recognized in the period in which the business combination is consummated unless the business combination involves a contingent consideration agreement (i.e., an "earn-out provision") that could result in additional cost of the acquired company. If an extraordinary gain is recognized before the end of the allocation period, any subsequent adjustment to the extraordinary gain resulting from changes in the purchase price allocation should be recognized as an extraordinary item.

The allocation of negative goodwill under Statement 141 reduces the values assigned to certain noncurrent assets, which changes the amounts of temporary differences related to those assets and thus changes the amounts of deferred tax assets or liabilities. The deferred taxes resulting from that computation will again change the amount of negative goodwill, the allocation to assets, the related temporary difference, deferred taxes and so on. The amount of negative goodwill, and any deferred tax asset or liability arising from a purchase business combination, are mutually dependent and iterative. The final amounts must be determined using iterative calculations or algebraic equations, which are illustrated in the following example.

Illustration C1-5

Assume that a company is acquired for $18,000 in a nontaxable purchase business combination. The tax rate is 40%. Fair values and tax bases are as follows:

	Fair value	Tax basis	Initial purchase price allocation
Noncurrent assets	$ 5,000	$ 1,000	$ 1,000
Inventory	17,000	15,200	17,000
Nondeductible goodwill	-	1,800	-
	$ 22,000	$ 18,000	$ 18,000

Under Statement 141.44, the company would assign the $18,000 purchase price to identified assets and liabilities. In this case, negative goodwill before recognition of deferred taxes is $4,000 ($22,000 total fair value less $18,000 purchase price). The initial amount assigned to noncurrent assets, before consideration of deferred taxes, would be $1,000 ($18,000 purchase price less $17,000 assigned to inventory).

The allocation of negative goodwill to noncurrent assets and the determination of deferred taxes may be solved using an equation as illustrated in the following formula, assuming that the tax rate is the same for all future years:

DTL = Tax rate x (original temporary difference + DTL)
DTL = 40% x ($1,800(a) + DTL)
DTL = $720 + 0.4DTL
DTL − 0.4DTL = $720
0.6DTL = $720
DTL = $720 ÷ 0.6
DTL = $1,200

(a) The original temporary difference equals the fair value of acquired assets less initial negative goodwill less the tax basis of acquired assets (or $22,000 − $4,000 − ($1,000 + $15,200)).

The deferred tax liability of $1,200 reduces the amount of negative goodwill initially allocated to reduce noncurrent assets. As a result, $1,200 would be added to the net value assigned to noncurrent assets before consideration of deferred taxes as follows:

Fair value of noncurrent assets	$ 5,000
Negative goodwill	(4,000)
	1,000
Addition to noncurrent assets	1,200
Net value assigned to noncurrent assets	$ 2,200

A proof of the purchase price allocation follows:

	Book basis	Tax basis	Taxable temporary difference
Noncurrent assets	$ 2,200	$ 1,000	$ 1,200
Inventory	17,000	15,200	1,800
Nondeductible goodwill	–	1,800	N/A
Deferred tax liability	(1,200)	N/A	N/A
Totals	$ 18,000	$ 18,000	3,000
Tax rate			40%
Deferred tax liability			$ (1,200)

Final purchase accounting:

Noncurrent asset	$ 2,200
Inventory	17,000
Deferred tax liability	(1,200)
Purchase price	$ 18,000

As illustrated in the above example, amounts allocated to assets and liabilities (including deferred tax liabilities) equal the purchase price, and taxable temporary differences multiplied by the tax rate equal the recorded deferred tax liability.

In the above example, the allocation of negative goodwill reduced noncurrent assets to $2,200. In some business combinations, the allocation of negative goodwill may reduce noncurrent assets to zero. The balance of unallocated negative goodwill does not give rise to temporary differences for which deferred tax assets and liabilities should be recognized. Statement 109.30, prior to the adoption of Statement 141(R), specifies that deferred taxes shall not be provided for unallocated negative goodwill.

Illustration C1-6

Assume that a business is acquired for $18,000 in a nontaxable business combination and that there is not any contingent purchase price agreement. The tax rate is 40% and the company could recognize tax benefits for deductible temporary differences, if any, arising from the acquisition. Fair values and tax bases are as follows:

	Fair value	Tax basis	Initial purchase price allocation
Noncurrent assets	$ 5,000	$ 1,000	$ –
Inventory	23,200	15,200	18,000
	$ 28,200	$ 16,200	$ 18,000

Following Statement 141.44, the company would assign the $18,000 purchase price to identified assets and liabilities. In this case, the amount of negative goodwill (before allocation to noncurrent assets and determination of deferred taxes) is $10,200 ($28,200 fair value of net assets acquired less $18,000 purchase price). Negative goodwill of $5,000 would be allocated to reduce noncurrent assets to zero and a deferred tax liability of $2,800 would be recognized for the difference in book and tax basis of assets and liabilities (40% of the difference between the book basis of $23,200 and the tax basis of $16,200). A simultaneous equation is not required in this example because the initial negative goodwill is greater than the fair value of all noncurrent assets. Any amount allocated to noncurrent assets through the recognition of deferred tax liabilities would be further reduced by the remaining negative goodwill. The remaining unallocated negative goodwill in the amount of $2,400 would not give rise to a temporary difference and additional deferred taxes would not be recognized.

A summary of the purchase price allocation is as follows:

	Book basis	Tax basis	Taxable (deductible) temporary difference
Noncurrent assets	$ –	$ 1,000	$ (1,000)
Inventory	23,200	15,200	8,000
Net deferred tax liability	(2,800)	–	N/A
Unallocated negative goodwill	(2,400)[(a)]	N/A	N/A
Totals	$ 18,000	$ 16,200	7,000
Tax rate			40%
Net deferred tax liability			$ 2,800

(a) Because there is no contingent consideration in this example, the unallocated negative goodwill is recognized as an extraordinary gain in the period that the business combination is consummated.

As illustrated, amounts allocated to assets and liabilities equal the purchase price, and resulting temporary differences multiplied by the tax rate equal the recorded deferred tax liability.

The above examples ignore the impact on the computations of such complexities as multiple-tax rates, operating losses of the acquiring entity offsetting future taxable income from the acquired entity, deferred tax assets for deductible temporary differences related to acquired long-term assets that require a valuation allowance, and many others. The equations used should reflect the interdependence of negative goodwill and deferred taxes, considering the particular facts and circumstances related to the business combination.

C1.3.7 Deposit-based intangibles — before the adoption of Statement 141(R)

Acquired deposit-based intangibles, or core deposits, often are valued separately from goodwill for financial statement and tax purposes. Statement 109 distinguishes between nondeductible goodwill and other types of intangible assets. No deferred tax liability or asset is recognized for goodwill temporary differences if the goodwill amortization is not deductible for tax purposes (Statement 109.9(d)). This exclusion from the comprehensive recognition of deferred taxes does not extend, however, to other types of intangible assets, whether deductible for tax purposes or not. Accordingly, temporary differences associated with deposit-based intangibles result in a deferred tax liability or asset.

Tax amortization of deposit-based intangibles continues to be a major source of controversy between financial institutions and taxing authorities. The Internal Revenue Service continues to challenge the deductibility of amortization of deposit-based intangibles, even though a number of court decisions have allowed the deductions. It may be necessary to consider potential challenges from taxing authorities in determining the amount of deductible temporary differences associated with controversial items such as deposit-based intangibles in accordance with FIN 48, after it is adopted (see Chapter 19, *Accounting for uncertainty in income taxes*, for additional discussion).

C1.3.8 Acquired research and development deferred tax liabilities — before the adoption of Statement 141(R)

In some business combinations, the presence of in-process research and development activities has raised questions regarding the recognition of a deferred tax liability at the consummation date for the initial difference (that is, prior to the write-off of acquired in-process research and development) between the amounts assigned for financial reporting purposes to in-process research and development and its underlying tax basis.

In EITF Issue No. 96-7, "Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination" (EITF 96-7), the Task Force concluded the write-off of amounts assigned for financial reporting purposes to in-process research and development occurs prior to the measurement of deferred taxes in a purchase price allocation. Accordingly, deferred taxes are not provided on the initial differences between the amounts assigned for financial reporting and tax purposes, and in-process research and development is charged to expense on a gross basis at acquisition. That is, the charge for writing off in-process research and development does not reflect any tax benefit.

EITF 96-7 assumes there is no tax basis in the in-process research and development (i.e., after the write-off of the in-process research and development for financial reporting purposes, there is no book-tax basis difference because both are zero). However, EITF 96-7 does not specifically address the situation in which there is a tax basis in the in-process research and development that results in a book-tax basis difference once the in-process research and development is written off for financial reporting purposes. For example, assume a company initially allocates $1,000 to in-process research and development for financial reporting and tax purposes. Once the $1,000 is written off for financial reporting purposes, there is a $1,000 difference between the book basis (zero) and the tax basis ($1,000) of in-process research and development. We believe if there is a book-tax basis difference once the in-process research and development is written off for financial reporting purposes (i.e., when there is a tax basis in the in-process research and development), it would be appropriate to record a deferred tax asset and a related tax benefit.

C1.3.9 Effect of acquirer-specific attributes on measurement of acquired deferred taxes — before the adoption of Statement 141(R)

C1.3.9.1 Apportioned tax rates — before the adoption of Statement 141(R)

Deferred tax assets and liabilities related to a business combination should be measured at rates enacted as of the acquisition date. If in periods subsequent to a business combination the combined company expects to file a consolidated tax return, the enacted tax rates for the combined entity should be used in measuring deferred tax assets and liabilities. Many states require apportionment of taxable income to the states in which companies operate based on various factors. As a result of a business combination and apportionment tax rules, the overall tax rate applied to acquired deferred taxes and liabilities is often different from the rate that was applicable when the acquiree was not part of the combined entity. Deferred taxes acquired in a business combination should be measured based on the expected tax consequences to the combined entity, even if such measurement is affected by acquirer-specific attributes (i.e., the acquirer should not separately calculate deferred taxes using the acquiree's historic rate and only include that portion in acquisition accounting and the remainder in the acquirer's current income statement). In addition, if the tax rate applicable to existing deductible or taxable temporary differences of the acquirer changes as a result of a business combination, the effect of the change should be reported in current operating results and not in acquisition accounting (See section C1.5, Effects of change in tax laws or rates subsequent to a business combination — *before the adoption of Statement 141(R)* below).

C1.3.9.2 Unborn foreign tax credits — before the adoption of Statement 141(R)

Companies may have foreign subsidiaries that are taxed at a local tax rate that is higher than the parent's tax rate (e.g., a US company with a 35% tax rate may have a foreign subsidiary that is taxed at a 40% rate). When earnings from these subsidiaries are remitted to the parent, they generate tax credits that may be available for use against taxes due for other foreign subsidiaries that pay taxes at a lower rate (e.g., if a US company with a 35% tax rate has a foreign subsidiary with a 20% local tax rate, simplistically, the company would be required to pay US taxes of 15% on repatriated earnings unless the company has offsetting foreign tax credits). Foreign tax credits that exist on unremitted earnings of foreign subsidiaries are often referred to as unborn tax credits. Unborn tax credits are not reported as deferred tax assets but are considered in measuring deferred tax liabilities on outside basis differences in foreign subsidiaries with lower tax rates.

In a business combination, an acquirer may determine that its existing unborn tax credits may be used to offset a tax liability associated with unremitted earnings of an acquiree in a jurisdiction with a lower tax rate when the acquirer plans to repatriate earnings. As discussed above, deferred taxes acquired or assumed in a business combination should be measured based on the expected tax consequences to the combined entity. Therefore, it is appropriate to take into account the effect of acquirer unborn tax credits when measuring acquired deferred tax liabilities (i.e., the effect of the acquirer's unborn tax credits on deferred tax liabilities assumed in the business combination would be included in acquisition accounting). In addition, if the situation were reversed (i.e., the acquiree is in a tax jurisdiction with a higher tax rate than the acquirer and will provide the acquirer with tax credits that may be used to reduce existing acquirer deferred tax liabilities), the effect of such unborn tax credits on the measurement of existing deferred tax liabilities should also be included in the accounting for the business combination.

C1.3.9.3 Assertion regarding indefinite reinvestment — before the adoption of Statement 141(R)

In a business combination, the acquiring company must make its own determination as to the reinvestment strategy related to any acquired foreign operations. That is, upon consummation of the business combination, the purchaser's assertion regarding the indefinite reinvestment or repatriation of any current outside basis differences, as well as any future earnings of the foreign operations, is made without regard to any prior assertions made by the target (seller). To the extent the purchaser asserts the outside basis difference related to acquired foreign operations will be repatriated in the foreseeable future, deferred tax liabilities associated with those basis differences would be recognized in acquisition accounting regardless of the preacquisition determination of the seller. Refer to Chapter 14, *Foreign and domestic subsidiaries,* for additional discussion of the accounting for the outside basis difference of foreign subsidiaries.

C1.4 Impairment of identifiable intangible assets and goodwill — before the adoption of Statement 141(R)

Identifiable intangible assets and goodwill are oftentimes amortized at a faster rate for tax purposes than for financial reporting purposes or are not subject to amortization at all for financial reporting purposes under Statement 142 (i.e., indefinite-lived identified intangible assets and goodwill). In these situations, the excess tax amortization over book amortization generally results in a lower tax basis than financial reporting basis in those assets. The difference in the basis for financial vs. tax reporting creates a taxable temporary difference and resultant deferred tax liability. The recognition of a book impairment loss attributable to identifiable intangible assets or tax-deductible goodwill results in (1) the reversal of an existing taxable temporary difference, (2) the creation of a deductible temporary difference after reversal of the existing taxable temporary difference, or (3) an increase to an existing deductible temporary difference.

Conversely, recognition of a book impairment loss for nondeductible goodwill does not impact deferred taxes due to the prohibition in Statement 109.9(d) and .30 against recognition of deferred taxes for nondeductible goodwill.

C1.4.1 Impairment of tax-deductible goodwill — before the adoption of Statement 141(R)

When tax-deductible goodwill is impaired for financial reporting purposes under Statement 142, deferred tax amounts should be adjusted to reflect the changes in the temporary differences. As goodwill is not amortized for financial reporting purposes while amortization is recognized for tax purposes, the book basis of goodwill prior to an impairment write-down will often exceed the tax basis goodwill. Accordingly, a deferred tax liability is generally recognized for financial reporting purposes prior to the impairment write-down. If the impairment write-down reduces the book basis of tax-deductible goodwill below the tax basis, the entire deferred tax liability would be reversed and a deferred tax asset would be recognized, subject to valuation allowance considerations. Noteworthy, however, is that a partial impairment of tax-deductible goodwill for financial reporting purposes that reduces the book basis below the tax basis would generally be expected to reverse in future periods as amortization deductions are recognized for tax purposes.

C1.4.2 Impairment of nondeductible goodwill — before the adoption of Statement 141(R)

As discussed in section C1.3.1, *Nondeductible Goodwill — before the adoption of Statement 141(R)*, Statement 109.9(d) and .30 prohibit recognition of deferred taxes for nondeductible goodwill. Therefore, when nondeductible goodwill is impaired under the provisions of Statement 142, that impairment does not result in a change to the previously recorded deferred taxes. Thus, the impairment is treated as a "temporary difference without tax consequences" (commonly referred to as a "permanent difference") and; therefore, no tax benefit is recorded.

C1.4.2.1 Allocation of subsequent impairments to deductible and nondeductible goodwill — before the adoption of Statement 141(R)

In some business combinations, the acquisition may result in both deductible and nondeductible goodwill. For example, a company may have tax basis in some, but not all, of the goodwill recognized for financial reporting purposes. Another example, although not as common as the prior example, would be tax-deductible goodwill acquired in a nontaxable transaction (e.g., acquisition of the acquired company's stock) in which the acquirer receives carryover basis in the acquired company's goodwill and recognizes additional nondeductible goodwill associated with the current acquisition. As discussed above, in these situations, the acquirer would recognize deferred taxes attributable to the tax-deductible goodwill while no deferred taxes would be recognized for the nondeductible goodwill.

If the acquirer subsequently recognizes an impairment of a portion, but not all, of its goodwill attributable to that acquisition, the impairment would need to be allocated between the deductible and nondeductible components of goodwill. If the acquirer has maintained sufficient records to specifically identify the components of goodwill that are subsequently impaired, the impairment loss should reduce the deductible and nondeductible components of goodwill accordingly. However, practice has indicated that most acquirers do not have such records and thus must allocate the impairment in a systematic and rational method (e.g., pro rata, first reduce deductible goodwill, first reduce nondeductible goodwill) between the two components of goodwill. We believe the preferable method is to allocate the impairment on a pro rata basis as the other methods would generally not be supportable in the absence of sufficient records to directly attribute the impairment to either or both components of goodwill.

C1.4.3 Foreign currency temporary differences from "pushdown" adjustments — before the adoption of Statement 141(R)

Under Statement 52, following a business combination, the amounts allocated as of the acquisition date to the assets acquired and liabilities assumed (including goodwill) should be translated as if the purchase adjustments were recorded directly on the books of the foreign subsidiary (i.e., pushdown accounting is required under Statement 52). This also would be the case for foreign investees accounted for by the equity method.

Purchase price adjustments, other than nondeductible goodwill, allocated to the assets and liabilities of a foreign enterprise generally create temporary differences under Statement 109 because such allocations generally do not result in adjustments to the foreign tax bases of those assets and liabilities. These temporary differences result whether the foreign entity uses the US dollar or the foreign currency as its functional currency (although Statement 109.9(f) provides an exception for nonmonetary assets for a foreign entity when the parent's currency is its functional currency — see section 3.2.3, *Foreign currency differences,* for a discussion of this exception).

Illustration C1-7

Assume at 31 December 20X0, a US multinational company purchased a foreign subsidiary for an amount that is $100,000 in excess of the foreign entity's book value and tax basis. At the acquisition date, the exchange rate was FC2 = $1.00 and the fair value of the foreign subsidiary's land and buildings exceeded their respective book values by $75,000. The excess of the purchase price over the fair value of the assets acquired ($25,000) was allocated to goodwill. For purposes of this example, assume (1) the foreign currency is the functional currency, (2) foreign earnings are permanently reinvested, (3) amortization and depreciation charges are immaterial, and (4) purchase adjustments are reflected for US consolidation purposes only and are not pushed down to the foreign entity's local statutory accounting records.

The $100,000 of purchase price adjustments are converted into FC amounts and allocated to the foreign subsidiary at the acquisition date as follows:

	US dollar amount	Exchange rate	Foreign currency equivalent
Land and buildings (no amortization)	$ 75,000	FC2 = $1.00	FC150,000
Goodwill	25,000	FC2 = $1.00	50,000
Translation component of other comprehensive income	N/A		N/A
Total	$ 100,000		FC200,000

Deferred taxes are provided on the FC150,000 taxable temporary difference related to land and buildings at the foreign entity's effective tax rate of 40% = FC60,000. This amount is added to goodwill and then translated into dollars at the current exchange rate as follows:

	Foreign currency equivalent	Exchange rate	US dollar amount
Deferred tax liability	FC (60,000)	FC2 = $1.00	$ (30,000)
Goodwill	60,000	FC2 = $1.00	30,000

Translated amounts at the end of 20X1 when the foreign currency strengthens in value from FC2 = $1.00 to FC1.6 = $1.00 are as follows:

	Foreign currency equivalent	Exchange rate	US dollar amount
Land and buildings	FC 150,000	FC1.6 = $1.00	$ 93,750
Goodwill	110,000	FC1.6 = $1.00	68,750
Deferred tax liability	(60,000)	FC1.6 = $1.00	(37,500)
Translation adjustment component of other comprehensive income	N/A		N/A
Total	FC 200,000		$125,000

Deferred taxes of FC60,000 continue to be provided on the temporary difference related to land and buildings.

C1.5 Effects of change in tax laws or rates subsequent to a business combination — before the adoption of Statement 141(R)

Deferred tax assets and liabilities related to a business combination should be measured at rates enacted as of the acquisition date. Tax rate changes, or any deferred tax adjustments for new tax legislation, following a purchase business combination should be reflected in continuing operations in the period in which the change in tax laws or rates is enacted. This treatment would be applied regardless of how soon after an acquisition the new law is enacted, whether the negotiating parties contemplated the effects of the new tax law, or if the change in tax laws or rates was retroactive. Statement 109.27 specifically requires that deferred taxes be adjusted for the effect of a change in **tax laws or rates** and that the effect to be included in income from continuing operations in the period that includes the enactment date.

The following example illustrates applying the provisions of Statement 109 to the accounting for the effects of rate changes following a purchase business combination.

Illustration C1-8

Assume a calendar-year company acquired another company for $200,000 in a nontaxable business combination on 30 June 20X0, when the tax rate was 40%. Acquired fixed assets have a tax basis of zero and are appraised at $100,000. There are no other temporary differences and all other identifiable assets and liabilities net to zero. In November 20X0, a new tax law was enacted that reduced the tax rate to 30%. Also, for simplicity, assume no amortization of fixed assets or impairment of goodwill was recorded in 20X0 subsequent to the acquisition. The purchase price allocation would be as follows:

Fixed assets — fair values	$ 100,000
Tax basis	–
Temporary difference — taxable	100,000
Enacted tax rate at year end	40%
Deferred tax liability	$ 40,000

Fixed assets	$ 100,000
Deferred tax liability	(40,000)
Goodwill (derived)	140,000
Purchase price	$ 200,000

Deferred taxes at the end of 20X0 and the deferred tax provision for 20X0 would be computed as follows:

Fixed assets — book values	$ 100,000
Tax basis	–
Temporary difference — taxable	100,000
Enacted tax rate at year end	30%
Deferred tax liability	$ 30,000

Deferred tax liability, 31 December 20X0	$ 30,000
Deferred tax liability, 30 June 20X0	40,000
Deferred tax benefit, income statement	$ 10,000

In this example, the benefit of $10,000 from the reduction of deferred tax liabilities would be reflected as a reduction of income tax expense in the continuing operations portion of the income statement.

C1.6 Valuation allowance in a business combination — before the adoption of Statement 141(R)

When deferred tax assets resulting from a business combination are not more likely than not to be realized, based on all available evidence as of the acquisition date, Statement 109 requires the acquiring company to recognize a valuation allowance to reduce the carrying amount of the deferred tax assets to an amount that is *more likely than not* to be realized. The impact of recording a valuation allowance in purchase accounting is to increase the amount of goodwill recorded (or reduce the amount of negative goodwill to be allocated under Statement 141). To the extent the valuation allowance is subsequently reversed, the offsetting credit is recognized first as a reduction of goodwill, then other intangible assets, and lastly as a reduction in that period's income tax expense (no matter how long after the acquisition date initial recognition occurs).

C1.6.1 Acquired company tax benefits — before the adoption of Statement 141(R)

When deferred tax assets resulting from a business combination are not more likely than not to be realized based on all available evidence as of the acquisition date, Statement 109 requires the acquiring company to recognize a valuation allowance to reduce the carrying amount of the deferred tax assets to an amount that is more likely than not to be realized.

If, subsequent to a business combination, the combined company expects to file a consolidated tax return and the tax law permits the use of either of the combining companies' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other company subsequent to the business combination, an assessment of the need for, and amount of, a valuation allowance would be based on the combined company's past and expected future results of operations as of the acquisition date. For example, preexisting deferred tax liabilities of the acquirer may be available to offset acquired deferred tax assets. When assessing the need for, and amount of, a valuation allowance, past results of operations for the acquired company may need to be adjusted to reflect depreciation and amortization charges based on values assigned in the purchase price allocation.

As discussed in section C1.6.2, *Acquiring company valuation allowance reduced in a business combination — before the adoption of Statement 141(R),* a decrease in an acquirer's existing valuation allowance caused by a business combination should be accounted for as part of the business combination accounting. However, there is no similar requirement to recognize the effect of acquirer-specific attributes on the measurement of acquired deferred taxes separately from the measurement of acquired assets and assumed liabilities in a business combination. For example, a valuation allowance or lack thereof reported on deferred tax assets acquired in a business combination is attributed to the business combination even when the tax attributes of the acquirer (e.g., the reversal of the acquirer's preexisting taxable temporary differences) are the determining factor in the analysis of whether a valuation allowance is required. The following example further illustrates this point.

Illustration C1-9

Assume a company acquired another company at the beginning of 20X0 for $60 million in a nontaxable business combination. The company's only acquired book-tax basis difference relates to depreciable property and equipment with a fair value of $50 million and no tax basis. Assume that the fair values of other identified assets acquired and liabilities assumed net to zero. The tax rate is 40% and no future rate changes have been enacted. Also, assume the acquired company has a $55 million NOL carryforward that, under the tax law, can be used by the acquiring company. The acquiring company has a deferred tax liability of $4 million on temporary differences of $10 million. All temporary differences reverse within the acquired company's NOL carryforward period.

In assessing the need for a valuation allowance for the $22 million deferred tax asset related to the $55 million NOL carryforward, future taxable income would not need to be considered because the $55 million NOL carryforward would be offset by $50 million of taxable temporary differences of the acquired company and $10 million of taxable temporary differences of the acquiring company. The purchase price allocation would be (in millions):

Property and equipment	$ 50
Deferred tax liability recognized for the acquired company's taxable temporary differences ($50 million at 40%)	(20)
Deferred tax asset recognized for the acquired company's loss carryforward based on offset against the acquired company's taxable temporary differences ($50 million at 40%)	20
Deferred tax asset recognized for the acquired company's loss carryforward based on offset against half of the acquiring company's taxable temporary differences ($5 million at 40%)	2
Goodwill (derived)	8
Purchase price	$ 60

In the above example, the acquired company's operating loss carryforward is offset by the taxable temporary differences of both the acquired company and the acquiring company. In this regard, estimates of the acquiring company's temporary differences may be necessary at the acquisition date to determine if deductible temporary differences and operating loss carryforwards are offset by taxable temporary differences. An assessment of the need for, and amount of, a valuation allowance should consider any provisions in the tax law that restrict the future use of either of the combining companies' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other company subsequent to the business combination.

If the tax law limits the use of the acquired company's deductible temporary differences and carryforwards to subsequent taxable income of the acquired company in a consolidated tax return for the combined company or the acquired company will file a separate tax return, an assessment of the need for and amount of a valuation allowance would be based on the acquired company's separate past and expected future results of operations.

C1.6.1.1 Subsequent recognition of acquired company deductible temporary differences and carryforwards — before the adoption of Statement 141(R)

In the event a valuation allowance is established at the acquisition date for some or all of a deferred tax asset for deductible temporary differences and net operating loss and tax credit carryforwards of an acquired company, the initial recognition of the tax benefits for those items (by elimination of the valuation allowance) after the acquisition date would first reduce the remaining balance of goodwill related to that acquisition, then other noncurrent intangible assets related to that acquisition, and then income tax expense (no matter how long after the acquisition date that initial recognition occurs). If other noncurrent intangible assets are reduced, then amortization of finite-lived intangible assets is adjusted prospectively.

Illustration C1-10

Assume a company acquires another company at the beginning of 20X0 for $70 million in a tax-free business combination. The only acquired-company book/tax basis difference relates to property, plant and equipment with a fair value of $50 million and a tax basis of $70 million, resulting in a deductible temporary difference of $20 million. Also, assume the acquired company has a $5 million NOL carryforward that under the tax law can be used by the acquiring company, and the fair values of other identified assets acquired and liabilities assumed net to zero. The tax rate is 40%.

Assume the acquiring company has no taxable temporary differences or carryback potential and, based on an assessment of all available evidence, management has concluded that a valuation allowance is required for the full amount of the acquired deferred tax asset.

The purchase price allocation would be (in millions):

Property and equipment		$ 50
Deferred tax asset recognized for the acquired company's:		
Loss carryforward ($5 million at 40%)	$ 2	
Deductible temporary differences ($20 million at 40%)	8	10
Valuation allowance for deferred tax assets		(10)
Goodwill		20
Purchase price		$ 70

Assume the company reports 20X0 book and taxable income of $30 million and the $20 million deductible temporary difference is expected to reverse in 20X1. Current taxes payable and the income tax provision for 20X0 would be computed as follows (in millions):

Current taxes payable:		
Taxable income before net operating loss	$	30
Net operating loss deduction		(5)
Taxable income after net operating loss		25
Tax rate		40%
Taxes payable	$	10
Deferred taxes payable:		
Deferred tax asset (net of valuation allowance):		
End of year	$	8
Beginning of year		–
Change in deferred taxes	$	8

Current taxes payable would be reduced by $2 million ($5 million NOL deduction times 40%), which results in the initial recognition of a deferred tax benefit of $2 million for the acquisition-date carryforward of the acquired company. In addition the payment of $10 million related to 20X0 eliminates the need for a valuation allowance for the acquired company's remaining acquisition-date deductible temporary difference, because the deductible temporary difference expected to reverse in 20X1 could be carried back against taxable income in the current year. This results in the initial recognition of a deferred tax benefit of $8 million for the acquired company's $20 million deductible temporary difference. The subsequent recognition of the tax benefits for the deductible temporary difference and operating loss carryforward of the acquired company would result in a $10 million reduction of goodwill in 20X0.

The entries to record the provision are as follows (in millions):

Current tax expense	$	10		
Current taxes payable			$	10

To record current taxes payable:

Valuation allowance for deferred tax asset	$	10		
Deferred tax expense		2		
Goodwill			$	10
Deferred tax asset				2

To eliminate the deferred tax asset realized during the current year and to reduce the valuation allowance to zero.

Total tax expense for 20X0 is $12 million, which is equal to 40% of pretax financial income of $30 million, and the deferred tax asset at 31 December 20X0 is $8 million. Goodwill was reduced for the initial recognition of tax benefits related to acquired deductible temporary differences and NOLs.

C1.6.1.2 Decrease in valuation allowance established in a business combination as a result of a change in tax law — before the adoption of Statement 141(R)

Statement 109.30 requires that the effects of eliminating a valuation allowance that initially was recorded in the allocation of the purchase price in a business combination reduce first the remaining balance of goodwill related to that acquisition, then other noncurrent intangible assets related to that acquisition, and then income tax expense. However, Statement 109.27 indicates that the effect of a change in tax laws or rates should be included in income from continuing operations in the period that includes the enactment date. In EITF Issue No. 99-15, "Accounting for Decreases in Deferred Tax Asset Valuation Allowances Established in a Purchase Business Combination As a Result of a Change in Tax Regulations" (EITF 99-15), the Task Force concluded that the effect of a change in tax law or regulation that results in a decrease in a valuation allowance that initially was recorded in the allocation of the purchase price in a business combination should be included in income from continuing operations pursuant to Statement 109.27. This guidance applies to any reduction in the valuation allowance that otherwise would not have been recognized except for the change in tax law or regulation, even if the reduction occurs in a period subsequent to the enactment date.

C1.6.2 Acquiring company valuation allowance reduced in a business combination — before the adoption of Statement 141(R)

In some business combinations, the acquirer has cumulative losses or other negative evidence, which resulted in a valuation allowance on its deferred tax assets (including net operating losses) immediately prior to the acquisition, and the business combination deferred tax liabilities that arise are available to offset the reversal of the acquirer's preexisting deferred tax assets. As a result of the business combination, the acquiring company determines its preexisting deferred tax assets are *more likely than not* to be realized by the combined enterprise and the valuation allowance should be reduced or eliminated. Statement 109.266 **requires that the reduction in the acquiring company's valuation allowance be accounted for as part of the business combination**. Therefore, the reduction in the acquiring company's valuation allowance impacts the purchase price allocation.

The liability method requires recognition of a deferred tax asset at the acquisition date for **either company's** deductible temporary differences and carryforwards to the extent permitted by tax law. The following example illustrates a situation in which the acquiring company's carryforwards offset taxable temporary differences of the acquired company.

Illustration C1-11

Assume the same facts as Illustration C1-9 in section C1.6.1, *Acquired company tax benefits — before the adoption of Statement 141(R)*, except the acquiring company has a $50 million operating loss carryforward with a full valuation allowance, no deferred tax liabilities, and the acquired company does not have an operating loss carryforward. If the acquiring company's operating loss carryforward can reduce future taxes payable of the acquired company under provisions of the tax law, the benefit of the operating loss carryforward of the acquiring company would offset deferred tax liabilities recognized as a result of the acquisition (assuming the related depreciation temporary differences reverse within the operating loss carryforward period). As a result, a valuation allowance for the acquiring company's deferred tax asset would no longer be required and the purchase price allocation would be (in millions):

Property and equipment	$ 50
Deferred tax liability recognized for the acquired company's taxable temporary differences ($50 million at 40%)	(20)
Deferred tax asset recognized for the acquiring company's loss carryforward based on offset against the acquiring company's taxable temporary differences ($50 million at 40%)	20
Goodwill (derived)	10
Purchase price	$ 60

Illustration C1-12

Assume the same facts as Illustration C1-11 and that the acquiring company's operating loss carryforward is utilized the year after the acquisition by offsetting pretax income from continuing operations of either company, which equals the $50 million operating loss carryforward. Thus, taxable income (and current taxes payable) is $0 (or $50 million pretax book income less $50 million carryforward).

Upon utilization of the operating loss carryforward, assuming no change in the other temporary differences, the company must eliminate the deferred tax asset, which would result in a $20 million charge to deferred tax expense. Because the benefit of the operating loss carryforward was recognized at the acquisition date, subsequent utilization of the operating loss carryforward does not result in a reduction of income tax expense for financial reporting purposes (it has already been recognized).

As a result of the above, total tax expense is $20 million ($0 current provision and $20 million deferred provision), which is equal to 40% of pretax book income.

C1.6.2.1 Subsequent recognition of acquiring company deductible temporary differences and tax carryforwards — before the adoption of Statement 141(R)

If the acquiring company had recorded a valuation allowance related to a portion (or all) of its deferred tax assets **prior to the acquisition date** and its assessment of whether it is more likely than not that those assets would be realized does not change as a result of the acquisition, the subsequent recognition of a tax benefit for that item (by elimination of the valuation allowance) is reported as a reduction of income tax expense because the tax benefit was not considered in determining the purchase price.

C1.6.3 Acquiring company valuation allowance increased in a business combination — before the adoption of Statement 141(R)

Although rare, in some business combinations the acquiring company concludes its prior valuation allowance, if any, should be increased at the business combination consummation date due to the tax attributes and/or forecasted operations of the acquired company. In that scenario, the increase in the acquiring company's valuation allowance, attributable to the acquirer's preexisting deferred tax assets, should be recognized in earnings rather than as part of the business combination.

Illustration C1-13

Assume Company LNS has NOLs that are expected to be realized through future taxable income (thus, no valuation allowance was recognized). Further, assume Company LNS acquires Company MLS, which has a history of losses. Due to the impact of Company MLS on the combined operations, Company LNS believes, based on the weight of all available evidence, it is more-likely-than-not that 50% of Company LNS' preexisting NOLs will no longer be realized. Company LNS would record a valuation allowance, recognized through earnings, and would not adjust its purchase price allocation for Company MLS.

C1.7 Post-combination net operating losses — before the adoption of Statement 141(R)

Companies that establish valuation allowances in a purchase price allocation must maintain detailed records of the related acquired deductible temporary differences and carryforwards in order to properly account for the initial recognition of these acquired tax benefits. In some situations, an acquired deductible temporary difference (with a full valuation allowance) will reverse in a period when there is a loss for tax purposes. In that situation the subsequent recognition of the post-acquisition-date net operating loss would have to be segregated because the tax benefit related to the portion of the net operating loss due to the acquired deductible temporary difference would reduce goodwill (and then noncurrent intangible assets).

Several questions have arisen regarding the evaluation and reporting of net operating losses generated after a business combination by the combined company. When considering the realizability of deferred tax assets (e.g., net operating losses, deductible temporary differences), Statement 109.21 requires consideration of deferred tax liabilities expected to reverse prior to the expiration of the deferred tax asset. Therefore, post-acquisition net operating losses of the combined company should be recognized (assuming the company files a combined return) and the need for a valuation allowance should be assessed based on the existence and timing of reversal of deferred tax liabilities, including those related to the acquired business.

Illustration C1-14

Assume Company A acquired Company B in 20X1. Immediately prior to the acquisition, Company A had deferred tax assets and liabilities of $500 and $600, respectively, and, as a result of the acquisition of Company B, recorded additional deferred tax liabilities of $500. Further, assume all deferred tax liabilities were expected to reverse within five years (prior to the expiration of the deferred tax assets for both Company A and B). Projected operations of the combined entity, Company AB, for the next 3 years would be at break even or slightly positive. Company AB's effective tax rate is 40%. A valuation allowance was not considered necessary as of the combination date for preexisting deferred tax assets because Company AB was in a net deferred tax liability position. The combined Company AB will file a consolidated return for all periods subsequent to the acquisition.

In 20X2, Company AB had a net loss for book and tax purposes of $1,200 (a deferred tax asset of $480). Due to the existence of net deferred tax liabilities of $600 before consideration of the 20X2 NOL which will reverse over the next 4 years (well within the loss carryforward period), Company AB recognized the full deferred tax asset attributable to the 20X2 NOL of $480 and a corresponding income tax benefit in its statement of operations. This benefit would be recorded regardless of the original source of the deferred tax liabilities. That is, even though $500 of Company AB's deferred tax liability was recognized as a result of purchase accounting adjustments, the benefit of the current year loss of the combined company is reflected in continuing operations.

C1.8 Ordering pre- and post-acquisition tax benefits — before the adoption of Statement 141(R)

The tax law usually determines the sequence in which acquisition-date and post-acquisition-date benefits are utilized for tax purposes. Statement 109.268 provides that the same provisions in the tax law that identify the sequence of acquisition-date and post-acquisition-date amounts should be used for financial reporting purposes. Statement 109.268 also provides that if the sequence for utilizing acquisition-date and post-acquisition-date amounts cannot be determined based on the tax law, the tax benefit should be recognized for financial reporting purposes on a proportionate basis (i.e., the ratio of acquisition date benefits to total benefits).

Illustration C1-15

Assume at 1 January 20X0, a company is acquired in a business combination. Goodwill is $1 million and the acquired company has $1 million in deductible temporary differences that will reverse in 20X0. The tax rate is 40%. Based on an assessment of all available evidence management has concluded that a valuation allowance is required for the full amount of the $400,000 ($1 million at 40%) deferred tax asset relating to the deductible temporary differences.

During 20X0, the combined companies incurred a book loss of $1 million and reversal of the deductible temporary differences increased the tax loss to $2 million at the end of 20X0. Based on an assessment of all available evidence, management again concludes a valuation allowance is required for the full amount of the deferred tax asset (now an NOL carryforward of $800,000).

Assume the combined companies have book and taxable income of $1 million in 20X1, and utilize $1 million of the net operating loss carryforward to reduce current taxes payable. However, the $1 million net operating loss carryforward used on the tax return cannot be identified as attributable to the pre-acquisition-date net operating loss carryforward (resulting from the reversal of the deductible temporary differences that reversed in 20X0) or the net operating loss carryforward that arose in 20X0 because they both were included in the 20X0 income tax return. Also, assume management's assessment of all available evidence indicates a valuation allowance is still required for the remaining $1 million deferred tax asset.

The tax benefit of $400,000 recognized for financial reporting must be prorated between the acquisition-date and post-acquisition-date net operating loss carryforward. The total net operating loss carryforward consists of equal amounts of the acquisition-date and post-acquisition-date net operating loss carryforward; therefore, utilization is also assumed to be equal. Thus, the total benefit of $400,000 ($1 million at 40%) is allocated, $200,000 to reduce income tax expense and $200,000 to reduce goodwill.

Illustration C1-16

Assume a company has deductible temporary differences of $100 for warranty accruals at 1 January 20X0 and the tax rate is 40%. No carryback potential exists, no taxable temporary differences exist and, based on an assessment of all available evidence, management concludes a valuation allowance is required for the full amount of the $40 deferred tax asset related to the warranty deductible temporary differences. On 30 June 20X0, the company purchases another company and allocates the purchase price as follows:

	Book	Tax
Fixed assets	$ 200	$ 200
Liabilities litigation accrual	(100)	–
Deferred tax asset	40	–
Valuation allowance for deferred tax asset	(40)	–
Goodwill	300	200
Purchase price	$ 400	$ 400

In December 20X0, the acquiring company settles its warranty claim reserves (for the recorded amount of $100), and management's assessment of all available evidence indicates a valuation allowance is still required for the acquired company's $40 deferred tax asset related to the litigation deductible temporary difference.

Taxable income for 20X0 is computed as follows:

	20X0
Book income	$ –
Temporary differences — warranty reserves	(100)
Net operating loss for tax purposes	$ (100)

In 20X1, the company earns $100 and settles its litigation liability by payment of $100. Taxable income is computed as follows:

	20X1
Book income	$ 100
Temporary differences — litigation accrual	(100)
Taxable income	$ –

Reversal of temporary differences related to the acquired company reduced 20X1 taxable income by $100. Thus, the company should reflect realization of the $40 tax benefit as a reduction of goodwill. The tax net operating loss carryforward of $100 reflected on the company's tax return has not changed, thus the tax benefit should not be attributed to pre-acquisition amounts (i.e., the acquiring company's deductible temporary differences at the acquisition date).

C1.9 Tax benefits of non-qualified options issued in a purchase business combination — before the adoption of Statement 123(R) and Statement 141(R)

Issue 29 of EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44" (EITF 00-23), addresses the accounting for tax benefits from an employee's exercise of non-qualified employee stock-based compensation awards that were issued or granted in a purchase business combination for a company that accounts for stock compensation in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). Refer to Issue 29 of EITF 00-23 for an example that illustrates the following consensuses.

In Issue 29(a) of EITF 00-23, the Task Force concluded that the expected tax benefit from fully vested stock-based compensation awards issued to the target company's employees as consideration in a purchase business combination does not result in a deferred tax asset on the business combination consummation date. The future income tax deduction, if any, that results from an exercise of the non-qualified award is recognized as an adjustment to the acquired business purchase price when realized to the extent that the deduction reported for tax purposes does not exceed the fair value of awards recognized as part of the purchase price. The benefit of any remaining excess deduction (that is, the excess of the ultimate income tax deduction over the fair value of the non-qualified awards at the business combination consummation date) is recognized as an increase to additional paid-in capital.

In Issue 29(b) of EITF 00-23 the Task Force concluded that the vested portion (that is, the portion of the vesting period that has expired at the consummation date) of the unvested employee stock options issued in a purchase business combination should be accounted for consistently with the above consensus.

Furthermore, the Task Force concluded that the accounting for the tax benefit from the unvested portion of non-qualified awards issued in a purchase business combination (that is, the compensatory portion attributable to service to be provided by the employees in future periods) is the same as for non-qualified awards granted to employees absent a business combination. That is, assuming the non-qualified awards are accounted for as fixed awards, the intrinsic value of the unvested awards is recognized as compensation expense by the purchaser over the vesting period. FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation an interpretation of APB Opinion No. 25* (FIN 44), provides guidance on the accounting for deferred taxes resulting from outstanding stock options, and accordingly, the Task Force believes that a deferred tax asset should be recognized when the unearned compensation, measured at the consummation date of the business combination, is recognized as compensation expense.

These issues had to be applied to exchanges of awards in a business combination that occur after 18 January 2001.

Note: See our FRD, ***Share-based payment***, for discussion of accounting post-adoption of Statement 123(R).

C2 (Non-authoritative) Asset acquisitions — before the adoption of Statement 141(R)

C2.1 Asset acquisitions — prior to adoption of Statement 141(R)

EITF 98-11 provides guidance and examples on accounting for asset purchases that are not business combinations when the amount paid for an asset differs from the tax basis of the asset. EITF 98-11 prescribes accounting for asset purchases similar to the accounting for purchase business combinations described in Statement 109 and EITF 93-7. The Task Force reached a consensus that the tax effect of asset purchases that are not business combinations in which the amount paid differs from the tax basis of the asset should not result in immediate income statement recognition. The Task Force also concluded the net tax benefit resulting from a purchase of future tax benefits from a third party that is not a government acting in its capacity as a taxing authority should be recorded using the same model. In addition, the Task Force reached a consensus that transactions directly between a taxpayer and a government (acting in its capacity as a taxing authority) should be recorded directly in income (similar to a change in tax laws, rates or other tax elections under Statement 109).

Matters addressed in EITF 98-11 include the purchase of an asset or group of assets (including intangible and financial assets) not deemed to be a business, the acquisition of future tax benefits including net operating loss carryforwards, the purchase of tax basis step-ups from a governmental authority and the purchase of company stock when the company consists solely of one or a few assets. See sections C2.1.1 through C2.1.7 below for examples.

The consensus in EITF 98-11 requires the use of the simultaneous equations method to record the assigned value of the asset and the related deferred tax asset or liability. However, an acquired financial asset should be recorded at fair value, acquired assets held for disposal should be recorded at fair value less cost to sell, and deferred tax assets should be recorded at the amount required by Statement 109.

An excess of the amounts assigned to the acquired assets over the consideration paid should be allocated pro rata to reduce the values assigned to noncurrent assets acquired (except financial assets, assets held for disposal and deferred tax assets). If the allocation reduces the noncurrent assets to zero, the remainder should be classified as a deferred credit. The deferred credit is not a temporary difference under Statement 109. The deferred credit arising from the application of EITF 98-11 is amortized to income tax expense in proportion to the realization of the tax benefits that gave rise to the deferred credit. The deferred credit should not be classified as part of deferred tax liabilities or as an offset to deferred tax assets.

In addition, a reduction in the acquiring company's valuation allowance directly attributable to the asset acquisition should be accounted for as an adjustment of the purchase price in accordance with Statement 109.266. Subsequent accounting for an acquired valuation allowance (e.g., the subsequent recognition of an acquired deferred tax asset by elimination of a valuation allowance established at the date of acquisition of the asset) would be in accordance with Statement 109.30, which would reduce to zero other noncurrent intangible assets related to that acquisition, if any, and recognize any remaining reductions in the valuation allowance in income. If, subsequent to the acquisition, it becomes *more likely than not* that some or all of the acquired deferred tax asset will not be realized, the effect of the change in the valuation allowance is recognized in continuing operations as part of income tax expense and a proportionate share of any remaining unamortized deferred credit balance should be recognized as an offset to income tax expense.

Income tax uncertainties that exist at the asset acquisition date should be accounted for as follows: (1) any unfavorable adjustments should be recognized in earnings; (2) any favorable adjustments should be applied as a reduction of other noncurrent intangible assets related to the acquisition, if any; and (3) any remaining amount of favorable adjustments should be recognized in earnings.

C2.1.1 Asset acquired with tax basis greater than book basis — before the adoption of Statement 141(R)

As an incentive for acquiring specific types of equipment in certain sectors, some foreign jurisdictions permit a tax deduction in excess of the acquired asset's cost. In addition, an asset acquired in a nontaxable transaction can result in a different book and tax basis of the asset because the asset's tax basis is the same as the seller's basis (i.e., carryover basis), while the asset is generally recorded at fair value for financial reporting purposes. If an asset is purchased in a transaction that is not a business combination and the amount paid is less than the tax basis of the asset, EITF 98-11 requires the future tax benefits be recognized at the asset's acquisition date.

Illustration C2-1

Assume Company MLS purchases a machine for $100 and its tax basis is automatically increased to $150. Upon sale of the asset, there is no recapture of the "excess" tax deduction (a). Further, assume the tax rate is 40%.

In accordance with EITF 98-11, the amounts assigned to the equipment and the related deferred tax asset should be determined using the simultaneous equations method as follows (where FBB is final book basis; TB is the tax basis; CPP is cash purchase price; and DTA is deferred tax asset):

Equation A — computation of FBB of the machine is:	
CPP = FBB − (Tax rate × (FBB − TB))	
At a 40% tax rate, Equation A is:	CPP = FBB − 0.40FBB + 0.40TB
	.60FBB = CPP − 0.40TB
	FBB = (CPP − 0.40TB) ÷ 0.60
Equation B — computation of amount assigned to the DTA is:	
DTA = (TB − FBB) × Tax rate	
At a 40% tax rate, Equation B is:	DTA = 0.40TB − 0.40FBB

In the above example, the following variables are known:

Tax basis	$ 150
Tax rate	40%
Cash purchase price	$ 100

The unknown variables (FBB and DTA) are solved as follows:

Equation A:	FBB = $ 67	= ($100 − $60) ÷ 0.60
Equation B:	DTA = $ 33	= $60 − $27

Accordingly, Company MLS records the purchase of the machine in the following journal entry:

Machine	$ 67	
Deferred tax asset	33	
Cash		$ 100

(a) This is a key assumption. Any recapture on sale would create a temporary difference.

C2.1.2 Asset purchased for more than tax basis — before the adoption of Statement 141(R)

Companies acquiring assets in nontaxable transactions record the assets at fair value for financial reporting purposes and record the seller's tax basis in those assets (i.e., carryover basis) for tax purposes. EITF 98-11 requires the recognition of the deferred tax impact of acquiring an asset in a transaction that is not a business combination when the amount paid exceeds the tax basis of the asset on the acquisition date.

Illustration C2-2

Assume Company LNS pays $1 million for all of the outstanding stock of Company MEF in a nontaxable acquisition (that is, carryover basis for tax purposes). Further, assume Company MEF's sole asset is an FCC license that has a tax basis of zero. Because the acquisition of Company MEF is in substance the acquisition of an FCC license, the purchase of MEF's outstanding stock is not considered to be a business combination and goodwill is not recognized. A deferred tax liability is recorded for the temporary difference (in this case, the entire $1 million plus the tax-on-tax effect from increasing the carrying amount of the FCC license acquired) related to the FCC license. Also, assume the tax rate is 40%.

In accordance with EITF 98-11, the amounts assigned to the FCC license and the related deferred tax liability are determined using the simultaneous equations method as follows (where FBB is final book basis; TB is the tax basis; CPP is cash purchase price; and DTL is deferred tax liability):

Equation A — computation of FBB of the FCC license is:

CPP = FBB − (Tax rate × (FBB − TB))

At a 40% tax rate, Equation A is:	FBB − 0.40FBB + 0.40TB = CPP
	0.60FBB = CPP − 0.40TB
	FBB = (CPP − 0.40TB) ÷ 0.60

Equation B — computation of amount assigned to the DTL is:

DTL = (TB − FBB) × Tax rate

At a 40% tax rate, Equation B is:	DTL = 0.40TB − 0.40FBB

In the above example, the following variables are known:

Tax basis	$ –
Tax rate	40%
Cash purchase price	$1,000,000

The unknown variables (FBB and DTL) are solved as follows:

Equation A:	FBB = $1,666,667 = ($1,000,000 − $0) ÷ 0.60
Equation B:	DTL = $666,667 = $666,667 − $0

Accordingly, Company LNS records the acquisition of all outstanding shares of Company MEF which, for accounting purposes, is treated as a purchase of the FCC license, in the following journal entry:

FCC license	$ 1,666,667	
Cash		$ 1,000,000
Deferred tax liability		66,667

C2.1.3 Deferred credit from tangible asset acquisition — before the adoption of Statement 141(R)

As an incentive for acquiring specific types of equipment in certain sectors, some foreign jurisdictions permit a tax deduction in excess of the acquired asset's cost. In addition, an asset acquired in a nontaxable transaction can result in a different book and tax basis of the asset since the asset's tax basis is the same as the seller's basis (i.e., carryover basis), while the asset is generally recorded at fair value for financial reporting purposes. If an asset is purchased in a transaction that is not a business combination and the amount paid is less than the tax basis of the asset, EITF 98-11 requires the future tax benefits be recognized at the asset's acquisition date. Immediate income statement recognition is prohibited.

Illustration C2-3

Assume Company LFS buys a machine for $50 with a tax basis of $200 and the tax rate is 40%.

In accordance with EITF 98-11, the amounts assigned to the machine and the deferred tax asset are determined using the simultaneous equations method as follows (where FBB is final book basis; TB is the tax basis; CPP is cash purchase price; and DTA is deferred tax asset):

Equation A — computation of FBB of the machine is:
CPP = FBB − (Tax rate × (FBB − TB))

At a 40% tax rate, Equation A is:	FBB − 0.40FBB + 0.40TB = CPP
	0.60FBB = CPP − 0.40TB
	FBB = (CPP − 0.40TB) ÷ 0.60

Equation B — computation of amount assigned to the DTA is:
DTA = (TB − FBB) × Tax rate

At a 40% tax rate, Equation B is:	0.40TB − 0.40FFB = DTA

In the above example, the following variables are known:

Tax basis	$ 200
Tax rate	40%
Cash purchase price	$ 50

The unknown variables (FBB and DTA) are solved as follows:

Equation A:	FBB = $ − [(a)] = ($50 − $80) ÷ 0.60
Equation B:	DTA = $ 80 = $80 − $0

The excess of the amount assigned to the deferred tax asset over the cash purchase price paid for the machine is recorded as a deferred credit. Accordingly, Company LFS records the purchase of the machine in the following journal entry:

Deferred tax asset	$ 80	
Machine	– (a)	
Cash		$ 50
Deferred credit		30

The deferred credit is amortized to earnings (as a component of income tax expense) on a proportionate basis with the reversal of the deferred tax liability. Thus, in this example, future earnings will only be impacted by the actual purchase price.

(a) Although the computation yields a result of $(50), assets cannot be recorded below zero; therefore, the assigned value for the final book basis of the machine is zero.

C2.1.4 Deferred credit from the acquisition of assets recorded at fair value — before the adoption of Statement 141(R)

Certain assets acquired in transactions that are not business combinations are required to be recorded at fair value (e.g., marketable securities pursuant to Statement 115 or assets held for disposal). If the acquired financial asset has a different tax basis (i.e., carryover basis or the tax basis is other than fair value), Statement 109 requires a deferred tax asset or liability to be recognized for the income tax effect of the basis difference. To the extent generally accepted accounting principles dictate the initial recognition of acquired assets at fair value, EITF 98-11 requires the difference between (1) the fair value and deferred tax asset recognized and (2) the purchase price to be recognized as a deferred credit at the acquisition date. Any resultant deferred credit is amortized to income tax expense in proportion to the recognition of the tax benefits that gave rise to the credit.

Illustration C2-4

Assume Company LNS acquires the stock of Company CS for $250. The principal asset of Company CS is a marketable equity security with a readily determinable fair value of $200 and a tax basis of $500. Further, assume the tax rate is 40% and Company CS has no operations; thus, the acquisition is accounted for as an asset purchase and not as a business combination.

The acquired financial asset is recognized at fair value pursuant to Statement 115 and a deferred tax asset is recognized (subject to a valuation allowance) pursuant to Statement 109. The excess of the fair value of the financial asset and the deferred tax asset over the purchase price is recorded as a deferred credit pursuant to EITF 98-11. Accordingly, Company LNS records the purchase of marketable securities in the following journal entry:

Marketable securities (at fair value)(1)	$ 200	
Deferred tax asset ([$500-$200] x 0.40)	120	
Cash		$ 250
Deferred credit (derived)		70

(1) Any adjustments to the deferred credit for subsequent changes in the fair value of the marketable security should be recognized on a proportionate basis as an offset to the change in the related deferred tax balance.

C2.1.5 Valuation allowance reduced due to acquired intangible asset — before the adoption of Statement 141(R)

In some asset acquisitions, the purchaser has cumulative losses or other negative evidence, which resulted in a valuation allowance on its preexisting deferred tax assets (including net operating losses) immediately prior to the acquisition while the assets acquired will result in the recognition of a deferred tax liability. As a result of the asset acquisition, the acquiring company may determine its preexisting deferred tax assets are *more likely than not* to be realized by the company and the valuation allowance should be reduced or eliminated. Statement 109.266, applied by analogy as required by EITF 98-11, requires that the reduction in the acquiring company's valuation allowance be accounted for as an adjustment to the purchase price of the acquired asset. Therefore, the reduction in the acquiring company's valuation allowance reduces the assigned values of acquired noncurrent assets (except for: financial assets other than investments accounted for by the equity method; assets to be disposed of by sale; deferred tax assets and prepaid assets relating to postretirement benefit plans) or creates/increases the deferred credit. See section C1.6.2, *Acquiring company valuation allowance reduced in a business combination — before the adoption of Statement 141(R)*, for discussion of the application of Statement 109.266 in a business combination.

The following example illustrates the concepts to be applied to Statement 109.30 and Statement 109.266.

Illustration C2-5

Assume Company MLS acquires the stock of Company CS for $7 million. The principal asset of Company CS is a license with a tax basis of $2 million. Further, assume Company CS had no operations; thus, the acquisition is accounted for as an asset purchase and not as a business combination. Also, assume Company MLS has a deferred tax asset of $1.5 million, a valuation allowance of $1.5 million and the tax rate is 40%.

As a result of acquiring the license, Company MLS now has a taxable temporary difference that is expected to reverse (amortizing intangible) during the same period its preexisting deductible temporary difference is expected to reverse. (It is assumed the income taxes otherwise payable upon the reversal of Company CS' taxable temporary difference will be reduced as the result of Company MLS' preexisting deferred tax asset.) Therefore, Company MLS' deferred tax asset valuation allowance of $1.5 million is no longer required.

In accordance with EITF 98-11, the amounts assigned to the license and deferred tax liability and the amount of the deferred tax asset valuation allowance released are determined using the simultaneous equations method as follows (where FBB is final book basis; TB is the tax basis; VAR is the valuation allowance released; CPP is cash purchase price; and DTL is deferred tax liability):

Equation A — computation of FBB of the license is:

$CPP = FBB - (\text{Tax rate} \times (FBB - TB)) + VAR$

Assuming a tax rate of 40%, Equation A is: $0.60FBB = CPP - VAR - 0.40TB$

$FBB = (CPP - VAR - 0.40TB) \div .060$

Equation B — computation of amount assigned to the DTL is:

$DTL = (FBB - TB) \times \text{Tax rate}$

At a tax rate of 40%, Equation B is: $0.40FBB - 0.40TB = DTL$

In the above example, the following variables are known:

Tax basis	$ 2,000,000
Tax rate	40%
Cash purchase price	$ 7,000,000
Valuation allowance reduction	$ 1,500,000

The unknown variables (FBB and DTL) are solved as follows:

Equation A:	FBB = \$ 7,833,333 = (\$7,000,000 − \$1,500,000 − \$800,000) ÷ 0.60
Equation B:	DTL = \$ 2,333,333 = \$3,133,333 − \$800,000

Accordingly, Company MLS would record the acquisition of the license, reduction of the deferred tax asset valuation allowance directly related thereto and deferred tax liability attributable to the license in the following journal entry:

License	\$ 7,833,333	
Deferred tax asset valuation allowance	1,500,000	
Cash		\$ 7,000,000
Deferred tax liability		2,333,333

C2.1.6 Purchase of future tax benefits — before the adoption of Statement 141(R)

The Task Force concluded in EITF 98-11 that the tax benefit (that is, the difference between the amount paid and the deferred tax asset recognized) resulting from the purchase of future tax benefits from a non-governmental third party should be recognized as a deferred credit, which is recorded in earnings as the deferred tax asset is recognized.

Illustration C2-6

Assume a foreign entity that has nominal assets other than its net operating loss carryforwards (NOLs) is acquired by a foreign subsidiary of a US entity for the specific purpose of utilizing the NOLs (this type of transaction is often referred to as a "tax loss acquisition"). It is presumed that this transaction does not constitute a business combination because the acquired entity has no operations and is merely a shell company. As a result of the time value of money and because the target company is in financial difficulty and has ceased operations, the foreign subsidiary is able to acquire the shell entity at a discount from the amount corresponding to the gross deferred tax asset for the NOLs. Assume, for example, that \$2 million is paid for NOLs having a deferred tax benefit of \$5 million for which it is more likely than not that the full benefit will be realized. The tax rate is 40%.

In accordance with EITF 98-11, the amount assigned to the deferred tax asset should be recorded at its gross amount (in accordance with Statement 109) and the excess of the amount assigned to the deferred tax asset over the purchase price should be recorded as a deferred credit (which will be amortized to income tax expense in proportion to the recognition of tax benefits that give rise to it) as follows:

Deferred tax asset	\$ 5,000,000	
Deferred credit		\$ 3,000,000
Cash		2,000,000

As with the other deferred credits initially recognized pursuant to EITF 98-11, the \$3 million in this example would be recognized in earnings, on a proportionate basis, as the deferred tax asset is realized. As with any deferred tax asset, the company would evaluate the need for, and amount of, a valuation allowance for this deferred tax asset under the provisions of Statement 109.20.

C2.1.7 Transaction directly with a governmental taxing authority — before the adoption of Statement 141(R)

Certain taxing authorities (primarily outside the US) allow corporate taxpayers to elect to step-up the tax basis of certain assets (e.g., plant and equipment located within the taxing authority's jurisdiction) in exchange for a current payment to the taxing authority. These payments are generally a percentage of the step-up in tax basis (e.g., 3% of additional basis). The Task Force in EITF 98-11 concluded transactions directly between a taxpayer and a government (in its capacity as a taxing authority) should be recorded directly in income in a manner similar to a change in tax laws or rates (assuming a temporary difference is not created and the step-up is not the result of an intercompany transaction).

In situations in which the tax basis step-up relates to goodwill that was previously not deductible, a deferred tax asset is not recorded for the increase in tax basis except to the extent the newly deductible goodwill amount exceeds the remaining balance of book goodwill. In addition, if the purchase of tax benefits results from intercompany transactions between members of a consolidated entity, Statement 109.9(e) prohibits recognition of a deferred tax asset for the difference between the tax basis of assets in the buyer's tax jurisdiction and the cost of those assets as reported in the consolidated financial statements.

Illustration C2-7

Assume the tax laws in a foreign country enable Company LNS to step-up the tax basis for its manufacturing plant in that country from historical cost ($1 million) to fair value as of the date of the election ($2 million) in exchange for a current payment to the taxing authority of 3% of the step-up. Company LNS will make this election (and the upfront payment of $30,000) if it believes it is likely the additional deductions (at a 40% tax rate) created by the step-up will be utilized to reduce future taxable income and the timing and amount of the future tax savings justifies the current payment. For purposes of this example, it is assumed the transaction that accomplishes this tax step-up (1) does not create a taxable temporary difference as described in Statement 109 (e.g., the tax benefit associated with the transaction with the governmental taxing authority becomes taxable in certain situations, such as those described in EITF Issue No. 93-16, "Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Criterion of APB Opinion No. 23" (EITF 93-16); and (2) is not an intercompany transaction as discussed in Statement 109.9(e).

In accordance with EITF 98-11, the tax effects of transactions directly with a taxing authority are recorded directly in earnings as follows:

Deferred tax asset	$ 400,000	
Deferred income tax benefit		$ 370,000
Cash		30,000

C3 (Non-authoritative) income tax exposures (contingencies) — before the adoption of the accounting for uncertainty in income taxes in ASC 740-10

This chapter is not intended to provide the accounting guidance relating to income tax exposures post-adoption of FIN 48. Chapter 19, *Accounting for uncertainty in income taxes*, provides our interpretative guidance on FIN 48, and should be utilized after the adoption of this Interpretation.

Often companies will accrue income tax liabilities for potential adjustments that could result from examinations of the current or prior tax returns by the taxing authorities. Accruals of this nature typically include tax liabilities related to permanent differences (basis differences that will not result in taxable or deductible amounts in future years) and uncertainties related to basis differences that could be challenged by the taxing authority. Tax liabilities also can consist of negotiated settlement amounts with the taxing authority. In some cases, companies also include penalties and interest potentially due to the taxing authority within accrued income tax liabilities.

Accounting for income taxes is governed by Statement 109; however, specific guidance on accounting for income tax exposures or related disclosure in the financial statements is not provided by Statement 109. With respect to tax exposures, the SEC staff continues to focus on the timing of the recognition and reversal of accruals, including accruals for income tax exposures, as part of its initiative to determine that such transactions are accounted for on a gross basis in accordance with Statement 5. Further, Staff Accounting Bulletin No. 99, *Materiality* (SAB 99), emphasizes the importance of adjusting excess liability amounts promptly.

C3.1 Initial recognition of tax benefits — before the adoption of FIN 48

The SEC staff first discussed the criteria for the initial recognition of tax benefits at the 11 December 2003 AICPA/SEC Current Developments Conference and noted that, in its view, "the recognition of the gross amount of a contingent tax asset, whether or not resulting from a tax-advantaged transaction, should be evaluated for initial recognition like any other asset. That is, the company and auditor should conclude that it is at least probable the deduction will be sustained and the temporary difference will truly exist before that asset is recognized in the company's financial statements. Statement 109 is then used to evaluate any deferred tax asset for impairment." The "probable" criterion referred to by the SEC staff was "probable" as defined in Statement 5 as "likely to occur." While Statement 5 does not ascribe a percentage to it, "probable" is intended to denote a high likelihood of prevailing (e.g., 70% or more).

In a December 2004 speech at the AICPA/SEC Current Developments Conference, the SEC staff acknowledged that varying approaches were being utilized to account for the initial recognition of tax benefits and that until the FASB completes its project on uncertain tax positions, they expect registrants to use a consistent method and have a reasoned basis for their accounting. They also encouraged disclosure where a company's accounting policy could have a material effect on the financial statements.

The SEC staff speeches have received a great deal of focus and arguably left open many related questions. While the FASB has addressed the accounting for the initial recognition of contingent tax benefits in FIN 48, the ability to early adopt is greatly constrained. As a result, we expect to continue to see some variance in companies' accounting for the initial recognition of uncertain tax positions prior to the adoption of FIN 48.

C3.2 Accounting for income tax exposures — before the adoption of FIN 48

Accounting for income tax exposures is encompassed by Statement 5, which provides that an estimated loss from a loss contingency should be accrued by a charge to income if both of the following criteria are met:

- Information available prior to issuance of the financial statements indicates that it is probable (i.e., likely to occur) that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- The amount of loss can be reasonably estimated.

A liability for income tax exposures should be accrued when both of the Statement 5 criteria have been met. Therefore, if based on the available information, it is probable that the taxing authority will disagree with a tax position (or some portion thereof) that will negatively affect the amount of taxes previously paid or currently due, the first criterion would be met because it is probable that a liability has been incurred. Satisfaction of the second criterion normally will depend on the ability of the company to reliably estimate the amount of the taxing authority assessment. In certain cases, it will be possible to meet the Statement 5 accrual criteria at the time a tax return is filed or when the provision for income taxes has been recognized in the financial statements based upon the intended filing (as most annual tax provisions are prepared prior to the filing of the current year's tax return). However, in other cases, it might not be possible to conclude that it is probable that a loss exists or estimate the amount of such loss prior to the taxing authority's examination (e.g., the ultimate amount due to the taxing authority will be subject to either negotiation or possible litigation). The likelihood of a taxing authority discovering an exposure on examination does not impact whether or not the exposure should be subject to the recognition provisions of Statement 5. Instead, it should be presumed that the taxing authority will focus on the exposure and that presumption should continue until the statute of limitations has expired.

In addition to the guidance in Statement 5, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss — an interpretation of FASB Statement No. 5* (FIN 14), discusses ranges of probable losses and states that when some amount within the range is a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, FIN 14 requires that the minimum amount in the range should be accrued.

The following example illustrates the recognition of income tax liabilities for potential adjustments that could result from examination of current-year or prior-year tax returns by the taxing authority.

Illustration C3-1

Company A has recognized three separate items in its prior-year tax returns, which are currently under examination. Company A has concluded that it is probable (i.e., likely to occur) that the taxing authorities might disallow a portion of the previous tax deduction. The accrued income tax liability related to the probable adjustments follow:

Tax exposure issue no.	Gross amount of the permanent item [(a)]	Range of probable loss (estimated exposure)[(b)]	
1	$ 1,000,000	$ 400,000	$ 600,000
2	$ 1,000,000	500,000	600,000
3	$ 3,000,000	900,000	1,200,000
Range of probable loss		1,800,000	2,400,000
Federal tax rate		35%	35%
Range of federal tax exposure		$ 630,000	$ 840,000

(a) In order to recognize an income tax exposure item, the company must conclude that it is probable that the taxing authority will disallow a portion or all of a previously recognized tax position.

(b) Consistent with Interpretation 14, when some amount within the range ($630,000 — $840,000) is a better estimate than any other amount within the range, that amount should be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range should be accrued ($630,000).

Assuming the same tax exposures exist at the state/local income tax level and the appropriate state/local tax rate is 8%, Company A would have the following:

Range of probable loss per above	$1,800,000	$2,400,000
State/local tax rate	8%	8%
Range of federal tax exposure	144,000	192,000
Federal benefit of state/local tax	(50,400)[(c)]	(67,200)[(d)]
Range of state/local tax exposure	$ 93,600[(e)]	$ 124,800[(e)]

(c) Computed as $144,000 at 35%.

(d) Computed as $192,000 at 35%.

(e) Alternatively, Company A could have computed the range of state/local tax exposure net of federal benefit as the probable loss multiplied by the state/local tax rate, net of the federal benefit (or $1,800,000 x [.08 x (1-.35)]).

It should be noted that it would not be appropriate to apply a weighted-average methodology as discussed in FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, to quantify the tax exposure liability. For example, a 20% likelihood that an exposure would be settled for $150,000 and an 80% likelihood that the same exposure would be settled for $200,000 would not result in an estimated liability of $190,000 under Statement 5. Instead it establishes a range of exposure and may indicate $200,000 as a best estimate. In another example, a 30% likelihood that an exposure would be settled for $100,000 and a 70% likelihood that the taxpayer would prevail would not result in any recorded liability under Statement 5 as 30% does not indicate a probable tax liability.

A liability for income tax exposures should be reversed in the period that one or both of the criteria of Statement 5 are no longer met. Likewise, an adjustment to the amount accrued, due to a change in facts and circumstances, should be recognized in the period (including interim period) that the change in estimate regarding the liability is determined. As with the reversal or adjustment of any liability for a loss contingency, the timing of the reversal or adjustment should occur in the period in which the underlying event occurs and any adjustment is considered a discrete event and should not be recognized by adjusting the annual effective rate calculation. That is, it cannot be anticipated or spread over interim periods.

Examples of underlying events indicating the liability might need to be adjusted include a court ruling related to another taxpayer having the same exposure, the taxpayer agreeing to a settlement with the taxing authority for an amount different from the amount accrued, or the statute of limitations expiring. Because income tax exposures arise principally as a result of filing positions taken on tax returns, it generally would be unlikely that a company would be able to estimate a probable liability and record an appropriate accrual in one period and in the following period not be able to determine a range or best estimate of loss if the liability were still probable. If, however, a company is no longer able to estimate the loss or a range of loss because of specific events occurring, a liability would be reversed as the requirements of Statement 5 for accrual would no longer be met.

C3.3 Recording an accrual for income tax exposures in the financial statements — before the adoption of FIN 48

If the accrual for income tax exposures relates to the deductibility of an item as opposed to the timing of the deduction (see following paragraph) and the exposure is expected to be settled with the taxing authority within one year, the accrual should be included in taxes currently payable.

Basis difference issues that merely relate to when the item is reflected for income tax purposes do not impact net income. Therefore, basis differences in and of themselves do not result in income tax exposures that are recognized. As illustrated in the following example, companies generally have used one of two methods to record an accrual for tax exposures related to basis differences:

1. Provide deferred taxes for the difference between the financial reporting basis and probable tax basis of the item and provide an accrual for the exposure on the difference between the probable tax basis and as-filed tax basis. In this instance the accrued exposure would be classified in the balance sheet as a tax liability as opposed to deferred taxes payable.

   Or

2. Provide deferred taxes for the difference between the financial reporting amount and as-filed tax basis. Under this method the accrued exposure is effectively embedded within the deferred tax amounts.

At the 11 December 2003 AICPA/SEC Current Developments Conference, the SEC staff indicated that if the exposure under Method 2 is included within the deferred tax accounts, consistent disclosure of the deferred tax liabilities from year to year should be made — that is, the amount of accrued exposure should be separately disclosed.

The following example illustrates the two alternatives.

Illustration C3-2

Company A acquired an enterprise resource planning (ERP) information system in 20X0. The capitalized costs of the ERP system for financial reporting purposes was $100,000. An additional $20,000 of process reengineering costs were charged to expense as incurred in 20X0 for financial reporting purposes. In preparing the 20X0 tax provision, Company A has assumed that it will deduct $12,000 of process reengineering costs and that it will capitalize the remaining $8,000 of process reengineering costs in its 20X0 tax return (as filed). Company A believes that it is not probable that upon examination, its position supporting immediate expensing of the $12,000 will prevail and that the taxing authority will require Company A to capitalize all process reengineering costs for tax purposes.

Financial reporting basis of ERP system	$	100,000
As-filed tax basis of ERP system		108,000
Probable tax basis of ERP system		120,000
Current-year tax deduction per provision/tax return		12,000
Tax rate		35%

Therefore, Company A should disregard its tax position related to the immediate deduction of $12,000 process reengineering cost for financial reporting purposes. That is, a tax exposure accrual of $4,200 should be recognized in earnings in 20X0 under one of the following methods:

Method 1

Assuming an accrual for the exposure related to the difference between as-filed and probable tax bases is maintained in a tax liability account other than deferred taxes:

Reduction in amount due to taxing authority (current-year deduction x 35%, or $12,000 x 35%)	$	4,200
Deferred tax asset ([probable tax basis — financial reporting basis] x 35%, or ($120,000 — $100,000) x 35%)		7,000
Taxes payable ([probable tax basis — as-filed tax basis] x 35%, or ($120,000 — $108,000) x 35%)		(4,200)
Tax effect of ERP process reengineering costs ($20,000 x 35%)	$	7,000

Disclosure and separate reporting of tax contingencies is required.

As illustrated above, the company's aggressive as-filed tax position reflects a deduction for receiving credits that under Statement 5 should be reserved to reflect the probable outcome. Thus, the company has recognized $4,200 of additional tax expense (as compared to the amount shown on the tax return).

Method 2

Assuming an accrual for the exposure on the difference between as-filed and probable tax bases is maintained in deferred taxes:

Reduction in amount due to taxing authority (Current-year deduction x 35%, or $12,000 x 35%)	$	4,200
Deferred tax liability ([(As-filed tax basis — financial reporting basis) x 35%], or [($108,000 — $100,000) x 35%])		2,800
Tax effect of ERP process reengineering costs ($20,000 x 35%)	$	7,000

Disclosure and separate reporting of the contingent gain embedded in the net deferred tax asset is required.

C3.4 Interest — before the adoption of FIN 48

Companies generally follow one of two alternatives in accruing interest that would be payable to the taxing authority on probable tax exposures. Some companies record the interest as a charge to interest expense (gross) while others accrue it as a component of tax expense (net). Although technically interest charges should be reported in interest, either method is acceptable in practice as long as it is consistently applied. Noteworthy, however, is that interest that accrues on a tax exposure is a period expense that increases over time. That is, each year an exposure for a previous deduction remains outstanding, additional accruals for interest due to the taxing authority are required. It is not appropriate to preaccrue interest (i.e., it is not appropriate to accrue for five years of interest due to a taxing authority in the year a deduction is taken under the assumption that in five years when it is settled that amount of interest will be due; instead the interest would be accrued annually over the five-year period as a period cost).

C3.5 Income tax reserves established in purchase business combinations — before the adoption of FIN 48 and Statement 141(R)

See section C3.5.3, *Deferral of FIN 48 and adoption of Statement 141(R) for certain nonpublic enterprises*, for a discussion of how FSP FIN 48-3 affects the accounting for uncertain tax positions established at the date of acquisition and subsequent changes to these tax positions. Also, see Chapter 11, *Business combinations*, for further discussion regarding the accounting for income taxes after the adoption of Statement 141(R).

Companies often record reserves for uncertainties related to income taxes that might exist or arise in connection with a purchase business combination. Examples include uncertainties about the allocation of the purchase price to individual assets and liabilities for tax purposes in a taxable business combination, uncertainties about the carryover bases of assets, liabilities and carryforwards in a nontaxable combination, or uncertainties about tax returns for periods prior to the acquisition. In addition, at the acquisition date, companies often establish valuation allowances for uncertainties relating to the realizability of deductible temporary differences and operating loss and tax credit carryforwards.

Guidance regarding the accounting for accruals for income tax exposures and valuation allowances recorded in a purchase business combination is included in EITF 93-7 and Question 17 of the Statement 109 Special Report. In general, this guidance provides that adjustments upon resolution of income tax uncertainties that predate or result from a purchase business combination should be recorded as an adjustment to increase or decrease goodwill, regardless of the time that has elapsed since the acquisition date. The effect of a decrease in tax reserves and valuation allowances established in a purchase business combination should be applied first to reduce to zero any goodwill related to the acquisition, second to reduce to zero other noncurrent intangible assets related to the acquisition, and third to reduce income tax expense. The one important exception to this guidance is that the effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years ordinarily should be included in income from continuing operations (e.g., the launch of an entirely new line of business and forecasted profitability that was not envisioned at the date of acquisition or the expiration of a loss carryforward due to shortfalls from expected operating income). In addition, interest paid on settlement that accrued subsequent to the acquisition should not be included in the goodwill adjustment.

C3.5.1 Tax allocation uncertainties in a business combination — before the adoption of FIN 48 and Statement 141(R)

In taxable business combinations, the purchase price for tax purposes is generally allocated to assets and liabilities in accordance with tax regulations. The tax regulations for allocating cost in business combinations differ from the concepts used for financial reporting purposes. In most cases, the tax basis of assets and liabilities generally is evident and can be determined from initial and subsequent filings with the taxing authority. However, in some cases, the tax law does not provide clear guidance for allocating the purchase price to individual assets and liabilities, or for determining what amortization period, if any, is appropriate for certain assets. In those cases, the tax basis may not be readily determinable from filings with the tax authority. Instead, the tax basis may be determined by applying tax regulations, negotiations with the tax authority, appeals procedures, or, in some cases, legal proceedings.

Deferred tax assets and liabilities at the acquisition date should reflect management's best estimate of the tax basis of acquired assets and liabilities that will ultimately be accepted by the tax authority (Question 17 of the Statement 109 Special Report). The actual tax bases of assets and liabilities might not equal amounts determined simply through analysis of tax return information. As a result, prior to the final determination of the tax basis, taxable income will be computed based on the initial tax basis and tax benefits will be received that the company expects to return to the taxing authority. In this situation, the company should determine deferred taxes based on the expected final tax basis and recognize a liability for the excess tax benefit.

Illustration C3-3

Assume Company A acquired Company B at the beginning of 20X0 in a taxable purchase business combination for $2 million. The enacted tax rate is 35% for all years presented. The purchase price allocation is as follows:

	Financial reporting	Initial tax allocation	Expected final tax allocation
Fixed assets	$1,000,000	$1,000,000	$1,000,000
Identifiable intangible assets	1,000,000	1,000,000	–
Nondeductible goodwill	350,000	–	1,000,000
Deferred tax liability	(350,000)[(a)]	–	–
Total	$2,000,000	$2,000,000	$2,000,000

(a) Based on management's best estimate of a zero tax basis for identifiable assets ($1,000,000 x 35% = $350,000).

Assume that fixed assets are depreciated using the same method and over the same years for financial reporting and tax purposes. Also, assume that the identifiable intangible assets have a five-year life for book and tax purposes. Pretax income for financial reporting and taxable income is as follows:

	Financial reporting	Tax return
Income before amortization of intangibles	$5,000,000	$5,000,000
Amortization of identifiable intangible assets	(200,000)	(200,000)
Pretax book income and taxable income	$4,800,000	$4,800,000
Current taxes payable (at 35%)		$1,680,000

Income taxes for financial reporting purposes at 31 December 20X0 would be calculated as follows:

	Financial reporting	Tax return
Current income tax expense:		
Taxes currently payable ($4,800,000 x 35%)		$1,680,000
Liability for disallowance of "excess" tax benefit in 20X0 ([$1,000,000 ÷ 5 years] x 35%) or [$200,000 x 35%])		70,000
		1,750,000
Deferred income tax benefit:		
Deferred tax liability at acquisition date	$ (350,000)	
Deferred tax liability at 31 December 20X0 ([$800,000[(b)] – 0[(c)]] x 35%)	280,000	(70,000)
Total income tax expense		$1,680,000

(b) Identifiable intangible assets of $1 million less $200,000 amortization in 20X0.

(c) Based on management's best estimate of a zero tax basis for identifiable assets.

Deferred tax assets or liabilities should be adjusted for subsequent changes in management's best estimate of the ultimate tax bases of acquired assets and liabilities, as well as actual settlement of the tax basis with the taxing authority. The effect of that adjustment, including amounts of any settlement with the tax authority for prior years, should be applied to first increase or decrease the remaining balance of goodwill related to that acquisition. If goodwill is reduced to zero, the remaining portion of the adjustment would reduce other noncurrent intangible assets related to that acquisition and then reduce income tax expense. In that regard, a different allocation that results from an IRS examination does not automatically result in a direct income statement adjustment. Because negative adjustments, which result from payment of additional taxes, would increase goodwill, an assessment about the recovery of the carrying amount of goodwill also should be made.

Statement 109 governs the accounting treatment for (1) temporary differences and carryforwards that existed at the acquisition date and (2) income tax uncertainties related to the acquisition (for example, aggressive positions taken for tax purposes that ultimately may be challenged by the taxing authority). The following example illustrates adjustment of deferred tax liabilities and goodwill based on settlement with the taxing authority of the tax bases of assets acquired.

Illustration C3-4

Assume the same facts in Illustration C3-3. In addition, assume that at the beginning of 20X1 the tax allocation basis was settled with the taxing authority as follows:

	Financial reporting	Initial tax allocation	Expected final tax allocation
Fixed assets	$1,000,000	$ 1,000,000	$1,000,000
Identifiable intangible assets	1,000,000	1,000,000	400,000
Nondeductible goodwill	350,000	–	600,000
Deferred tax liability	(350,000)[(a)]	–	–
Total	$2,000,000	$ 2,000,000	$2,000,000

(a) Based on management's best estimate of a zero tax basis for identifiable assets (or $1,000,000 x 35% = $350,000).

Taxes payable at the beginning of 20X1 would be adjusted as follows:

		Adjustment to goodwill
Current:		
Amortization of identifiable intangible assets as deducted on tax return in 20X0 ($1,000,000 ÷ 5 years)	$200,000	
Amortization of identifiable intangible assets expected to be allowed in 20X0 ($400,000 ÷ 5 years)	(80,000)	
Excess amortization deducted on tax return	120,000	
Tax rate	35%	
Current payable	42,000	
Liability for disallowance of "excess" tax benefit at 31 December 20X0 ([$1,000,000 ÷ 5 years] x 35%)	(70,000)	
Adjustment to reduce liability to final amount due taxing authority		$ (28,000)
Deferred:		
Deferred tax liability at 31 December 20X0 based on final tax basis [($800,000[b] − 270,000[c]) x 35%]	(185,500)	
Deferred tax liability at 31 December 20X0	(280,000)[d]	
Adjustment to reduce deferred taxes		(94,500)
Total adjustment to goodwill		$(122,500)

(b) Identifiable intangible assets of $1,000,000 less $200,000 amortization in 20X0.

(c) Final tax basis computed as $350,000 less $80,000 amortization allowed for 20X0.

(d) Deferred tax liability at the acquisition date ($350,000) less partial reversal in 20X0 ($70,000). Noteworthy, however, is that a benefit was not recognized in earnings because of the recognition of a $70,000 liability for the disallowance of "excess" tax benefits in 20X0.

Goodwill at the beginning of 20X1 would be as follows:

Original allocation	$ 350,000
Adjustment based on final tax basis	(122,500)
Final goodwill balance[e]	$ 227,500

(e) Computed as excess of book basis over tax bases of identifiable intangible assets at the applicable statutory rate (or [($1,000,000 − $350,000) x 35%]).

The reduction in goodwill would be offset by a similar reduction in the deferred tax liabilities recorded in the purchase price allocation. In essence, goodwill, with the exception of previously recognized amortization and/or impairment charges, and the deferred tax liabilities are adjusted to the amounts that would have resulted had the final tax allocation been known at the acquisition date.

C3.5.2 Income tax uncertainties in a business combination — before the adoption of FIN 48 and Statement 141(R)

A number of uncertainties related to income taxes may exist at the time of, or arise in connection with, a purchase business combination. Examples include uncertainties about the allocation of the purchase price to individual assets and liabilities for income tax purposes in a taxable business combination as discussed above, uncertainties about the carryover bases of assets, liabilities and carryforwards at the acquisition date in a nontaxable combination, or uncertainties about tax returns of the acquired company for periods prior to the acquisition date. Statement 141.40 requires preacquisition contingencies attributable to the potential income tax effects of (1) temporary differences and carryforwards of the acquired enterprise that exist at the acquisition date and (2) income tax uncertainties related to the acquisition (for example, an uncertainty related to the tax basis of an acquired asset that will ultimately be agreed to by the taxing authority) or adjustments that result from realization of those benefits be accounted for under Statement 109. That is, they are not within the scope of Statement 141. The Task

Force reached a consensus in EITF 93-7 that all income tax uncertainties existing at the time of or arising in connection with a purchase business combination should be accounted for pursuant to Statement 109 rather than FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*. Statement 38 was subsequently superseded by Statement 141; however, EITF 93-7 was not affected.

Further, the Task Force reached a consensus that the guidance contained in Question 17 of the Statement 109 Special Report should be applied to changes in estimates and final settlements of all income tax uncertainties that predate, or result from, a purchase business combination with the exception of uncertainties related to the valuation allowance of a deferred tax asset. The Task Force observed in its consensus that EITF 93-7 does not apply to changes in judgment about the realization of deferred tax assets because Statement 109.26 and Statement 109.30 provide guidance for changes in a valuation allowance related to an acquired deductible difference or carryforward. Further, the Task Force noted that the requirement in Statement 109.30 regarding reductions in a valuation allowance established at the acquisition date applies only to the initial recognition of an acquired benefit. All other changes in the valuation allowance due to a change in judgment about the realizability of the deferred tax asset should be included in income from continuing operations pursuant to Statement 109.26.

As indicated in Question 17 of the Statement 109 Special Report (as discussed in section C3.5.1, *Tax allocation uncertainties in a business combination — before the adoption of FIN 48 and Statement 141(R)*), deferred tax assets and liabilities at the date of a purchase business combination should be based on management's best estimate of the ultimate tax bases that will be accepted by the tax authority, and liabilities for prior tax returns of the acquired entity should be based on management's best estimate of the ultimate settlement. Deferred tax assets and liabilities should be adjusted whenever management's best estimate of the ultimate tax bases of acquired assets, liabilities and carryforwards changes as well as at the time the tax basis is settled with the tax authority to reflect the revised tax basis and the amount of any settlement with the tax authority for prior-year income taxes. Similarly, whenever there is a change in management's best estimate of items relating to the acquired entity's prior tax returns or those items are settled with the tax authority, any liability previously recognized should be adjusted. The effect of those adjustments should be applied to increase or decrease the remaining balance of goodwill attributable to that acquisition. If goodwill is reduced to zero, the remaining amount of those adjustments should be applied initially to reduce to zero other noncurrent intangible assets related to that acquisition, and any remaining amount should be recognized in earnings.

Interest on the final settlement with the tax authority accrued subsequent to the acquisition date should not be included in the goodwill adjustment pursuant to EITF 93-7. Instead interest should generally be included as a component of interest expense or income tax expense in the income statement.

C3.5.3 Deferral of FIN 48 and adoption of Statement 141(R) for certain nonpublic enterprises

On 30 December 2008, the FASB issued FSP FIN 48-3, which further delays the effective date of FIN 48 for certain nonpublic enterprises until annual financial statements for fiscal years beginning after 15 December 2008. This FSP does not apply to nonpublic consolidated entities of public enterprises that apply US GAAP or nonpublic enterprises that issued a full set of annual financial statements incorporating the recognition, measurement and disclosure requirements of FIN 48 prior to the issuance of this FSP. As such, nonpublic enterprises within the scope of the FSP that elect not to adopt FIN 48 will continue to account for and disclose income tax exposures pursuant to Statement 5.

FSP FIN 48-3 is effective upon issuance. Upon the adoption of FIN 48, nonpublic enterprises that elected to defer the adoption of FIN 48 pursuant to FSP FIN 48-3 will be required to apply the provisions of FIN 48 as of the beginning of the nonpublic enterprise's fiscal year (i.e., as a cumulative adjustment to beginning retained earnings). This requirement includes uncertain tax positions that were assumed in business combinations after the adoption of Statement 141(R). As such, nonpublic entities that complete acquisitions after the adoption of Statement 141(R) but prior to the adoption of FIN 48 will need to reassess their accounting for these acquisitions upon the adoption of FIN 48.

The FASB's decision to further defer the effective date of FIN 48 for certain nonpublic enterprises requires certain amendments to Statement 141(R).[74] These amendments provide guidance on the accounting for acquired uncertain tax positions at the acquisition date and thereafter after the adoption of Statement 141(R) for nonpublic enterprises that adopt FSP FIN 48-3. These amendments were necessary because Statement 141(R) nullifies the guidance in EITF 93-7 and Question 17 of the Statement 109 Special Report) which, prior to the adoption of FIN 48 and Statement 141(R), included guidance on accounting for acquired uncertain tax positions and subsequent changes to these tax positions.

FSP FIN 48-3 amends paragraph 27 of Statement 141(R) to clarify that after the adoption of Statement 141(R), nonpublic enterprises that elected to defer the adoption of FIN 48 should continue to account for acquired uncertain tax positions at the acquisition date using literature that was authoritative immediately prior to the effective date of FSP FIN 48-3 and Statement 141(R). That is, at the acquisition date, acquired uncertain tax positions should be measured at management's best estimates pursuant to EITF 93-7 and Question 17 of the Statement 109 Special Report, until FIN 48 is adopted.

FSP FIN 48-3 also amends paragraph 77 of Statement 141(R) for nonpublic enterprises that elect to defer the adoption of FIN 48. After the adoption of Statement 141(R) and until the adoption of FIN 48, changes to acquired uncertain tax positions after the acquisition date are recognized as adjustments to income tax expense. This requirement applies to all changes to acquired uncertain tax positions, even if the acquisition was completed prior to the adoption of Statement 141(R). This amendment represents a significant change to the accounting for subsequent changes to uncertain tax positions pursuant to EITF 93-7 and Question 17 of the Statement 109 Special Report, which provided that such changes were recognized as adjustments to the purchase price allocation in the business combination. However, this change is consistent with the accounting for changes to acquired uncertain tax positions after the adoption of Statement 141(R).

See Chapter 11, *Business combinations,* for further discussion on accounting for changes to uncertain tax positions established at the date of a business combination after the adoption of Statement 141(R).

C3.6 Disclosure — before the adoption of FIN 48

FSP FIN 48-3 requires nonpublic enterprises that elect to defer the adoption of FIN 48 to explicitly disclose the following in each set of financial statements that are issued while the deferral in the FSP is being applied (e.g., in interim financial statements):

- That the enterprise has elected to defer the adoption of FIN 48
- The enterprise's accounting policy for evaluating uncertain tax positions

These disclosure requirements were included in the FSP by the FASB to minimize confusion among users of financial information from nonpublic enterprises that issue interim financial statements. Such interim financial statements will not reflect the adoption of FIN 48. However, the annual financial statements that include these interim periods will reflect the adoption of FIN 48.

[74] Statement 141(R) is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 15 December 2008.

For an accrued tax exposure, disclosure of the following information may be necessary for the financial statements not to be misleading:

- The nature of the accrual
- In some circumstances, the amount of the accrual

In addition, consistent with the SEC staff's position regarding disclosure of material changes in and charges to restructuring and purchase accounting reserves, companies should disclose material changes and charges (income) related to accruals for income tax exposures. In certain cases it may be determined that cash payments against the accrual and adjustments to the accrual are adequately disclosed through standard income taxes paid and effective tax rate reconciliation disclosures.

For a tax contingency that is not accrued because one or both conditions for accrual are not met, or if an exposure to loss exists in excess of the amount accrued, the following disclosures are required when there is at least a reasonable possibility that a material loss or an additional material loss may have been incurred:

- The nature of the contingency
- An estimate of the possible loss or range of loss (including the amount in excess of any reserve recorded) or a statement that an estimate cannot be made

Public companies should also assess the need to include appropriate discussion of these matters in management's discussion and analysis of financial condition and results of operations, including liquidity.

Statement of Position No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (SOP 94-6), builds on disclosure requirements of Statement 5 by adding a requirement for disclosure when estimates involving loss contingencies could change in the near term.

D Summary of important changes

The following highlights the related topics for which substantive updates have been made since the prior edition of this publication:

Chapter 2: Scope

- Added section 2.5.1, *Determining if government assistance is within the scope of ASC 740*.
- Moved section 4.2.8.1, *Scope*, to section 2.5.1.1, *Overview*.
- Moved section 4.2.8.4, *Grant accounting*, to section 2.5.1.2, *Grant accounting*.
- Added sections 2.5.1.3, *Accounting for refundable income tax credits*, and 2.5.1.4, *Accounting for nonrefundable tax credits with transferability features*, to add interpretive guidance on refundable income tax credits and nonrefundable tax credits with transferability features, as created by the Inflation Reduction Act and CHIPS and Science Act of 2022.

Chapter 4: Temporary differences

- Consolidated section 4.2.6, *Effect on deferred taxes of ability to delay payment*, into section 4.2.2, *Temporary differences — effect on deferred taxes of ability to delay payment*.
- Updated section 4.2.7, *Government assistance received (investment tax credits and government grants)* (prior year section 4.2.8).
- Moved section 4.2.8.1, *Scope*, to section 2.5.1.1, *Overview*.
- Moved section 4.2.8.4, *Grant accounting*, to section 2.5.1.2, *Grant accounting*.
- Updated section 4.2.7.2, *Investments in partnership or other pass-through entities that generate tax credits*, to reflect the issuance of ASU 2023-02, *Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*.
- Updated section 4.2.7.5, *Investments in qualified affordable housing projects (before the adoption of ASU 2023-02)*, to reflect the issuance of ASU 2023-02, *Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*.
- Added section 4.2.7.5A, *Proportional amortization method for equity investments in qualified tax credit programs (after the adoption of ASU 2023-02)*, to add interpretive guidance on ASU 2023-02.

Chapter 5: Recognition and measurement

- Updated section 5.5, *Alternative minimum tax*, to reflect the enactment of the Inflation Reduction Act, which includes a corporate alternative minimum tax, and the effects of the global minimum tax under the OECD's pillar two global anti-base erosion model rules.

Chapter 6: Valuation allowances

- Updated section 6.9, *Effect of AMT on deferred tax assets*, to reflect the enactment of the Inflation Reduction Act, which includes a corporate alternative minimum tax.

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