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Income taxes

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About the Income taxes guide

PwC is pleased to offer our updated comprehensive guide on the accounting for income taxes. This guide focuses on the accounting and financial reporting considerations for income taxes. It supplements information provided by the authoritative accounting literature and other PwC guidance.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations are:

- *Business combinations and noncontrolling interests (BCG)*
- *Consolidation and equity method of accounting guide (CG)*
- *Financial statement presentation (FSP)*
- *Financing transactions (FG)*
- *Foreign currency (FX)*
- *Property, plant, equipment and other assets (PPE)*
- *Stock-based compensation (SC)*
- *Equity method investments and joint ventures (EM)*

Summary of significant changes

The following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions to guide made in October 2021

TX 1, Scope of ASC 740

- TX 1.3.1.3 was added related to accounting considerations for digital service taxes.

TX 2, Objectives and basic principles

- Question TX 2-4 was added related to the deferred tax accounting associated with a transfer of acquired IP to a different jurisdiction.
- Former section TX 2.6 and its sub-sections related to correction of an error versus a change in estimate were moved to TX 6.

TX 3, Book versus tax basis differences

- Question TX 3-1 was added related to valuation allowance considerations when a deferred tax liability exists for US GAAP purposes but not for statutory purposes.
- TX 3.3.6.2 (formerly TX 3.3.8) was updated to discuss impairment considerations for low-income housing investments accounted for using the proportional amortization method.
- TX 3.3.6.4 (formerly TX 3.3.8) was updated to clarify why deferred taxes are not recognized when using the proportional amortization method of accounting.
- Former TX 3.3.5 and TX 3.3.6, both related to acquisitions of assets that do not qualify as a business combination, were moved to TX 10.

TX 4, Recognition and measurement

- Example TX 4-2 was added to illustrate the determination of tax effects of temporary difference reversals on an incremental basis.
- Former Example TX 4-7, relating to the election to include or exclude originating differences in the scheduling related to a tax holiday, was removed as the key concept is now incorporated in TX 4.3.3.3.
- Former Example TX 4-12, relating to the greater of income-based or on non-income based computation, was removed as a result of adoption of ASU 2019-12, *Simplifying the Accounting for Income Taxes*.
- TX 4.2.1 was added to provide additional insight around scheduling of temporary differences.
- TX 4.3.3.3 (formerly TX 4.3.3.4) was revised to reflect considerations around renewal of tax holidays and limited circumstances where accounting for renewal at a continued preferential rate prior to filing/approval date may be appropriate.
- TX 4.3.3.5 (formerly TX 4.3.3.6) was updated to provide additional guidance related to derecognizing deferred tax assets.

- Former TX 4.3.4, related to alternative minimum tax considerations, was removed as it is no longer applicable as a result of the 2017 Act.

TX 5, Valuation allowance

- TX 5.4.1.1 (formerly TX 5.4.2.1) was clarified to address situations when carryback should be considered as a source of taxable income.
- Example TX 5-18 was added to illustrate scheduling and forecasting when interest limitations apply.
- Former Example TX 5-15, related to determining core earnings, was replaced with new Example TX 5-14, to illustrate adjustments to arrive at earnings from core operations.
- Guidance related to the impact of a going concern on the valuation allowance assessment was clarified and separated into its own subsection (TX 5.2.4.2).
- TX 5.9 (which was formerly the content of TX 6) was added to reflect a summary of other valuation allowance considerations that may be found in other chapters.

TX 6 (former), A change in valuation allowance

- Content formerly in TX 6 was moved to TX 5.9.

TX 6 (new), Changes in tax return accounting methods and changes in estimates

- Content related to error versus change in estimate was moved from TX 2 to TX 6.
- Content related to changes in tax return accounting method was moved from TX 7 to TX 6.

TX 7, Change in tax law or rates

- Content related to changes in tax return accounting method was moved to TX 6.
- Former TX 7.3.1 and its subsections were removed because the content related to FASB guidance was only applicable for the 2017 change in US tax law. Ongoing disclosure requirements can be found in FSP 16

TX 8, Changes in the tax status of an entity

- Example TX 8-4 was added to address when to consider the effect of a retroactive "check-the-box" election in accounting for US federal taxation of foreign subsidiary earnings.

TX 9, Income tax accounting for financial instruments

- TX 9.3.7 was added related to the tax accounting for debt modifications.
- TX 9.4 and TX 9.4A and related subsections were updated to reflect the issuance of 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)*, which eliminates the beneficial conversion and cash conversion accounting models for convertible instruments.

TX 10, Business combinations and asset acquisitions

- Question TX 10-1 was added related to whether an asset should be recorded for GILTI Foreign Tax Credits in acquisition accounting when the GILTI period cost method is applied.
- The guidance formerly in TX 3.3.5 and TX 3.3.6 related to asset acquisitions was relocated to TX 10.12.

TX 11, Outside basis differences and other special areas

- Figure TX 11-1 was added to depict the difference between an outside basis difference and an inside basis difference.
- Former TX 11.4.9 was moved to TX 14.
- Added Example TX 11-11 to illustrate the consideration of GILTI- basket FTCs when measuring an outside basis deferred tax liability.

TX 12, Intraproduct tax allocation

- Former Question TX 12-1 was moved to Example TX 12-5.
- Former Question TX 12-4 is now Question TX 12-2.
- TX 12.5.2.1 (formerly TX 12.5.3) was updated to discuss a situation when a change in the realizability of deferred tax assets may be allocated to discontinued operations.
- Question TX 12-1, related to intraperiod allocation considerations for NOL carryforward limitations after an initial public offering, was relocated to TX 12.3.3.2 from TX 6.

TX 14, Separate financial statements of a subsidiary

- Example TX 14-8 (formerly example TX 14-7) was revised to include changes as a result of ASU 2019-12, *Simplifying the Accounting for Income Taxes*.
- TX 14.3.1 was added related to settling temporary differences due to a tax sharing agreement.
- TX 14.8.1 was moved from TX 11 related to spin off transactions and indefinite reversal assertion.

TX 15, Accounting for uncertainty in income taxes

- Content related to Form 20-F disclosures that was previously included in former TX 15.2.1.1 was moved to FSP 16.
- Question TX 15-3 was added from content that was moved from FSP 16 related to when a public entity should include claims for additional tax benefits during an IRS audit in its tabular rollforward.
- TX 15.4.5 was added to provide guidance on tax rates used for uncertain tax positions.

- Question TX 15-2 was added to clarify whether proposed regulations should be considered when assessing a company's tax position for financial reporting.

TX 16, Accounting for income taxes in interim periods

- Example TX 16-1 was clarified with regard to whether the tax effect of a goodwill impairment would be included in the annual effective tax rate or treated as a discrete item.
- Former Figure TX 16-1 related to the impact of including versus excluding an expense from the AETR was deleted and replaced with Example TX 16-2 to more clearly demonstrate the key points.
- Former Example TX 16-8 was removed and revised as Question TX 16-1.

TX 17, Income tax accounting for stock-based compensation

- Former TX 17.3.2, *Nonqualified stock options – employer payroll taxes*, was relocated to SC 10.7.

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Chapter 1: ***Scope of ASC 740***

1.1 Chapter overview—scope of ASC 740

Accounting Standards Codification (ASC) 740, *Income Taxes* addresses how companies should account for and report the effects of taxes based on income. While the scope of ASC 740 appears to be self-explanatory, the unique characteristics of different tax regimes across the United States and the world can make it difficult to determine whether a particular tax is based on income. This chapter looks at what would constitute a tax based on income and discusses the applicability of ASC 740 to various types of entities.

1.2 Entities and taxes covered by ASC 740

As discussed in ASC 740-10-15-2, ASC 740's principles and requirements apply to domestic and foreign entities, including not-for-profit (NFP) entities with activities that are subject to income taxes, and applies to federal, state, local (including some franchise), and foreign taxes based on income.

ASC 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.

ASC 740 applies to all entities that are part of a reporting entity of a reporting entity and are subject to tax. It is necessary, therefore, to consider the tax impact of all entities that impact the reporting entity (e.g., equity-method investees, consolidated or combined entities under common control, variable interest entities consolidated under ASC 810 *Consolidation*).

1.2.1 Non-income-based taxes

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. This guidance removes certain exceptions to the general principles of ASC 740 and simplifies several other areas. ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted in any interim or annual period. If a reporting entity chooses to early adopt, it must adopt all changes as a result of the ASU. The transition provisions vary by amendment.

If a tax system is based on the greater of an income-based calculation and a non-income-based calculation, ASU 2019-12 requires the amount of tax that is based on income to be accounted for under ASC 740 as an income-based tax, with any incremental amount accounted for as a non-income-based tax (i.e., "above the line") recognized entirely in the period incurred. This amendment should be applied on either a retrospective basis for all periods presented or a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. See TX 1.2.1.1 for applicable guidance after adoption of ASU 2019-12 and TX 1.2.1.1A for applicable guidance before adoption of ASU 2019-12.

1.2.1.1 Non-income-based taxes (after adoption of ASU 2019-12)

ASC 740 does not apply to franchise (or similar) taxes based on capital or a non-income-based amount as long as there is no aspect of the tax based on income. If a franchise tax is partially based on income, it is subject to accounting in accordance with ASC 740.

Withholding taxes that a reporting entity pays to the tax authority on behalf of its shareholders are also outside of the scope of ASC 740.

Excerpt from ASC 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.

Greater of an income-based or non-income-based tax computation (after adoption of ASU 2019-12)

Taxes based on capital or other non-income-based amounts are explicitly scoped out of ASC 740. However, certain jurisdictions (including several states in the US) impose a tax that is computed as the greater of a tax based on income or a tax based on capital or other non-income-based amounts. These are sometimes referred to as franchise taxes. As discussed in ASC 740-10-15-4, the amount of tax that is based on income (without regard to the amount that is based on capital or the non-income-based amount) is accounted for under ASC 740 as an income-based tax. If the tax based on capital or non-income-based amount is greater than the tax based on income, the incremental amount should be accounted for as a non-income-based tax and recognized as a pre-tax expense in the period incurred. ASC 740-10-55-139 through ASC 740-10-55-144 contains an example of the calculation.

Further, deferred tax assets and liabilities should be measured using the applicable statutory income tax rate when associated with an income based taxed. However, under ASC 740-10-15-4 it is not necessary to consider whether the income-based tax or non-income-based tax is expected to be greater

in years that temporary differences will reverse for purposes of assessing deferred tax assets for realizability. In other words, even if a temporary difference reverses in a year that the entity expects to be subject to a greater non-income-based tax and, therefore, the reversal would reduce that non-income based tax, that fact should not be considered when assessing the realizability of deferred tax assets.

1.2.1.1A Non-income-based taxes (before adoption of ASU 2019-12)

ASC 740 does not apply to franchise taxes (or similar) based on capital or a non-income-based amount as long as there is no aspect of the tax based on income. It also does not apply to withholding taxes that an entity pays to the tax authority on behalf of its shareholders.

ASC 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.

Greater of an income-based or non-income-based tax computation (before adoption of ASU 2019-12)

Taxes based on capital are explicitly scoped out of ASC 740. However, certain jurisdictions (including several states in the US) impose a tax that is computed as the greater of a tax based on income or a tax based on capital. These are sometimes referred to as franchise taxes. As discussed in ASC 740-10-15-4, taxes based on income in excess of the tax based on capital are subject to ASC 740. ASC 740-10-55-139 through ASC 740-10-55-144 contains an example of the calculation. If either of the taxes being compared is considered a tax based on income, the entity would need to develop an expectation of what portion of the tax in future periods represents the income-based portion and recognize deferred taxes on that portion.

In such circumstances, there is the question of how ASC 740 should be applied in determining the applicable tax rate used to compute deferred tax assets and deferred tax liabilities for temporary differences and carryforwards. We infer from ASC 740-10-55-144 that these tax regimes effectively operate as graduated rate systems, in which the total computed tax is an income tax only to the extent that the tax exceeds the non-income-based tax in a given year. Accordingly, assuming that the statute prescribes a single tax rate for the income-based calculation, the tax rate would be zero if the income-based tax calculation equals the non-income-based computation. Any additional taxable income would be taxed at the tax rate prescribed in the statute.

When graduated rates are a significant factor, the applicable rate is the average rate that is expected to be applicable to the amount of estimated taxable income in the reversal years. See additional discussion in TX 4.3.1.

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. If a tax system is based on the greater of an income-based calculation and a non-income-based calculation, ASU 2019-12 requires the amount of tax that is based on income to be accounted for under ASC 740 as an income-based tax, with any incremental amount accounted for as a non-income-based tax (i.e., “above the line”) recognized entirely in the period incurred. See TX 1.2.1 and TX 1.2.1.1 for additional information on ASU 2019-12, including effective dates and transition requirements, and post-adoption guidance.

1.2.2 Withholding taxes—entities that pay dividends

ASC 740-10-15-4 indicates that a withholding tax for the benefit of the recipients of a dividend is not an income tax of the entity that pays the dividend if certain conditions are met. We believe that this guidance would also apply to withholding taxes for the benefit of the recipients of interest, royalty, or other payments if those same conditions are satisfied.

1.2.3 Withholding taxes—entities that receive dividends

Reporting entities that have taxes withheld by another entity from dividends, interest, royalties or other income on their behalf must determine whether such withholding taxes are income taxes that must be accounted for in accordance with ASC 740.

In many cases, withholding taxes will be deemed to be income taxes of the entity that receives the dividends, interest, royalties or other income. Withholding taxes are typically considered under local country laws, together with respective tax treaties, to be prepayments of (or in lieu of) local income taxes. In other words, the withholding taxes are essentially a substitute for a complete income tax calculation because the recipient of the payment (against which the tax is withheld) is outside the country and may not otherwise be required to file a local income tax return. If the company that received the dividends, interest, royalties or other income were to file an income tax return in the local jurisdiction, it would be able to claim the withholdings as a prepayment of its income taxes otherwise due in that jurisdiction. For US-based entities, such withholding taxes may generate foreign tax credits, and thus directly interact with the recipient entity’s US income tax computation. While the withholding taxes may be creditable against the US income tax liability, this alone does not determine if the withholding tax is an income tax that is within the scope of ASC 740. In situations in which a payor has not withheld taxes and the withholding tax would have qualified as an income tax, and the company does not record a tax liability, ASC 740’s requirements for the accounting for uncertain tax positions should be considered.

1.2.4 Credits and other tax incentives

Certain expenditures may generate credits or other tax incentives under various governmental programs. These programs take many forms, including programs related to research and development, alternative fuels, renewable energy, and emissions allowances. These programs are often designed to foster infrastructure, research, and other targeted business investment. In some cases, these credits and incentives are transferrable or refundable.

While credits and incentives often arise in the tax laws and may be claimed on a tax return, they may not be subject to ASC 740. A number of features can make them more akin to a government grant or subsidy. Therefore, each credit and incentive must be carefully analyzed to determine whether it should be accounted for under ASC 740 or whether, in substance, it constitutes a government grant and, thus, is subject to other guidance.

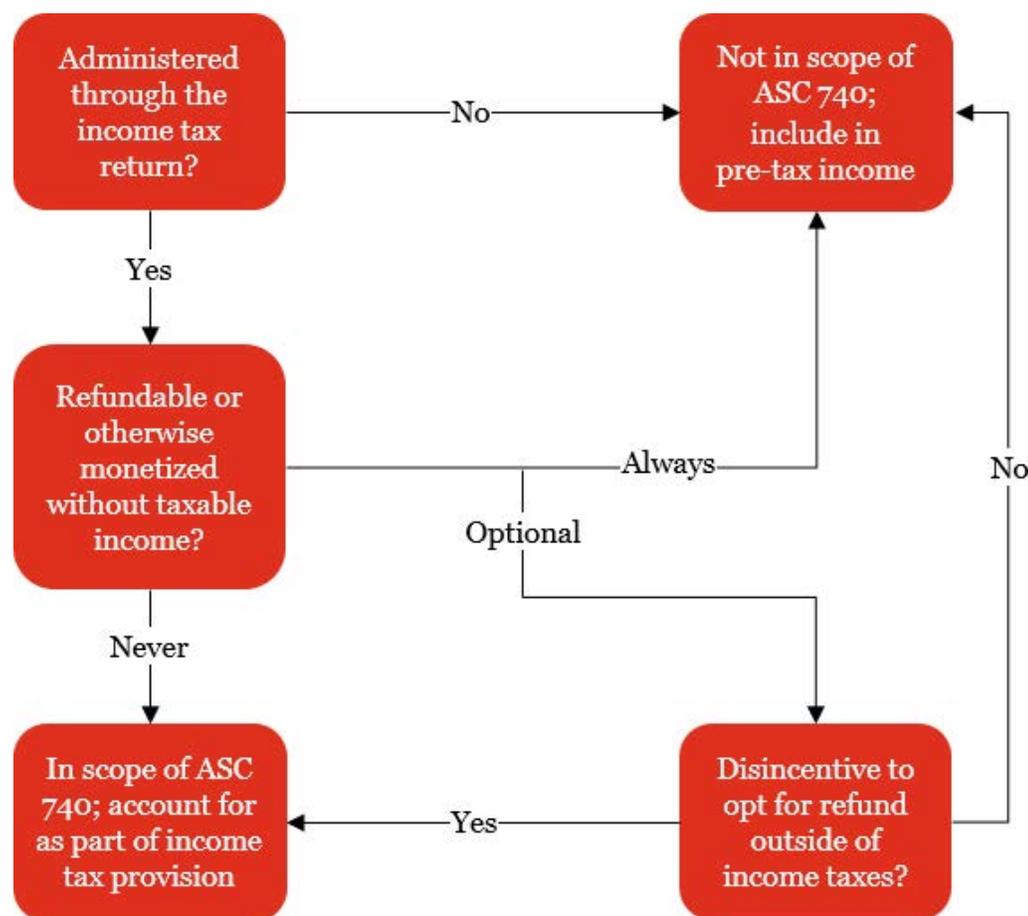
The application of income tax accounting is warranted if a particular credit or incentive can be claimed only on the income tax return and can be realized only through the existence of taxable income. When there is no connection to income taxes payable or taxable income and when the credits are refundable regardless of whether an entity has an income tax liability, we believe the benefit should be accounted for outside of the income tax model and presented within pre-tax income.

Some credits or other tax incentives may be refundable either through the income tax return or in some other manner (e.g., direct cash received from the government) at the option of the taxpayer. We believe that, regardless of the method a reporting entity chooses to monetize the benefit, the accounting would be outside the scope of ASC 740 if there is no direct linkage to a reporting entity's income tax liability. There may be some exceptions. For example, if the method of monetizing the benefits could result in significantly different taxation of the benefit, it may be that the method of monetization will impact the accounting for these benefits. If, for example, a company will be taxed by a jurisdiction if they claim a refund for the credit but not taxed if they reflect the credit through the income tax return, it may be appropriate to reflect the credit in accordance with ASC 740 if the impact of the incremental tax would be significant and therefore the company intends to reflect the credit on the income tax return.

Figure TX 1-1 may help evaluate whether the accounting for a credit is subject to ASC 740.

Figure TX 1-1

Determining whether credits are in the scope of ASC 740



1.3 Defining a “tax based on income”

The ASC Master Glossary defines income taxes as “domestic and foreign federal (national), state, and local (including franchise) taxes based on income.” ASC 740 establishes standards of financial accounting and reporting for the tax consequences of “revenues, expenses, gains, or losses that are included in taxable income.” The ASC 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.” Thus, we believe that implicit in ASC 740 is the concept that taxes on income are determined after revenues and gains are reduced by expenses and losses. Therefore, as discussed in TX 1.3.1.1, taxes based solely on revenues (e.g., gross receipts tax) would not be subject to ASC 740. However, in general, practice has been that a “tax based on income” would apply to tax regimes in which revenues or receipts are reduced even by only one category of expense.

The principles of ASC 740 are applicable to “taxes based on income.” However, US GAAP does not clearly define the term “tax based on income” or specify characteristics that differentiate taxes based on income from taxes that are not. The legal definition of the tax (as an income tax or otherwise) is not determinative in an evaluation of whether a tax should be accounted for as a tax based on income. We believe that a tax based on income is predicated on a concept of income less allowable expenses incurred to generate and earn that income. However, the tax does not need to be on total pre-tax

income in order to be an income tax. A tax on a subset of the income statement, such as a tax on net investment income (e.g., investment income less investment-related expenses), would also be a tax on income, since it would employ the net income concept.

1.3.1 Application of ASC 740 to specific types of taxes

Based on the manner in which a tax is computed, it is not always clear whether a tax meets the definition of a “tax based on income.” In some cases, the tax may be based only partially on income. In other cases, the law’s overall complexity may make it difficult to determine whether the tax is based (either wholly or partially) on income.

1.3.1.1 Gross receipts and margin tax

A gross receipts tax is generally based on a jurisdiction’s definition of “taxable gross receipts.” In devising this tax, many jurisdictions do not take into consideration any expenses or costs incurred to generate such receipts, except for certain stated cash discounts, bad debts, and returns and allowances. Because the starting point of the computation of a gross receipts tax is not “net” of expenses, we believe that a gross receipts tax is not a tax based on income subject to ASC 740. Treatment of gross receipts taxes as an operating expense and not as an income tax is also consistent with the treatment afforded to premium taxes that states often levy on insurance companies.

In jurisdictions in which a tax is calculated on *modified* gross receipts, consideration should be given as to whether it is a tax based on income. We believe that a tax based on gross receipts reduced for certain costs (e.g., inventory, depreciable and amortizable assets, materials and supplies, wages) is a tax based on income subject to ASC 740. Margin taxes are also generally within the scope of ASC 740.

1.3.1.2 Tonnage tax

In the shipping industry, it is common for tonnage taxes to be assessed based on the weight of goods transported or a deemed weight figure based on the size of the entity’s vessels. Tonnage taxes are not generally within the scope of ASC 740. Even in cases in which an entity makes an election to pay a tonnage tax instead of an income tax, the tonnage tax is not based on income.

1.3.1.3 Digital services tax

A digital services tax is generally assessed on certain activities of a business where the generation of revenue may not correspond with its physical presence. The calculation of digital services tax varies by jurisdiction and requires careful assessment to determine whether the tax is based on income, and therefore includable within the scope of ASC 740, or whether in fact the tax is a tax on gross receipts or some other measure. Generally, if the digital services tax is based on specific revenue transactions or revenue streams, without any deduction of expenses incurred, it would not be within the scope of ASC 740.

1.3.2 Other ASC 740 matters related to taxes not based on income—updated January 2022

There is a question as to whether reporting entities should account for (1) timing differences inherent in the computation of taxes that are not based on income and (2) tax credit carryforwards relating to taxes that are not based on income.

We believe that the effects of timing differences reflected in the computation of a tax not based on income should not be reflected in the financial statements because taxes not based on income are not within the scope of ASC 740. For example, in the case of a gross receipts tax, there may be differences between when gross receipts are included in GAAP income and when those amounts are included in the taxable base of gross receipts. Although these differences in the timing of recognition between GAAP and tax are analogous to temporary differences as defined in ASC 740, we do not believe that this analogy alone is sufficient to justify recording an asset or a liability.

Similarly, we do not believe deferred tax assets should be recorded for credits useable against taxes not based on income. FASB Concepts Statement No. 8, *Elements of Financial Statements*, defines an asset as “a present right of an entity to an economic benefit.” In many cases, therefore, an asset should not be recorded for non-income tax credit carryforwards, because the benefit often depends upon a future event (e.g., the generation of future income that is subject to tax) and is therefore not a “present right” to an economic benefit. We believe, however, that if a tax benefit can be achieved without future transactions (e.g., if a credit carryforward can be used to offset a tax on outstanding equity), it might be possible to justify recognizing an asset, albeit outside of ASC 740. Entities should make sure they understand the nature of how the carryforward arose and whether incremental benefit will be provided.

1.4 *Applicability of ASC 740 based on an entity’s legal form*

Certain types of entities are generally exempt from income taxes. It can be challenging to determine the extent to which ASC 740 is applicable. Some common examples are set out below.

1.4.1 *Limited liability companies under US tax law*

Questions often arise regarding how single-member and multiple-member limited liability companies (LLCs) should account for income taxes in their separate financial statements. ASC 740 provides guidance about single-member LLCs, and ASC 272, *Limited Liability Entities*, provides guidance on accounting for multiple-member LLCs. See TX 14.5 for a discussion of the applicability of ASC 740 to the separate financial statements of LLCs.

1.4.2 *Applying ASC 740 to general and limited partnerships*

In the United States, general and limited partnerships (except certain “master limited partnerships” discussed below) are not subject to tax, because their earnings and losses are passed directly to their owners and taxed at that level. ASC 740 does not apply to such partnerships. Although many tax regimes around the world have a similar approach for partnerships, this is not always the case. In certain jurisdictions, partnerships represent taxable entities. In those cases, the provisions of ASC 740 would apply to a tax based on income for that jurisdiction even if other jurisdictions do not subject such entities to tax.

Question TX 1-1 addresses whether the Bipartisan Budget Act of 2015 impacts the application of ASC 740 to US partnerships.

Question TX 1-1

Would the potential assessment of tax by the IRS at the partnership level for an imputed underpayment mean that ASC 740 applies to a US partnership?

PwC response

No. While the Bipartisan Budget Act of 2015 resulted in significant changes to the IRS' audits of partnerships and related adjustment procedures, ASC 740 provides that the determination of whether income taxes are attributable to the entity or its owners should be based on the laws and regulations of the taxing authority rather than on who pays the income taxes. For US federal purposes, partnerships are respected as flow-through entities that are not subject to income taxes. The partners of the partnership remain responsible for the tax consequences of the partnership and payment of any income tax obligations by the partnership is attributable to, and for the benefit of, the partners. This view is consistent with AICPA Technical Questions & Answers Section 7200.

While we believe that ASC 740 does not apply to the partnership itself, corporate partners of the partnership should continue to assess the impact of potential uncertain tax positions related to the outside basis of their partnership interests. See TX 11.7 for accounting for outside basis differences in a partnership.

1.4.3 Foreign withholding taxes levied on pass through entities

While partnerships, S-Corporations, and similar “pass through” entities may not be subject to tax in their home jurisdiction, this tax status is not always respected by the tax laws of overseas territories. Income generated in foreign jurisdictions may be subject to foreign withholding taxes. It is unclear how an entity that is otherwise a “pass through” entity for tax purposes should account for these withholding taxes. We believe, depending on the facts, there may be more than one acceptable presentation.

Because the taxes have been withheld on income, it would be acceptable to view these taxes as being within the scope of ASC 740 and record an income tax expense. Effectively the foreign jurisdiction has levied taxes on the entity despite its nontaxable status in its home territory.

Alternatively, the reporting entity could account for the taxes as a deduction from equity because the taxes have in substance been paid on behalf of the members. As a nontaxable “pass through” entity, any foreign taxes withheld are effectively being levied on the members.

Another alternative for entities operating as investment vehicles and reporting as an investment company might be to consider the withholding tax to be an “above-the-line” expense in accordance with the accounting for investment companies in ASC 946-225-45-3(h).

1.4.4 Master limited partnerships

In the US, publicly traded limited partnerships (“master limited partnerships”) are generally taxable as corporations. Certain limited partnerships, however, to the extent they generate substantially all (greater than 90%) of their income from “qualifying activities,” are exempt from tax (e.g., partnerships engaged in real estate activities or the transportation and distribution of natural resources). Assuming an entity is established to operate in an effectively tax exempt manner and continues to meet the

requirements to be exempt from federal income tax, the provisions of ASC 740 would generally not apply.

1.4.5 REITs and regulated investment companies

Regulated investment companies (RICs) and real estate investment trusts (REITs) are not subject to tax if distribution requirements and other conditions are met. Although the recognition and measurement provisions of ASC 740 would not be applicable to these entities, ASC 740-10-50-16 requires nontaxable entities (including RICs and REITs) that are publicly held to disclose the fact that they are not taxed. In addition, it requires such entities to disclose the net difference between the tax bases and the reported amounts of their assets and liabilities. However, for some entities, the depreciation or depletion deductions available to individual owners will not be pro rata to ownership interests but will instead reflect the different outside tax bases of the individual owners. Further, each owner's tax accounting (e.g., depletion calculations for mineral properties) might depend on his or her individual tax position. As a result, the reporting entity frequently will not have information about individual owners' tax bases. We believe that if these circumstances make it impracticable for an entity to determine the aggregate tax bases of the individual owners, the reporting entity should indicate this in its financial statements.

Chapter 2:
Objectives and basic principles

2.1 Chapter overview—objectives and basic principles of ASC 740

In general, when a tax is based on income, many items that enter into pretax accounting income enter into taxable income in the same year, and vice versa. Some events, however, are recognized for book purposes and tax purposes in different years. Over time, as these differences reverse, they eventually offset each other. The tax effects of these differences, referred to as deferred taxes, should be accounted for in the intervening periods.

2.2 Objectives of ASC 740

ASC 740-10-10-1 identifies two objectives of accounting for income taxes:

- Recognize the amount of taxes payable or refundable for the current year.
- Recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in a reporting entity's financial statements or tax returns.

2.3 Basic principles of ASC 740

Financial statements should reflect the current and deferred tax consequences of all events that have been recognized in the financial statements or tax returns (with the only exceptions identified in ASC 740-10-25-3, as discussed in TX 2.4). To accomplish this goal, the following basic principles were established:

- A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current and prior years.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- 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.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on all available evidence, are not expected to be realized.

2.4 Exceptions to the basic principles of ASC 740

There are certain situations in which deferred taxes are not provided. Some basis differences are not temporary differences because their reversals are not expected to result in taxable or deductible amounts. In addition, ASC 740-10-25-3 provides a number of specific exceptions to the underlying balance sheet approach to accounting for deferred taxes.

ASC 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. Recognition of temporary differences related to deposits in statutory reserve funds by U.S. steamship entities (see paragraph 995-740-25-2)
- 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.

2.4.1 “Outside basis” differences

ASC 740-10-25-3(a) provides that a deferred tax liability should not be recognized for certain specified temporary differences unless it becomes apparent that they will reverse in the foreseeable future. The most notable of these relates to an excess book-over-tax “outside basis” difference of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. The accounting for income taxes related to outside basis differences is discussed in TX 11.

2.4.2 Nondeductible goodwill

The tax treatment (deductible vs. nondeductible) of goodwill will vary depending on the tax laws of the jurisdiction where the goodwill is recorded. In the United States, for example, acquired goodwill is amortizable for US federal tax purposes over 15 years (goodwill that is “created” by a taxpayer is generally nondeductible). See TX 10 for further discussion of nondeductible goodwill.

ASC 805-740-25-3 prohibits the recognition of a deferred tax liability for the reported amount of goodwill (or portion thereof) that is not deductible for tax purposes. Because goodwill is the residual in the purchase price allocation under ASC 805, establishing a deferred tax liability for the basis difference in goodwill would result in an increase in the amount of goodwill. This in turn would require an increase in the deferred tax liability, which would further increase goodwill. The FASB concluded that the resulting grossing up of goodwill and the deferred tax liability would not add to the relevance of financial reporting.

The above exception does not apply if there is an excess of tax-deductible goodwill over book goodwill at the acquisition date (i.e., a deductible temporary difference exists). In that case, a deferred tax asset should be recognized in accordance with ASC 805-740-25-8 through ASC 805-740-25-9.

2.4.3 Foreign currency remeasurement and indexation of tax basis

ASC 740-10-25-3(f) prohibits the recognition of deferred taxes for temporary differences related to assets and liabilities that, under ASC 830-10, *Foreign Currency Matters*, are remeasured from the local currency to the functional currency using historical exchange rates and that result from either: (1) changes in exchange rates or (2) indexing of the tax basis in the foreign jurisdiction. It is important to note that this circumstance only arises when the local currency is not the functional currency of a reporting entity. See TX 13 for a discussion of the accounting for foreign exchange movements with respect to ASC 740.

2.4.4 Tax effects of intra-entity inventory transactions

Ordinarily, there are tax effects when an asset is sold or transferred between affiliated companies that are consolidated for financial statement purposes but file separate tax returns. In consolidation, however, the seller’s pretax profit will be deferred for financial statement purposes, and the inventory will be carried at its cost to the seller until it is sold to an unrelated third party or written down. Under ASC 740-10-25-3(e) and ASC 810-10-45-8, no immediate tax impact should be recognized in the consolidated financial statements as a result of intra-entity transfers of inventory. ASC 740-10-25-3(e) (often simply referred to as “3(e)”) prohibits the recognition of a deferred tax asset for basis differences relating to intra-entity transfers of inventory. This treatment of intra-entity transfers is an exception to the asset and liability approach prescribed by ASC 740. Similarly, ASC 810-10-45-8 precludes a reporting entity from reflecting a tax benefit or expense from an intra-entity transfer

between entities that file separate tax returns until the asset has been sold to a third party or written down.

This exception applies to intra-entity transfers of inventory between affiliated entities domiciled in different jurisdictions (e.g., a US corporation and a non-US corporation) as well as affiliated entities domiciled in the same jurisdiction but that file separate income tax returns (e.g., two affiliated US corporations that are not included in the same US corporate income tax return and hence are considered separate tax-paying components of the reporting entity).

Taxes paid (if any) by the seller, as well as any other tax consequences (e.g., as a result of temporary difference reversals), are deferred in consolidation. A question may arise as to the amount of tax paid by the seller on the intra-entity profit. We believe that, generally, the profit should be the last item to enter into the seller's computation of taxes payable in the period of the sale, and the deferred tax should be calculated as the differential in taxes payable with and without the intra-entity profit.

After the consummation of the transaction, there generally will be no temporary difference in either the seller's or the buyer's separate financial statements. The seller's separate financial statements generally will reflect the profit on the sale and a tax payable on that profit. The buyer's separate financial statements will reflect the inventory at the intra-entity transfer price, which will be the buyer's tax basis.

2.4.4.1 *Deferred charge differentiated from deferred tax asset*

Taxes paid on intra-entity transfers of inventory that are deferred for financial reporting purposes (deferred charges) are different from deferred tax assets recognized under ASC 740-10-30-5. Deferred tax assets are subject to revaluation for tax rate changes and are subject to realizability considerations using the model prescribed in ASC 740. However, deferred charges are not subject to the realizability model prescribed in ASC 740 and are not affected by tax rate changes. This is because the deferred charge represents the tax effect of a past event. The amount will not be changed by future events other than the sale or write-down of the related inventory. The only realization test applied would be part of an overall realization test for the related inventory. Thus, the carrying amounts of the inventory and the deferred charge, in total, should not exceed the anticipated after-tax proceeds on sale. In addition, since the deferred charge is associated with inventory, it would generally be classified as a current asset.

Question TX 2-1 addresses whether the tax effects of an intercompany toll manufacturing fee should be deferred on the basis that it is an intercompany transfer of inventory.

Question TX 2-1

Should the tax effects of an intercompany toll manufacturing fee be deferred on the basis that it is an intercompany transfer of inventory?

PwC response

Toll manufacturing arrangements occur when one reporting entity (the principal) purchases and holds title to raw materials or semi-finished goods throughout the manufacturing process. The principal, however, engages another reporting entity (the toll manufacturer) to perform aspects of the manufacturing process.

The toll manufacturer receives a fee for the manufacturing services performed under the tolling arrangement. In general, tolling arrangements do not compensate the toll manufacturer for holding inventory because the principal retains title to the inventory. Thus, the principal generally capitalizes the tolling fees paid as value is added to inventory for tax purposes, and eliminates any intercompany income or expense associated with the tolling arrangement.

We believe there are two acceptable views:

View A: A toll manufacturing arrangement is not an intra-entity transfer of inventory. The tolling fee under a toll manufacturing arrangement does not relate to the transfer of inventory since the principal maintains title throughout the tolling process. In other words, there is no transfer of inventory under ASC 740-10-25-3(e) and ASC 810-10-45-8. The tolling fee is instead a payment for services performed. Under this view, both parties (the principal and the toll manufacturer) would recognize the tax effects of the intercompany service fee and would not apply the exception in ASC 740-10-25-3(e).

View B: A toll manufacturing arrangement is an intra-entity transfer of inventory. We believe tolling arrangements could be interpreted to fall within the scope of the 3(e) exception because (1) the tolling arrangement resulted in a difference between tax and financial reporting basis from an intra-entity transaction, and (2) there is an income tax paid on intra-entity profits on assets remaining in the group. The wording of the exception under ASC 740-10-25-3(e) specifically prohibits recognition of a deferred tax asset on an intra-entity *transfer* of inventory. While inventory itself is not legally transferred under a tolling arrangement, there is an intercompany profit in the production of inventory that is eliminated in consolidation. Under this view, the tax effects on the inventory remaining within the consolidated group would be deferred until the inventory is sold to an unrelated third party.

2.4.4.2 *Intra-entity intellectual property migration arrangements*

Questions have arisen in practice around the tax accounting considerations for intra-entity intellectual property migration arrangements. Question TX 2-2 addresses different considerations when intellectual property is sold within the consolidated group for cash versus an installment note.

Question TX 2-2

When internally-generated intellectual property (IP) is sold to another member of the same consolidated group, are there any distinctions between a sale for cash versus a sale for an installment note?

PwC response

Yes. Depending on whether the sale is for cash or an installment note, the implications could be different. Consider an example in which a US parent transfers IP with a zero book basis to a foreign subsidiary.

For both the sale for cash and the sale for an installment note, the consolidated reporting entity would be required to recognize the deferred tax asset in the foreign subsidiary for the book/tax basis difference.

If the sale is for cash, the consolidated reporting entity would recognize tax expense on the sale of the IP. If the sale is for an installment note, there are two acceptable views when recording the tax effects

to the US parent in relation to the future taxes that will be paid as the intra-entity installment note is collected.

Under the first view, no temporary difference remains in the consolidated balance sheet since the installment note payable and receivable are eliminated in consolidation. A deferred tax liability would not be recognized under this view.

Under the second view, a fixed and unavoidable obligation to pay taxes over the period of the installment note exists and, therefore, a deferred tax liability should remain in the consolidated balance sheet.

The approach a reporting entity selects is an accounting policy election that should be applied consistently.

Question TX 2-3 addresses accounting for transactions in which the total consideration received is partially dependent on future events.

Question TX 2-3

How should companies account for transactions in which the total consideration received is partially dependent on future events?

PwC response

A reporting entity may transfer an asset from one jurisdiction (that of the seller) to another jurisdiction (that of the buyer) for an amount based on the asset's future productivity in the buyer's jurisdiction. In this instance, the seller's tax consequences are tied to revenues generated in the future and are therefore contingent.

One common contingent payment transaction is known for US tax purposes as a "367(d) transaction," which occurs when a US corporation transfers IP to a foreign corporation in exchange for shares of stock of 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. This deemed royalty is based upon a predetermined royalty rate and is included as taxable income in future periods.

In many jurisdictions, notwithstanding the deferred taxation of this transaction in the US, the IP will have an established tax basis at the time of transfer. Therefore, deferred taxes would need to be recorded in the buyer's jurisdiction if the buyer's tax basis is different than the consolidated book basis and will result in a future deductible amount.

For 367(d) transactions, the prevailing view is that since there is no book versus tax basis difference in the consolidated balance sheet, no deferred tax liability would be recorded. This view would result in recognition of only the foreign deferred tax basis difference that arises upon the transfer. No US tax expense would be recognized at the time of transfer; rather, the US current tax provision would reflect the effects of the deemed royalties in future periods as they are included in taxable income.

Based on discussion with the SEC staff, we understand that the staff would accept not recognizing a deferred tax liability in the US. A registrant that is considering recognizing a deferred tax liability

(similar to that described under the installment sale scenario in Question TX 2-2) is encouraged to consult with the SEC staff prior to electing this approach.

We believe that a similar approach would apply to other intra-entity transfers in which there may be contingent elements, similar to 367(d) transactions.

Question TX 2-4

If a US company transfers acquired IP that has an associated deferred tax liability (dating back to the IP's acquisition) to a reporting entity in another country through a 367(d) transaction, does the deferred tax liability remain with the transferor upon transfer?

PwC response

We believe that the US company transferring the acquired IP should retain the associated deferred tax liability. This is because even though the IP is no longer resident in the US, the tax consequences from recovering the IP will still occur in the US, only now in the form of future royalties. Companies should monitor for specific events (e.g., impairments, acquisitions) that may change the book value of the IP and therefore have an impact on the measurement of the associated deferred tax liability.

2.5 *Discounting of deferred taxes*

Although it might seem logical that an asset and liability approach to accounting for the impact of income taxes would give some consideration to the time value of money (i.e., a deduction today is worth more to a reporting entity than a deduction ten years in the future), ASC 740-10-05-7 and ASC 740-10-30-8 specifically preclude entities from present-valuing or discounting when measuring deferred taxes. There are conceptual arguments both for and against discounting deferred taxes for the time value of money. A strong reason not to discount deferred taxes is that such discounting would involve numerous operational issues, including the selection of the appropriate discount rate. Most importantly, discounting would routinely require a reporting entity to undertake a detailed analysis of future reversals of temporary differences to determine the future years in which the deferred tax amounts would become taxable or deductible. The FASB did not believe that the benefit of discounting outweighed the effort required to achieve that benefit. As a result, the time value of money is not considered in the accounting for income taxes (aside from an assessment of whether a tax-planning strategy is prudent and feasible).

While ASC 740 prohibits discounting deferred taxes, the relevant guidance on discounting income taxes payable or refundable is in ASC 835-30, *Imputation of Interest*. While ASC 835-30 generally requires discounting of payables and receivables with maturities in excess of a reporting entity's operating cycle, ASC 835-30-15-3(e) explicitly excludes "income tax settlements" from such guidance. Accordingly, income taxes payable or receivable would not be discounted. In conjunction with the enactment of the Tax Cuts and Jobs Act of 2017, the FASB staff issued Q&As #2 and #3 expressing their view that the tax liability on the deemed repatriation of foreign earnings and any AMT tax credits that become refundable should not be discounted.

***Chapter 3:
Book versus tax basis
differences***

3.1 Chapter overview—book versus tax differences

Temporary differences form the foundation for the deferred tax provision. The total tax provision is comprised of:

- The current tax provision – an estimate of taxes payable or refundable on the tax return for the current year
- The deferred tax provision – the change in the estimated future tax effects of temporary differences and carryforwards

Deferred tax assets and liabilities represent the future effects on income taxes that result from temporary differences and carryforwards that exist at the balance sheet date and are measured using enacted rates and provisions of the tax law. Deferred tax assets (DTAs) are recognized for deductible temporary differences (i.e., future tax-deductible amounts) as well as tax attributes (e.g., operating loss and credit carryforwards). Deferred tax liabilities (DTLs) are recognized for taxable temporary differences (i.e., future taxable amounts).

The recognition principle in ASC 740-10-25-5 and measurement principle of ASC 740-10-30-7 apply in computing the tax bases of assets and liabilities. A temporary difference exists when the tax basis of an asset or a liability differs from its reported amount in the financial statements and that difference, referred to as a basis difference, will result in taxable income or a tax deduction upon reversal. Reversal occurs when the reported amount of an asset or liability in the financial statements is recovered or settled, respectively. There are temporary differences that have balances only on the income tax balance sheet and are not identified with an asset or liability in the financial statements. For some of these differences, reversal occurs upon recognition in the tax return (e.g., tax credits). If a basis difference will not affect future taxable income, it is not a temporary difference. A presumption under ASC 740 is that assets will be recovered, and liabilities will be settled at their financial statement carrying amounts. Future changes in carrying amounts are not anticipated in determining temporary differences at the balance sheet date.

Because the definition of a temporary difference hinges on the difference between the book basis and tax basis of an item, the comparison of a GAAP-compliant balance sheet with a balance sheet that is prepared on a tax basis is often the best way to identify temporary differences. In many instances, there will be both a book and a tax basis (e.g., in the case of fixed assets). In other instances, there will be a book basis and no tax basis, as in the case of expense accruals that are not tax deductible until they are paid. In yet other instances, there may be a tax basis but no GAAP basis, as in the case of organizational costs expensed for GAAP purposes but capitalized and amortized for tax purposes.

3.2 Temporary difference—defined

A temporary difference is defined in ASC 740-10-20.

ASC 740-10-20

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 eight

examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see ASC 740-10-05-10 and ASC 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.

As noted in the definition, ASC 740-10-25-20 cites eight examples of temporary differences. Importantly, those examples are not intended to be all inclusive.

ASC 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 reduced tax credit (that is, investment tax credit and certain other tax credits) or taking the full tax credit and 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.

Other events not described in ASC 740-10-25-20 may give rise to temporary differences. Whatever the event or circumstance, a temporary difference will arise when a basis difference is expected to result in a taxable or deductible amount when the reported amount of an asset or liability is recovered or settled, respectively. ASC 740-10-25-23 describes taxable and deductible differences.

ASC 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 (the example in paragraph 740-10-25-20(h)) may give rise to both taxable and deductible temporary differences.

The financial statement reported amount of an asset or liability and its settlement or recovery is based on US GAAP. The tax basis of an asset or liability and the timing of its inclusion in taxable income is based on the laws and regulations of the relevant tax jurisdiction of each respective taxpaying component of the consolidated reporting entity (e.g., US federal, US state, non-US jurisdictions). For financial accounting purposes, the tax bases of assets and liabilities are based on amounts that meet the more-likely-than-not recognition threshold under ASC 740-10-25-5 and are measured pursuant to the measurement requirements of ASC 740-10-30-7. A tax basis computed pursuant to that recognition and measurement model may be different from a tax basis computed for and reported on a filed or expected-to-be-filed tax return. Therefore, adjustments from “as filed” amounts may be necessary in order to properly determine deferred taxes.

There are also certain circumstances when the deferred taxes recognized for US GAAP differ from those recognized for statutory reporting purposes. Question TX 3-1 addresses valuation allowance

considerations when there is a difference in deferred taxes recorded between US GAAP and statutory financial statements.

Question TX 3-1

A reporting entity has a deferred tax liability for US GAAP that represents a source of taxable income that could be used to realize existing deferred tax assets. However, for its statutory financial statements, the deferred tax liability does not exist. For purposes of assessing whether a valuation allowance is necessary for its deferred tax assets, should the absence of the deferred tax liability on the statutory financial statements be considered?

PwC response

No. If the financial statements being presented are US GAAP financial statements, the reporting entity should assess the need for a valuation allowance based on the US GAAP deferred taxes. As such, the deferred tax liability that exists for US GAAP should be considered as a potential source of taxable income that could realize existing deferred tax assets.

3.3 Examples of temporary differences

The first four examples of temporary differences in ASC 740-10-25-20 (reproduced in TX 3.2) result from items that are included within both pretax income and taxable income, but in different periods (for example, an asset is depreciated over a different period for book than for tax purposes). The remaining four examples illustrate other events that create book and tax basis differences.

TX 3.3.1 through TX 3.3.7 include examples of transactions or events that can result in temporary differences for both categories noted above.

3.3.1 Temporary differences—business combinations

ASC 805-740 requires recognition of deferred taxes for temporary differences that arise from a business combination. The differences between the book bases (as determined under ASC 805, *Business Combinations*) and the tax bases (as determined under the tax law and considering ASC 740's recognition and measurement model) of the assets acquired and liabilities assumed are temporary differences that result in deferred tax assets and liabilities. TX 10 discusses the accounting for deferred taxes in business combinations.

3.3.2 Temporary differences—indefinite-lived assets

Under ASC 740-10-25-20, recognition of deferred taxes assumes that the carrying value of an asset will be recovered through sale or depreciation. Thus, although indefinite-lived assets (e.g., land, indefinite-lived intangibles, and the portion of goodwill that is tax deductible) are not depreciated or amortized for book purposes, a deferred tax asset or liability is recognized for the difference between the book and tax basis of such assets as long the basis of the asset is deductible or taxable in the future. Though the tax effects may be delayed indefinitely, ASC 740-10-55-63 states that “deferred tax liabilities may not be eliminated or reduced because a reporting entity may be able to delay the settlement of those liabilities by delaying the events that would cause taxable temporary differences to reverse.”

Refer to TX 4 for a discussion of the appropriate applicable tax rate to apply to temporary differences related to indefinite-lived assets and TX 5 for implications of taxable temporary differences related to indefinite-lived assets (so called “naked credits”) on the consideration of a valuation allowance for deferred tax assets.

3.3.3 Temporary differences—inflation indexation

Some foreign tax jurisdictions allow for the tax bases of assets and liabilities to be indexed to inflation rates for tax purposes. Assuming the functional currency of the reporting entity in that jurisdiction is the local currency, for financial reporting purposes, the book bases of such assets do not change with inflation. Thus, when the tax bases are indexed for inflation, temporary differences arise as a result of the change in tax basis and those differences give rise to deferred taxes under ASC 740-10-25-20(g).

If, on the other hand, the jurisdiction in question is deemed to be hyperinflationary under ASC 830 and the functional currency is not the local currency, differences between the book and tax bases of assets can arise as a result of remeasuring the local currency assets into the functional currency using historical exchange rates. ASC 740-10-25-3(f) prohibits recognition of deferred taxes for temporary differences related to changes in exchange rates or indexing of nonmonetary assets and liabilities that, under ASC 830-10, are remeasured from the local currency into the functional currency using historical exchange rates (i.e., the functional currency is the reporting currency). Refer to TX 13 for additional guidance on foreign currency matters.

3.3.4 Share based compensation

Under ASC 718, *Compensation—Stock compensation*, the difference between the expense recognized for financial reporting purposes and the deduction taken on the tax return is also considered to be a temporary difference for which a deferred tax asset is recognized. Refer to TX 17 for guidance on how ASC 740 applies to stock-based compensation.

3.3.5 Investment tax credits

An investment tax credit (ITC) is a tax credit tied to the acquisition of an asset and that reduces income taxes payable. An ITC relates to the acquisition of qualifying depreciable assets either directly or through a flow-through equity method investment and is typically determined as a percentage of the cost of the asset. An ITC may also reduce the tax basis of the asset in some cases. Production tax credits, which vary in amount depending upon the output of the underlying assets, do not qualify as ITCs. Once a reporting entity determines that a tax credit qualifies as an ITC, the ITC would be reflected in the financial statements (1) to the extent it has been used to reduce income taxes otherwise currently payable, or, (2) if an allowable carryforward is considered realizable under the provisions of ASC 740-10-30-18.

What differentiates an ITC from other income tax credits and from grants is not always easy to discern because they often share at least a few characteristics. Care should be taken in assessing whether a particular credit should be accounted for as an investment credit, another type of income tax credit, or a government grant. Credits that are not within the scope of ASC 740 cannot apply the ITC guidance that is part of ASC 740. Refer to TX 1 for a discussion of the determination of whether credits and other tax incentives should be accounted for under ASC 740.

3.3.5.1 *Investment tax credits—accounting methods*

ASC 740-10-25-46 provides two acceptable methods to account for ITCs:

The “deferral” method, under which the tax benefit from an ITC is deferred and amortized over the book life of the related property.

The “flow-through” method, under which the tax benefit from an ITC is recorded in the period that the credit is generated. The ITC is a current income tax benefit.

As specified in ASC 740-10-25-46, the deferral method is preferable, although both are acceptable. The use of either method is an accounting policy election that should be consistently applied.

When the deferral method is elected, there are two acceptable approaches. The application of either approach under the deferral method represents an accounting policy election that should be consistently applied.

The first approach recognizes the tax benefit from an ITC as a reduction in the book basis of the acquired asset and thereafter reflects the benefit in pretax income as a reduction of depreciation expense. Alternatively, in the second approach, a deferred credit can be recognized when the ITC is generated. The deferred credit would be amortized as a reduction to the income tax provision over the life of the qualifying asset. The presentation on the income statement under this approach is similar to the flow-through method in that the ITC benefit is reported within the income tax provision. However, unlike the flow-through method, which recognizes the full benefit of the ITC in the period it is generated, the income tax provision approach under the deferral method recognizes the benefit over time based on the productive life of the asset.

3.3.5.2 *Investment tax credits—temporary differences*

In accordance with ASC 740-10-25-20(e) and 25-20(f), a temporary difference may arise when accounting for an ITC if (a) the relevant tax law requires that the reporting entity reduce its tax basis in the property or (b) if use of the deferral method reduces the book basis in the underlying asset. Regardless of the method chosen to account for ITCs, we believe there are two acceptable approaches to account for the initial recognition of temporary differences between the book and tax bases of the asset:

- a. The “gross-up” method, under which deferred taxes related to the temporary difference are recorded as adjustments to the carrying value of the qualifying assets. The gross-up method requires the use of the simultaneous equations method to calculate the deferred tax to be recognized (see TX 10.8.2.1 or ASC 740-10-55-170 through ASC 740-10-55-182).

The “income statement” method, under which deferred taxes related to the temporary difference are recorded in income tax expense.

The use of one of these accounting methods reflects a choice of accounting policy that should be consistently applied.

Example TX 3-1 and Example TX 3-2 illustrate application of various ITC methods.

EXAMPLE TX 3-1**Accounting for investment tax credits with no tax basis reduction**

Company A is entitled to an ITC for 30% of the purchase price of certain qualifying assets. The ITC can be used to reduce the company's income tax obligation in the year the assets are purchased. The tax law does not require a reduction to the tax basis of the qualifying assets. The applicable tax rate is 25%.

On January 1, 20X1, Company A purchases \$100 of qualifying assets. The assets will be depreciated for both financial statement and tax purposes on a straight-line basis over a 5-year period. There are no uncertain tax positions relating to the ITC or tax depreciation.

How should Company A account for the ITC?

*Analysis****The deferral method—reduction in book basis***

Under the deferral method, the ITC (\$30) is reflected as a reduction to income taxes payable and to the carrying value of the qualifying assets. Therefore, a deductible temporary difference arises since the recorded amount of the qualifying assets is \$30 less than its tax basis. Company A can use either the gross-up or income statement method.

- a. *The gross-up method.* Under the gross-up method, the recognition of the DTA related to the initial \$30 deductible temporary difference would result in a further reduction in the recorded amount of the qualifying assets, which would, in turn, increase the deductible temporary difference related to the qualifying assets. To avoid this iterative process, the ultimate carrying amount of the asset and the ultimate DTA can be determined using simultaneous equations.

Using simultaneous equations yields a DTA of \$10 and a corresponding reduction to the recorded amount of the qualifying assets of \$10. Thus, the qualifying assets should be recorded at \$60 (\$100 purchase price less the \$30 ITC and \$10 DTA) together with a DTA of \$10.

The simultaneous equations can be combined into the following formula:

$$\text{DTA} = \frac{\text{Tax Rate}}{(1 - \text{Tax Rate})} \times (\text{Tax Basis} - \text{IBB})$$

The following journal entries would be recorded:

Dr. PP&E	\$100
Cr. Cash	\$100

To record the acquisition of the qualifying asset.

Dr. Income tax payable	\$30
Cr. PP&E	\$30

To record the generation of the ITC.

Dr. Deferred tax asset	\$10
Cr. PP&E	\$10

To record the deferred tax asset and corresponding reduction to the book basis of the PP&E based on the gross-up method.

In 20X1 and each of the subsequent four years, the following entries would be recorded:

Dr. Depreciation expense	\$12
Cr. Accumulated depreciation	\$12

To record depreciation of PP&E (\$100 purchase price less ITC of \$30 and deferred tax asset of \$10 depreciable over 5 years).

Dr. Income tax payable	\$5
Cr. Current tax expense	\$5

To record the current tax benefit of depreciation for tax purposes (\$20 annual depreciation expense @ 25% tax rate).

Dr. Deferred tax expense	\$2
Cr. Deferred tax asset	\$2

Annual entry to adjust the deferred tax asset based on the ending temporary difference between the book and tax bases of the asset arising from the difference in the annual depreciation charge for book and tax purposes (\$8 tax-over-book depreciation @ 25% tax rate).

- b. *The income statement method.* Under the income statement method, the recognition of the DTA related to the initial deductible temporary difference of \$30 would result in the recognition of a \$7.5 DTA and a corresponding benefit in the income tax provision. The following entries would be recorded:

Dr. PP&E	\$100
Cr. Cash	\$100

To record the acquisition of the qualifying asset.

Dr. Income tax payable	\$30
Cr. PP&E	\$30

To record the generation of the ITC.

Dr. Deferred tax asset	\$7.5
Cr. Deferred tax expense	\$7.5

To record the deferred tax benefit related to the ITC that will be recorded directly to the income statement (\$30 temporary difference × 25% tax rate).

In 20X1 and each of the subsequent four years, the following entries would be recorded:

Dr. Depreciation expense	\$14
Cr. Accumulated depreciation	\$14

To record depreciation of PP&E (\$100 purchase price less ITC of \$30 depreciable over 5 years).

Dr. Income tax payable	\$5
Cr. Current income tax expense	\$5

To record current tax benefit of depreciation for tax purposes (\$100 purchase price depreciable over 5 years @ 25% tax rate).

Dr. Deferred tax expense	\$1.5
Cr. Deferred tax asset	\$1.5

Annual entry to adjust the deferred tax asset based on the ending temporary difference between the book and tax bases of the asset arising from the difference in the annual depreciation charge for book and tax purposes (\$6 tax-over-book depreciation @ 25% tax rate).

The flow-through method

Under the flow-through method, the ITC received (\$30) would be reflected as a current income tax benefit. Under this approach, the recognition of the ITC would not affect the book basis of the qualifying assets and, therefore, no temporary difference arises at initial acquisition (i.e., the book basis equals the tax basis). The following journal entries would be recorded under the flow-through method:

Dr. PP&E	\$100
Cr. Cash	\$100

To record the acquisition of the qualifying asset.

Dr. Income tax payable	\$30
Cr. Current income tax expense	\$30

To record the generation of the ITC.

In 20X1 and each of the subsequent four years, the following entries would be recorded:

Dr. Depreciation expense	\$20
Cr. Accumulated depreciation	\$20

To record depreciation of PP&E (\$100 purchase price depreciable over 5 years).

Dr. Income tax payable	\$5
Cr. Current income tax expense	\$5

To record current tax benefit of depreciation for tax purposes (\$100 purchase price depreciable over 5 years @ 25% tax rate).

In this example, because the book and tax depreciation periods are the same (5 years), no temporary difference would arise in subsequent years (assuming there is no impairment).

EXAMPLE TX 3-2

Accounting for investment tax credits with tax basis reduction

Company A is entitled to an ITC for 30% of the purchase price of certain qualifying assets. The ITC can be used to reduce the company's income tax obligation in the year the assets are purchased. The tax law requires that the tax basis of the qualifying assets be reduced by 50% of the ITC (e.g., a \$30 ITC reduces the tax basis by \$15). The applicable tax rate is 25%.

On January 1, 20X1, Company A purchases \$100 of qualifying assets. The assets will be depreciated for both financial statement and tax purposes on a straight-line basis over a 5-year period. There are no uncertain tax positions relating to the ITC or tax depreciation.

How should Company A account for the ITC?

Analysis

The deferral method—reduction in book basis

Under the deferral method, the ITC (\$30) is reflected as a reduction to income taxes payable and to the carrying value of the qualifying assets. Because the tax basis of the asset will only be reduced by 50% of the ITC a deductible temporary difference arises. The carrying amount of the qualifying assets will be reduced by the full amount of the ITC (\$30), while the tax basis will be reduced by only 50% of the ITC (\$15) resulting in a temporary difference of \$15. Company A can use either the gross-up or income statement method to account for the temporary difference.

- a. *The gross-up method.* Under the gross-up method, the recognition of the DTA related to the initial \$15 deductible temporary difference results in a further reduction in the recorded amount of the qualifying assets, which would, in turn, increase the deductible temporary difference related to the qualifying assets. To avoid this iterative process, the ultimate carrying amount of the asset and the ultimate DTA can be determined using simultaneous equations.

In this example, the simultaneous equations method (illustrated in Example TX 3-1) yields a DTA of \$5 and a corresponding reduction to the recorded amount of the qualifying assets. Thus, the qualifying assets should be recorded at \$65 (\$100 purchase price less the \$30 ITC and \$5 DTA) together with a DTA of \$5. In 20X1 and each of the subsequent four years, income taxes payable would be adjusted by \$4.25 to record the current tax benefit of depreciation (\$100 purchase price less \$15 reduction in tax basis over 5 years @ 25% tax rate) and an annual entry of \$1 to adjust the deferred tax asset based on the ending temporary difference between the book and tax basis arising from the difference in the annual depreciation charge for book and tax purposes (\$4 tax-over-book depreciation @ 25% tax rate).

- b. *The income statement method.* Under the income statement method, the recognition of the DTA related to the initial deductible temporary difference of \$15 results in the recognition of a \$3.75 DTA and a corresponding benefit in the income tax provision. In 20X1 and each of the subsequent four years, income taxes payable would be adjusted by \$4.25 to record the current tax benefit of depreciation (\$100 purchase price less \$15 reduction in tax basis over 5 years @ 25% tax rate) and an annual entry of \$0.75 to adjust the deferred tax asset based on the ending temporary difference between the book and tax basis arising from the difference in the annual depreciation charge for book and tax purposes (\$3 tax-over-book depreciation @ 25% tax rate).

The flow-through method

Under the flow-through method, the ITC (\$30) is reflected as a current income tax benefit. Under this approach, the recognition of the ITC does not affect the book basis of the qualifying assets. Therefore, the recorded amount of the qualifying assets remains at \$100 while the tax basis is reduced to \$85, resulting in a taxable temporary difference of \$15. The accounting for this temporary difference depends on whether the reporting entity uses the gross-up or income statement method.

- a. *The gross-up method.* Under the gross-up method, the recognition of the DTL related to the initial \$15 taxable temporary difference results in a further increase in the recorded amount of the qualifying assets, which would, in turn, increase the taxable temporary difference related to the qualifying assets. Consistent with the gross up method illustrated previously, the simultaneous equation will result in recording a DTL of \$5 and an increase in the qualifying asset of \$5. Thus, the qualifying asset should be recorded at \$105 (\$100 purchase price plus the DTL of \$5) together with a DTL of \$5. In 20X1 and each of the subsequent four years, income taxes payable would be adjusted by \$4.25 to record the current tax benefit of depreciation (\$100 purchase price less \$15 reduction in tax basis over 5 years @ 25% tax rate) and an annual entry of \$1 to adjust the deferred tax liability based on the ending temporary difference between the book and tax basis arising from the difference in the annual depreciation charge for book and tax purposes (\$4 tax-over-book depreciation @ 25% tax rate).
- b. *The income statement method.* Under the income statement method, the recognition of the DTL related to the initial taxable temporary difference of \$15 results in the recognition of a \$3.75 DTL and a corresponding expense in the income tax provision. In 20X1 and each of the subsequent four years, income taxes payable would be adjusted by \$4.25 to record the current tax benefit of depreciation (\$100 purchase price less \$15 reduction in tax basis over 5 years @ 25% tax rate) and an annual entry of \$0.75 to adjust the deferred tax asset based on the ending temporary difference between the book and tax basis arising from the difference in the annual depreciation charge for book and tax purposes (\$3 tax-over-book depreciation @ 25% tax rate).

3.3.5.3 *Investment tax credits through equity method investments*

There is no specific guidance on how to account for investment tax credits received in conjunction with an investment accounted for under the equity method. While the deferral approach (i.e., netting the credit against the carrying amount of the investment and amortizing the benefit of the credit against the earnings of the investment) is described only in terms of investments in depreciable property, we are aware that the deferral approach is being applied in practice to other types of assets by analogy. In these circumstances, it is important to understand the underlying nature of the credit, the conditions that generated the credit, and the manner of recovery. Also, it is important to discern whether the credit inures directly to the investor or is attributable to the investee.

If a reporting entity elects the fair value option for purposes of accounting for its equity method investment, we believe the flow through method should be applied as it aligns with the reporting entity's election to reflect the fair value of the investment.

3.3.6 *Low-income housing credits*

Section 42 of the Internal Revenue Code provides a low-income housing credit (LIHTC) to owners of qualified residential rental projects. The LIHTC is generally available from the first year the building is placed in service and continues annually over a 10-year period, subject to continuing compliance with the qualified property rules. The LIHTC is subject to annual limitations, and any unused portion of the credit can be carried forward for 20 years. An LIHTC carryforward should be recognized as a deferred tax asset and evaluated for realization like any other deferred tax asset. The full amount of the aggregate LIHTC that is potentially available over the 10-year period should not be included in the tax provision in the initial year that the credit becomes available because the entire amount of the credit has not been "earned." Only the portion of the LIHTC that is available to offset taxable income in each year should be included in the tax provision.

One of the more common structures in which LIHTC arise is through an investment in a limited liability entity that invests in qualified residential projects. Typically, an investor will account for its interest using the equity method. As such, a question arises as to whether the pretax results of the limited liability entity's activities should be presented separate from the tax benefits (LIHTC) that are also passed through to the investor and usable on the investor's tax return.

As noted in ASC 323-740-S99-2, the scope of ASC 323-740 is limited to investments in qualified affordable housing projects through limited liability entities that produce LIHTCs and should not be applied by analogy when accounting for investments in other projects for which substantially all of the benefits come from other tax credits and other tax benefits.

3.3.6.1 *Qualifying for the proportional amortization method*

Under ASC 323-740-25-1, an investor may elect to account for the investment using the proportional amortization method assuming the following conditions are met:

- a. It is probable that the tax credits allocable to the investor will be available.
- b. The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity.

- c. 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).
- d. The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.
- e. 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.

If the conditions are met and the proportional method is elected, investors would present the pretax effects and related tax benefits of such investments as a component of income taxes ("net" within income tax expense). If elected, the proportional amortization method must be applied as an accounting policy to all eligible investments in qualified affordable housing projects.

The application of ASC 810, *Consolidation*, may impact the accounting for investments in entities that hold investments in low-income housing credit projects because such entities may constitute variable interest entities. If an investor is required to consolidate the limited liability entity that manages or invests in qualified affordable housing projects, the proportional amortization method cannot be applied because it would not meet criteria b) listed above. Essentially, the investor would report the pretax results of the investment in pretax income and report the benefit from the LIHTC in the tax provision on a current basis.

3.3.6.2 Applying the proportional amortization method

The proportional amortization method requires the initial cost of the investment (inclusive of unconditional future capital commitments) to be amortized in proportion to the tax benefits received over the period that the investor expects to receive the tax credits and other tax benefits. The amortization is determined as follows:

$$\left(\begin{array}{l} \text{Initial cost of investment} \\ \text{expected residual value} \end{array} - \right) \times \left[\frac{\begin{array}{l} \text{Actual current tax credits} \\ \text{and other tax benefits} \end{array}}{\begin{array}{l} \text{Total estimated tax credits} \\ \text{and other benefits} \end{array}} \right]$$

The computation holds the initial investment balance constant each period (adjusted for any changes in the expected residual value). The amortization is based on a percentage of total tax benefits received in a particular year (numerator) relative to the total tax benefits expected over the life of the investment (denominator).

Under the proportional amortization method, an investment must be tested for impairment whenever events or changes in circumstances indicate the carrying amount of the investment may not be recoverable (ASC 323-740-35-6). The impairment loss is the difference between the excess of fair value over carrying value. Previously recognized impairment losses cannot be reversed.

3.3.6.3 Balance sheet classification of LIHTC

ASC 323-740 is silent about the balance sheet classification of investments accounted for under the proportional amortization method. Investments in qualified affordable housing projects would not meet the definition of a deferred tax asset. These investments are neither the result of a difference between the tax basis and reported amount in the financial statements, nor are they analogous to a tax

credit carryforward because the tax credits under the low-income housing credit program are earned over time and, therefore, are not available at the time of initial investment.

3.3.6.4 *Deferred taxes related to proportional amortization*

The tax benefits associated with low-income housing credits are recognized as they are reflected on the tax return each period. Therefore, we believe that deferred taxes should not be recognized on the basis difference of the investment. The reason there is a basis difference under the proportional amortization method is because the book basis of the investment is amortized as the tax credits are allocated to the investor (which is reflected in the book basis assigned to the tax credits), while there is no corresponding reduction in the tax basis of the investment (allocating the credits to the investor does not reduce the tax basis). The source of this difference is analogous to the basis difference that arises when a reporting entity purchases tax benefits as discussed in ASC 740-10-55-199 through ASC 740-10-55-201. In both situations, the basis difference is expected to be recovered or settled through realization of tax benefits (not pretax income) even though the financial statement carrying amount is not characterized as a deferred tax item in the financial statements.

We believe that the treatment of deferred taxes is also indirectly addressed in the example included in ASC 323-740-55. Deferred taxes were not provided in the proportional amortization method computation but were provided in the equity method and cost method computations. However, if an investor receives tax deductions in excess of the tax basis (i.e., negative tax basis) when applying the proportional amortization method, we would expect a deferred tax liability (or current tax liability) to be recognized for the potential “tax recapture” that will be imposed on the excess tax deductions.

If, however, the expected manner of recovering the investment was through a sale to a third party, we would expect deferred taxes to be recognized. In this case, the recovery of the asset for an amount different than the tax basis would trigger a tax consequence.

3.3.6.5 *Other methods for accounting for LIHTC*

Investors that do not qualify for the proportional amortization method (or do not elect to apply it) account for their investments under the equity method or cost method of accounting. The pretax results of the investment are reported in pretax income, and the benefits from any low-income housing credits that are passed through to them are reported in their income tax provision.

Prior to the changes in ASC 323-740-25-1, an effective yield method was allowable in limited circumstances. Investors that were applying the effective yield method to investments held prior to adopting the current standard may continue to do so.

ASC 323-740-55 contains a detailed numerical example illustrating the different approaches to accounting for investments in LIHTC. In the case of an investor applying the cost or equity method to the investment, deferred taxes may arise between the carrying amount of the investment and its related tax basis, which would give rise to deferred taxes independent of any deferred tax related to a carryforward of the credit.

3.3.7 *Global intangible low-taxed income (GILTI)*

For tax years beginning after December 31, 2017, the 2017 US tax reform legislation introduces new provisions intended to prevent the erosion of the US tax base. This is achieved, in part, through US

taxation of certain global intangible low-taxed income (GILTI). In short, GILTI inclusions will impact companies that have foreign earnings generated without a large aggregate foreign fixed asset base.

In considering the accounting for the impacts of GILTI, a question arises as to whether deferred taxes should be recognized for basis differences that are expected to reverse as GILTI in future years or if GILTI inclusions should be treated as period costs in each year incurred. Acknowledging the lack of specific guidance, the FASB staff concluded in their Q&A #5 that entities can apply either view as an accounting policy election. Companies will need to disclose their policy election. Measuring the impact of GILTI on deferrals introduces challenges that would not be present if treated as a period item. See TX 11.10.3 for a discussion on how to measure GILTI deferred taxes.

3.4 *Permanent differences*

ASC 740-10-25-30 discusses the concept of basis differences that do not result in a tax effect when the related assets or liabilities are recovered or settled. Events or transactions that do not have tax consequences when a basis difference reverses do not give rise to temporary differences. These situations are typically referred to as “permanent differences.” Below are some common examples of permanent differences in the US federal income tax jurisdiction:

- Interest income on tax-exempt securities
- Fines and penalties paid to governments for violation of the law
- Non-deductible portion of business meals and entertainment expenses
- Premiums paid (and subsequent proceeds) on life insurance policies for key management employees when held until death of the insured
- Compensation to covered employees in excess of \$1 million annually (see TX 17.8)
- Foreign-derived intangible income (FDII)
- Non tax-deductible goodwill amortization or impairment (see TX 10)
- Dividends-received deduction based on income from businesses in which a reporting entity has ownership
- Base erosion and anti-abuse tax (BEAT)

3.4.1 *Excess cash surrender value of life insurance*

The excess of the cash surrender value of a life insurance policy (the book basis) held by an employer over the premiums paid (the tax basis) is a basis difference. When a reporting entity owns a life insurance policy, management typically intends to maintain the policy until the death of the insured, in which case the proceeds of the policy would not be taxable. According to ASC 740-10-25-30, the excess of the book basis over the tax basis “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.”

Implicit in this guidance is the notion of an employer's control over the decision to surrender or hold the policy until the death of the employee. If an employer does not expect to keep an insurance policy in force until the death of the insured, it must record a deferred tax liability for the excess book-over-tax basis because the basis difference in this circumstance will be taxable when it reverses. If a reporting entity previously believed it would keep a policy in force until the insured's death but no longer believes that it will do so, then it must recognize a deferred tax liability on the basis difference even if it expects to keep the policy in force for a number of years. A reporting entity's ability to control the decision about holding a policy until the death of the insured may be affected by the existence of any employee cancellation option.

3.5 Issues to be considered in identifying temporary differences

There are several issues that should be considered when identifying temporary differences. First, ASC 740-10-25-3 lists exceptions to the use of the comprehensive model for recognizing deferred taxes. Refer to TX 2 for further discussion.

Additionally, under ASC 740-30-25-9, an outside tax-over-book basis difference in an investment in a subsidiary, or corporate joint venture that is essentially permanent in duration, will result in the recognition of a DTA only when it becomes apparent that the reversal of the temporary difference will occur in the foreseeable future. This is discussed in further detail in TX 11.5.

3.5.1 Taxable temporary differences—*indefinite reversal patterns*

The ASC 740 model generally does not take into account the timing of reversal of a taxable temporary difference. Although a reporting entity might be able to delay a tax effect indefinitely, the ability to do so is not a factor in determining whether a taxable temporary difference exists. ASC 740-10-55-63 addressed this issue.

Excerpt from ASC 740-10-55-63

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.

Although not typically considered in evaluating whether a temporary difference exists, the timing of reversal can impact the realizability of DTAs. See TX 5 for additional discussion of the assessment of the need for a valuation allowance.

3.5.2 Temporary differences not tied to an asset or liability

Some temporary differences result from events that have been fully recognized in the financial statements (i.e., no remaining asset or liability exists), but based on provisions of the tax law, require a different pattern of recognition for tax purposes. Such temporary differences will be taxable or deductible in the future and therefore cannot be identified with a particular asset or liability for financial reporting purposes. This is discussed in ASC 740-10-25.

ASC 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.

ASC 740-10-25-25

That occurs, for example, when a long-term contract is accounted for by the percentage-of-completion method for financial reporting and by the completed-contract method for tax purposes. 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.

ASC 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.

3.5.3 State temporary differences for US federal tax purposes

As referenced in ASC 740-10-55-20, state temporary differences have an effect on the calculation of US federal taxes.

ASC 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.

Chapter 4:
Recognition and measurement

4.1 Chapter overview—recognition and measurement

To achieve the objectives stated in ASC 740-10-10, reporting entities must compute deferred taxes to account for the expected future tax consequences of events that have been recognized in the financial statements or tax returns. The basic model for the recognition and measurement of deferred taxes consists of a five-step approach that accomplishes three primary objectives: (1) identification of all temporary differences, tax loss carryforwards, and tax credit carryforwards; (2) measurement of temporary differences using the applicable tax rate; and (3) assessment of the need for a valuation allowance.

Deferred tax asset and liability balances and the corresponding deferred tax expense recognized in the financial statements are determined for each tax-paying component in each jurisdiction.

ASC 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.

ASC 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.

ASC 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.

ASC 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 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.

4.2 Basic approach for deferred taxes

The tax provision for a given year as computed under ASC 740 represents not only the amounts currently due, but also the change in the cumulative future tax consequences of items that have been reported for financial reporting purposes in one year and taxable income purposes in another year (i.e., deferred tax). Under ASC 740, the current and deferred tax amounts are computed separately,

and the sum of the two equals the total provision. The total tax expense is meant to match the components of pretax income with their related tax effects in the same year, regardless of when the amounts are actually reported on a tax return. Therefore, it is necessary to determine which filing positions a reporting entity would take based on information available at the time the provision is calculated.

In ASC 740, the computation of the tax provision focuses on the balance sheet. A temporary difference is created when an item has been treated differently for financial reporting purposes and for tax purposes in the same period, and when it is expected to reverse in a future period and create a tax consequence. The tax effect of these differences, referred to as deferred taxes, should be accounted for in the intervening periods. A deferred tax asset or liability is computed based on the difference between the book basis for financial reporting purposes and the tax basis of the asset or liability.

This asset and liability method, required by ASC 740, measures the deferred tax liability or asset that is implicit in the balance sheet; it is assumed that assets will be realized, and liabilities will be settled at their carrying amounts. If the carrying amounts of assets and liabilities differ from their tax bases, implicit future tax effects will result from reversals of the book-and tax-basis differences.

The basic ASC 740 model is applied through the completion of the following five steps:

Step 1: Identify temporary differences. There are two categories of temporary differences: (1) taxable temporary differences that will generate future tax (i.e., deferred tax liabilities) and (2) deductible temporary differences that will reduce future tax (i.e., deferred tax assets). Temporary differences are most commonly identified and quantified by (1) preparing a tax balance sheet and comparing it with the financial statement balance sheet and (2) reviewing the reconciliation of book income with taxable income.

Step 2: Identify tax loss carryforwards and tax credits. A reporting entity may have US federal, state and local, and foreign tax loss carryforwards and certain tax credits. Tax loss carryforwards typically include net operating losses (NOLs) and capital losses, which, depending on the relevant jurisdiction's applicable tax law, may be carried back to prior periods and/or forward to future periods to offset taxable income. Tax credits may include research and development credit (R&D credit), foreign tax credits, investment tax credits, and other tax credits. Tax credits generally provide a "dollar-for-dollar" benefit against taxes payable.

Step 3: Determine the tax rate to apply to temporary differences and loss carryforwards. The applicable tax rate is the rate, based on enacted tax law, that will be in effect in the period in which temporary differences reverse or are settled. TX 4.3 discusses several factors that should be considered in determining the applicable rate.

Step 4: Calculate deferred tax assets and liabilities. This entails multiplying the gross temporary differences and tax loss carryforwards by the applicable rate and adding the resulting product to the tax credit carryforwards.

Step 5: Evaluate the need for a valuation allowance. Under ASC 740, deferred tax assets resulting from deductible temporary differences, loss carryforwards, and tax credit carryforwards must be recorded, and then subjected to a test for realizability. A valuation allowance must be established for deferred tax assets if it is "more-likely-than-not" that they will not be realized. TX 5 discusses the valuation allowance assessment in detail.

4.2.1 *Scheduling of temporary difference reversals*

Scheduling of temporary differences may be necessary when recognizing and measuring deferred tax assets and liabilities. For example, when enacted tax rates are scheduled to change in future years or will become effective in future years, the year in which taxable and deductible temporary differences are expected to be reported on the tax return affects the measurement of the deferred tax asset or liability. This is because the applicable tax rate would be different depending on the year of expected reversal. If temporary differences are expected to reverse during years in which different levels of tax rates are expected to be applied based on varying levels of income (i.e., graduated rates), this also could affect the measurement of the deferred tax asset or liability. Similarly, any rate differential should be considered in the measurement of deductible temporary differences that are expected to reverse and be realized through a carryback to a year with a different tax rate than the current enacted rate.

ASC 740-10-55-22 provides ground rules when scheduling temporary differences.

ASC 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 exist 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 investment in direct financing and sales-type leases.

Refer to TX 5.8 for further discussion on scheduling future taxable income in connection with a valuation allowance assessment. Refer to Example TX 7-1 for further discussion on scheduling related to changes in tax rates.

4.3 *Applicable tax rate*

The applicable tax rate used to measure deferred tax assets and liabilities is the enacted tax rate that is expected to apply when temporary differences are expected to be settled or realized. ASC 740-10-30-8 provides that the applicable rate applied to taxable or deductible temporary differences must be the jurisdiction's enacted tax rate, and not some form of effective tax rate.

ASC 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.

A reporting entity may utilize different applicable tax rates for several reasons, such as the type of temporary difference (e.g., ordinary income, capital gain), the jurisdiction of the temporary difference (e.g., domestic versus foreign or US federal versus state), or the period during which the temporary difference is settled or realized (e.g., carryback or carryforward periods). For example, when there is an enacted change in tax rates, the applicable tax rate could be the pre-change or the post-change tax rate depending on when the future reversals are expected to occur (i.e., the tax rate to be applied to a loss carryback is the rate expected to apply to taxable income for the year the loss is carried back to).

In some jurisdictions, capital gains are taxed at a different rate than ordinary income. As a result, determining which applicable tax rate is appropriate may depend on the expected method of recovery (i.e., through sale or through use) and the resulting character of the income (capital or ordinary). Example TX 4-1 illustrates the determination of the applicable rate used to measure a deferred tax asset or deferred tax liability.

EXAMPLE TX 4-1

Determination of applicable tax rate

A reporting entity's foreign subsidiary has an internally generated trademark with a book basis of zero and a tax basis of zero. The foreign country enacts a capital gains tax regime. Previously, all income was taxed at a single "ordinary" rate. Under the transition provisions in the legislation, intangible assets are assigned a tax basis equal to their fair value at the time of the law change. The tax basis is not amortizable against ordinary income but is allowable as a reduction to any gain on sale of the asset.

Under the presumption in ASC 740 that assets will be recovered at their recorded amounts, a deductible temporary difference (tax basis in excess of book basis) exists for the trademark.

Should a deferred tax asset be recorded and, if so, at what rate should it be measured?

Analysis

The tax law change created a temporary difference. Under ASC 740's comprehensive recognition model, no exception from recording deferred taxes exists for this type of temporary difference. Therefore, a deferred tax asset should be recorded in the year of enactment of the regime change.

Since the asset has no book basis and its tax basis is not amortizable, the only manner of recovery that would create a tax consequence is the sale of the asset. The trademark would be assumed to be sold at a tax loss (sold for its book basis of \$0), which would create a capital loss carryforward. As such, the DTA would be measured at that rate.

Depending upon the law, the recovery of the deferred tax asset may depend on future capital gains. In that case, if the reporting entity is unable to project future sources of capital gain income and is unable to identify any prudent and feasible tax planning strategies to generate capital gains income within the applicable carryforward period, a valuation allowance would need to be established.

4.3.1 Graduated tax rates

In accordance with ASC 740-10-30-9, before the appropriate applicable rate can be identified, it must be determined whether graduated tax rates are a significant factor. When graduated tax rates are a

significant factor, deferred taxes may need to be computed using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods during which the deferred tax assets and liabilities are expected to be realized or settled (e.g., when income levels are expected to fluctuate in and out of different tax brackets). See ASC 740-10-55-136 through ASC 740-10-55-138 for an example of how to apply graduated tax rates.

Because temporary differences may reverse in different periods and estimated taxable income may fluctuate in each period, more than one applicable tax rate may be appropriate at each balance sheet date. In general, future taxable income cannot be forecasted with precision and detailed scheduling of future taxable income and reversals might not produce more reliable amounts. For this reason, calculating deferred taxes using a single applicable rate based on the estimated average annual taxable income in future years is typically sufficient.

Situations may arise in which a specific applicable rate should be used for specific temporary differences. For example:

- If an unusually large temporary difference is expected to reverse in a single year, it may be appropriate to determine the applicable rate that is expected to apply to future taxable income in that specific year, since use of an average rate may not produce an appropriate measure of that deferred tax balance.
- If future taxable income (excluding reversals of temporary differences) is expected to reach an unusually high or unusually low level in a single year, it may be appropriate to apply that applicable tax rate to all temporary differences expected to reverse in that year.

Judgment should be applied to determine when the use of a specific applicable tax rate is appropriate.

ASC 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 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.

Under ASC 740-10-25-38, a reporting entity is not permitted to anticipate future tax losses when measuring the deferred tax consequences of existing taxable temporary differences. The lowest graduated tax rate (other than zero) should be used whenever the estimated average graduated rate would otherwise be zero (e.g., when losses are anticipated). Thus, a reporting entity should use the lowest tax rate (other than zero) in a graduated rate system to measure a deferred tax liability for tax consequences of taxable temporary differences even if tax losses that would otherwise expire unused are expected in future years. For example, if a taxable temporary difference exists at December 31, 20X1 that will reverse in 20X2 and future losses in excess of the taxable temporary difference are expected in 20X2, a deferred tax liability is nevertheless established for the taxable temporary difference as of December 31, 20X1. When the loss is actually incurred in 20X2, the deferred tax liability will have been avoided and its elimination would result in a deferred income tax benefit.

4.3.2 *Determining the applicable rate*

The applicable tax rate is based on the period in which the reversal of the temporary difference is expected to impact taxes payable (or refundable), and not only on the period in which the temporary difference is expected to reverse. That is, the period in which the temporary difference reverses may not be the period in which the temporary difference impacts the tax payable or refundable. ASC 740-10-55-129 through ASC 740-10-55-130 illustrate this distinction.

ASC 740-10-55-129

This Example illustrates the guidance in paragraph 740-10-55-23 for determination of the tax rate for measurement of a deferred tax liability for taxable temporary differences when there is a phased-in change in tax rates. At the end of Year 3 (the current year), an entity has \$2,400 of taxable temporary differences, which are expected to result in taxable amounts of approximately \$800 on the future tax returns for each of Years 4-6. Enacted tax rates are 35 percent for Years 1-3, 40 percent for Years 4-6, and 45 percent for Year 7 and thereafter.

ASC 740-10-55-130

The tax rate that is used to measure the deferred tax liability for the \$2,400 of taxable temporary differences differs depending on whether the tax effect of future reversals of those temporary differences is on taxes payable for Years 1-3, Years 4-6, or Year 7 and thereafter. The tax rate for measurement of the deferred tax liability is 40 percent whenever taxable income is expected in Years 4-6. If tax losses are expected in Years 4-6, however, the tax rate is:

- a. 35 percent if realization of a tax benefit for those tax losses in Years 4-6 will be by loss carryback to Years 1-3
- b. 45 percent if realization of a tax benefit for those tax losses in Years 4-6 will be by loss carryforward to Year 7 and thereafter.

Example TX 4-2 illustrates the applicable tax rate to utilize when carryback periods exist.

EXAMPLE TX 4-2

Determination of tax effects of temporary difference reversals on an incremental basis

Assume a reporting entity expects to have pretax book earnings of \$50 in a future year and anticipates existing net deductible differences of \$200 will reverse in that year, resulting in a taxable loss of \$150 for that future year. Assume also that the future year has a different enacted tax rate than the years in the carryback period because an existing law changes the tax rate applicable to that future year.

Which applicable tax rate should be utilized?

Analysis

The deferred tax asset related to the deductible temporary difference, which will result in a future year's taxable loss and will be carried back (i.e., \$150), should be recorded at the applicable rate in the carryback period (i.e., the pre-rate-change period). The portion of the deductible temporary difference that shelters the pretax book income earned in the future year from tax (i.e., \$50) or that would result

in a net operating loss carryforward (because the losses cannot be absorbed in the carryback period) should be recorded at the future applicable rate (i.e., the post-rate change).

4.3.3 Complexities in determining the applicable tax rate

There are several situations that create additional complexities when determining the appropriate rate at which temporary differences should be measured. Several of the more common circumstances are discussed in the sections that follow.

4.3.3.1 Applicable rate related to undistributed earnings

The applicable rate related to undistributed earnings should reflect any dividends-received deductions, deductions or credits for foreign taxes, or withholding taxes (per ASC 740-10-55-24). For more on measuring deferred taxes related to outside basis differences, see TX 11.

4.3.3.2 Special deductions

ASC 740-10-25-37 and ASC 740-10-30-13 stipulate that the tax benefit of special deductions should be recognized no earlier than the year in which the deductions can be taken on the tax return. ASC 740 does not define “special deductions,” but offers three examples: (1) statutory depletion, (2) special deductions available for certain health benefit entities, and (3) special deductions for small life insurance companies. The FASB also concluded in ASC 740-10-55-29 that the IRC Section 199 deduction for qualified domestic production activities also qualifies as a special deduction. The IRC Section 199 deduction was repealed as part of the 2017 Tax Cuts and Jobs Act (“the 2017 Act”). The 2017 Act also introduced a new deduction for foreign-derived intangible income (FDII). We believe that FDII should be accounted for as a special deduction.

As discussed in ASC 740-10-55-30, a reporting entity estimating future taxable income to determine the applicable rate should consider future special deductions in its deferred tax computations if graduated rates are a significant factor or if the reporting entity is assessing the need for a valuation allowance and must consider future taxable income (excluding reversals of temporary differences). Therefore, although tax benefits from special deductions are recognized no earlier than the year in which the special deductions are deductible on a tax return, they may affect the calculation of deferred taxes because their future tax benefit is implicitly recognized in the determination of the average graduated tax rate and the assessment of the need for a valuation allowance.

Statutory depletion

If the special deduction is statutory depletion, the estimates of future taxable income will be reduced by the total future statutory depletion that is expected to be deductible in future years on all properties, not just the statutory depletion related to the carrying amount of properties on the balance sheet date (i.e., the total statutory depletion includes both the current depletion and statutory depletion on assets to be acquired). Because statutory depletion generally is not limited by the adjusted basis in the property, it is possible that the taxpayer’s aggregate deductions for depletion will exceed the property’s adjusted basis.

As with other assets and liabilities, the temporary difference related to properties for which statutory depletion is available should be measured as the difference between the tax basis of the asset and its reported amount in the financial statements. As noted above, the reporting entity should recognize the

tax benefit of the special deduction no earlier than the year in which the deductions can be made on the tax return. Accordingly, a deferred tax liability should be recognized for this temporary difference, even though it is probable that future tax depletion will exceed book depletion. The tax basis in a depletable property represents the historical-cost basis of the property less the property's aggregate deductions for depletion that the reporting entity reports on its tax returns. The tax basis of the property, however, cannot be reduced below zero.

4.3.3.3 *Tax holidays*

In certain jurisdictions, tax holidays (i.e., periods of full or partial exemption from tax) are provided as an incentive for certain entities. This raises the question of whether a tax asset should be established for the future tax savings of a tax holiday on the premise that such savings are akin to an NOL carryforward. In these cases, the FASB concluded that a deferred tax benefit should not be recorded. In reaching this conclusion, the FASB distinguished between two types of tax holidays: one that is generally available to any entity within a class of entities and one that is controlled by a specific entity that qualifies for it. The first type was likened to a general exemption from taxation for a class of entities creating nontaxable status, while the second type was perceived to be unique because it was not necessarily available to any entity within a class of entities and, as a result, might conceptually require the recognition of deferred tax benefits. As discussed in ASC 740-10-25-35 through ASC 740-10-25-36, the FASB decided to prohibit recognition of a deferred tax asset for any tax holiday (including those considered unique) because of the practical problems associated with (1) distinguishing between a general tax holiday and a unique tax holiday and (2) measuring the deferred tax asset associated with future benefits expected from tax holidays.

In order to properly account for a tax holiday, careful consideration must be given to the specific aspects of the tax holiday, including the approval process, terms, and conditions. In general, the effects on existing deferred income tax balances resulting from the initial qualification for a tax holiday should be treated in a manner similar to a voluntary change in tax status, which under ASC 740-10-25-33 is recognized on the approval date or on the filing date if approval is not necessary. Therefore, the effects of a tax holiday should be recognized in the deferred tax computation upon receipt of the last necessary approval for the tax holiday.

Limited circumstances exist that can support the accounting for a tax holiday renewal at the continuing preferential rate when the extension requests are perfunctory in nature and the criteria to maintain the tax holiday is specific, objectively determinable, and within the reporting entity's control. This determination requires consideration of the reporting entity's specific facts and circumstances and the relevant tax laws.

Example TX 4-3 illustrates considerations in determining the timing of the recognition of a tax holiday.

EXAMPLE TX 4-3

Timing of the recognition of a tax holiday

Company A operates in Jurisdiction S. On November 5, 20X1 (i.e., Q4 20X1), Company A filed its initial application for a specific tax holiday in Jurisdiction S. The holiday lasts for five years and applies to corporations that meet certain objectively verifiable, statutory requirements with respect to the company's management, ownership, and foreign sales as a percentage of total sales. The statute that sets forth the requirements provides no discretion to the taxing authority or government officials

to deny the application if the taxpayer meets the requirements set forth in the statute. On January 20, 20X2 (i.e., Q1 20X2), Company A receives a letter of acknowledgment from the taxing authority in Jurisdiction S acknowledging receipt of Company A's application.

In which period should the Company A account for the effects of the tax holiday: (1) the period in which the Company A filed its application (i.e., Q4 20X1), or (2) the period in which the letter of acknowledgment was received (i.e., Q1 20X2)?

Analysis

In general, we believe the tax effects resulting from the initial qualification for a tax holiday should be treated in a manner similar to a change in tax status (see TX 8). Accordingly, consistent with ASC 740-10-25-33, Company A should record the effects of the holiday in the period in which the application was filed, rather than in the period in which the acknowledgement letter was received.

In this instance, Company A was legally entitled to the holiday in Q4 20X1 at the point in time that it had both met all the requirements set forth in the applicable statute and formally filed its application. As such, there was no basis for the taxing authority to deny the application. Receipt of the acknowledgement letter was merely confirmation of Company A's entitlement to the holiday rather than formal approval of it.

It should be noted, however, that if there is discretion on the part of the taxing authority or any government official to deny the application or alter its terms, the effects of the holiday should not be reflected in the financial statements until the formal government approval date.

Differences often exist between the book basis and tax basis on balance sheet dates within the holiday period. Consistent with ASC 740-10-30-8, if these differences are scheduled to reverse during the tax holiday, deferred taxes should be measured for those differences based on the conditions of the tax holiday (e.g., full or partial exemption). ASC 740-10-30-8 states 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." If the differences are scheduled to reverse after the tax holiday, deferred taxes should be provided at the enacted tax rate that is expected to be in effect after the tax holiday expires. The expiration of the holiday is similar to an enacted change in future tax rates, which must be recognized in the deferred tax computation. Tax-planning actions to accelerate taxable income into the holiday or to delay deductions until after the holiday would only be considered if the reporting entity has committed to their implementation and such implementation is within the reporting entity's control.

Example TX 4-4 illustrates the consideration of originating differences when scheduling the reversal of temporary differences in the context of a tax holiday.

EXAMPLE TX 4-4

Tax holiday—scheduling temporary differences

A foreign government grants a company a tax holiday. During the holiday, the company will be 100% exempt from taxation. Upon expiration of the holiday, the company will be subject to taxation at the statutory rate. The company is scheduling the reversal of existing temporary differences related to depreciable assets to determine whether any are expected to reverse after the tax holiday for which deferred taxes should be provided.

Should the company consider future originating differences related to its existing fixed assets when scheduling the reversal of existing temporary differences?

Analysis

ASC 740-10-55-22 provides ground rules for scheduling temporary differences. Some of those ground rules are: (i) the method used should be systematic and logical; (ii) minimizing complexity is an appropriate consideration in selecting a method; and (iii) the same method should be used for all temporary differences within a particular category.

When scheduling the reversal of depreciable asset temporary differences to determine whether any are expected to reverse (and in what amount) after the expiration of a tax holiday, we believe that it is acceptable to either consider or exclude future originating differences. We believe that both methods are systematic and logical and can be reasonably supported.

A method that considers originating differences is based upon the view that future originating differences are inherent in the asset that exists at the balance sheet date and, therefore, should not be ignored.

A method that does not consider originating differences is based upon the view that only differences that exist at the balance sheet date should be considered. This method is consistent with the guidance in ASC 740-10-55-14, which indicates that future originations and their reversals are a factor to be considered when assessing the likelihood of future taxable income. By implication, they would not be considered part of the reversal of the temporary difference existing at the balance sheet date. A method that does not consider originating differences may also minimize the complexity of the calculation.

In circumstances in which the tax holiday is contingent on meeting a certain status or maintaining a certain level of activities, a reporting entity must make the determination as to whether or not it has met the requirements to satisfy the conditions of the holiday. If a reporting entity has initially met such conditions and expects to continue to meet them, it should measure its temporary differences using the holiday tax rate. If the reporting entity later determines that it no longer meets the necessary conditions of the tax holiday (e.g., it is no longer able to maintain a required level of activity within the tax jurisdiction), it would need to remeasure its deferred taxes at the statutory rate and recognize an additional tax liability for any potential retroactive effects in the period that the determination is made.

In accordance with ASC 740-10-10-3, a reporting entity should establish deferred taxes using the enacted tax rate expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

Example TX 4-5 illustrates the accounting for NOLs during a tax holiday that does not start until the reporting entity first has taxable income.

EXAMPLE TX 4-5

Accounting for NOLs during a tax holiday

As an incentive to establish operations in Jurisdiction B, the taxing authority in Jurisdiction B provides Company A with a two-year tax holiday commencing with the first year in which taxable

income is generated (i.e., after full utilization of all net operating losses generated during the start-up phase). After the initial two-year holiday, Company A is eligible for a reduced corporate tax rate during the remaining benefit period. The benefit period is defined by Jurisdiction B as no more than twelve years from the year in which operations commenced. Thus, for example, if Company A takes five years to utilize its NOLs, it will have a subsequent two-year period at the zero-percent rate and a five-year period at the reduced tax rate (a total of twelve years). However, if Company A does not fully utilize its NOLs before the expiration of the twelve-year period, it will not be entitled to the tax holiday and any future earnings after utilization of the NOLs will be taxed at the full tax rate.

What is the appropriate tax rate to apply to the NOLs that will be generated during the start-up phase?

Analysis

ASC 740-10-25-35 through ASC 740-10-25-36 prohibits the recognition of deferred tax assets for a tax holiday. However, in this fact pattern, the tax holiday does not start until the company first has taxable income, which will not occur until after the NOLs are fully utilized. As a result, the NOLs that are generated and expected to be utilized in a tax year prior to the start of the zero-percent rate period should be measured at the normal statutory tax rate in Jurisdiction B (i.e., the tax that will be avoided prior to the start of the holiday period). ASC 740-10-10-3 provides that deferred tax assets and liabilities are measured at the enacted tax rate that is expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be settled or realized. In this case, the NOLs effectively delay the start of the holiday period.

The deferred tax asset related to these NOLs, like all deferred tax assets, should be evaluated for realizability.

Example TX 4-6 illustrates deferred measurement considerations when a reporting entity expects to incur future tax losses before the tax holiday begins.

EXAMPLE TX 4-6

Tax holidays and expected future tax losses

A foreign government grants a reporting entity a ten-year tax holiday, which starts when the reporting entity begins to generate taxable income. During the holiday, the reporting entity will be exempt from taxation. The reporting entity currently expects that it will incur losses for the next five years and then return to profitability. The reporting entity has taxable temporary differences related to property, plant, and equipment that will reverse over the next twenty years.

Is the applicable exemption period ten years or fifteen years (i.e., five years of expected losses and ten years of tax holiday)?

Analysis

The tax holiday is ten years. Accordingly, the reversal of temporary differences should be scheduled at each balance sheet date, and only those differences that reverse in periods beyond the ten-year tax holiday should be tax-effected. In this case, the applicable tax holiday on each balance sheet date would remain ten years, as long as the reporting entity incurs losses. The reporting entity may not consider the five years of losses before it expects the holiday to begin because anticipating future tax losses is prohibited by ASC 740-10-25-38.

4.3.3.4 ***Tax rate applied to nonamortizing assets***

For assets that are amortized for financial reporting purposes, the presumption in the deferred tax accounting model is that the carrying value of the asset will be recovered over time through the reporting entity's ordinary activities, which would be taxed at the ordinary rate. Accordingly, deferred tax assets and liabilities that result from temporary differences relating to such items are normally recognized at the ordinary tax rate.

However, for assets that are not amortized for financial reporting purposes (e.g., indefinite-lived intangible assets and tax-deductible goodwill), the presumption inherent in the pretax accounting is that the value of the asset does not decline (i.e., any revenues generated by the asset are not a recovery of the asset's carrying value). Thus, the carrying value of the asset is not scheduled to be recovered at any specific time in the future—it has an indefinite life.

As indicated in ASC 740-10-25-20, the deferred tax accounting model is predicated on the assumption that assets will be recovered at their carrying amounts. Thus, future changes, such as an impairment, are not anticipated. Furthermore, ASC 740-10-30-8 indicates that reporting entities should use enacted tax rates expected to apply to taxable income in the periods in which the deferred tax liability or asset is "expected to be settled or realized." When the ordinary tax rate and the capital gains tax rate differ, the question arises as to which rate—the ordinary rate used if an asset is recovered through use or the capital rate that would be used if an asset will be recovered through sale—is the "applicable tax rate" for a temporary difference relating to an asset with an indefinite life for book purposes. Importantly, in some instances, the deferred tax may be measured using both rates depending on the tax law. For example, in some jurisdictions, the tax law has provisions for recapturing amortization previously taken at the ordinary rate and then incremental capital gains (over the original cost basis of the asset) would be taxed at the capital gains rate.

ASC 350-30-35-4 clarifies that the term "indefinite" does not equate to "infinite." An indefinite-lived intangible asset is not amortized because there is no foreseeable limit on the period of time over which it will be consumed—not because the useful life is unlimited, or the asset is not consumed. While no anticipation of a future impairment is appropriate, the expectation is that eventually the asset will be consumed through ordinary use. This supports using the ordinary tax rate. The alternative perspective is that the future consumption through use of the asset may not be assumed or anticipated, and thus the only way it will be recovered is through sale. This would support using the capital gains tax rate.

We believe that a reporting entity should consider the specific facts and circumstances relating to the asset (i.e., whether the asset will be consumed over an indefinite period of time or recovered through sale) and apply the tax rate (ordinary or capital) that is expected to apply in the future.

It should also be noted that taxable temporary differences related to assets that are not amortized for financial reporting purposes generally cannot be used as a source of taxable income to support the realization of deferred tax assets relating to the reversal of deductible temporary differences or tax attributes with defined expiry dates. They can, however, be considered a source of income to support realization of tax attributes with an unlimited carryforward period and deductible temporary differences expected to reverse into an attribute (e.g., NOL) with an indefinite carryforward period. Implications to the valuation allowance assessment when such taxable temporary differences are present are discussed in TX 5.5.1.

4.3.3.5 “Worthless” deferred tax assets

When deductions or loss carryforwards are expected to expire unutilized, it is generally not appropriate to use zero as the applicable tax rate. Rather, a deferred tax asset should be recorded at the applicable tax rate and a valuation allowance of an equal amount would be provided. However, in certain rare situations, it may be appropriate to use a zero rate or to write off the asset against the valuation allowance. This reduces the valuation allowance and the gross deferred tax assets disclosed.

A write-off might be appropriate if there is only a remote likelihood that the carryforward will be utilized. This may be the case, for example, when a reporting entity has a loss carryforward that has not yet expired in a country where the reporting entity no longer conducts business. As with many other areas of ASC 740, this determination requires the use of professional judgment and a careful consideration of the relevant facts and circumstances.

For example, situations may exist where reporting entities put intercompany tax planning structures in place that may result in the accumulation of NOLs in a particular jurisdiction that will not be realized for a long period of time. In these cases, recording a valuation allowance versus writing off the asset is appropriate. Unlike Example TX 4-6, the reporting entity is still doing business in the jurisdiction. In the United States, in certain circumstances, IRC Section 382 imposes a limitation on the utilization of net operating losses, credit carryforwards, built-in losses, and built-in deductions after an ownership change. When this (or a similar) limitation mathematically precludes use of a portion of a carryforward or a deductible difference, it is appropriate for a reporting entity to write off the deferred tax asset. This would be the case, for example, if a reporting entity has NOLs in excess of the maximum amount that could be utilized over the carryforward period as determined by the Section 382 limitation calculation.

If carryforwards and built-in losses are subject to the same aggregate limitation, the estimate of the “permanent” loss of tax benefits should be reflected as an unallocated reduction of gross deferred tax assets.

4.3.3.6 Dual-rate jurisdictions

Certain jurisdictions tax corporate income at different rates depending on whether (and, in some cases, when) that income is distributed. For example, a jurisdiction may have a tax system under which undistributed profits are subject to a corporate tax rate of 45% and distributed income is taxed at 30%. Entities that pay dividends from previously undistributed income receive a tax credit (or tax refund) equal to the difference between (1) the tax computed at the “undistributed rate” (45% in this example) in effect during the period in which the income was earned and (2) the tax computed at the “distributed rate” (30% in this example). The opposite scenario may also exist where the tax rate assessed on an entity’s income when distributed is *higher* than the rate applicable to undistributed earnings.

ASC 740-10-25-39 through ASC 740-10-25-41 contains the only authoritative literature regarding such dual-rate jurisdictions. It was written within the context of a particular tax regime that existed at the time in which the “undistributed” tax rate was higher than the “distributed” tax rate. Accordingly, that guidance only explicitly addresses the appropriate accounting in a dual-rate regime that allows for the recovery of prior taxes paid (e.g., tax credit or refund) when those earnings are distributed. In the instance of a dual-rate regime that requires the payment of additional tax when dividends are distributed (i.e., distributed tax rate is higher than undistributed tax rate), application of the guidance in ASC 740-10-25-39 through ASC 740-10-25-41 requires interpretation in the broader context of the ASC 740 model, as further discussed below.

Lower tax rate on distributed earnings

The guidance depends on whether the assessment is in the context of the consolidated parent's financial statements or the separate financial statements of the subsidiary, and whether that subsidiary is in a foreign jurisdiction relative to its parent (i.e., eligible for the indefinite reinvestment exception).

Subsidiary

Under ASC 740-10-25-40, when the distributed tax rate is lower than the undistributed tax rate, the subsidiary paying dividends (i.e., distributing income) does not recognize a deferred tax asset for the potential future tax credits that will be realized when (if) the previously taxed income is distributed. Instead, 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. Accordingly, the entity should use the undistributed rate to measure the tax effects of temporary differences.

Parent

In the consolidated financial statements of the parent, the tax effects related to operations of its subsidiary when the foreign subsidiary distributes income is dependent on whether the parent asserts indefinite reinvestment with respect to the earnings of the subsidiary.

- If the parent is unable to, or does not, avail itself of the indefinite reinvestment exception under ASC 740-30-25-17 for purposes of preparing its consolidated financial statements, the parent company should recognize income tax expense and deferred taxes based on the distributed rate for both (1) the future tax credit that will be received when dividends are paid and (2) the deferred tax effects related to the assets and liabilities of the foreign subsidiary.
- If the parent applies the indefinite reinvestment exception, the parent should apply the undistributed rate in its consolidated financial statements.

Corporate joint ventures

Although not specifically addressed by the FASB, we believe that similar treatment should be applied by investors when measuring the tax effects of a corporate joint venture in a jurisdiction in which the distributed rate differs from the undistributed rate because ASC 740-10-25-3 specifically extends the application of the indefinite reversal exception to an investment in a foreign corporate joint venture that is essentially permanent in duration.

Example TX 4-7 illustrates application of the guidance in ASC 740-10-25-39 related to dual-rate jurisdictions.

EXAMPLE TX 4-7

Use of distributed and undistributed tax rates as applicable rates

In Country X, companies are subject to a 25% income tax rate plus an additional 10% corporate income tax assessment if their taxable income is not distributed before the end of the subsequent year. The additional tax assessment is due in the second subsequent year (i.e., the undistributed rate is effectively 35%, which is higher than the distributed rate of 25%).

Which rates should be used by companies in Country X?

Analysis

Under the guidance in ASC 740-10-25-39, tax would be provided at the undistributed rate (in this case, 35%) in the period during which the income is earned. Any reduction in the liability that arises when the income is ultimately distributed is not anticipated but is instead recognized in the period during which the distribution plan becomes final.

Alternatively, if a reporting entity in Country X's circumstances can demonstrate its intent and ability to distribute 100% of its earnings within the period provided by the law, it should disregard the additional 10% assessment and record taxes at the lower (25%) tax rate.

Higher tax rate on distributed earnings

There is no authoritative guidance that expressly addresses instances of a dual-rate regime that requires the payment of additional tax when dividends are distributed (i.e., distributed tax rate is higher than undistributed tax rate). In a parent's consolidated financial statements, the same considerations would apply as in the case when the distributed rate is lower.

For the separate financial statements of the entity in the foreign jurisdiction, use of either the distributed or the undistributed rate have been accepted in practice, although use of the higher distributed rate is generally considered preferable on the basis that those earnings ultimately cannot be delivered to the entity's shareholders without incurring those taxes. As such, if the lower, undistributed rate is used, additional disclosures may be required.

4.3.3.7 *Hybrid tax systems*

Some tax jurisdictions have tax systems that are based on the greater of a non-income-based computation or an income-based computation. Refer to TX 1.2.1.1 for discussion of whether the taxes assessed in these types of regimes are considered non-income-based or income-based.

4.3.3.8 *Deferred taxes related to foreign branch operations*

Under the US federal income tax system, a branch represents a US corporate entity that physically conducts its business in another country. The branch income and losses are generally taxable in the branch home country based on the local country's tax law and in the United States based on US federal income tax law. Under US federal tax law, local country taxes imposed on the branch are considered foreign taxes of the US corporation, which may deduct them as a business expense or claim them as a foreign tax credit. That is, the US corporation branch owner can deduct foreign branch taxes (i.e., a tax benefit measured at the US federal rate of 21%) or receive US foreign tax credits (i.e., a tax benefit measured at 100%), which, subject to limitations, can offset the US federal income tax imposed on the branch income. Because the branch is taxed in two jurisdictions under two different tax regimes, we would generally expect the reporting entity to have one set of temporary differences for the US return (i.e., those temporary differences would be included in the deferred tax computation for the US consolidated tax group) and another set of deferred taxes for foreign tax purposes.

TX 11.10.1 provides a more detailed discussion of the accounting for branch operations.

4.3.3.9 *Aggregating tax computations for separate jurisdictions*

Although deferred taxes ordinarily must be determined separately for each tax-paying component in each tax jurisdiction, ASC 740-10-55-25 acknowledges that in certain situations the tax computations for two or more jurisdictions can be combined. This is possible when (1) the same operations are taxed in two or more jurisdictions and (2) either there are no significant differences between the tax laws of the jurisdictions (e.g., carryback and carryforward periods are similar, as are the significant components of the tax laws) or any difference in computation would have no significant effect, given the reporting entity's facts and circumstances. In making this determination, reporting entities should also consider the provisions of ASC 740-10-45-6 about the offset of deferred tax liabilities and assets of different jurisdictions.

In practice, many reporting entities employ a "blended rate" approach at the legal-entity level to simplify the income tax calculation for reporting entities operating in multiple jurisdictions (e.g., operating in multiple US states). Management should be able to support its decision to use a blended rate and must not presume that a blended-rate approach is acceptable. Use of this approach should be continually assessed in light of the considerations enumerated in ASC 740-10-55-25 and other practical considerations. This may make the use of a blended rate unacceptable—especially as more and more states continue to decouple their tax calculations from the US federal tax calculation. Examples of when problems can result from the use of a blended rate include the following:

- When a reporting entity enters or exits a particular jurisdiction
- When a reporting entity needs to schedule deductible temporary differences and taxable temporary differences in order to determine the realizability of deferred tax assets for a component jurisdiction
- When there is a change in the assessment of a valuation allowance in one of the component jurisdictions
- When there is a tax law change that substantially changes the tax structure of one of the component states
- When there is a tax uncertainty that relates to only one or a subset of jurisdictions

When jurisdictions are combined for purposes of calculating an income tax provision, some reporting entities choose to employ an aggregate applicable rate (e.g., the US federal applicable rate plus the applicable state rate, net of the federal effect at the applicable federal rate). In calculating a state tax provision, a reporting entity's use of a state rate, net of federal benefit, would be inconsistent with the principles of ASC 740, because the reporting entity would effectively be netting the state tax with the deferred federal benefit. ASC 740-10-55-20 states that deferred state taxes result in a temporary difference for purposes of determining a deferred US federal income tax asset or liability. ASC 740-10-45-6 states that "an entity shall not offset deferred tax liabilities and assets attributable to different tax jurisdictions."

Because ASC 740 does not allow the netting of different tax jurisdictions, a state tax rate should be applied separately to temporary differences; in calculating a temporary difference (for purposes of determining a deferred federal benefit) that arises from deferred state taxes, a reporting entity should use the federal tax rate.

4.3.3.10 State income taxes—apportionment factors

Many state tax jurisdictions assess a tax based on the portion of taxable income earned in their jurisdiction. The process used to determine a respective state's share of a reporting entity's business is typically referred to as "apportionment." Although each state has its own laws for determining apportionment, many states use the following three factors in their determination: sales within the jurisdiction compared with total sales; assets within the jurisdiction compared with total assets; and payroll within the jurisdiction compared with total payroll.

In each state that follows an apportionment formula, the calculation of deferred taxes should use the apportionment factors that are expected to apply in future years. In practice, preparers of financial statements often use their current factors or factors shown in their most recently filed tax returns as the primary basis for estimating their future apportionment. While that may be useful as a starting point, the analysis should be adjusted to reflect any changes, such as the movement of employees and fixed assets out of a state due to an internal restructuring.

Additionally, we believe that when a change in the state rate is attributable to a change in the way a state computes its apportionment factors, the effect of the change should generally be treated as a change in tax rate and recorded entirely as a component of the income tax provision related to continuing operations, consistent with the treatment of enacted law changes described in ASC 740-10-45-15. See TX 7 for a discussion of changes in tax laws and rates.

4.3.4 Impact of base erosion and anti-abuse tax (BEAT)

The 2017 Act introduced a new minimum tax on international payments as a means to reduce the ability of multi-national reporting entities to erode the US tax base through deductible related-party payments. The minimum tax, known as BEAT, is imposed when the tax calculated under BEAT exceeds the corporation's regular tax liability determined after the application of certain credits allowed against the regular tax. BEAT is measured based on modified taxable income (i.e., taxable income after adding back base erosion payments). With certain exceptions, base erosion payments are payments to related foreign persons that result in a US tax deduction generally excluding payments for cost of goods sold.

FASB Staff Q&A #4 indicates that reporting entities should account for BEAT as a period cost and that deferred taxes should be recorded at the regular statutory rate. The FASB noted that BEAT is designed to be an incremental tax in which a reporting entity can never pay less than the statutory tax rate of 21%. The effect of this conclusion is that deferred tax assets and liabilities will be measured at regular tax rates (even for reporting entities that expect to be BEAT taxpayers) and that any BEAT tax exposure will be recognized as a period cost.

In certain instances, deferred tax assets, such as NOLs, may not be fully realized if a reporting entity is subject to BEAT in future years. The FASB staff noted that a reporting entity would not need to evaluate the effect of potentially paying BEAT on the realization of deferred tax assets. However, we believe a reporting entity may make an accounting policy election to consider the impact of paying BEAT on the realization of deferred tax assets. This is discussed further in TX 5.7.3.4.

4.3.5 Impact of GILTI on measurement of deferred taxes

The 2017 Act introduces a new tax on the global intangible low-taxed income (GILTI) of a US shareholder's controlled foreign corporations. Reporting entities that are subject to GILTI must make

an accounting policy election to treat GILTI as a period cost, or to record deferred taxes for basis differences that are expected to reverse as GILTI in future years. For reporting entities that choose the latter, measuring GILTI deferred taxes can be complex. For more on how to measure GILTI deferred taxes, see TX 11.10.3

Chapter 5:

Valuation allowance

5.1 Chapter overview—valuation allowance

Evaluating the need for and amount of a valuation allowance for deferred tax assets often requires significant judgment and extensive analysis of all the positive and negative evidence available to determine whether all or some portion of the deferred tax assets will not be realized. A valuation allowance must be established for deferred tax assets when it is more -likely-than-not (a probability level of more than 50%) that they will not be realized. Reporting entities with gross deferred tax assets are required to undertake a valuation allowance assessment. Being in a net deferred tax liability position does not exempt a reporting entity from this valuation allowance assessment because of the possibility that deferred tax liabilities may not reverse in a manner that provides a source of taxable income.

In general, “realization” refers to the incremental benefit achieved through the reduction in future taxes payable or an increase in future taxes refundable from the deferred tax assets.

5.2 Assessing the need for a valuation allowance

A valuation allowance assessment is both subjective and mechanical. Multiple factors that enter into the assessment to make it highly subjective include:

- assessing whether the weight of available evidence supports the recognition of some or all of an entity’s deferred tax assets;
- determining how objectively verifiable an individual piece of evidence is, and thus how much weight should be given to the evidence; and
- establishing the reversal patterns for existing temporary differences.

However, once those determinations have been made, the process of computing the valuation allowance necessary may be quite mechanical. This mechanical process is important and will have an impact when the weight of available evidence suggests that income in applicable future periods will be insufficient to support the realization of all deferred tax assets. In circumstances when a partial valuation allowance is warranted, the valuation allowance required generally must be supported through detailed scheduling of reversals of temporary differences.

The valuation allowance recorded should be based on management’s judgment of what is more-likely-than-not considering all available information, both quantitative and qualitative. An approach in which a valuation allowance is determined by reference to a certain percentage of an entity’s deferred tax assets would not be appropriate.

Ultimately, the realization of deferred tax assets will depend on the existence of future taxable income, sources of which are covered in TX 5.3.

5.2.1 Evidence to be considered

ASC 740-10-30-17 indicates that all available evidence should be considered when assessing the need for a valuation allowance.

ASC 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.

"All available evidence" includes historical information supplemented by all currently available information about future years. For example, a company may have classified a portion of its business as held-for-sale at period end. The impact of the anticipated disposal of this business on the company's valuation allowance assessment should generally be considered in the period in which the business is classified as held-for-sale. This is because, to classify for held-for-sale accounting, the disposal of the business must be probable. This is a higher level of certainty than the valuation allowance threshold of more-likely-than-not. However, gains associated with the disposal that may arise because the disposal group is expected to be sold for more than book value should not be anticipated since ASC 740 assumes recovery of assets and settlement of liabilities at the amounts reported in the financial statements.

Many events occurring subsequent to an entity's year-end but before the financial statements are released that provide additional evidence (negative or positive) regarding the likelihood of realization of existing deferred tax assets should be considered when determining whether a valuation allowance is needed.

However, not all subsequent events should factor into determining the need for a current year valuation allowance. For example, the tax effects of a natural disaster or catastrophe, such as an earthquake or a fire, should be recognized in the period in which they occur. In addition, the effects on the valuation allowance assessment of certain fundamental transactions, such as a business combination or an initial public offering, should not be considered until the period in which they occur. In addition, ASC 740 provides specific guidance for the timing of recognition of other events such as changes in tax law or rates which would not be anticipated in the valuation allowance assessment until such change is enacted. Refer to TX 7.3 for guidance on accounting for changes in tax laws and rates.

Anticipating sales or other transactions that are inconsistent with other financial statement assertions should generally be excluded from consideration (e.g., sales of securities classified as held to maturity or sales of long-lived or indefinite-lived assets that are not classified as held for sale).

Management should exercise judgment when financial statements are issued long after the balance sheet date. The longer after the balance sheet date the financial statements are released, the more difficult it becomes to assess whether new information represents a subsequent year event or whether it should be considered as part of the prior period's valuation allowance assessment. We generally do not believe that the delayed issuance of a set of financial statements should result in a different assessment of whether a valuation allowance is required.

Example TX 5-1 illustrates limitations on the use of hindsight when assessing the need for a valuation allowance as part of a restatement of prior results.

EXAMPLE TX 5-1

Use of hindsight when assessing the need for a valuation allowance as part of a restatement of prior results

Company A is restating its financial statements for the prior three years 20X1 to 20X3 for items unrelated to taxes. Prior to the restatement and the related filing of amended tax returns, Company A was profitable for each of the three years in the restated period. As a result, it had no valuation allowance recorded against any of its existing deferred tax assets. After taking into consideration the pretax accounting entries, Company A now reflects a significant loss for the year-ended December 31, 20X1, which is of sufficient size to put it into a three-year cumulative loss position at December 31, 20X1. On a restated basis, Company A reports a loss for 20X2, but in 20X3, it returned to significant profitability.

At December 31, 20X1, Company A had a post-restatement deferred tax asset relating primarily to net operating losses (NOLs) that will expire. If the financial results at December 31, 20X1 included the restatement items, there would have been significant uncertainty as to whether Company A would return to profitability in future periods.

Can Company A utilize the knowledge of the profitable results in 20X3 as positive evidence in evaluating whether a valuation allowance is considered necessary for the 20X1 restated accounts?

Analysis

No. We generally believe that the “all available evidence” standard of ASC 740-10-30-17 applies to the information that would have been available at the time of the original issuance of the financial statements. Although Company A returned to significant profitability in 20X3, only information available as of the original issuance date of the financial statements should be used in determining the valuation allowance as of the end of 20X1.

Due to the uncertainty of future GAAP income at December 31, 20X1, positive evidence of sufficient weight was not available to overcome the significant negative evidence of cumulative losses at December 31, 20X1.

In determining whether the valuation allowance is still necessary as of December 31, 20X2 and December 31, 20X3, Company A should re-evaluate the need for a valuation allowance based on all evidence that would have been available at the time of the issuance of the original 20X2 and 20X3 financial statements. It is conceivable that Company A, in its restated financial statements, would report a valuation allowance in 20X1 and a reversal of the valuation allowance in 20X3 based on the weight of evidence available at the time the original financial statements were issued—even though both years are within the restatement period.

5.2.2 Weighting of available evidence

ASC 740 requires the application of a “more-likely-than-not” threshold when determining the need for and amount of a valuation allowance.

ASC 740-10-30-5(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 should be sufficient to reduce the deferred tax asset to the amount that is more-likely-than-not to be realized.

ASC 740-10-30-23 prescribes the weighting of evidence, making the recognition of a deferred tax asset for an entity that has exhibited cumulative losses in recent years difficult.

ASC 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.

ASC 740 prescribes the manner in which available evidence should be weighted. What has already occurred (and thus can be objectively verified) carries more weight than what may occur (e.g., projections of future income, which are not typically objectively verifiable). In assessing the need for a valuation allowance, each piece of evidence should be evaluated in light of the extent to which it is objectively verifiable and should be weighted accordingly.

ASC 740's more-likely-than-not threshold for recognition of an allowance is arguably a lower asset impairment threshold than other asset impairment thresholds within the US GAAP framework. For example, when evaluating accounts receivable, an impairment loss should not be recognized until it is probable that an asset has been impaired and the amount of the loss can be reasonably estimated. "Probable" in that accounting framework is a higher threshold than the more-likely-than-not threshold. As defined in ASC 740-10-30-5, more-likely-than-not is a likelihood of more than 50%, where in practice, 75% is often used as a threshold for "probable." Therefore, despite using the same information about the results of future operations, inconsistent results may arise when an entity performs an asset impairment analysis versus its valuation allowance assessment. It is not uncommon for an entity to record a valuation allowance against its net deferred tax assets while other assets (e.g., fixed assets or goodwill) are not impaired.

Partial valuation allowance

The weight of the available evidence may in some situations indicate that only a portion of a company's deferred tax assets will be realized, resulting in the need to record a partial valuation allowance. For example, this can occur when deferred tax assets have attributes with a limited window of use or require income of a certain character, such as a foreign tax credit.

ASC 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.

A company's assessment of the available evidence may cause it to record a partial valuation allowance, or release a portion of a full valuation allowance that was previously recorded. In a subsequent period, the facts and circumstances may change, leading the company to conclude that the amount of valuation allowance needs to change. This ongoing reassessment requires significant judgment, especially since changes in the valuation allowance cause volatility in the company's effective tax rate. Given the inherently imprecise nature of forecasts of future taxable income, partial valuation allowances should generally be tied to objective information about specific deferred tax assets.

5.2.3 Character of income or loss

Reporting entities must consider the character of income (for example, "ordinary" versus "capital," "domestic" versus "foreign") when considering whether a valuation allowance for deferred tax assets may be necessary. In the US, for example, capital loss carryforwards may only be utilized against capital gains. If a reporting entity does not have sufficient positive evidence to indicate that capital gains will be generated during the lifetime of the capital loss carryforward such that the carryforward would be realized, a valuation allowance would be necessary. This is true even if the reporting entity generates ordinary income.

5.2.4 Assessing positive and negative evidence

ASC 740-10-30-17 requires reporting entities to consider both positive and negative evidence, keeping in mind two previous concepts discussed in TX 5.2.1 and TX 5.2.2: evidence to be considered and weighting of available evidence.

Determining whether positive evidence outweighs negative evidence is often an area of significant judgment. Reporting entities start their valuation allowance assessment by understanding the positive and negative evidence and the weight it carries (i.e., where it is on the sliding scale of being objectively verifiable).

5.2.4.1 Cumulative losses and other negative evidence

ASC 740-10-30-21 provides examples of negative evidence and indicates that it is difficult to avoid a valuation allowance when there is negative evidence such as cumulative losses in recent years. Other forms of negative evidence to be considered may include recent downward trends in a company's results and anticipated cumulative losses in the near future.

Of the negative evidence cited, "cumulative losses in recent years" is probably the most frequent to be considered. ASC 740 does not define this term. Generally, we believe that the guideline—not a "bright line" but a starting point—should be aggregate pretax results adjusted for permanent items (e.g., nondeductible goodwill impairments) for three years (the current and the two preceding years). The three-year timeframe associated with the cumulative loss assessment may have arisen from past

discussion in FAS 109's *Basis for Conclusions*. However, there is no authoritative guidance requiring a three-year assessment. That said, three years generally seems to be a long enough period to not be overly influenced by one-time events, but not so long that it would be irrelevant as a starting point for gauging the future. Further, the three-year period is not only a retrospective assessment. We believe it is appropriate to conclude that there are cumulative losses in situations in which an entity is projecting a loss within a year that will put it in a three-year cumulative loss position.

In addition to pretax results adjusted for permanent items, cumulative income or loss would include discontinued operations and other comprehensive income items. The only item that should be excluded from the determination of cumulative losses is the cumulative effect of accounting changes. While some of these items may not be indicative of future results, they are part of total historical results, and similar types of items may occur in future years.

Judgment is necessary to determine the weight given to the results of the cumulative period. Although having a cumulative loss is a significant piece of negative evidence, it does not automatically mean a valuation allowance is necessary; likewise, having cumulative income does not automatically mean a valuation allowance is not needed. As discussed in TX 5.2.2, the weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. Because a cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome, an entity would need objective positive evidence of sufficient quality and quantity to support a conclusion that, based on the weight of all available evidence, a valuation allowance is not needed. Positive evidence to be considered could include the fact that past losses were clearly tied to one-time, nonrecurring items, or the fact that the company's earnings are trending positively and they have returned to profitability in recent periods. See TX 5.2.4.3 for further discussion of positive evidence.

If an entity has cumulative losses in recent years, but has very recently returned to profitability, it must consider whether the evidence of recent earnings carries sufficient weight to overcome the weight of existing significant negative evidence. It must also consider whether the level of uncertainty about future operations allows a conclusion that the entity has indeed returned to sustainable profitability.

Example TX 5-2 presents scenarios that are solely intended to illustrate that three years of cumulative losses is not a "bright line" test and that additional analysis and significant judgment are required to determine whether a valuation allowance is necessary. These scenarios are for illustrative purposes only and do not include all of the information that may be necessary to form a conclusion regarding the need for a valuation allowance.

EXAMPLE TX 5-2

Cumulative loss in recent years

At the quarter ended September 30, 20X2, Companies A, B, and C are assessing whether the valuation allowances previously recorded on their respective DTAs are needed or should be reversed. None of the companies has any tax-planning strategies available. Each of the companies' income (loss) in 20X1 includes a \$0.6 million nonrecurring charge for a securities class-action legal settlement. The only deferred tax assets the companies have recorded are related to indefinite-lived NOLs.

The following summarizes pretax income (loss) for each of the three companies:

Year ended	Pretax income (loss) (in millions)		
	Company A	Company B	Company C
December 31, 20X0	(\$2.0)	(\$1.5)	\$2.0
December 31, 20X1	(\$0.5)	(\$1.0)	(\$1.0)
Projected December 31, 20X2	(\$1.5)	\$1.5	(\$0.5)
<i>Projected 3-year cumulative income (loss) as of December 31, 20X2</i>	<i>(\$4.0)</i>	<i>(\$1.0)</i>	<i>\$0.5</i>
Projected December 31, 20X3	\$1.5-\$2.0	\$1.5-\$2.0	(\$1.5)-(\$2.0)

What are some of the factors each company should consider when determining whether to retain its valuation allowance at the quarter ended September 30, 20X2?

Analysis

Company A – Three-year cumulative loss; income is projected in the following year

Company A is projecting a cumulative three-year loss of \$4.0 million for the period ending December 31, 20X2. Company A expects to incur losses in the fourth quarter of 20X2 and in each of the first three quarters in 20X3 with significant income expected in the fourth quarter of 20X3 that Company A expects will result in overall income for 20X3. Despite the fact that Company A expects to earn income in 20X3, the valuation allowance may continue to be necessary at September 30, 20X2 due to the following:

- Three years of cumulative losses is considered significant negative evidence that is difficult to overcome.
- Although Company A expects income in 20X3, Company A expects continued losses in the fourth quarter of 20X2 and during each of the first three quarters in 20X3.
- Given that Company A incurred net losses in each of the last two years and expects a loss for the full year ending December 31, 20X2, it will be difficult for Company A to assert that there is enough objectively verifiable evidence of future earnings to outweigh the historical negative evidence.
- Even if the \$0.6 million nonrecurring charge for the legal settlement in 20X1 is excluded, Company A would continue to be in a three-year cumulative loss position as of December 31, 20X2.

Company B – Three-year cumulative loss; income in the most recent year and income projected in the following year

From an earnings perspective, Company B has been improving each year. Company B is projecting a three-year cumulative loss of \$1.0 million as of December 31, 20X2, however, it recorded income of

\$0.9 million through the third quarter of 20X2, with an additional \$0.6M projected in the fourth quarter, resulting in a projected \$1.5 million of income for 20X2. Based on the most recent results, Company B is also projecting income for 20X3. Therefore, it would appear that the valuation allowance recorded by Company B may not be necessary due to the following:

- Company B has continuously improved its results over the past three years and has turned to profitability in 20X2.
- Company B has generated income through the third quarter of 20X2 (i.e., the most recent period) and is projecting income for the fourth quarter of 20X2 and for the full year ending December 31, 20X3.

Company C — Three-year cumulative income; loss projected in the following year

From an earnings perspective, Company C has been trending negatively. Company C previously recorded a valuation allowance despite its cumulative income position due to uncertainty in its forecast and other negative evidence. While Company C is not projected to have a three-year cumulative loss as of December 31, 20X2, Company C has projected a loss in the following year, 20X3, that would result in a three-year cumulative loss of \$1.0 million to \$1.5 million as of December 31, 20X3. Therefore, it would appear that the valuation allowance recorded in a prior period may continue to be necessary due to the following:

- Company C has incurred net losses in two of the last three years (even excluding the \$0.6 million nonrecurring charge for the legal settlement in 20X1).
- Company C is projecting a loss in 20X3 and, based on its projection, will have a three-year cumulative loss as of December 31, 20X3.

When considering cumulative losses, it may be necessary to segregate earnings (losses) subject to capital gains rules from those subject to taxes at ordinary rates. This concept is illustrated in Example TX 5-3.

EXAMPLE TX 5-3

Evaluating the need for a valuation allowance on deferred tax assets that are capital in nature

Corp X has a history of profitable operations and is projecting continued profitability. Consequently, Corp X determined that no valuation allowance was necessary for its deferred tax assets in prior periods. However, in the current year, Corp X generated unrealized and realized losses on its portfolio of equity securities.

As of the end of the current year, Corp X has recorded a deferred tax asset for (1) accumulated capital loss carryforwards, (2) net unrealized losses on equity securities that, if sold, would result in additional capital losses and (3) temporary differences (for example, reserves) subject to ordinary income tax rates. Under the tax law, Corp X can only utilize capital losses to offset realized capital gains. A net capital loss in a particular year may be carried back 3 years and forward 5 years.

On the basis of total income, Corp X is not in a cumulative loss position. Although Corp X has generated capital gains income in the past, the realized and unrealized losses generated in the current year that are capital in nature were significant enough to put Corp X into a cumulative loss position

related to its assets that are capital in nature. Corp X expects to generate capital gains in the future; however, management realizes that the assessment of whether or when such gains would occur is inherently subjective in nature.

Corp X does not have any other sources of capital gains income (e.g., tax-planning strategies or carryback availability).

Should Corp X record a valuation allowance for its deferred tax assets that are capital in nature?

Analysis

Yes. A full valuation allowance would be required on its deferred tax assets that are capital in nature. Corp X must assess the realizability of these deferred tax assets separately from the deferred tax assets that are ordinary in nature. Corp X has incurred cumulative losses related to its assets that are capital in nature. As discussed in ASC 740-10-30-21, cumulative losses in recent years represent negative evidence that is difficult to overcome. As a result, objective positive evidence is needed to overcome the significant negative evidence of the cumulative losses. Expectations about the future are inherently subjective, particularly when those expectations depend on future market appreciation, and, therefore, they generally will not be sufficient to overcome negative evidence that includes cumulative losses in recent years. Corp X would not be able to rely on its ability to generate capital gains in the future given the significant capital losses generated in the current year, including the unrealized losses (which gave rise to cumulative losses of a capital nature) and, therefore, must look to other sources of capital gains income (e.g., tax-planning strategies or carryback availability) which are not available.

5.2.4.2 *Going concern uncertainty*

ASC 205-40, *Presentation of Financial Statements—Going Concern*, requires management to assess the reporting entity's ability to continue as a going concern. When management concludes that substantial doubt exists regarding an entity's ability to continue as a going concern, that conclusion would constitute significant negative evidence under ASC 740 that may result in a valuation allowance for all deferred tax assets that are not assured of realization by either (1) carryback to prior tax years or (2) reversals of existing taxable temporary differences. There may be some limited circumstances when the immediate cause for the going concern uncertainty is not directly related to the entity's operations, and, absent the matter that led to the uncertainty, the entity would expect to continue generating operating and taxable profits. In these limited circumstances, the company may still be able to support realization of its deferred tax assets.

5.2.4.3 *Positive evidence*

The existence (or absence) of cumulative losses is only one piece of evidence that should be considered in assessing the need for a valuation allowance. While ASC 740-10-30-21 indicates that it will be difficult for positive evidence to overcome the types of negative evidence cited, ASC 740-10-30-22 gives examples of positive evidence that should be considered.

ASC 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, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

It is important to note that the examples of positive evidence require deeper consideration—i.e., they do not automatically overcome negative evidence. For example, a mere backlog of orders is not sufficient on its own. In addition to being able to evidence a backlog, management must be able to objectively support that the existing backlog of orders will be profitable and accretive to earnings.

Likewise, management's belief that the tax assets will be realized is not by itself sufficient, objective positive evidence to overcome objective negative evidence, such as recent losses. Indeed, management may conclude that, while it believes the deferred tax assets will be realized, the weight of objective evidence requires a valuation allowance. In these circumstances, public entities should be mindful that the SEC does not allow assertions (stated or implied) in the forepart of the prospectus for a public offering or a periodic report (e.g., Form 10-K) that are inconsistent with the assumptions used in the preparation of the financial statements.

Illustrative examples of positive evidence

The following examples illustrate when positive evidence may outweigh significant negative evidence so that no, or only a partial, valuation allowance is necessary. Each situation is based on specific facts and circumstances. Similar situations may not necessarily result in the same conclusions.

- An entity underwent a leveraged buyout (LBO) and incurred a large amount of debt as a result of that transaction. For several years after the LBO, the entity incurred substantial losses. Without the interest expense on the LBO-related debt, however, the entity would have been profitable.

Recently, the entity had an initial public offering (IPO) of equity securities. The proceeds of the IPO were used to completely pay off the LBO debt.

After the IPO and the related payoff of the LBO debt, the entity concluded that future income would preclude the need for a valuation allowance for its NOL carryforward deferred tax asset.

This situation demonstrates the concept of “earnings from core operations” (see TX 5.7.3.1). Absent the interest expense from the LBO, the company consistently demonstrated the ability to operate at a profit. While the company still had to overcome the significant negative evidence that resulted from cumulative losses in recent years, the company's objectively verifiable earnings from core operations were sufficient to overcome the losses caused by the LBO interest expense.

In contrast, if the entity was incurring significant losses as a result of interest on LBO-related debt, but planned to undergo an IPO three or four years into the future, the uncertainty regarding the entity's ability to carry out an IPO would likely lead to a conclusion that a full valuation allowance was appropriate.

- During the past five years, a bank incurred substantial losses as a direct result of commercial real estate and lesser-developed-country (LDC) loans. The bank has fully reserved these problem loans and has not originated any new commercial real estate or LDC loans. The bank's core businesses, which are primarily consumer and non-real estate commercial lending, historically have been, and continue to be, very profitable.

Management forecasts that, based on historical trends, earnings from its core businesses will, over the next five years, be more than sufficient to recover the losses resulting from the old commercial real estate and LDC loans. Accordingly, it was concluded that a valuation allowance was not necessary for the bank's deferred tax assets.

In this fact pattern, the bank had demonstrated the ability to be profitable in what it considered to be its core businesses. Once it concluded that it was going to cease originating commercial real estate and LDC loans (and the bank had fully reserved problem loans), the available evidence supported recognition of the deferred tax assets. However, exiting unprofitable businesses does not necessarily ensure that the ongoing entity will be profitable. In some cases, the losses in certain lines of business are indicative of challenges in the company's broader business model. In other cases, costs associated with those unprofitable businesses may need to be absorbed by the remaining businesses, hindering the historically profitable businesses' abilities to continue to be profitable. Careful analysis is necessary to determine whether exiting an unprofitable business is sufficient to overcome the losses incurred in recent years.

- An entity had three separate and distinct lines of business. Historically, two of the lines have been, and continue to be, profitable. The third line incurred substantial losses that led to an NOL carryforward on the entity's consolidated tax return. The entity recently discontinued its unprofitable line and sold the related assets.

The historical profit levels of the continuing operations were such that the entity could realize the NOL in approximately eight years. Because this was well within the NOL carryforward period in the applicable tax jurisdiction, it was concluded that a valuation allowance was not necessary for the entity's NOL carryforward and other deferred tax assets.

As in the bank example, the mere exiting of a business often does not, in and of itself, ensure future profitable operations. In this case, the company had a clear track record of profitable results in the other lines of business and could demonstrate realization within the carryforward period after considering all of the impacts of the discontinued business. This was considered sufficient positive evidence.

- A company had significant losses in the first two years of operations due to substantial start-up costs and marketing expenses. During year three, the company incurred losses in the first three quarters and income in the last quarter that resulted in a near breakeven year. In year four, although the entity reported increasing levels of income in each quarter, it was still in a three-year cumulative loss position at the end of its fiscal year due to the significant start-up costs and marketing expenses incurred during the first two years of operations. At the end of year four, management's projections show continued profitability with significant growth going forward. Based on the income recorded in year four (the most recent period), the NOL carryforwards were expected to be utilized well in advance of their expiration dates when the income level forecasted in future years was held consistent with year four and excluded any expected growth in years five and beyond.

Notwithstanding the cumulative loss evidence, as a result of the company's demonstrated profitability, it was concluded that no valuation allowance is necessary. Depending on the facts and circumstances, other factors such as what caused the losses and when the losses occurred in the three-year period may impact the assessment and conclusion.

5.2.5 Changes in judgment

Determining the need for a valuation allowance is inherently dependent, to some extent, on management judgment. Such judgments may change from period to period. However, when those judgments change, there should be clear, explainable reasons. In assessing changes in the valuation allowance, it is important to consider the basis for amounts previously provided and how new qualitative and quantitative information modifies previous judgments. For example, management should consider whether the results for the current year provide additional insights as to the recoverability of deferred tax assets or as to management's ability to forecast future results.

The amount of deferred tax assets, net of the valuation allowance, and the amount of change in the valuation allowance in the current year should make sense considering the prior year's assessment, current year's earnings, and other available evidence. In general, if adjustments are made in the first quarter, the entity should be able to explain the change from the preceding year-end. Based on the short time period between issuance of an entity's year-end financial statements and release of its first-quarter Form 10-Q, changes in judgment during this period would be expected to be relatively uncommon and generally would result from a specific, significant event or change in facts and circumstances that could not have been foreseen.

5.3 Sources of taxable income

Taxable income of the appropriate character (e.g., ordinary or capital) within the carryback and carryforward periods available under the tax law is necessary to achieve future realization of deferred tax assets. ASC 740-10-30-18 identifies four sources of taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards. They are listed here in order of the most objective to the most subjective:

- Taxable income in prior carryback years if carryback is permitted under the relevant tax law (see TX 5.4)
- Future reversals of existing taxable temporary differences (see TX 5.5)
- Tax-planning strategies (see TX 5.6)
- Future taxable income exclusive of reversing temporary differences and carryforwards (see TX 5.7)

Reporting entities must consider each source of income in order to determine the amount of the valuation allowance that should be recorded against deferred tax assets. If one or more sources are sufficient to realize the deferred tax asset, no further consideration is required of the remaining sources. If, for example, existing taxable temporary differences are greater than deductible temporary differences and loss carryforwards, and the reversal patterns and taxable income limitations (if applicable) are such that offset is expected under the tax law, there is no need to consider the remaining sources of taxable income, even if future losses are expected.

Excerpt from ASC 740-10-30-18

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.

5.3.1 Unrecognized tax benefits as a source of taxable income

Unrecognized tax benefits may be a source of taxable income for purposes of determining the expected realization of a deferred tax asset. Because settlement with the taxing authority is presumed to be at the recorded amount of the liability, the position's resolution effectively amounts to additional taxable income over and above the taxable income expected on the "as-filed" or expected-to-be-filed tax return. Therefore, unrecognized tax benefits should be viewed as an additional source of taxable income and be considered as part of the assessment of whether a deferred tax asset is realizable.

Consistent with all sources of taxable income, and to the extent necessary under the relevant tax law, the character of the uncertain tax position should be considered. For example, in the United States, an uncertain tax position that avoided recognition of capital gains may provide a source of income to realize capital losses that otherwise would not be realizable. In addition to character, an understanding of the period in which the taxing authority would assess the tax (to the extent the position was lost) also would need to be considered.

5.4 Taxable income in prior carryback years

When a tax attribute may be carried back to a prior year, and taxable income existed in a year to which carryback is permitted under the tax law, that carryback is an objectively verifiable source of income.

5.4.1 Carrybacks that free up credits

Deferred taxes are recorded at the applicable tax rate prior to consideration of credits. This may lead to a situation when net deductible temporary differences reversing in a single future year will be included in a tax loss, and that tax loss will be carried back to prior years and will at least partially free up tax credits rather than result in a refund (i.e., the credits had originally been used to reduce the tax payable). We believe that realization of deferred tax assets requires incremental cash tax savings. Merely replacing one deferred tax asset (e.g., a deductible temporary difference) with another deferred tax asset (e.g., a credit carryforward) when there is not a source of income to realize it does not represent realization of the initial deferred tax asset, and a valuation allowance would be necessary on the credit carryforward.

5.4.1.1 Carryback availability that may not be used

Companies should carefully consider whether carryback availability truly provides an incremental source of taxable income to support realization of deferred tax assets. In concept, carryback availability will provide a source of income to realize a deferred tax asset only if carryback will actually occur. In general, we believe that the valuation allowance assessment should consider what the company expects to report on its tax return in the carryback window.

For example, the Internal Revenue Code provides an election to forgo the carryback of a loss when there is available taxable income in the carryback years. An entity might make this election if rates in the carryforward period are higher than rates in the carryback period. An entity also might make this election if it has used foreign tax credits to reduce or even eliminate the actual taxes payable in the preceding three years. To that extent, the loss carryback will not result in a refund but will only free up the foreign tax credits. However, given the short carryforward period of ten years for foreign tax credits and other restrictive limitations on their use, any freed-up foreign tax credits might expire unused. The election to forgo a carryback should be reflected in the deferred tax computation only when that election actually is expected to be made.

Notwithstanding the preceding paragraphs, there may be situations where other sources of income are insufficient to realize a company's deferred tax assets, and carryback is an available source of income that would provide incremental realization. In these situations, we believe a company should take that carryback into consideration in its valuation allowance.

5.4.1.2 ***Carryback and future originating differences***

Reporting entities may have a deferred tax asset whose reversal may trigger taxable losses in near-term future years, which would, in turn, generate a loss carryback. Carryback availability should be considered in determining the amount of any valuation allowance. However, ASC 740 is not clear as to how to consider the impact of future originating deductible differences when evaluating the realizability of existing deferred tax assets via the carryback source. Example TX 5-4 demonstrates this concept.

EXAMPLE TX 5-4

Whether future originating differences should be considered when assessing carryback availability

As of December 31, 20X2, Company A has a net deferred tax asset. Company A was breakeven in 20X2. Company A has concluded that a valuation allowance is required on the net DTA for the portion of the DTA not supported by reversing taxable temporary differences and/or carryback capacity. In tax year 20X1, Company A generated taxable income. Under the relevant jurisdiction's tax law, Company A is allowed a 2-year carryback of taxable loss and must carryback to the oldest year first. Therefore, Company A has a carryback source of income in 20X1 to support recoverability if a taxable loss is generated in 20X3.

As of December 31, 20X2, Company A expects to breakeven in 20X3 on both a book and taxable basis. Although the existing net DTA is expected to partially reverse in 20X3, the reversal is expected to be fully offset by the origination of additional deductible differences. If the actual 20X3 results occur as expected, no taxable loss would be available in 20X3 to carryback and the carryback availability from 20X1 would expire unutilized. However, if originations were not considered, the reversal of existing deductible temporary differences would exceed the reversal of taxable temporary differences in 20X3.

Should Company A consider future originating differences when assessing carryback availability as a potential source of taxable income to realize its net DTA?

Analysis

We believe there are two supportable views when assessing carryback availability as a potential source of taxable income:

View A — Company A should not consider future originating differences

Under this view, Company A would assess the realizability of the existing net DTA by solely assessing the expected reversal of existing temporary differences in the 20X3 year, assuming zero pretax book income in 20X3. This approach would not consider future originating temporary differences. If the assessment results in an expected tax loss in 20X3, which can be recovered by carryback to prior years within the carryback period (i.e., 20X1), then no valuation allowance for that portion of the DTA would be recorded.

This view would consider actual taxable income in the available carryback period to be a source of taxable income that is not dependent upon future events other than assumed reversals of existing temporary differences. The available carryback is considered objectively verifiable evidence supporting that amount of net DTA.

Under this view, it would be inappropriate to assume originating temporary differences in the 20X3 year, as the originating differences would be based on events that have not yet taken place.

View B — Company A should consider future originating differences

Under this view, Company A would assess the realizability of the existing net DTA by assessing the expected reversal of existing temporary differences along with an estimation of originating temporary differences. In essence, Company A would attempt to estimate its 20X3 taxable income/loss from reversing and originating temporary differences only. If taxable income or a breakeven result is anticipated, no carryback would be available in 20X3 and a full valuation allowance would be needed. If, however, a tax loss is expected in 20X3, which can be carried back to profitable prior years within the carryback period, the amount of loss from the reversal and origination of temporary differences eligible for carryback would provide a source of realization for the amount of DTAs as of December 31, 20X2 that will reverse in 20X3, indicating they would not need a valuation allowance.

This view is supported by the concept that carryback availability will provide a source of income to realize a DTA only if an actual carryback is expected to occur. In this case, the reversal of one DTA is expected to be replaced by an originating DTA and would not result in realization. This view, while potentially more complex to apply, is seen as more consistent with the overall expectations-based assessment of the tax consequences resulting from temporary differences.

Note that in both View A and View B, management should consider whether there are tax-planning strategies available to accelerate tax deductions (or delay future originations) in order to ensure carryback availability is utilized.

5.5 *Future reversals of existing taxable temporary differences*

Reversal of existing taxable temporary differences must be considered as a source of taxable income for purposes of assessing deferred tax asset realization. The mere existence of taxable temporary differences does not make them a source of taxable income for the recognition of deductible temporary differences. Scheduling generally will need to be performed at some level to determine whether the existing taxable temporary differences will reverse in a period that will allow them to be a source of income to realize deductible temporary differences.

In some cases, scheduling can be an in-depth detailed analysis of reversal patterns, specifically tracking reversals of taxable and deductible temporary differences in order to ensure the realizability of existing deductible temporary differences. In other cases, obtaining a general understanding of reversal patterns is sufficient. Refer to TX 4.2.1 for guidance on scheduling the reversal of temporary differences.

Example TX 5-5 illustrates considerations related to limitations on the use of net operating loss carryforwards in determining the need for a valuation allowance.

EXAMPLE TX 5-5

Limitations on the use of net operating loss carryforwards

In the prior year, Company A determined that a valuation allowance for deferred tax assets was not required for its foreign subsidiary, Company B, based on the scheduling of taxable and deductible temporary differences, along with tax loss carryforwards.

Company B has recorded DTAs based on deductible temporary differences and NOLs of \$180 and \$120, respectively. In addition, Company B has recorded DTLs for taxable temporary differences of \$300. The existing inventory of deductible and taxable temporary differences is expected to reverse ratably over the next three years. Company B is unable to rely on a projection of taxable income (exclusive of reversing temporary differences). There are no other sources of future taxable income, such as tax-planning strategies or actions.

Historically, Company B had the ability to carry forward tax losses on a fifteen-year basis with no limitation on the amount utilized. In the current period, the government enacted tax law changes that impacted the utilization of existing losses in fiscal years commencing in 20X1 (the current year) and thereafter. Under the new provisions, NOLs expire in three years and can only be utilized to offset 70% of taxable income in any given year.

Company B expects to earn \$40 in taxable income in each of the next three years from its reversing net temporary differences.

The following table summarizes NOL utilization after application of the new loss limitation rule:

Account	BOY 20X1	Reversal 20X1	Reversal 20X2	Reversal 20X3
Temporary deductible differences— other	\$180	(\$60)	(\$60)	(\$60)
Temporary taxable differences	\$300	100	100	100
Taxable income		40	40	40
NOL utilization (70% limitation)		(28)	(28)	(28)
NOL remaining	\$120	\$92	\$64	\$36

In determining the need for a valuation allowance, how should Company A consider the loss limitations imposed by the tax law change enacted in Company B's jurisdiction?

Analysis

According to ASC 740-10-55-36, provisions in the tax law that limit utilization of an operating loss or tax credit carryforward should be applied in determining whether it is more-likely-than-not that some or all of the deferred tax asset will not be realized by reduction of taxes payable on taxable income during the carryforward period.

The restrictions enacted by the government pose new evidence that may shift loss utilization into later years or suggest that income in future periods will be insufficient to support realization of existing deferred tax assets. As a result, a partial valuation allowance could be required.

Under the new tax law enacted in 20X1, the NOLs expire in three years and are only available to offset 70% of taxable income in any given year. Accordingly, a partial valuation allowance would be required for the NOLs expected to remain at the end of the carryforward period (\$36 that exist at the end of 20X3) and would be expected to expire prior to realization.

A similar scheduling exercise would be required if Company B previously maintained a full valuation allowance against its net DTAs. Assume Company B had taxable temporary differences of \$210 that reverse ratably over three years and a full valuation allowance recorded against its net DTAs. The following table summarizes the valuation allowance assessment assuming application of the loss limitation:

Account	BOY 20X1	Reversal 20X1	Reversal 20X2	Reversal 20X3
Temporary deductible differences—other	\$180	(\$60)	(\$60)	(\$60)
Temporary taxable differences	\$210	70	70	70
Taxable income		10	10	10
NOL utilization (70% limitation)		(7)	(7)	(7)
NOL remaining	\$120	\$113	\$106	\$99
Net DTA (30% tax rate)	\$27			30
Valuation allowance	(\$27)			(\$30)

Company B would need to increase the existing valuation allowance from \$27 to \$30 to account for the NOLs that are expected to expire prior to realization. Even if Company B were in an overall net deferred tax liability position, a valuation allowance may be required if income in future periods is insufficient to support realization of NOLs prior to expiration.

When assessing the realizability of DTAs, companies need to evaluate all of the relevant tax laws and other evidence. While detailed scheduling is not required by ASC 740 in all cases, it is necessary when it has an impact on the valuation allowance assessment.

ASC 740-10-25-38 specifically precludes anticipating future tax losses. As a result, in situations when future taxable income cannot be relied upon, our view is that the benefit of any reversing taxable temporary differences (and the effect of any taxable income limitation) be determined with an assumption of break-even future income.

5.5.1 *Naked credits*

“Naked credits” are deferred tax liabilities that have an indefinite reversal pattern, such as a deferred tax liability that relates to an asset with an indefinite useful life (e.g., land, goodwill, indefinite-lived intangible asset). Naked credits would not ordinarily serve as a source of income for the realization of deferred tax assets with a finite loss carryforward period. In situations when another source of taxable income is not available, a valuation allowance on deferred tax assets is necessary even though an entity may be in an overall net deferred tax liability position.

However, if a company can determine the expected timing of the reversal of the temporary difference, it may be appropriate to consider a naked credit as a source of income for the realization of deferred tax assets. For example, if a company enters into a sale agreement and as a result, an indefinite-lived intangible asset was classified as held for sale pursuant to ASC 360-10-45-9, the timing of the reversal of the deferred tax liability is now predictable, and therefore can be considered as a source of income to support realization of deferred tax assets. Another example is an indefinite-lived intangible for in-process R&D depending on when the reversal of the deferred tax liability is expected.

In a situation when the deductible temporary difference is indefinite in nature, it may be appropriate to use a deferred tax liability related to an indefinite-lived asset as a source of income to support realization of a deferred tax asset in a jurisdiction with unlimited carryforward. This assumes that they are within the same jurisdiction, of the appropriate character, and that the deferred tax asset is realizable if the taxable income were to become available.

Example TX 5-6 demonstrates valuation allowance considerations when there is a deferred tax liability related to an indefinite-lived asset in a jurisdiction with an unlimited loss carryforward period.

EXAMPLE TX 5-6

Deferred tax liability related to an indefinite-lived asset in a jurisdiction with an unlimited loss carryforward period

Company A is in a jurisdiction with an unlimited NOL carryforward period. Included in Company A’s net deferred tax asset is a deferred tax liability recorded for the basis difference in an indefinite-lived intangible asset. There have been significant historical losses and the taxable temporary difference related to the indefinite-lived intangible asset is the only source of income available to support realization of the deferred tax asset related to the NOL carryforward. In this jurisdiction, the use of NOLs is limited to 80% of taxable income in any given year. The taxable temporary difference related to the indefinite-lived asset is equal to Company A’s NOL carryforward.

Should Company A consider the taxable temporary difference associated with the indefinite-lived asset as a source of taxable income to support realization of the NOL deductible temporary difference?

Analysis

Yes. Because there is an unlimited loss carryforward period, the taxable temporary difference related to the indefinite-lived asset would constitute a source of taxable income to support the realization of the deferred tax assets with an unlimited carryforward period since both have indefinite reversal or expiration periods. This assumes that both are within the same tax jurisdiction, of the appropriate character, and that the deferred tax asset is realizable if the taxable income from the taxable temporary difference were to become available.

However, as a result of the tax law limitation on the utilization of a net operating loss to 80% of taxable income, Company A will still need a partial valuation allowance because in this circumstance, the reversal of the taxable temporary difference is the only source of income.

There may be cases when an indefinite-lived deferred tax asset will not be realizable at the time the naked credit reverses. For example, if tax-deductible goodwill associated with the naked credit is subsequently impaired, the deferred tax liability will reverse and provide taxable income at the time of impairment. However, this may not support realization of a deferred tax asset related to land since the deduction is dependent on the sale or impairment of the land. By contrast, if the deferred tax asset was an NOL carryforward in an unlimited carryforward jurisdiction, the NOL deferred tax asset would be realizable at the time of the goodwill impairment.

5.5.2 Book amortization of tax deductible goodwill

ASC 350-20-35-63 provides companies that do not meet the definition of a public business entity with the option to amortize goodwill generated by a business combination on a straight-line basis over 10 years (or less). The guidance does not specifically address income tax accounting implications of electing this option. In addition to the complexities discussed in TX 10.8.4, electing this alternative may affect existing valuation allowances on deferred tax assets.

When a company elects to apply the goodwill amortization accounting alternative, any taxable temporary difference associated with goodwill would be expected to reverse because goodwill is also being amortized for tax purposes (albeit generally over a different period) (see TX 10.8 for discussion around components of goodwill). As a result, a company should consider the taxable temporary differences associated with goodwill as a source of taxable income when evaluating recoverability of its deferred tax assets.

In the period a company adopts the goodwill amortization accounting alternative, it may determine that it can reverse all or part of its valuation allowance because of the additional source of taxable income. This change in judgment is an indirect effect of a change in accounting principle and, therefore, it should be recognized as an income tax benefit in continuing operations in the period of adoption and not as part of the change in accounting principle.

5.6 Tax-planning strategies

Tax-planning strategies must meet several criteria to be used to support realization of deferred tax assets, as described in ASC 740-10-30-19.

Excerpt from ASC 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 incurred 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.

Although the ASC 740 criteria is explicit, it is not necessarily easy to interpret. The following bullets provide additional context for how we believe companies should interpret the tax-planning strategy criteria.

- *Prudent and feasible* — Management must have the ability to implement the strategy and expect to do so unless the need is eliminated in future years. If management would not implement a strategy because it would not be in the entity's best interests, it would not be prudent. If management does not have the ability to carry out the strategy, it would not be feasible. The strategy need not be in the unilateral control of management, but it must be primarily within its control. For example, restrictions in loan agreements would have to be considered in determining whether a strategy is feasible.
- *Ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused* — Strategies that the entity takes ordinarily for business reasons are generally not tax-planning strategies.

ASC 740-10-30-20 makes it clear that the unit of account, recognition, and measurement principles for unrecognized tax benefits should be applied when determining whether a tax-planning strategy provides a source of future taxable income for the realization of deferred tax assets. In effect, a proposed tax-planning strategy would need to meet the ASC 740 more-likely-than-not recognition threshold from a tax law perspective. Assuming recognition is met (and the tax-planning strategy was determined to be prudent and feasible), the amount of taxable income that would be provided by the tax-planning strategy should be measured as the largest amount of benefit that is more-likely-than-not to be realized.

Some tax-planning strategies (e.g., triggering a LIFO reserve or shifting a tax-exempt portfolio to taxable) create additional taxable income. Other tax-planning strategies may affect only the timing of specific taxable income or deductions. In some cases, tax-planning strategies may only extend the period of future years to which the entity may look for additional taxable income to be generated other than from reversals. As mentioned in ASC 740-10-55-37, a reduction in taxable income or taxes

payable as a result of NOLs and credit carryforwards does not solely constitute recognition of a tax benefit. To the extent that a tax-planning strategy results in the utilization of existing NOLs and credits merely through replacement with a temporary difference that will result in future deductible amounts, absent future taxable income to realize the deferred tax asset, the tax-planning strategy may not result in realization of the deferred tax asset. Realization would be achieved only if the entity was able to support the existence of a future source of taxable income.

A tax-planning strategy that triggers a gain on the appreciation of certain assets for tax purposes (including LIFO inventories) may require special consideration. ASC 740-10-30-22 cites appreciation in net assets as an example of positive evidence. For the strategy to create additional taxable income rather than merely affect the timing of taxable income and deductions, the appreciation would have to be unrecognized and unrealized. Recognized, but unrealized, appreciation (e.g., certain securities carried at market value under ASC 320, *Investments—Debt Securities* and ASC 321, *Investments—Equity Securities*, but not subject to the mark-to-market tax rules) would have generated a taxable temporary difference that would already have been considered as a source of income.

An available tax-planning strategy to create additional taxable income may not ensure realization of deferred tax assets if future operating losses are expected to offset the taxable income from the strategy. Example TX 5-7 demonstrates this concept.

EXAMPLE TX 5-7

Potential tax-planning strategy that only reduces future loss

XYZ Company has experienced a history of operating losses over the past five years that total \$20 million and has a net deferred tax asset of \$5 million (tax rate of 25%) arising primarily from NOL carryforwards from such losses. A full valuation allowance has historically been recorded against the net deferred tax asset.

Based on the introduction of a new product line, Company XYZ is currently projecting that, for the next three years, it will experience losses of approximately \$5 million in the aggregate before it “turns the corner” and becomes profitable. Due to appreciation in the real estate market, Company XYZ’s investment in a shopping mall property is now valued at approximately \$500,000 more than the carrying amount in its financial statements. The entity proposes to reverse \$125,000 ($\$500,000 \times 25\%$) of its valuation allowance based on a tax-planning strategy to sell the investment in the shopping mall. The shopping mall is not a “core” asset of the entity, and management asserts that it would sell the shopping mall property, if necessary, before it would permit the NOL carryforward to expire unused.

Should the valuation allowance be reduced for the tax-planning strategy?

Analysis

No. Even if XYZ Company executed the tax-planning strategy in a year during which it is projecting losses, the gain realized on the sale of the appreciated asset would not shift the Company into a profitable position. In the above case, based on (1) the entity’s history of losses, (2) an unproven new product line, and (3) the fact that the entity does not anticipate being profitable for at least three years, little weight can be assigned to the projection of profitability. Accordingly, there is no incremental tax benefit (at least for the foreseeable future), as the potential gain on the sale of the shopping mall

property would only reduce what otherwise would be a larger operating loss. Thus, it would not be appropriate to reduce the valuation allowance.

The consideration of future losses in Example TX 5-7 differs from the principle established in ASC 740-10-25-38, which notes that “the anticipation of the tax consequences of future tax losses is prohibited.” ASC 740-10-25-38 considers that a company anticipating losses for the foreseeable future might conclude that there is no need to record deferred tax liabilities because they might not represent an incremental increase to the company’s tax liability. However, the Board rejected this notion. In this context, future losses are considered as part of determining whether the implementation of the proposed tax-planning strategy will indeed provide a source of income for the realization of deferred tax assets. Future losses should also be considered when determining whether a tax-planning action will provide a source of income, as discussed further in Example TX 5-8.

It is important to differentiate tax-planning *actions* from tax-planning *strategies*. Tax-planning *actions* are typically contemplated in the ordinary course of business while tax-planning *strategies* are those that a company ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused. Tax-planning *actions* are reflected in estimates of future taxable income when scheduling or projecting income only if the entity is currently in a position to employ those actions and has already done so or will do so in the near-term. Therefore, the timing of the recognition of the effects of tax-planning actions is different than for tax-planning strategies, which are anticipated based on management’s intent and ability, if necessary.

Example TX 5-8 illustrates considerations when distinguishing between a tax-planning strategy and a tax-planning action.

EXAMPLE TX 5-8

Tax-planning action vs. tax-planning strategy

Company X acquires certain entities in Europe that have net deferred tax assets. In completing an evaluation of the recoverability of the net deferred tax assets and assessing the need for a valuation allowance, Company X considers the following:

- Company X is contemplating a new business model to create an operating platform that is substantially different from the current platform. The new platform would involve the creation of a new European headquarters to centralize many of the risks and functions currently borne by various entities. Aside from the European headquarters operation, the other European territories would be established as contract manufacturers. As a result of the new platform, income would be shifted to certain entities, which would allow Company X to take advantage of more favorable tax rates and may in some cases shift income to certain jurisdictions that currently generate net operating losses and require full valuation allowances.
- Company X has noted that combining two of its entities in Jurisdiction A for tax purposes would allow it to utilize all of its existing net operating losses.

Do either of the above considerations qualify as a tax-planning strategy as defined in ASC 740-10-30-19?

Analysis

The first scenario would not be considered a tax-planning strategy, but rather a tax-planning action, as the action is contemplated in the ordinary course of business and is a planned operational change in the company's underlying organization. In this case, it seems clear that the specific action is being undertaken for reasons that go well beyond realizing an existing tax attribute. The tax-planning action would be considered in the forecast at the time that it is completed, or when Company X commits to implementation in the near term with no significant uncertainties or contingencies.

The second scenario might qualify as a tax-planning strategy as the action is one that management would take in order to realize the benefit of its net operating losses prior to expiration.

The distinction between a tax-planning strategy and a tax-planning action is important because of how they are considered in valuation allowance assessments. It also dictates how the costs associated with each are handled. For purposes of determining the need for a valuation allowance, a tax-planning strategy can be anticipated and incorporated into future income projections. On the contrary, any potential future income from an anticipated tax-planning action ordinarily would not be included in projections until the company effects the action or commits to implementing the action in the near term because the impacts of the tax-planning action would not be objectively verifiable. However, in circumstances when the effects of the tax-planning action are objectively verifiable (i.e., no significant uncertainties or contingencies exist), the anticipated effects of such action would be included and incorporated into overall future income projections.

Pursuant to ASC 740-10-30-19, the costs of implementing a tax-planning strategy (net of any tax benefits associated with those expenses) would be netted when the company determined the amount of valuation allowance to be recorded. Conversely, the costs of implementing a tax-planning action are recognized when incurred as these costs are related to an action that a company may take in the ordinary course of business for reasons other than realization of tax attributes. See TX 5.6.5 for additional information on the cost of tax-planning strategies.

Determining whether a particular action can be considered a tax-planning strategy depends largely on the specific facts and circumstances and requires significant judgment. Sometimes companies may have a tax-planning strategy that is valid in one year that becomes invalid in a subsequent year. For example, assume a company concludes that a sale of its non-strategic investment in a parcel of appreciated real estate would generate a gain, and that the strategy meets the criteria in ASC 740-10-30-19. However, in a subsequent year, the parcel may become strategic due to the company considering expanding into the geography where the real estate is located. Alternatively, the value of the real estate may decline such that its sale would no longer generate a gain. Both of these circumstances (or others like them) could cause the tax-planning strategy to no longer meet the criteria in ASC 740-10-30-19. If the impact on the valuation allowance determination is significant, management should consider disclosing the nature of the change regarding the tax-planning strategy and its financial statement impact.

5.6.1 Requirement to consider tax-planning strategies

The consideration of tax-planning strategies is not elective when assessing the need for a valuation allowance. If there is an available tax-planning strategy that is prudent and feasible, it must be incorporated into the assessment unless the company's other sources of taxable income are sufficient to realize its DTAs. This requirement often leads to a question about the extent to which management must actively search for usable strategies.

Management should undertake a reasonable effort to identify prudent and feasible tax-planning strategies. If a tax-planning strategy is discovered in the current year that could have been considered in a prior year, it could raise a question about whether the prior year's financial statements were misstated. The FASB provides the following guidance with regard to the identification of tax-planning strategies:

ASC 740-10-55-41

Management should make a reasonable effort to identify those qualifying tax-planning strategies that are significant. Management's obligation to apply qualifying tax-planning strategies in determining the amount of valuation allowance required is the same as its obligation to apply the requirements of other Topics for financial accounting and reporting. However, if there is sufficient evidence that taxable income from one of the other sources of taxable income listed in paragraph 740-10-30-18 will be adequate to eliminate the need for any valuation allowance, a search for tax-planning strategies is not necessary.

Tax-planning strategies (1) may provide assurance of realization in a situation in which a valuation allowance otherwise might be necessary, and (2) may reduce the complexity of applying ASC 740 whether or not the tax-planning strategy is used or needed to avoid a valuation allowance. The latter purpose suggests that it is in management's best interests to identify tax-planning strategies, even beyond what is required as part of a valuation allowance assessment. For example, an entity could have a deferred tax liability in excess of the deferred tax assets recorded for a particular tax jurisdiction. However, it is not clear that the reversals of the taxable differences will offset the reversals of the deductible differences and carryforwards represented by the tax assets within the applicable carryback and carryforward periods. If future prospects are marginal, the entity may face a full-scale scheduling exercise to determine the extent to which reversing taxable differences will offset the deductible differences both as to amount and timing. But scheduling would be unnecessary if the entity has a valid tax-planning strategy that ensures that taxable income or deductions from reversals can be shifted among future years if any required future taxable income, other than reversals, is not generated, such that deductible differences and carryforwards will be offset by taxable differences.

5.6.2 Tax-planning strategies where carryforwards never expire

By definition, a tax-planning strategy is an action an entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused. The question then arises: if an NOL carryforward never expires, is it possible to consider tax-planning strategies as a source of taxable income to support realization of deferred tax assets?

Example TX 5-9 illustrates the general guidance related to tax-planning strategies in jurisdictions where NOL carryforwards never expire.

EXAMPLE TX 5-9

Tax-planning strategies in jurisdictions where NOL carryforwards never expire

As of December 31, 20X1, Company X has \$40 million of NOL carryforwards for which it has recorded \$10 million of deferred tax assets (i.e., a tax rate of 25%) and is evaluating the need for a valuation allowance. Company X has cumulative losses in recent years and cannot rely on projections of future taxable income. As a result, it is considering whether it can use tax-planning strategies as a source of taxable income.

The tax law in the jurisdiction in which Company X operates provides that NOL carryforwards do not expire. Company X has assets with an appreciated value of \$50 million (i.e., fair value of \$60 million and a book value of \$10 million) that are not integral to the business. Company X does not have intentions to sell the appreciated assets, but it has asserted that it would do so, if necessary, to realize the tax benefit of the NOL carryforwards.

In assessing the need for a valuation allowance, can Company X consider a tax-planning strategy of selling the appreciated assets as a possible source of taxable income available to realize a tax benefit for the NOL carryforwards?

Analysis

No. ASC 740-10-55-39(b) indicates that strategies that are expected to be employed for business or tax purposes, other than utilization of carryforwards that otherwise expire unused, are not tax-planning strategies as that term is used in ASC 740.

Accordingly, a company with operations in a jurisdiction in which NOLs do not expire cannot consider tax-planning strategies as a possible source of taxable income. Company X would not be precluded from considering the other possible sources of taxable income noted in ASC 740-10-30-18, including consideration of the impact of an objectively verifiable tax-planning action on future income projections (see Example TX 5-8). For example, if Company X had committed to a definitive plan to sell the appreciated assets such that the assets were classified as held-for-sale (rather than simply asserting that it would be willing to sell them, if needed), it would be able to consider the anticipated incremental income from the sale when assessing the need for a valuation allowance. However, Company X would have to consider whether the anticipated incremental taxable income from the sale of the appreciated assets would enable it to realize the NOL carryforwards, rather than simply reducing what otherwise would be a larger operating loss.

The conclusion in Example TX 5-9 may appear counterintuitive as the company has unrecognized appreciated assets that, if currently sold, would generate taxable income sufficient to realize the NOLs. However, ASC 740-10-30-23 requires any source of income to be weighted “commensurate with the extent to which it can be objectively verified.” As there is no expiration on the NOLs and no definitive plan to sell the appreciated assets, the ability to verify whether the taxable income associated with the appreciated assets is sufficient to realize the existing NOLs becomes challenging. For example, since there would be no separate tax motivation for selling the appreciated assets in the near term (i.e., no expiring attributes), it would be difficult to objectively verify the fact that the unrealized appreciation will be available at some point in the distant future when the assets are eventually sold.

5.6.3 Examples of common tax-planning strategies

Reporting entities employ a wide variety of tax-planning strategies, some more straightforward than others. The following list represents some common actions that may qualify as tax-planning strategies.

- Selling operating assets and simultaneously leasing them back for a long period of time
- Selling an appreciated asset that is not core to the business (TX 5.6.3.1)
- Filing a consolidated or combined tax return with a profitable entity

- Disposing of obsolete inventory that is reported at net realizable value in the financial statements
- Selling loans at their reported amount (i.e., net of an allowance for bad debts)
- Shifting an investment portfolio classified as available-for-sale or trading under ASC 320 from tax-exempt to taxable debt securities
- Changing from LIFO to some other method of accounting for inventories for tax purposes or deliberately reducing LIFO inventories to liquidate layers
- Electing out of the installment sales provisions for tax purposes

The following sections discuss specifics of tax-planning strategies related to the sale of appreciated assets.

5.6.3.1 Sales of appreciated assets

Reporting entities may consider the sale of appreciated assets in order to trigger taxable income equal to the appreciation on those assets. This is a potential tax-planning strategy. Because a valuation allowance assessment is based on the weight of available evidence, to be considered a tax-planning strategy, the appreciation would have to exist at the balance sheet date. If the sale would not be required until some future date, then there must be a reasonable basis for concluding that the appreciation would still exist.

Generally, an outright sale would have to be of assets that individually are not integral to the business (such as securities). Any outright sale of fixed assets used in operations entails economic considerations that go well beyond those typically involved in tax-planning strategies. Similarly, unrealized appreciation in intangibles generally cannot be severed from the business itself. Sales of these assets involve questions of whether the entity wants to remain in certain business lines, products, or marketing areas. In most cases, it would be difficult to make a realistic assessment about whether the outright sale of such assets would be prudent and feasible.

A sale of appreciated assets generally has an effect on taxable income beyond the sale date. For example, if appreciated debt securities are sold, interest income in future years will be reduced. Such impacts on future taxable income, other than reversals, should be considered.

Appreciated securities

The sale of appreciated debt securities classified as available-for-sale or trading could be considered an available tax-planning strategy. As discussed in ASC 320-10-25-5, planning to sell appreciated securities that are classified as held-to-maturity does not qualify as a tax-planning action or strategy because considering them available-for-sale would be inconsistent with the held-to-maturity designation.

The sale of appreciated securities classified as available-for-sale or trading should only be considered an available tax-planning strategy to the extent that a company is prepared to sell the debt securities in order to realize the gains and utilize related loss carryforwards before they expire. If a company is not willing or able to sell the debt securities and trigger the realized gains, it would not be appropriate to consider the potential sale as a tax-planning strategy. However, due to the presumed tax advantages of

utilizing carryforward attributes before they expire, it is essential to understand and document the business reasons for believing it would not be prudent or feasible to trigger the gains in such a case.

Tax-planning strategies involving available-for-sale or trading securities may impact both the timing and/or character of income. With respect to timing of income recognition, entities that have expiring attributes often will assert their ability and intent to sell appreciated securities, if necessary, to avoid the expiration of attributes, such as capital loss carryforwards. Entities also might assert their ability and intent to sell securities carried at an unrealized loss to take advantage of capital gains income that exists in the carryback period. Selling appreciated securities ensures that the deferred tax liability on the unrealized gains will serve as a source of income in the proper period to avoid the loss of the related attributes.

In either case, it is important that management perform a detailed-enough analysis to be able to conclude that sufficient income of the appropriate character will be generated (or exists in the carryback period). Management must also consider the sale of the securities to be prudent and feasible within the timeframe necessary to avoid the expiration of the attributes or the close of the carryback window.

US taxpayers and taxpayers in other jurisdictions with relatively short carryback provisions most likely will need to be ready to implement any strategy in the relative near term. Furthermore, because of the potential for volatility of market values of securities, expectations of invoking the strategy at a date in the distant future may not be appropriate. As a result, management should document and support its readiness and intent to sell securities and ensure this assertion is consistent with other financial statement assertions related to the securities (e.g., the determination of expected credit losses).

Available-for-sale debt securities with unrealized losses

ASC 740-10-25-20 indicates that there is an inherent assumption in a reporting entity's balance sheet that the reported amounts of assets will be recovered and liabilities settled. Based on that assumption, a decline in fair value of a debt security below its tax basis is presumed to result in a future tax deduction, even though a loss has not yet been realized for book or tax purposes. Along with any other deferred tax assets, the company must evaluate the available evidence to determine whether realization of that future tax deduction is more-likely-than-not. An initial step in this assessment process is to determine whether a deferred tax asset related to an unrealized loss on a debt security will reverse through (1) holding the security until it recovers in fair value or (2) through sale at a loss.

Hold to recovery

A company's assertion that it has the intent and ability to hold an available-for-sale debt security until it recovers in value (maturity, if necessary) will eventually result in recovery of the book basis of the security through collection of the contractual cash flows. While the recovery in book basis provides a source of future taxable income to be considered in the overall assessment of the need for a valuation allowance against the company's deferred tax assets, this source of taxable income should not be viewed in isolation. In other words, to the extent that the expected recovery in book value of the available-for-sale debt security, in conjunction with other projected sources of income, is expected to result in positive future income for the company as a whole, such income may be used to support realization of deferred tax assets.

If there is significant negative evidence, such as cumulative losses in recent years or an expectation of additional near-term losses, taxable income implicit in the expected recovery of the book basis of the

available-for-sale security may only serve to reduce future losses of the company. In such circumstances, the expected appreciation would not provide support for the realization of deferred tax assets because there would be no incremental future tax benefit to the company. This would be the case even though the deductible temporary difference related to the available-for-sale debt security is expected to reverse as the respective book and tax bases of the investment converge upon maturity of the security.

Companies cannot avoid a valuation allowance unless there is evidence that the benefit of the deferred tax asset will be realized as a result of future taxable income (or one of the other potential sources identified in ASC 740-10-30-18). It is not sufficient to merely project that the deductible temporary difference will reverse.

Sale at a loss

A sale of a depreciated debt security would result in a tax loss that is capital in nature. Avoiding a valuation allowance in that case may depend on having sufficient taxable income of the appropriate character (i.e., capital gains instead of ordinary income). Holding the security until maturity (or until the unrealized loss is eliminated) would effectively eliminate the need to consider whether there are sources of capital gains to offset the potential capital loss implicit in the temporary difference. Therefore, the positive assertion of the intent and ability to hold the available-for-sale debt security until it recovers in value would alleviate the “character of income” concern for such a company. If such an assertion cannot be made, however, the company must look to available sources of capital gains for recovery of the deferred tax asset.

Although asserting the ability to hold a security until it recovers in value (maturity, if necessary) may appear, on the surface, to be contrary to the available-for-sale classification under ASC 320, we do not believe that the two positions are incompatible. Classifying a security as held-to-maturity under ASC 320 requires a positive assertion of intent and ability to hold the security *to maturity*. However, an entity must only be able to assert that it has the intent and ability to hold a debt security *to maturity, if necessary to recover its value*, to consider the expected recovery in book value as a source of future taxable income.

When a debt security is classified as available-for-sale, but management asserts that it will hold the asset until it recovers in value, we believe that the reversal pattern of the temporary difference would be determined as if the security would be carried at amortized cost in the future for book purposes using the balance-sheet-date market value as amortized cost at that date. The reversal in each future year would be determined as the difference between the recovery of book basis and the recovery of tax basis assigned to that year under the method—loan amortization or present value—that has been elected for the category of temporary differences in which the security is included. The loan amortization method and the present value method are illustrated in Example TX 5-19.

Question TX 5-1 addresses whether a company that has debt securities with unrealized gains and debt securities with unrealized losses must consider the debt securities and their related temporary differences together (net) when assessing whether a valuation allowance is necessary for any of its deferred tax assets.

Question TX 5-1

A company has debt securities with unrealized gains and debt securities with unrealized losses. For purposes of assessing whether a valuation allowance is necessary for any of its deferred tax assets (not just those related to the debt securities with unrealized losses), must the debt securities and their related temporary differences be considered together (net)?

PwC response

No. A company may assert that it will hold the debt securities with unrealized losses until they recover in value (maturity, if necessary), meaning that the deferred tax asset associated with those debt securities would reverse over time, and the related income would be ordinary in character. At the same time, it could assert that it would sell the debt securities with unrealized gains (e.g., as a tax-planning strategy) in order to generate capital gains income and prevent any existing capital loss tax attributes from expiring. If the company has no capital loss tax attributes, then assessing the debt securities with unrealized losses separate from the debt securities with unrealized gains has no practical benefit or accounting impact.

Question TX 5-2 addresses considerations when a company asserts that it will hold debt securities with unrealized losses until they recover and subsequently sells a debt security for a gain.

Question TX 5-2

A reporting entity has debt securities with unrealized losses, and asserts that it will hold the securities until they recover (maturity, if necessary). In the following year, some of the securities are now in an unrealized gain position, while others are still in an unrealized loss position. If the entity sells any of the securities, would that be problematic due to its assertion that it would hold them until recovery (maturity, if necessary)?

PwC response

If the entity sells securities that are still in an unrealized loss position, the action would potentially be inconsistent with an assertion to hold to recovery. However, because management's assertion is to hold the security until it recovers in value, sale of an available-for-sale security that is in an unrealized gain position would not be inconsistent with this assertion.

5.6.4 Noneconomic tax-planning strategies

Certain tax-planning strategies may provide a source of income for the apparent recognition of deferred tax assets in one jurisdiction, but not provide incremental tax savings to the consolidated entity. In order to avoid a valuation allowance by relying on a tax-planning strategy, we believe the tax-planning strategy generally must provide cash savings to the consolidated entity. To the extent that the only benefit a proposed tax-planning strategy provides is a financial reporting one (i.e., the avoidance of the need to record a valuation allowance), we do not believe it constitutes "realization" of the deferred tax asset.

Example TX 5-10 demonstrates the concept of a noneconomic tax-planning strategy.

EXAMPLE TX 5-10

Noneconomic tax-planning strategies

Company A operates in Jurisdictions A and B. Due to poor sales in Jurisdiction A, Company A has incurred losses resulting in significant NOL carryforwards. Its operations in Jurisdiction B have historically been profitable, but due to the specifics of the local tax law, no tax is due on that income.

For financial reporting purposes, Company A has a deferred tax asset for the NOL sustained in Jurisdiction A. In order to realize the deferred tax asset, and avoid the need for a valuation allowance, Company A has proposed to move income from Jurisdiction B to Jurisdiction A.

Does this represent a valid tax-planning strategy?

Analysis

No. The proposed tax-planning strategy does not provide any incremental tax benefit to Company A, as the same amount of tax would be due to taxing authorities (on a consolidated basis) before and after consideration of the tax-planning strategy (i.e., zero tax rate in Jurisdiction B versus no taxable income in Jurisdiction A after consideration of the NOL carryforward). The only “benefit” achieved is a potential financial reporting benefit for the recording of an asset that in actuality would ultimately provide no incremental benefit to Company A. In addition, without a valid business purpose, this action would cause Company A to pay taxes once it utilized all of its NOL carryforwards in Jurisdiction A. It would likely be difficult for management to therefore conclude that this strategy would be prudent.

If Company A intends to move income from Jurisdiction B to Jurisdiction A for a valid business purpose, and would continue to subject that income to tax after the losses are fully utilized, it may be appropriate to treat the movement of income as a tax-planning action and incorporate the effects in the projection of future taxable income.

Example TX 5-11 discusses how to assess a tax-planning strategy to combine a profitable company with an unprofitable company.

EXAMPLE TX 5-11

Assessing a tax-planning strategy to combine a profitable and an unprofitable company

Company X, a US company, has a wholly-owned holding company that, in turn, owns 100% of an operating company. The holding company and the operating company are in the same foreign jurisdiction but file separate returns. Historically, the holding company has generated losses (primarily due to interest expense from intercompany loans) and has significant NOL carryforwards. The operating company has generated profits in the past, which are expected to continue for the foreseeable future. In addition, the operating company has been benefiting from a tax holiday (i.e., a period of not paying taxes) for the past 15 years and expects the tax holiday to continue for the foreseeable future.

In assessing the need for a valuation allowance on the deferred tax asset arising from the NOLs, Company X considers a tax-planning strategy that would merge the two companies. It is projected that the combined company would be profitable and therefore would utilize the holding company’s NOLs.

However, the merger would violate the conditions of the tax holiday, and the combined entity would become subject to the normal income tax rate.

Would the combination of the two companies be considered a prudent and feasible tax-planning strategy under ASC 740-10-30-19?

Analysis

No. Implementing the strategy might be feasible, but neither the holding company nor the operating company currently pay cash taxes. If the two companies were to merge, the tax holiday would be forfeited, and the combined company would be in a tax-paying position after using the NOLs. Since the tax-planning strategy is economically detrimental to Company X, it would not satisfy the requirement to be prudent in order to qualify as a tax-planning strategy.

5.6.5 Costs to implement a tax-planning strategy

The tax benefit recognized for a tax-planning strategy would be net of any expense or loss to be incurred in implementing the strategy. ASC 740-10-55-159 through ASC 740-10-55-162 provide an example of how implementation costs impact the valuation allowance.

If and when the tax-planning strategy actually is triggered and any related professional fees or other expenses are incurred, they should not be presented as components of income tax expense. This is the case even though such expenses would have been estimated for purposes of reducing the amount of tax benefit realizable as a result of the potential tax-planning strategy.

Certain tax-planning strategies involve an intra-entity asset transfer from a higher tax-rate jurisdiction where the entity currently does not pay taxes as a result of losses to a lower tax-rate jurisdiction where the entity does pay taxes. In such circumstances, as illustrated in Example TX 5-12, the tax benefit of the tax-planning strategy is measured at the lower tax rate. The tax rate differential effectively is a cost associated with implementing the strategy.

EXAMPLE TX 5-12

Measuring the benefit of a cross-jurisdiction tax-planning strategy

Company A currently has a full valuation allowance recorded against its net deferred tax asset, which is comprised primarily of expiring NOL carryforwards. Company A currently owns intellectual property (IP) in Jurisdiction A that is used by its foreign subsidiary and that is expected to generate taxable income. Company A has incurred operating losses for several years in Jurisdiction A and has significant negative evidence; however, its foreign subsidiary has been generating profits and paying foreign income taxes, albeit at a lower tax rate.

Company A has a tax-planning strategy to sell the rights to this IP to the subsidiary. The value of the IP approximates the amount of Company A's NOLs. Therefore, the utilization of the NOL carryforwards would offset Company A's tax gain on the sale. In effect, the tax benefit related to the NOLs will be realized through increased tax amortization on the transferred IP asset that reduces tax payments in the foreign jurisdiction. In this regard, management determines it is more-likely-than-not that the foreign subsidiary will be profitable in future years at a level sufficient to utilize the amortization as tax deductions to reduce taxable income.

Management also concludes that the tax-planning strategy appears to meet the prudent and feasible criteria stipulated by ASC 740-10-30-19 since the subsidiary is paying taxes and could benefit from the tax amortization on the stepped-up IP tax basis.

How should the effects of the tax-planning strategy be measured? What should the accounting be if the strategy is actually implemented in a subsequent period?

Analysis

In our view, the amount of the valuation allowance that should be reversed is equal to the amount of benefit that ultimately would be received in the subsidiary's jurisdiction, which should be measured at the subsidiary's tax rate. For example, assume that the tax rate in Jurisdiction A is 25% and the tax rate in the subsidiary's jurisdiction is 15%. As the tax benefit in the IP sale strategy ultimately will be realized at a 15% tax rate, the amount of US deferred tax asset that does not require a valuation allowance as a result of the tax-planning strategy equals the gain multiplied by the 15% tax rate in the buyer's jurisdiction. If Jurisdiction A's deferred tax asset was based on \$100 of NOLs, which corresponds to a resulting deferred tax asset of \$25, the portion of the deferred tax asset that is expected to be realized under the strategy would be measured at a 15% tax rate. Therefore, \$15 of the \$25 valuation allowance should be reversed and a \$10 valuation allowance should remain, absent any other source of future taxable income.

If in a subsequent period, Company A actually implements the tax-planning strategy, the net income statement impact in consolidation would be zero. Jurisdiction A would recognize \$15 of net tax expense on the gain on sale, and the buyer's jurisdiction would recognize a net tax benefit of \$15 from recording a deferred tax asset for the tax-over-book basis of the IP.

If the facts were different, and there was not objective and verifiable evidence of future taxable income in the subsidiary's jurisdiction, this tax-planning strategy would not result in the realization of deferred tax assets, and the valuation allowance should not be released. Simply transferring the IP and utilizing NOLs that have a full valuation allowance does not result in a realizable benefit if the IP is transferred to another jurisdiction and its new tax basis does not result in an incremental tax benefit to Company A.

5.6.6 Examples of actions that are not tax-planning strategies

There are certain actions that companies sometimes undertake that generally do not qualify as tax-planning strategies. Some examples include:

- Selling certain operating assets that are important to future operations, such as trademarks or patents
- Excluding a loss subsidiary from tax consolidation
- Acquiring a profitable entity (see TX 5.6.6.1)
- Disposing of a subsidiary that is not profitable (could be an action)
- Initiatives that reduce costs in order to increase the entity's profitability (could be an action)

- Changing an entity's tax status (the effect of a change in tax status is reflected on the approval date, or on the filing date if approval is not necessary, and is considered a discrete event)
- Moving income from a nontax jurisdiction to a taxable one solely to realize net operating loss carryforwards (see Example TX 5-10)

5.6.6.1 Valuation allowance impact of acquiring a profitable entity

Acquiring a profitable business may provide a source of income that would result in realization of a deferred tax asset. However, we do not believe that a proposed business combination can be anticipated. As discussed at TX 5.2.1, transactions that are inherently outside the company's control and fundamental to its organizational structure are not considered in the valuation allowance assessment until they have been completed, consistent with many other areas of GAAP.

5.6.7 Issues in evaluating tax-planning strategies

There are additional considerations that may complicate management's evaluation of possible tax-planning strategies.

5.6.7.1 Time value of money consideration in tax-planning strategies

Although ASC 740 precludes discounting deferred taxes, the time value of money may need to be considered in assessing whether a tax-planning strategy is prudent. For instance, scheduling should not reflect forgoing a carryback that would maximize a deferred tax asset (and thus delay the receipt of cash) if it is not reasonable to expect that the entity actually would take such an action given the time value of money. ASC 740-10-55-43 through ASC 740-10-55-44 gives an example of a tax-planning strategy to sell installment sales receivables to accelerate the reversal of the related taxable temporary differences. If a higher rate of interest would be earned on the installment sales receivables than could be earned on an alternative investment, the interest rate differential—the reduction in future interest income—must be considered in determining whether the strategy would be prudent. If, after considering the time value of money, a tax-planning strategy is deemed to be prudent, the loss of future interest income is not considered a cost of the tax-planning strategy.

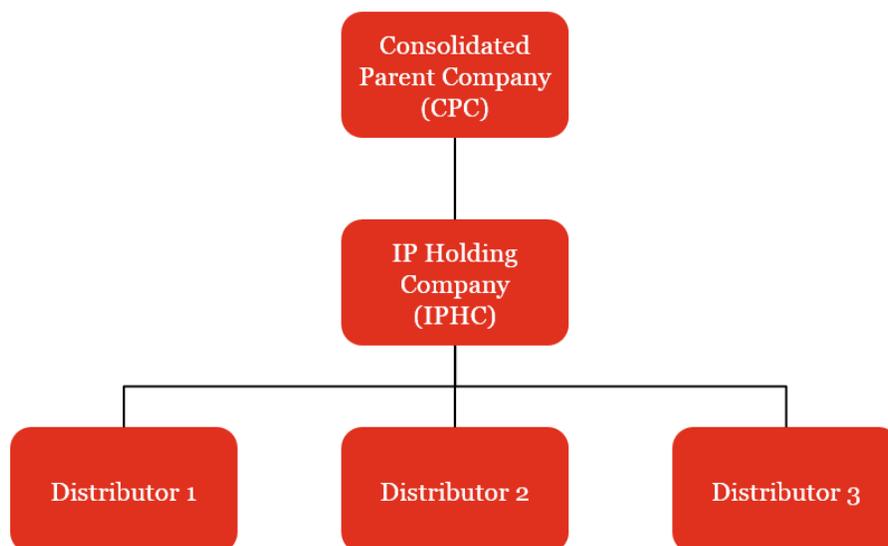
5.6.7.2 Evaluation of strategies—consolidated vs. subsidiary

It is important to evaluate tax-planning strategies for a subsidiary in the context of the consolidated group's tax-planning objectives. Management of the subsidiary may not be in a position to be able to fully assess whether the strategy is prudent and feasible. A strategy that may seem prudent and feasible to management of the subsidiary may not be prudent and feasible in the context of the worldwide objectives. The parent company may have business plans for the subsidiary (e.g., discontinuances of certain product lines, relocation of certain functions to other countries or other subsidiaries, acquisition or other commencement of new operations that will be placed in the subsidiary) to which management of the subsidiary is not privy. It also may be necessary to obtain documentation from the parent company to support tax-planning strategies that have effects on other entities within the consolidated group to ascertain feasibility and prudence.

Valuation allowance assessments generally should occur at the individual taxpaying component level (e.g., each subsidiary/jurisdiction in the consolidated financial statements). However, the assessment should also consider the evidence in the context of the consolidated entity. Example TX 5-13 demonstrates this concept.

EXAMPLE TX 5-13**Assessing realizability of deferred tax assets at a subsidiary in a consolidated group**

Distributor 1 is a subsidiary in a consolidated entity as shown in the following diagram.



Distributor 1 is a separate legal entity in a separate tax jurisdiction and prepares a standalone tax return. Distributor 1 has a three-year cumulative loss, has no carrybacks or carryforwards to use, has no available tax-planning strategies, and future reversals of existing taxable temporary differences would not be sufficient to realize its deferred tax assets. However, due to a restructured transfer pricing arrangement with IPHC, Distributor 1 is to be compensated with a 3% profit on its net sales, and is therefore forecasting future taxable income for the foreseeable future.

What factors should the consolidated parent company consider when assessing the need for a valuation allowance on Distributor 1's deferred tax assets?

Analysis

Generally, the assessment of the need for a valuation allowance for Distributor 1 should be based on its individual facts and circumstances (not those of the consolidated group). The primary positive evidence for Distributor 1 is its forecast for future taxable income, which is supported by historical sales results as well as the existence of the transfer pricing arrangement with IPHC. Assuming the forecasted future taxable income is sufficient to realize the existing deferred tax assets, it would seem that the parent company could conclude that Distributor 1 does not need a valuation allowance.

This example involves a situation where the restructured transfer pricing arrangement has already been executed and therefore should be considered in the valuation allowance analysis. If the facts were different and the company were assessing the appropriateness of a tax-planning strategy based on an anticipated plan to enact a transfer pricing agreement that has yet to occur, the company would need to assess the criteria in ASC 740-10-30-19 to determine if the strategy may be used to support realization of its deferred tax assets. If the anticipated transfer pricing arrangement only serves to

create losses in IPHC for which no tax benefit can be recognized, such an arrangement would not result in realization of Distributor 1's deferred tax assets.

5.6.7.3 *Consistent use in different jurisdictions*

Tax-planning strategies that assume transactions affecting the timing of deductions and taxable income must be reflected consistently across all entities (e.g., parent entity and its subsidiaries) and jurisdictions (e.g., federal and state) affected by the strategies. It is possible that actions or strategies that reduce taxes in one jurisdiction will increase taxes in another. Of course, when inconsistent tax elections are allowed in different tax jurisdictions (e.g., whether to file consolidated or separate returns), it may be appropriate to use different elections.

5.7 *Projections of future taxable income*

To the extent realization is not assured by carryback, reversals of taxable temporary differences, or tax-planning strategies, projections of future taxable income will be necessary. Companies sometimes question whether the focus should be on future taxable income or future pretax book income. Although the realization of tax benefits ultimately depends on the availability of taxable income, in general, forecasts of future pretax book income (adjusted for permanent differences) should be used when assessing the realizability of deferred tax assets. This is because over the remaining lifespan of the entity, future taxable income will, in the aggregate, equal future pretax book income adjusted for permanent differences. Estimates of future taxable income may be particularly relevant when evaluating realizability of tax carryforwards or other attributes subject to a relatively short remaining carryforward period.

In projecting future income, all available information should be considered. This includes operating results and trends in recent years, internal budgets and forecasts, and anticipated changes in the business. Generally, the most recent results should be considered indicative of future results, absent evidence to the contrary.

Question TX 5-3 addresses valuation allowance considerations when a company can objectively demonstrate that it will have taxable income that will allow for utilization of tax credits in an upcoming year but the entity is projecting book losses for the foreseeable future.

Question TX 5-3

An entity is projecting book losses for the foreseeable future, but can objectively demonstrate that it will have taxable income in an upcoming year that would fully utilize the tax credits it has generated before they expire. Should it record a valuation allowance on the tax credits?

PwC response

No. The company should undertake an analysis that is similar to a scheduling exercise to determine whether the credit carryforward will result in incremental tax savings. If the conclusion is that the tax credit will reduce overall taxes paid, then it will be realized and should not attract a valuation allowance, despite the fact that the entity is projecting future book losses.

5.7.1 Assessment of appropriate outlook period

While it is difficult to generalize, once an entity concludes that positive evidence outweighs negative evidence so that some or all of a valuation allowance can be released, we would not normally expect the release of the valuation allowance to occur over a number of successive years. A particular concern arises when an entity that has returned to profitability reflects no tax provision or benefit, net of valuation allowance release, for a length of time.

In this regard, the SEC staff has questioned the retention of a valuation allowance when it appears to be overly conservative and when it may suggest earnings management (i.e., “selecting” the future period(s) in which to release the valuation allowance by modifying assumptions that are not objectively verifiable).

We have observed that companies sometimes limit the estimate of future income used in determining the valuation allowance to a relatively short time horizon, such as projecting out the same number of years as the entity has been profitable, or projecting out for the same period (e.g., three years) that the company uses for internal budgetary purposes. Except in certain rare situations based on the individual facts and circumstances, we generally do not believe that such an approach is appropriate. Mere uncertainty about the sustainability of taxable income due to general business and macro-economic risk factors is not a valid reason to use a short-term outlook. This is because the use of projections based on a relatively short timeframe fails to consider all available evidence.

As a general rule, the appropriate place to consider the inherent risk of future operations is in the quantification of earnings from core operations or in the development of projections, not through excluding consideration of potential positive evidence that may be present in later years. Because of the inherently arbitrary nature of truncating projections of future taxable income after a specific short-term period, the use of this approach may be challenged and would need to be appropriately supported with specific facts and circumstances. Assuming such a short-term outlook approach was deemed appropriate, it would generally be acceptable only for a short timeframe. If the entity continued to meet or exceed projections, this myopic outlook would no longer be appropriate.

5.7.2 Consistency of projections with other accounting estimates

As a starting point, the projections used for valuation allowance assessments should generally be consistent with other projections or estimates used in the preparation of the financial statements and in other filing disclosures (e.g., impairment tests under ASC 360, *Property, Plant and Equipment* or ASC 350, *Intangibles—Goodwill and Other*). This is particularly true when a company does not have cumulative losses in recent years or has returned to sustained profitability. In such cases, the SEC staff has challenged registrants that have used a short-term outlook when assessing the realizability of their deferred tax assets, but have used longer-term forecasts to support the carrying value or amortization periods of long-lived assets.

On the other hand, if a company has cumulative losses in recent years, it is generally appropriate to adjust the projections used in the valuation allowance analysis to a level that is objectively verifiable. Most recent historic results are generally considered to be the most objectively verifiable; although under circumstances in which sufficient evidence exists, it may be appropriate to consider earnings from core operations. The impairment models for long-lived assets generally consider management’s best estimates of future results, while ASC 740-10-30-23 requires the evidence considered in a valuation allowance assessment to be “weighted” based on the extent it can be objectively verified. Therefore, projections of taxable income (which are inherently subjective) generally will not carry

sufficient weight to overcome the objective negative evidence of cumulative losses unless they are adjusted to a level that is objectively verifiable.

In either case, if a company uses assumptions in its valuation allowance assessment that are not consistent with other projections or estimates used in the preparation of its financial statements (or other disclosures), it should be prepared to explain and provide support for any such differences.

5.7.3 Projecting future pretax book income

In general, once the results of scheduling reflect the temporary difference reversals in the years they are expected to take place, future taxable income amounts for each year should be scheduled to determine the net taxable result for each future year.

The following are guidelines for projecting future earnings for purposes of the valuation allowance assessment:

- It is generally presumed that an entity with cumulative profits in recent years (or that is in a cumulative loss situation, but has demonstrated a return to sustainable profitability) will remain profitable unless there is objectively verifiable evidence to the contrary.
- The starting point for the projection should be the amount and trend of book income (i.e., pretax income adjusted for permanent items) during the past year because this evidence is typically the most objective indicator available.
- While projections of future income should be consistent with historical results, it is sometimes necessary to “adjust” the historical earnings for unusual items (both positive and negative), the effects of purchase accounting, or changes in capital structure. The goal of these adjustments would be to determine the existence of earnings from core operations that have been demonstrated in the past and that would be reasonable to assume for the future. For example, if the proceeds of a recent public offering were used to pay down debt, the interest expense in periods prior to the offering should be adjusted to arrive at historical earnings from core operations, which forms the starting point for projections of future periods. Likewise, if the company was recently acquired and is now heavily leveraged, the impact of the higher interest expense costs should be considered when assessing earnings from core operations in the prior periods.
- Favorable improvements in profitability based on items such as built-in growth rates and “synergistic” effects of recently completed acquisitions should be approached with a high degree of skepticism. Since growth rates and the effects of acquisitions are inherently difficult to objectively verify, generally very little weight can be given to their effects until demonstrated.

Question TX 5-4 considers whether future disqualifying dispositions of incentive stock options should be assumed when forecasting taxable income for purposes of assessing the need for a valuation allowance.

Question TX 5-4

Incentive stock options (ISOs) normally do not result in a tax deduction for the company that issued them. However, if the ISOs are exercised before a minimum holding period (known as a “disqualifying disposition”), they do provide a tax deduction to the company. If a company has a history of ISO disqualifying dispositions, should it assume future disqualifying dispositions when forecasting taxable income for purposes of assessing the need for a valuation allowance?

PwC response

When the realizability of deferred tax assets is based on projections of future taxable income, which incorporate a number of assumptions regarding the future, it may be appropriate to consider a consistent past history of significant disqualifying dispositions of ISOs in the projections of future taxable income. On the surface, this view may seem contrary to ASC 718-740-25-3, which states “[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.” However, the purpose of that guidance was to clarify that a deferred tax asset should not be recognized for an award that, by its terms, does not provide the company with a tax deduction. Circumstances that may make it appropriate to consider the effects of future disqualifying dispositions include, but are not limited to, a consistent history of disqualifying dispositions or expectations of unusually large disqualifying dispositions.

Similar in concept, we believe that it is inappropriate to ignore anticipated future excess tax deductions (so-called windfall tax benefits) from other stock-based awards when forecasting taxable income for purposes of assessing realizability of deferred tax assets. This is particularly true when the windfalls are expected in the near term and the underlying assumptions (i.e., market price of the stock relative to exercise price) are objectively verifiable. Refer to TX 17.14 for further guidance on the interplay of stock compensation and valuation allowances.

5.7.3.1 Earnings from core operations

A projection of future taxable income is inherently subjective and therefore carries less weight than the objective evidence presented by cumulative losses in recent years. As such, projected future taxable income, absent a history of strong earnings from core operations, generally will not be sufficient to overcome negative evidence that includes cumulative losses in recent years. On the other hand, an expectation of future taxable income supported by a recent history of strong earnings from core operations is an example of positive evidence under ASC 740 that may support a conclusion that a valuation allowance is not needed. Generally, the most recent results should be considered indicative of future results, unless there are certain aberrational items in the recent results that should be considered when determining projected future taxable income, such as the effects of purchase accounting or changes in capital structure.

Management should challenge themselves when evaluating whether items are truly aberrational and should therefore be excluded from a company’s analysis of earnings from core operations. In general, it is often difficult to obtain objectively verifiable evidence that such items are, in fact, aberrational. Management’s expectation—without sufficient corroborating evidence—is not enough to assert that items are aberrational. Also, it is often difficult to justify the exclusion of nonrecurring, unusual, or infrequent items because items of a similar nature may have occurred in the past or may be expected to occur in the future.

For an entity that has demonstrated earnings from core operations, we believe prospects for the near term are important, as they are likely to represent more objective positive evidence when compared with potential negative evidence based on business or macro-environmental risk factors that are not objectively verifiable. In addition to a baseline of current operating results, the projections should consider factors such as any demonstrated cyclical aspects of the entity's industry and the entity's stage of development. Management must exercise judgment when determining how detailed or formalized projections should be to assess the objective verifiability of the end result. The weight given to the forecast will be dependent on the extent to which the major assumptions can be objectively or independently supported, and the entity's previously demonstrated ability to accurately budget and project future results. Refer to TX 5.2.4.3 for illustrative examples of positive evidence related to earnings from core operations.

Example TX 5-14 demonstrates the concept of assessing earnings from core operations.

EXAMPLE TX 5-14

Assessing earnings from core operations

During the current year, Company A partially repaid its outstanding debt balance which will eliminate a portion of future interest expense. In assessing the realizability of its deferred tax assets, should Company A make any adjustments to its most recent results when estimating future taxable income?

Analysis

It may be appropriate to adjust for certain items to determine the existence of earnings from core operations that have been demonstrated in the past and that would be reasonable to assume in the future. In this situation, Company A has partially paid down its debt which will reduce the amount of interest expense that has historically been included in its financial results. As such, it would be appropriate to adjust the historical earnings for the interest expense that will no longer recur as part of determining earnings from core operations for purposes of forecasting future taxable income.

This example illustrates a straightforward adjustment when using the most recent results as the baseline for projecting future taxable income. Many items, however, will require significant judgment in determining whether the impact should be adjusted for when determining future taxable income. For example, if Company A also had a significant legal settlement during the year or recorded a significant asset impairment, it would have to carefully assess whether it is appropriate to adjust historical results for these items when determining future taxable income. This assessment would include considering, for example, whether there is a recent history of similar events occurring (even if for different reasons) and the possibility that they may occur in the future (e.g., an impaired asset has significant remaining carrying value after the impairment). It is generally not appropriate to adjust for nonrecurring items when it is likely that items of a similar nature will occur in the future.

5.7.3.2 Evaluating the effect of a restructuring

When an entity is determining whether positive evidence outweighs negative evidence in forming a conclusion that a valuation allowance is not needed, it may be appropriate for the effect of a restructuring (i.e., an implemented plan to exit an activity) to be considered. In evaluating assumptions that decrease historical costs, it would not be appropriate to consider the effect of cost-cutting measures until they have been successfully implemented. These measures are likely to impact

the historical earnings trend in two ways. First, these measures usually require an earnings charge at the time they are implemented, which may not recur in the future. Second, they should result in a reduction of ongoing operating costs.

To the extent that the reduction in costs associated with the restructuring measures can be “objectively verified,” it is appropriate for an entity to consider those reductions in future projections as positive evidence when assessing the need for a valuation allowance. However, the effects that these cost-cutting measures may have on revenues and profitability also should be considered carefully (e.g., a significant reduction in sales force generally would correlate to a loss of sales volume). In contrast, if the strategy is to implement an exit plan at some future date, that would be difficult to objectively verify because it is a future event.

An entity with significant negative evidence, such as a history of recent losses, normally will find it very difficult to demonstrate that even an implemented exit plan provides sufficient objective evidence that the entity will be restored to profitability until it actually becomes profitable.

5.7.3.3 *Originating temporary differences in future projections*

In concept, future taxable income (other than reversals) includes the effect of future originating temporary differences for assets in place, as well as their reversals. It also includes the origination and reversals for depreciable or amortizable assets to be acquired in the future. Thus, future taxable income embraces not only future book income and future permanent differences, but also temporary differences other than reversals of those existing at the balance sheet date. Estimating future originations and their reversals on a year-by-year basis generally would be quite an exhaustive exercise, and one that could not be very precise.

However, shortcuts may be employed. For example, the net amount of recurring temporary differences may be expected to remain at approximately the same level at each future balance sheet date (i.e., new originations may be assumed to replace reversals each year). The year-by-year effect of future originating differences could be approximated at an amount equal to reversals of existing temporary differences. The net originations would be deductible if the net reversals were taxable, and vice versa.

However, shortcut approaches must be used with care. Originating deductible differences may provide the taxable income that “uses” reversing deductible differences, but at the same time they will create new deductible differences, which will reverse in later future periods. For example, an originating deductible difference for accrued vacation increases taxable income in the year of accrual but when the vacation is taken or paid, the temporary difference will reverse and will decrease taxable income in a future period. Consistent with ASC 740-10-55-37, we do not believe that a tax benefit is realized from the reversals of existing deductible differences if they are only replaced by new deductible differences that will not be realized. Thus, inclusion of taxable income from originating differences in the scheduling may require companies to consider whether the deductible differences they create will be realized. This could extend the analysis further and further into the future. Ultimately, there must be future pretax income after considering permanent differences to realize the benefit of the existing deductible differences.

Because of the imprecise nature of the estimates of future taxable income other than reversals, we believe that specific consideration of future originations of temporary differences is generally not warranted. Rather, estimates of future pretax book income, adjusted for future permanent differences that are expected to be significant, usually will suffice as a surrogate for future taxable income. However, the actual timing of deductions and taxable income is relevant under the tax law and must

be considered in applying ASC 740. Thus, care should be taken to ensure that large net originations that might alter the analysis are not likely to occur before skipping specific consideration of future originations of temporary differences for purposes of assessing the need for a valuation allowance.

5.7.3.4 Interaction of BEAT and the valuation allowance assessment

FASB Staff Q&A #4 on base erosion and anti-abuse tax (BEAT) states that companies should account for BEAT as a period cost – that is, a company should not consider BEAT in the measurement of deferred taxes. The FASB staff Q&A document also notes that “[t]he 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.”

Although FASB Staff Q&A #4 indicates that companies would not *need* to evaluate the effect of the interaction of BEAT with the realizability of its deferred tax assets, we believe that companies may elect to do so. A company may choose to consider the effect of BEAT on realizability in order to avoid an abnormally high effective tax rate in a future year when a deferred tax asset is consumed in the regular tax calculation but a BEAT liability exists such that no benefit (or a reduced benefit) is realized from the deferred tax asset.

If companies elect to consider the impact of BEAT in assessing the realizability of their deferred tax assets, we believe one reasonable approach would be to consider the expected benefit of an NOL on a “with-and-without” basis. This approach would compare estimates of the total tax due considering utilization of NOLs (the “with” calculation) to an estimate in which the NOL does not exist (the “without” calculation). A valuation allowance would be recorded for the difference between these two amounts.

By necessity, this approach will require scheduling both future taxable income and future estimated BEAT payments. These projections would then need to be updated each period to reflect current projections.

5.7.3.5 Interaction of GILTI and the valuation allowance assessment

A company may have NOLs and expect future global intangible low-taxed income (GILTI) inclusions. The GILTI inclusion will utilize the NOL. However, absent any NOLs, the GILTI inclusion would not have resulted in a cash tax payment due to availability of GILTI foreign tax credits and the Section 250 deduction. Thus, the use of NOLs does not provide an incremental cash tax savings.

We believe there are two acceptable views for considering the impact of GILTI on the assessment of the realizability of deferred tax assets.

Incremental cash tax savings approach - A company should look to whether the NOL reduces expected cash taxes payable to determine whether the related deferred tax asset is expected to be realized. A company may use a with-and-without approach that compares (1) what it expects its incremental cash taxes to be with the NOL and (2) what its incremental cash taxes would be without the NOL. A valuation allowance would be recorded for the difference (i.e., the extent to which the NOL does not provide an incremental benefit).

Tax law ordering approach - A company should look to tax law ordering to determine whether the existing NOL deferred tax asset is expected to be realized. NOLs have the potential to reduce or even fully eliminate the Section 250 deduction and foreign tax credit (FTC) benefits otherwise available with respect to GILTI inclusions. Based on the tax law ordering approach, NOL carryforwards are realizable if they will reduce the expected tax liability when utilized. Under this view, the fact that a company will be unable to utilize the future (and as yet unrecognized) Section 250 deductions or related FTCs that may otherwise have been available in the absence of the NOL carryforward is irrelevant. A valuation allowance should only be recorded to the extent future taxable income, inclusive of GILTI, does not support utilization of existing deferred tax assets.

For entities that have elected to recognize deferred taxes for basis differences that are expected to reverse as GLTI in future years, the policy choice for assessment of the valuation allowance and the measurement of deferred taxes should be consistent (see TX 11.10.3.1).

5.7.3.6 Additional considerations for valuation allowances

There are certain additional considerations that reporting entities should take into account when projecting future taxable income. These include the unique treatment of certain deferred tax assets and group relief considerations.

Loss carryforwards that do not expire

An unlimited carryforward period does not necessarily ensure realization, which is ultimately dependent on future income. Projections of future taxable income must consider all years that may provide a source of taxable income for the realization of deferred tax assets. The requirement that projections of future taxable income be objectively verifiable does not change when there is an unlimited carryforward period. In jurisdictions where an unlimited carryforward period exists and an entity has objectively demonstrated, or returned to, a level of profitability considered sustainable, it is often difficult to identify and objectively verify any negative evidence that would outweigh that positive evidence.

As a result, even though realization of deferred tax assets in a jurisdiction that has an unlimited carryforward period for net operating losses (or those deductible temporary differences that are expected to reverse and become indefinite-lived attributes) may be expected to occur in the distant future based on current projections, absent specific negative evidence of sufficient weight, the full deferred tax asset should be recognized. An entity should consider enhanced disclosures if deferred tax assets will be realized over an extended period of time. If an entity's operations turn for the worse in future years, the change associated with a change in assessment about the realizability of deferred tax assets would be properly reflected in the period in which the operations deteriorated and the weight of existing negative evidence overcame the existing positive evidence.

Other postretirement benefits (OPEBs)

Assessing the realization of deferred tax assets associated with OPEBs is problematic because the tax deductions typically will occur over a period of 40 or 50 years or even longer. It is unlikely that the reversal of significant taxable temporary differences for which deferred tax liabilities have been provided would extend into such distant future years.

We believe that the focus should be first on other deferred tax assets that are expected to reverse in the foreseeable future and whose realization is dependent on future taxable income other than offsetting

taxable differences or carrybacks. If those tax assets are significant and if no valuation allowance is required for them because sufficient forecasted taxable income is expected, generally no valuation allowance should be required for the deferred tax asset associated with OPEB accruals.

The reversal pattern for OPEBs can be determined by application of one of two methods—the loan amortization method or the present value method. See TX 5.8.2.2 for further discussion of those two methods.

FTC carryforwards under US federal tax law

When foreign source earnings are included in a US tax return, a credit can be taken (with certain limitations) for the income taxes paid or accrued on those earnings in the foreign country or countries (e.g., foreign income taxes attributable to Subpart F income or global intangible low-taxed income). Credits also are generated by foreign taxes actually paid by (or on behalf of) the US entity directly to a foreign taxing authority (e.g., income taxes on branch income, withholding taxes on distributions of foreign income previously taxed in the US, or withholding taxes on interest, royalties or other payments received by a US entity from foreign sources).

The tax laws governing the use of foreign tax credits are complex and contain various limitations and provisions (e.g., the requirement to allocate and apportion certain US expenses to the various categories of foreign source income) that must be considered in the valuation allowance assessment. In many cases, it will be difficult to avoid a valuation allowance for FTC carryforwards. Unless the circumstances that generated the carryforwards were aberrational, it is likely that future foreign source income will generate excess FTCs that will become additional carryforwards rather than utilize existing FTC carryforwards.

FTC limitations must be calculated separately for certain categories of foreign-source income (i.e., general basket, passive income basket, GILTI basket, and branch income basket). Generally, FTCs can be carried back one year and forward ten years. FTCs attributable to GILTI are not allowed to be carried back or carried forward. To realize the deferred tax asset recorded for FTC carryforwards, an entity must be able to generate sufficient future taxable income in total in addition to sufficient foreign-source taxable income (within the applicable category). In addition, generally that income must, in the aggregate, have been taxed in foreign jurisdictions at less than the US tax rate. A valuation allowance would generally be expected for excess foreign tax credits resulting from income taxed in countries where the tax rate is higher than the company's US tax rate. Use of the credits also may be limited if there is a taxable loss from domestic sources since such a loss would offset the foreign-source income before the credits were applied.

“Group relief”

Certain tax jurisdictions provide a “group relief” mechanism. Group relief permits companies under common ownership that file individual tax returns in the same tax jurisdiction to claim the losses of another group member or surrender losses to another group member for use in their respective individual tax returns.

For purposes of assessing the need for a valuation allowance in the consolidated financial statements, the group relief provisions must be considered. In other words, it is not appropriate to assess the need for a valuation allowance at each individual company and then aggregate them in the consolidated financial statements if group relief would provide for recovery of losses that one of the individual companies could not utilize.

Example TX 5-15 depicts the consideration of group relief in assessing the need for a valuation allowance.

EXAMPLE TX 5-15

Assessing the need for a valuation allowance in jurisdictions with group relief

Company A owns 100% of Company B. Both companies are based in the UK, file separate tax returns, and have net operating loss carryforwards. Company A expects to generate taxable income in future years, but Company B expects to continue to generate taxable losses. Their respective NOLs and income/loss projections are as follows:

Year	Company A	Company B	Consolidated
Current year NOL	£(100)	£(150)	£(250)
Year 2 profit (loss)	50	(90)	(40)
Year 3 profit (loss)	40	(80)	(40)
Year 4 profit (loss)	40	(60)	(20)

The UK permits group relief, whereby the losses in one entity in a group may be transferred to another entity in the group. However, restrictions apply to the use of NOLs generated prior to April 1, 2017 ('old' tax losses). These must first be used to offset the taxable income of the entity that generated them before they can be used to offset another group member's loss. In addition, old tax losses may only be transferred between group entities in the year in which they are created. If they cannot be used to provide group relief in that year, they are generally carried forward and restricted to use by the entity that generated the loss.

For NOLs generated on or after April 1, 2017, these restrictions do not apply.

For the current year consolidated financial statements of the group, how much of a valuation allowance should be recorded against the NOLs?

Analysis

The consolidated financial statements should reflect a full valuation allowance for the £250 of NOLs as the consolidated group is expecting future taxable losses, and the NOLs will not provide any incremental tax savings. Any income in Company A will be offset by the losses in Company B and therefore, with or without the NOL carryforward from Company A, there would be no tax liability.

5.8 Scheduling future taxable income

Scheduling future taxable income, if carried to its full extent, involves extensive number-crunching. At the extreme, it would be tantamount to estimating what the tax return would look like for each future year in which temporary differences reverse.

When is scheduling future taxable income necessary? The simple answer is: When it matters. Scheduling is important when the assessment of the appropriate valuation allowance or the applicable tax rate could vary materially depending on relatively minor shifts in the timing of taxable income. For example, scheduling will generally have to be considered in the following situations:

- The realization of the deferred tax asset is dependent upon future reversals of existing taxable temporary differences. In other words, there is a deferred tax asset, but the likelihood of future taxable income from sources other than reversing taxable differences does not provide sufficient assurance of realization to avoid a valuation allowance. ASC 740 requires that projections of future taxable income must consider all years that may provide a source of taxable income for the realization of deferred tax assets. The entity must determine to what extent reversals of taxable temporary differences ensure realization through offsetting. This situation could occur not only when future prospects are marginal or worse, but also in jurisdictions where carryback and carryforward periods are relatively limited, future results are expected to be erratic, or there is a limitation on the use of certain tax attributes. For example, certain states limit the amount of NOL available in any one period. Another example is when a jurisdiction limits interest deductions in any one period (e.g., the 163(j) interest limitation in the United States).
- A change in the tax rate is enacted but will not take effect until a future year. The entity must determine the amount of temporary differences for which the current tax rates are applicable and the amount of temporary differences for which the rates enacted for the future will be applicable. Refer to TX 7 for guidance on changes in tax rates.

Example TX 5-16 discusses the realizability considerations when there are certain income limitations and various sources of income being assessed.

EXAMPLE TX 5-16

Evaluating the realizability of deferred tax assets including interest expense carryforwards

Company A is assessing the realizability of its deferred tax assets as of December 31, 20X1 for a particular jurisdiction. Company A has the ability to reliably forecast its results but due to the magnitude of its interest expense (\$800 per year), the company generates a pretax loss of \$200 per year. It has no permanent differences.

Company A has a deferred tax asset for a net operating loss of \$800 that does not expire and is not subject to any taxable income limitations when used. A portion of the deferred tax asset relates to its interest expense that is not currently deductible. The interest carryforward of \$300 does not expire. Interest expense deductions each year are limited to 30% of Adjusted Taxable Income (ATI), which for this jurisdiction equates to taxable income before interest deductions. Company A expects to continue to generate new interest carryforwards each year for the foreseeable future. Neither the net operating losses nor the interest carryforward can be carried back.

Company A also has a deferred tax liability of \$300 related to a finite-lived intangible asset that has book basis but no tax basis. The deferred tax liability will reverse in equal amounts over the next three years as the intangible asset is amortized. Company A also has a deferred tax liability of \$400 related to goodwill, which will not reverse until the business is sold or the goodwill is impaired.

Company A has not identified any prudent and feasible tax-planning strategies.

How should Company A assess whether it needs a valuation allowance?

Analysis

Company A has two potential sources of future taxable income to consider—reversals of existing taxable temporary differences and forecasts of future taxable income (exclusive of reversing temporary differences and carryforwards). ASC 740-10-30-18 states, “[t]o 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.”

Company A’s deferred tax liabilities are not sufficient to realize all of its deferred tax assets. Therefore, it must consider whether it can forecast future taxable income. Although it is expecting to continue to generate a pretax loss, Company A can reliably forecast future taxable income (after taking into account the interest deduction limitation) as shown in the chart below. Therefore, Company A can reliably forecast future taxable income and should consider it as a source of taxable income.

	Forecast			
	20X1	20X2	20X3	20X4
Taxable income:				
Pretax loss		(200)	(200)	(200)
Reversal of taxable temporary difference on intangibles		100	100	100
Add back: Interest expense		800	800	800
Adjusted taxable income (ATI)		700	700	700
Interest deduction (limited to 30% of ATI)		(210)	(210)	(210)
Taxable income		490	490	490
NOL utilization		(490)	(310)	0
Ending deferred tax balances (gross):				
NOL carryforward	800	310	0	0
Interest carryforward	300	890	1,480	2,070
Total deductible temporary differences and carryforwards	1,100	1,200	1,480	2,070
Taxable temporary difference - Intangibles	(300)	(200)	(100)	0
Taxable temporary difference - Goodwill	(400)	(400)	(400)	(400)
Net deferred tax asset (gross)	400	600	980	1,670
NOL realizable (from utilization above)	(800)			
Interest carryforward realizable (30% of DTL on Goodwill)	(120)			
Valuation allowance needed (\$300 interest carryforward less \$120 of future taxable income from goodwill temporary difference)	180			

Company A concludes that it needs a valuation allowance of \$180 (gross). Of its \$1,100 in deductible temporary differences and carryforwards at December 31, 20X1, \$920 (all of the NOL and \$120 of the

interest carryforward) is realizable. The remainder (\$180) of the interest carryforward requires a valuation allowance.

Even though Company A will continue to generate additional interest carryforwards as evident in the forecast based on Company A's existing operating and financial structure, the existing taxable temporary difference for goodwill is available as a source of income for the interest carryforward (since both are indefinite-lived), albeit limited by the 30% taxable income limitation for the interest carryforward under the tax law. Consistent with ASC 740-10-30-18, this source of income cannot be ignored. If the facts were different and Company A could not reliably forecast future taxable income, then only the taxable temporary differences from goodwill and intangibles would serve as a source of realization for the DTAs. Company A would have to schedule the reversal of its taxable temporary difference for intangibles to determine how much realization it provides for the NOL and interest carryforward annually. Once that scheduling was done, Company A would then determine how much realization the taxable temporary difference for goodwill would provide for each DTA. The potential origination of additional interest carryforwards would not be considered in this fact pattern. Origination of new temporary differences is only considered if a company can forecast future taxable income.

5.8.1 General approach to scheduling

There are two basic approaches to the scheduling exercise. The approach used depends on whether a company can rely on forecasted taxable income.

Company cannot reliably forecast taxable income

If a company cannot reliably forecast taxable income, items considered in the scheduling exercise include only reversals of temporary differences, actual carryback availability, and available strategies. This approach does not consider future originating differences and is typically used when a company is not able to rely on projections of future taxable income. Therefore, the precision of the scheduling of reversals becomes critical. This approach also requires consideration of the extent to which carryback availability provides assurance of realization.

An abbreviation of this approach, a scheduling of reversals of temporary differences only, also could be used to determine the amount of reversals that will occur before and after an enacted future rate change when taxable income is expected in each future year.

Company is able to reliably forecast future taxable income

This approach is the same as the first approach, except that it considers estimated future taxable income (including future originating differences). When it is not clear whether all deductible differences and carryforwards will be used, this approach can be used to estimate the amount that will expire unused. It may also be employed to determine the applicable rate when enacted future rate changes and carrybacks from future years exist.

While the following discussion is in the context of full-scale scheduling and detailed deferred tax computations, reasonable approaches to aggregate temporary differences may be sufficient in many cases. For example, when there is a loss carryforward that expires in 10 years, the question may be the amount of reversals that will occur during the remainder of the carryforward period, and year-by-year scheduling will be unnecessary.

Example TX 5-17 demonstrates a high-level scheduling exercise for determining whether future taxable income including reversals supports the realization of a company's deferred tax assets.

EXAMPLE TX 5-17

Example of scheduling resulting in an unused deduction

At the end of 20X0, Company A has taxable temporary differences related to property of \$5,000, which will reverse at a rate of \$500 per year over the next 10 years. Company A also has deductible temporary differences related to OPEB of \$5,000, which reverse at the rate of \$250 per year over the next 20 years. Expected taxable income, excluding the reversals of temporary differences, is \$100 per year. There are no available tax-planning strategies or existing carryforwards, and any NOLs generated can be carried forward for 10 years.

Does Company A need to record a valuation allowance?

Analysis

As indicated in the following scheduling exercise, after considering the 10-year carryforward period of the losses created after the first 10 years, \$500 of the OPEB deductions would not offset any taxable income. Since there are no available tax-planning strategies and no remaining source of future taxable income, a valuation allowance for \$500 of the deductible temporary differences that reverse in years 11 through 20 should be recorded. If the facts were changed such that any losses created could be carried forward indefinitely, then no valuation allowance would be required since there is available taxable income excluding the reversals of temporary differences.

	Years 1 through 10	Years 11 through 20	Years 21 through 30
Deductible temporary difference reversals	\$ (250)	\$ (250)	\$ —
Taxable temporary difference reversals	500	—	—
Expected future taxable income other than reversals	100	100	100
Expected taxable income/(loss) per year	350	(150)	100
	x 10 yrs.	x 10 yrs.	x 10 yrs.
	3,500	(1,500)	1,000
Carryforward from years 11 through 20 to years 21 through 30	—	1,000	(1,000)
	\$3,500	\$ (500)	\$ —

The \$500 of unused deductions consists of \$50 in each of years 11 through 20.

This example suggests a level of precision in estimates of future taxable income on a year-by-year basis. Even if estimates are made for distant future years on a year-by-year basis, such forecasts are inherently imprecise. However, when it is necessary to estimate the deductible differences or carryforwards that will not be used, an overall estimate would follow the approach illustrated.

5.8.2 *Patterns of temporary difference reversals*

Scheduling temporary differences can be extremely technical. For each class of temporary differences, the pattern of reversal must be determined. ASC 740-10-55-15 through ASC 740-10-55-22 acknowledges that in many cases, there is more than one logical approach. It further notes that the consideration of reversal patterns is relevant primarily in assessing the need for a valuation allowance. Judgment is critical in that assessment, and attempts at precision in predicting future taxable income other than reversals, would be pointless. The guiding concepts in determining reversal patterns are discussed in ASC 740-10-55-12 through ASC 740-10-55-14.

The particular years in which temporary differences result in taxable or deductible amounts are generally determined by the timing of the recovery of the related asset or settlement of the related liability. The tax law determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years.

In addition, ASC 740-10-55-15 through ASC 740-10-55-22 provides some ground rules:

- The methods used for determining reversal patterns should be systematic and logical.
- Minimizing complexity is an appropriate consideration in selecting a method.
- The same method should be used for all temporary differences within a particular category of temporary differences for a particular tax jurisdiction.
- The same method for a particular category in a particular tax jurisdiction should be used consistently from year to year.

“Category” is not defined in the guidance but two examples are cited: (1) liabilities for deferred compensation and (2) investments in direct financing and sales-type leases. Different methods may be used for different categories of temporary differences. If the same temporary difference exists in two tax jurisdictions (e.g., US federal and a state tax jurisdiction), the same method should be used for that temporary difference in both tax jurisdictions. See ASC 740-10-55-22.

A change in method is a change in accounting principle subject to the guidance in ASC 250, *Accounting Changes and Error Corrections*. Such a change, if material in its effects, would have to be justified as a change to a preferable method, and an SEC registrant would be required to obtain a preferability letter from its independent auditors.

The remaining sections discuss scheduling concepts related to common types of temporary differences, though they do not cover all possible types of temporary differences.

5.8.2.1 Scheduling depreciable and amortizable assets

Only reversals of temporary differences that exist at the balance sheet date would be scheduled. As indicated in ASC 740-10-55-14, the future originations and their reversals would be part of future taxable income, but would not be considered as part of the scheduling exercise for reversing differences. Example TX 5-18 illustrates scheduling the reversal of temporary differences related to depreciable assets.

EXAMPLE TX 5-18

Scheduling reversals of temporary differences—depreciable assets

At December 31, 20X0, Company A has a \$12,000 taxable temporary difference related to a depreciable asset with a future pattern of depreciation expense as follows:

	Basis difference at Jan. 1	Book depreciation	Tax depreciation	Difference
20X1	(\$12,000)	\$2,400	\$5,000	(\$2,600)
20X2	(14,600)	2,400	5,000	(2,600)
20X3	(17,200)	2,400	2,000	400
20X4–20Y0 (\$2,400 book depreciation each year)	(16,800)	16,800	—	16,800
Total	\$—	\$24,000	\$12,000	\$12,000

Under ASC 740, the \$12,000 temporary difference would be deemed to reverse as follows:

	20X1	20X2	20X3	20X4–20X7 (\$2,400 each year)	20X8
Depreciable asset	—	—	\$400	\$9,600	\$2,000

How should the reversal of the temporary difference be considered in the scheduling exercise?

Analysis

The origination of the additional \$5,200 temporary difference in 20X1 and 20X2 and its reversal in 20X8 through 20Y0 would not be considered to be part of the reversal of the temporary difference existing at the balance sheet date. They would instead be considered as part of future taxable income other than reversals.

We believe that the following methods of categorizing temporary differences for determining reversal patterns may be used:

- Asset-by-asset approach

- Asset category (e.g., buildings)
- Total property, plant, and equipment category

To the extent certain assets within a particular category are indefinite-lived assets for financial reporting purposes (e.g., land, goodwill, indefinite-lived intangibles), we believe that as a general rule when assessing the need for a valuation allowance, those assets should be isolated and the reversal of taxable temporary differences associated with them not scheduled. For example, in assessing the need for a valuation allowance, a taxable temporary difference associated with land that there is no present plan to dispose of should not be offset against deductible temporary differences associated with depreciable plant and equipment. Refer to TX 5.5.1 for further guidance on “naked credits.”

Nonamortizable tax intangibles (other than goodwill)

In business combinations in which the tax basis of the acquired entity’s assets and liabilities is stepped up, tax basis may have been assigned to identifiable intangible assets other than goodwill. In some taxing jurisdictions, the intangibles may not be amortizable for tax purposes, even though they may be for book purposes. In these circumstances, the laws of the particular taxing jurisdiction would need to be considered to assess whether the recovery of the tax basis of the intangibles is allowed other than through a disposition or liquidation of the *entire business*—for example, whether the tax basis can be recovered by disposition or abandonment of just the intangible asset. If the basis can be recovered, entities should consider the appropriate tax rate to apply to gains and losses resulting from the relevant disposal options.

While these assets may seem similar to goodwill, they are different in their nature and do not represent a residual. In future periods, book amortization will give rise to a temporary difference for the excess tax basis, and a deferred tax asset will be recognized for the deductible temporary difference. While there may be no plans for sale or disposition of the intangibles, and it would not be expected to occur (if at all) before some distant future year, under the ASC 740 comprehensive allocation system, reversal of the temporary difference would be assumed. The question is whether a valuation allowance must be established.

To the extent that a loss on the sale of the intangible asset is expected, the company needs to consider whether there will be sufficient future taxable income of appropriate character available to realize the loss.

5.8.2.2 *Scheduling assets or liabilities measured at present value*

Many assets and liabilities are measured at present value for book purposes. This broad grouping includes many financial instruments (e.g., loans receivable and long-term debt), leases that are capitalized by the lessee or recorded as receivables by the lessor, most accruals for individual deferred compensation contracts, and OPEB obligations. We believe there are two basic approaches for scheduling the reversal of temporary differences related to assets and liabilities that are measured at present value: the loan amortization method and the present value method.

With respect to an asset or liability measured at present value, the aggregate future cash payments will exceed the principal balance at the balance sheet date, and the difference between the two scheduling methods involves the portion of future cash payments expected in each future year that is deemed to recover or settle the principal balance at the balance sheet date.

The two approaches are termed the loan amortization method and the present value method. Under the loan amortization method, future payments are considered to apply first to accrued interest, with the balance applied to principal. The application to principal would cause the reversal of the basis difference. Under this method, when payments are level, annual reversals will increase each year. This model mirrors the model used generally in financial statements in accounting for assets and liabilities measured at present value (i.e., the reversal amount for each future year will be the amount by which the recorded asset or liability is expected to be reduced in that year). The recorded asset (liability) may be expected to increase in a future year if the payments receivable (payable) in that year will be less than the interest income (expense) expected to accrue. Therefore, no reversal would be deemed to occur in that year.

The present value method assigns to each reversal year the present value at the balance sheet date of the payment to be made in that year. When payments are level, annual reversals will decrease each year. The present value method can be viewed as considering each required future payment as a separate zero-coupon asset or liability, with all interest accruing unpaid from the balance sheet date to the payment date. In contrast, the loan amortization method (and the financial statement model) emphasizes that the series of payments constitutes a single contract.

The results of the loan amortization method and the present value method are illustrated in Example TX 5-19.

EXAMPLE TX 5-19

Scheduling reversals of temporary differences—assets and liabilities measured at present value

On December 31, 20X1, Company X records an asset in the amount of \$614,457. This amount represents the present value, using a 10% interest rate, of 10 payments due of \$100,000 on December 31 of each of the next 10 years.

How would the reversal patterns differ under the loan amortization method vs. the present value method?

Analysis

The reversal for 20X2 under the loan amortization method would be based on the allocation of the 20X2 payment (\$100,000) first to interest (\$61,446) ($\$614,457 \times 10\%$) and the remainder to principal (\$38,554). A similar allocation would be made for each subsequent year.

In contrast, under the present value method, the reversal assigned to 20X2 would be the present value at December 31, 20X1 of the lease payment to be made on December 31, 20X2, which is calculated to be \$90,909. A similar calculation would be made for each subsequent year using a present value formula (not shown in this example).

The reversal patterns under the two methods would be as follows:

Year	Loan amortization	Present value
20X2	\$38,554	\$90,909
20X3	42,410	82,645

20X4	46,651	75,131
20X5	51,316	68,302
20X6	56,447	62,092
20X7	62,092	56,447
20X8	68,302	51,316
20X9	75,131	46,651
20Y0	82,645	42,410
20Y1	90,909	38,554
Total	\$614,457	\$614,457

Note that when the asset or liability requires a series of level payments from the balance sheet date until liquidation, the reversal pattern derived under the loan amortization method is the exact reverse of that derived under the present value method.

It generally will be easier to apply the loan amortization method because the reversal amounts are usually consistent with the financial statement amounts. Accordingly, the amounts may be readily available, and the reversals deemed to occur in future years for a particular asset or liability may not change from year to year. Application of the present value method, by contrast, may require computations to be made solely to determine the reversals. Further, the reversal deemed to occur in any specific future year for any particular asset or liability will change from year to year. This occurs because, as the period between the balance sheet date and the future year decreases, the discount to present value also decreases, and the reversal deemed to occur in that future year increases.

While both may be acceptable, whichever method is selected must be used consistently.

Financial instruments

Scheduling reversals of temporary differences associated with financial instruments varies depending on how the financial instrument is valued for book and tax purposes.

Carried at amortized cost for both book and tax

The selected method—loan amortization or present value, discussed in TX 5.8.2.2—is applied separately to the book basis and to the tax basis of the financial instrument. Application to book basis would use the interest rate embedded in the book accounting, and application to tax basis would use the interest rate implicit in the tax accounting. In effect, the reversal of the temporary difference at the balance sheet date that is deemed to occur in each future year is the difference between the recovery in that year under the selected method of the book basis and of the tax basis.

In general, the reversal pattern under the loan amortization method would track the change in the temporary difference, assuming neither the book nor the tax balance increases during any year.

However, for a loan receivable with a tax basis equal to the principal amount, a lower book basis, and the entire principal due at maturity, the amortization method would schedule the reversal of the entire temporary difference in the year of maturity since it is only in that year that recovery of (reduction in) the tax basis occurs. The amount of the temporary difference would change each year and, accordingly, the amount of the reversal deemed to occur in the year of maturity also would change in each year's deferred tax calculations.

We believe that it also would be an acceptable application of the loan amortization method under ASC 740 to consider the reversals of the temporary difference at the balance sheet date to occur as the book basis is accreted to the principal amount and the temporary difference is correspondingly reduced. Under this approach, the expected future book interest income in excess of taxable interest income in each future year would be deemed to result in a tax deduction in that year. Even though actual tax deductions are not expected to occur in this pattern, the pattern would reflect the book income expected to be recognized without being reported as taxable income.

There are situations (e.g., marketable bonds) when the discount or premium for tax purposes is amortized on a straight-line basis or is not amortized at all. We believe that it would be reasonable in such cases to consider the temporary difference to reverse in the pattern in which the discount or premium is expected to be reduced for book purposes.

ASC 310, *Receivables*, requires amortization of certain net fees or costs (i.e., those related to revolving lines of credit) on a straight-line basis. Assuming that the net fees or costs were taxable (deductible) on loan origination, we believe it would be appropriate to schedule deductions (taxable income) based on expected book amortization.

Carried at amortized cost for book and fair value for tax

Debt securities that are held-to-maturity and carried at amortized cost under ASC 320, *Investments—Debt Securities*, but marked to market for tax, have a temporary difference reversal pattern that may be problematic. Because the security is classified as held-to-maturity, the premium or discount for tax purposes will be presumed to disappear over the remaining life of the instrument, but it will not amortize in any systematic pattern. Rather, the market value/tax basis will change as a result of the shortening of the period to maturity, changes in market interest rates, and changes in the issuer's credit standing. For purposes of determining the reversal pattern, we believe it is reasonable to assume that market interest rates and the issuer's credit standing will remain unchanged to maturity. The reversal pattern would be determined as though tax reporting in the future were to be based on amortized cost using the balance-sheet-date tax basis as amortized cost at that date. The reversal in each future year would be determined as the difference between the recovery of book basis and the recovery of tax basis assigned to that year under the method (loan amortization or present value) elected for the category of temporary differences in which the security is included.

Carried at fair value for book and amortized cost for tax

When a security is carried at market under ASC 320, but at cost or amortized cost for tax purposes, the reversal pattern will depend on management's intentions and expectations. For example, we believe that it would not be prudent to anticipate changes in market prices in determining reversal patterns. Accordingly, the timing of the reversal of the balance-sheet-date unrealized appreciation or depreciation of a debt security should correspond to the period in which management intends to sell the security, and should be consistent with the operating plans of the entity.

On the other hand, when a debt security is classified as available-for-sale, but management has no particular expectation that it will be sold prior to maturity, the best approach may be to assume that the security will be held to maturity and that market interest rates and the issuer's credit standing will remain unchanged. The reversal pattern then would be determined as if the security were to be carried at an amortized cost in the future for book purposes using the balance-sheet-date market value as an amortized cost at that date. The reversal in each future year would be determined as the difference between the recovery of book basis and the recovery of tax basis assigned to that year under the method (loan amortization or present value) elected for the category of temporary differences in which the security is included.

A company may expect to sell a debt security within the next few years but considerably in advance of its scheduled maturity. In this situation, we believe it is reasonable for the reversal pattern to mirror the pattern suggested for a debt security for which there is no particular expectation for sale; the balance of the temporary difference reversal should be assigned to the year in which sale is expected.

Leases

When a lessor records its investment in leased property as a sales-type or direct-financing lease, the book asset is measured at present value, and the accounting is similar to that for a loan receivable. The lessor accrues interest on its investment and applies lease payments to reduce it. An operating lease results in the recognition of lease income on a straight-line basis, while the underlying leased asset remains on the lessor's balance sheet and continues to depreciate. If the agreement qualifies as a lease for tax purposes, the lessor owns a depreciable asset and depreciates the tax basis as permitted by the tax law.

Under ASC 842, a lessee that records a right-of-use asset and lease obligation will amortize the asset over the lease term (or shorter useful life) in its financial statements. The liability is measured at present value, and the lessee accrues interest on the recorded obligation and applies lease payments to reduce it. However, if the agreement is a lease for tax purposes, the lessee is entitled to tax deductions for the full amount of its lease payments.

The accounting described in the preceding paragraphs for both the lessor and lessee is the result of a single transaction, a lease. However, both have two temporary differences. The lessor in a direct-financing or sales-type lease has an investment in the lease (an asset measured at present value) for book purposes with no tax basis, and a separate temporary difference related to the property recorded for tax purposes with no book basis. The lessee has both a right-of-use asset and a lease liability for book purposes, each with a tax basis of zero.

It is important to track the two temporary differences separately for purposes of disclosure and due to a potential impact on valuation allowance assessments. A lessor would include in its deferred tax assets the amount related to the tax basis of its depreciable property. In its deferred tax liabilities, the lessor would include the amount related to taxable income to be reported on collection of its lease payments, which are deemed to be the recovery of its investment in the leased property. The lessee would include in deferred tax assets the amount for the future deductions for lease payments, which are deemed to reduce the lease liability. In its deferred tax liabilities, the lessee would include the amount for future taxable income equal to the amortization of its right-of-use asset. In terms of disclosure, as discussed in FSP 16.4, gross deferred tax assets and gross deferred tax liabilities must be disclosed.

The other reason to track the two temporary differences separately is to understand how the reversal pattern of the temporary differences impacts future taxable income, which could impact the measurement of valuation allowances.

Deferred compensation

For deferred compensation contracts with individual employees other than pensions and OPEBs, the accrued liability may represent the present value at the balance sheet date of stipulated payments scheduled to commence upon an employee's retirement. Under the present value method, reversals are deemed to occur equal to the present value of payments to be made in each future year.

The loan amortization method assumes that any benefit payment applies first to interest accrued after the balance sheet date, including the interest from the balance sheet date to the retirement date, as well as the interest accruing between the retirement and payment dates. Under this approach, only a portion of payments due in the later payment years relates to the liability accrued at the balance sheet date.

In some cases, the present value at retirement of expected deferred compensation payments is accrued by straight-line charges over the period to retirement. Under ASC 715, *Compensation—Retirement Benefits*, the present value of the deferred compensation payments must be fully accrued at the “full eligibility date,” which may precede the retirement date. For simplicity, this discussion assumes those dates are the same.

Even when the accrual of the liability prior to the retirement date is not interest-adjusted, in concept the liability is measured at present value. This is why it is appropriate to apply either the loan amortization method or the present value method to expected actual future payments to determine the reversal pattern of the liability that will be accrued at the retirement date. Those reversals would be deemed to relate to the accrued liability at the balance sheet date based on the ratio of the accrued liability to the expected liability at the retirement date.

When payments will be made for the remaining life of the employee rather than for a stipulated period, the actuarial assumption used in providing the accrual also should be used in estimating the timing of the payments. The method of payment (lump sum versus annuity), as well as early or late retirement options, may be at the employee's election. Absent any data on likely employee options that are expected to be selected, management judgment will be required.

Pensions

Accounting for pensions under ASC 715 can give rise to a number of temporary differences. In general, there will be no pension asset or liability for tax purposes. Deductions are generally available for qualified arrangements when cash contributions are made. The pension asset or liability for financial reporting thus will constitute a temporary difference.

Because the accounting model for pensions estimates future benefit payments and discounts them to present values, at first it might seem appropriate to consider any pension an asset or liability to be measured at present value for purposes of determining reversal patterns. Further, the ASC 715 model for OPEBs is based on the model for pensions, and we consider the recorded OPEB obligation to be a liability measured at present value as discussed above. However, because pension obligations typically are funded in advance to some extent, the US federal tax code provides for a tax deduction at the time of the funding, not at the time of the future benefit payment. As such, we do not believe the use of the

loan amortization method or the present value method is appropriate under ASC 740 for pension-related deferred tax balances. Contrast this with OPEBs, where the US Federal tax code provides for a tax deduction upon direct payment to the individual (as it is unfunded). Because of the timing of OPEB tax deductions, we believe that use of the loan amortization or present value methods would be appropriate.

We believe that it is appropriate to base the reversal of a pension asset or liability on estimates of how and when the recorded asset or liability actually will be reduced. If it is expected that there will be increases in the recorded asset or liability before reductions occur, those would be ignored. The first reductions anticipated would be deemed to apply to the asset or liability existing at the balance sheet date. This approach is similar to that for depreciable assets, when increases in the temporary difference are ignored and reversals are applied on a FIFO basis. Predictions of future events will be very important in estimating the pension reversal pattern.

There may be circumstances in which it would be difficult to estimate when reduction of the pension temporary difference will occur with any level of precision. The FASB provided a pragmatic approach, which might be reasonable depending on the entity's circumstances. Under this approach, the temporary difference is deemed to reverse pro rata over the average remaining service life of employees expected to receive benefits under the plan. If all or almost all participants are in active, the temporary difference is deemed to reverse pro rata over their average remaining life expectancy.

If the circumstances are such that a prepaid pension asset is not expected to reverse for the foreseeable future, the associated deferred tax liability should be treated similar to other "naked credits." Therefore, the taxable temporary difference should not be considered a source of taxable income to support realization of deferred tax assets that have a scheduled reversal pattern or attributes that are otherwise subject to expiration. See TX 5.5.1 for further discussion of naked credits.

5.8.2.3 *Scheduling deferred revenue or income*

For many types of revenue that enter into taxable income currently but are deferred to some future period for financial reporting (e.g., rent received in advance), it may be difficult to discern just how the temporary difference reverses (i.e., what the future tax consequence will be of earning the income). Under ASC 740, the deferred revenue indicates that a future sacrifice will be required in order to earn the revenue, and that sacrifice is measured by the amount of the deferred revenue. The deferred revenue frequently will include future gross profit (i.e., it will exceed the amount of tax deductions expected to be generated in earning the revenue). Nevertheless, the entire amount of deferred revenue must be considered a deductible difference. For purposes of considering its reversal pattern, it is probably easiest to think of the deferred revenue as a liability that will be settled by a deductible cash payment in the period recognized.

5.8.2.4 *Scheduling sale-leasebacks*

The gain on a sale-leaseback is a type of deferred income. It is not uncommon for capital gains tax to be incurred on sales of real estate. Any benefit of a lower capital gains rate would be reflected in the current tax provision, and the deferred gain would be a deductible temporary difference. The deferred gain is deemed to reverse as ordinary deductions occur (i.e., the excess of future ordinary deductions for lease payments over future book expense, whether rent in an operating lease or depreciation in a capital lease).

5.8.2.5 *Scheduling reserves for bad debts and loan losses*

For specific reserves for bad debts, reversal will occur in the future year when the receivable is expected to be charged off. However, when an allowance for loss on a loan is based on present value measurements under ASC 310, the increase in the present value may be recognized with the passage of time. If so, this would indicate that the pattern of reversal of deductible temporary differences would be determined as discussed for financial instruments in TX 5.8.2.2 (i.e., using the loan amortization or present value method).

Unallocated reserves cannot be associated with an individual loan or trade receivable. Estimates of reversals should be based on management's best estimate of when receivables or loans outstanding at the balance sheet date will result in actual charge-offs for tax purposes. For financial institutions to assume the sale or exchange of loans (to generate deductions), the loans would have to be carried at the lower of cost or market value. The carrying amount would consider the loan-loss reserves to the extent that they have been provided to cover losses on sales or swaps.

5.8.2.6 *Scheduling contract accounting*

The percentage-of-completion method typically will be used for both book and tax purposes in accounting for contracts. However, the tax law measures completion of a contract on the basis of a cost-to-cost analysis and incorporates a number of accounting conventions, which may result in significant differences from the method employed for financial reporting. This temporary difference may originate over several periods and reverse over several periods. Reversals would be determined by estimating all future book and tax amounts. The accumulated differences at the balance sheet date would reverse in the first years in which the differences run in the opposite direction.

5.9 *Accounting for changes in valuation allowance*

Accounting for changes in valuation allowance can be complex. Often the reason for the change in a valuation allowance can impact how it is accounted for.

Excerpts from ASC 740 and ASC 805

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 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.

ASC 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:

- d. 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.
- e. 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).

ASC 740-10-45-20 essentially groups changes in valuation allowances into the following three categories:

- Effects 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 (see TX 12.3.2.3).
- Effects of a change to valuation allowances of certain tax benefits that are adjusted within the measurement period as required by ASC 805-740-45-2 related to business combinations (see TX 10.5.5).
- Effects resulting from the initial recognition (that is, by elimination of the valuation allowance) of tax benefits related to the items specified in ASC 740-20-45-11(c)–(f) (see TX 12.3.2.4).

All other changes should be allocated based on ASC 740's general rules for intraperiod allocation (see TX 12.3).

Figure TX 5-1 summarizes the sections of this guide that address the accounting for changes in valuation allowance in various situations.

Figure TX 5-1

Other considerations in accounting for the impacts of changes in valuation allowance

Topic	Reference
Tax effects of a change in tax law that result in a change in valuation allowance that was initially recorded in acquisition accounting	TX 7
Acquired deferred tax assets and changes to the valuation allowance required at the time of acquisition	TX 10.5
Subsequent changes to acquired deferred tax assets	TX 10.5.4, TX 10.5.5
Changes in the acquirer's valuation allowance due to an acquisition	TX 10.4

Valuation allowance and transactions with shareholders	TX 10.9
Change in the valuation allowance as a result of a common control transaction	TX 10.10
Intraperiod allocation for changes in valuation allowances	TX 12.3.2.3, TX 12.3.2.5, TX 12.3.3.3
Restating prior-period presentation and intraperiod allocation for discontinued operations when there is a change in the beginning-of-the-year valuation allowance that results from a change in assessment about future realizability of deferred tax assets	TX 12.5.2.1
Changes in valuation allowance due to NOL carryforward limitations after an initial public offering	TX 12.3.3.2
Changes in valuation allowance in spin-off transactions	TX 14.8.2

***Chapter 6:
Changes in tax return
accounting methods and
changes in estimates***

6.1 Chapter overview—changes in tax return accounting methods or estimates

This chapter focuses on two separate topics: (1) accounting for changes in tax return accounting methods and (2) accounting for changes in estimates and errors in the tax provision.

6.2 Changes in US tax methods of accounting

The two most important characteristics of a tax method of accounting (hereinafter "accounting method") are (1) timing and (2) consistency. In order to affect timing, the treatment must impact the year in which an income or expense item is to be reported. If the treatment of the item affects the total amount of income or expense recognized by the taxpayer over the item's life, then an accounting method is not involved and generally IRS approval is not needed to change it.

In general, to establish an accounting method, the method must be consistently applied. This consistency requirement varies depending upon whether an accounting method is proper or improper (i.e., impermissible):

- The use of a proper accounting method in a single US federal income tax return constitutes consistency and, therefore, results in the adoption of an accounting method.
- An improper accounting method is adopted after it has been used consistently in two or more consecutive returns.

Once an accounting method has been adopted for tax purposes, any change must be requested by the taxpayer and approved by the IRS. Changes in accounting methods generally cannot be made by amending returns. Rather, there are two procedures for requesting a voluntary change from the IRS: (1) automatic and (2) non-automatic. In the case of an automatic change, IRS consent is deemed to have been received once all the requirements of the IRS guidance are met. With a non-automatic change, IRS consent is received only upon written consent from the IRS. In either case, the request for change is generally filed on federal Form 3115.

6.2.1 Transition to new accounting method

In general, the tax law provides two approaches for a transition from an old accounting method to a new accounting method: the cut-off approach and the cumulative catch-up approach.

The "cut-off" approach results in a prospective change beginning with the year of change. Transactions arising during or subsequent to the year of change are reported utilizing the new accounting method. Transactions arising prior to the year of change continue to be accounted for using the old accounting method.

The "cumulative catch-up" approach, as the name implies, results in a catch-up adjustment, referred to as an Internal Revenue Code §481(a) adjustment. Under this approach, a taxpayer must compute a §481(a) adjustment as of the first day of the year of change as if the new method of accounting had

been used previously. In general, a negative §481(a) adjustment (i.e., reduction of taxable income) is taken into income entirely in the year of change while the tax law permits a positive adjustment (i.e., increase to taxable income) to be spread over four years, beginning with the year of change. In certain circumstances, the four-year period may be shortened, and therefore, the applicable procedures governing tax accounting method changes should be carefully considered in relation to the taxpayer's specific facts and circumstances.

ASC 740-10-55-59 through ASC 740-10-55-61 address the temporary differences created when a taxpayer changes its accounting method. Accounting method changes that result in a positive adjustment (i.e., an increase in taxable income) and do not conform to the book treatment for the related item initially will result in two temporary differences. The first temporary difference is the basis difference between book and tax basis of the asset or liability, like any other temporary difference. The second temporary difference relates to the deferred income, for tax purposes, from the §481(a) adjustment.

Accounting method changes that result in a negative adjustment (i.e., a reduction of taxable income) and do not conform to the book treatment for the related item will generally result in only one temporary difference: the basis difference between book and tax, like any other temporary difference.

6.2.2 *Timing of recognizing changes in accounting methods*

When the effects of a change in accounting method are reflected in a reporting entity's financial statements depends on whether or not a company is changing from a proper or improper accounting method and whether or not the change qualifies as an automatic or non-automatic change.

6.2.2.1 *Voluntary change from one accounting method to another*

Changes from one proper accounting method to another can be either automatic or non-automatic.

IRS guidance specifies the accounting changes that qualify for automatic approval, assuming the taxpayer complies with all of the provisions of the automatic change request procedure. We believe that automatic changes should be reflected in the financial statements when management has concluded that the entity qualifies, and management has the intent and ability to request the change. An automatic change in accounting method is similar to other annual elections that are made by the taxpayer upon filing the tax return. Management should make its best estimate as to how it will treat such items when filing its tax return and account for the items in a consistent manner when preparing the financial statements.

Non-automatic changes require the affirmative consent of the IRS. The effects of a non-automatic change from one proper method to another should not be reflected in the financial statements until approval is granted because there is discretion on the part of the IRS to deny the application or alter its terms. Appropriate financial statement disclosure of anticipated or pending requests for method changes should be considered. Example TX 6-1 illustrates the accounting for a non-automatic proper to proper accounting method change.

EXAMPLE TX 6-1**Non-automatic proper to proper accounting method change that results in a positive §481(a) adjustment**

Company XYZ, a calendar year taxpayer, has elected to change its accounting method of depreciating fixed assets for tax year 20X1. The change is from one proper accounting method to another and is a non-automatic method change as prescribed by the IRS. In the second quarter of 20X2, Company XYZ received approval of the method change from the IRS. A positive §481(a) adjustment of \$2 million (increase to taxable income), is calculated as of 1/1/20X1. The applicable statutory tax rate is 25%. The following book and tax bases in the fixed assets exist as of 1/1/20X1:

	Existing Method	New Method
Book basis of fixed assets	\$9,000,000	\$9,000,000
Tax basis of fixed assets	4,000,000	6,000,000
Taxable temporary difference	\$5,000,000	\$3,000,000

What is the accounting treatment?

Analysis

In its 20X1 financial statements, Company XYZ would not reflect the impact of the accounting method change, as approval has not been received from the taxing authority. To the extent the potential impact of the method change is significant to the financial statements, disclosure may be warranted.

When IRS approval is received in the second quarter of 20X2, Company XYZ would reflect the impact of the accounting method change in its financial statements. The Company would record the deferred tax liability for the positive §481(a) adjustment as a result of the increased tax basis of fixed assets. Additionally, the Company would record the impact of adjusting the taxable temporary differences as of 1/1/20X1 as well as recognizing the tax expense for 20X1 and the first half of 20X2 portion of the §481(a) adjustment. In this case, the positive §481(a) adjustment will be recognized in taxable income over the customary four-year period.

Company XYZ will also need to account for the impact of the 20X1 current and deferred activity under the new accounting method and consider whether the new accounting method and the 20X2 portion of the §481(a) adjustment would impact its 20X2 estimated annual effective tax rate calculation.

Company XYZ would unwind the remaining deferred tax liability related to the §481(a) adjustment over the remainder of 20X2, and the following two years.

6.2.2.2 Voluntary change from an improper accounting method

A taxpayer may determine that it is using an improper accounting method. As a result, it will need to consider whether the historical financial statements included an error and the effects of an uncertain tax position, including potential interest and penalties. Refer to TX 6.3 for a more detailed discussion on discerning a financial statement error from a change in estimate.

A company may look to change voluntarily to a proper accounting method by filing a Form 3115 with the IRS. When a taxpayer files for a change from an improper to a proper accounting method, the taxpayer generally receives “audit protection” for prior years, which means that the IRS cannot require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change and therefore the taxpayer will generally not be subject to interest and penalties. We believe that the tax effects of making a voluntary change from an improper method to a proper method (e.g., release of uncertain tax position, interest etc.) should generally be recorded in the financial statements when the Form 3115 has been filed with the IRS to the extent that an analysis of the law confirms that the company has audit protection.

Upon changing to a proper accounting method with a positive §481(a) adjustment, any liability for unrecognized tax benefits previously recorded should be reclassified to a deferred tax liability, which now represents the deferred tax consequences of the §481(a) adjustment.

6.2.3 *Changes in accounting methods as a result of tax law change*

In the event that a change in accounting method is tied to a change in tax law, the tax effects of the change would be reported as a change in tax law in continuing operations in the period in which the change in tax law is enacted (pursuant to ASC 740-10-45-15) unless IRS permission is required to change the accounting method. If IRS permission is required, the tax effects of the change would be reported in the period in which IRS permission is granted.

6.3 *Changes in accounting estimates and errors*

The ASC Master Glossary definition of “change in accounting estimate” refers to changes resulting from “new information.” In contrast, the ASC Master Glossary definition of “error in previously issued financial statements” indicates that errors result from “mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared.”

As it relates to accruals for income taxes, we believe that, in general, an adjustment of a prior-period tax accrual that results either from new information (including a change in facts and circumstances) or later identification of information that was not reasonably “knowable” at the original balance sheet date and that results in improved judgment would lead to a change in estimate. However, an adjustment that arises from information that was reasonably “knowable” during the prior reporting period (or represents a reconsideration of the same information) may constitute “oversight or misuse of facts” and, therefore, may be an error. In this regard, consideration should be given to whether the information was (or should have been) “readily accessible” from the reporting entity’s books and records in a prior reporting period and whether the application of information commonly known by competent corporate tax professionals at that time would have resulted in different reporting.

The distinction between a correction of an error and a change in estimate is important because each is reflected differently in the financial statements. In accordance with ASC 250-10-45-23, a correction of an error is typically accounted for by restating prior-period financial statements. However, ASC 250-10-45-17 specifies that a change in accounting estimate is accounted for prospectively “in the period of change if the change affects that period only or in the period of change and future periods if the change affects both.”

The guidance in TX 6.3.1 and TX 6.3.2 is intended to help evaluate when changes in tax positions reflected in prior periods or changes in income tax amounts accrued in prior periods constitute financial reporting “errors” rather than changes in estimate.

In addition to a correction of an error and a change in estimate, changes may be recognized related to a change in accounting principle. Refer to FSP 30.4.3 for further guidance on the appropriate presentation and disclosure.

6.3.1 Tax accounting errors

The following are examples of errors:

- A tax accrual is intentionally misstated (without regard to materiality).
- A mechanical error is made when calculating the income tax provision (e.g., if meals and entertainment expenditures were deducted twice instead of being added back to taxable income or if the wrong disallowance rate was applied).
- Misapplications of ASC 740 and related accounting principles and interpretations are made. For example, the reporting entity failed to record a tax benefit or contingent tax liability at the balance sheet date that should have been recognized considering the facts and circumstances that existed at the reporting date and that were reasonably knowable at the date the financial statements were issued.
- The reporting entity chose to estimate rather than obtain an amount for tax provision purposes at the balance sheet date that was “readily accessible” in the reporting entity’s books and records, and the actual amount differs from the estimate.

6.3.2 Changes in estimates in the tax provision

A change in accounting estimate may occur when an event results in a change in judgment with respect to the sustainability of an uncertain tax position or an amount related thereto. Changes in estimate may be triggered by: (1) a settlement being reached with the taxing authorities related to a previously identified uncertain tax position; (2) a change in interpretation of tax law or new administrative ruling; (3) additional expert technical insight obtained with respect to complex, highly specialized or evolving areas of tax law interpretation and knowledge; or (4) additional information becomes known based on other taxpayers with similar situations that provides better insight into the sustainability of the uncertain tax position.

To close its books on a timely basis, a reporting entity may need to estimate certain amounts that are not “readily accessible” based on information available at the time. In assessing whether information was (or should have been) “readily accessible,” consideration should be given to the nature, complexity, relevance, and frequency of occurrence of the item. Assuming the reporting entity had a reasonable basis for its original estimate, we believe any subsequent adjustment is typically a change in estimate.

Distinguishing when information was (or should have been) “readily accessible” will often be judgmental and will need to be based on the facts and circumstances of each situation.

Examples of changes in estimates include:

- The reporting entity, with the assistance of highly specialized tax experts, obtains a new insight or point of view in relation to the application of the tax law with respect to prior tax return positions involving nonrecurring or complex transactions or technical tax issues.

Because of the level of sophistication and expertise required, and recognizing that insight with respect to complex tax laws is continually evolving both on the part of tax professionals and the taxing authorities, these circumstances would typically suggest a change in estimate rather than an error.

- The reporting entity makes a retroactive tax election that affects positions taken on prior tax returns (as is sometimes permitted under the tax code), as long as the primary factors motivating such change can be tied to events that occurred after the balance sheet date. For example, based on subsequent-year developments, such as lower than expected operating results in succeeding periods, a reporting entity concludes that it is more tax efficient to deduct foreign income taxes paid than to claim a foreign tax credit for foreign taxes paid.
- Due to a change in facts and circumstances, there is an economic basis to pursue a tax credit or deduction retroactively that was previously considered not to be economical. This is premised on the reporting entity having evaluated the acceptability of the tax position at a previous balance sheet date, having performed a reasoned analysis of the economics, and reaching a conclusion that it was not prudent to pursue such benefit. For example, a reporting entity may consider the potential tax savings associated with pursuing tax credits for certain research activities. Based on the company's lack of current taxable income, it may conclude that the additional administrative burden of pursuing such credits is not economical. Then, in a subsequent period, based on a change in the company's operating results and perhaps due to an increase in the amount of the potential credits, the reporting entity may decide to put in place the necessary infrastructure to be able to claim the credit, including for retroactive periods.
- New tax software that makes it economical to pursue a tax benefit.

To the extent the effect of a change in the estimate would be material to the financial statements, we would expect disclosures (e.g., "early warning" disclosures prescribed by ASC 275-10-50-8 through ASC 275-10-50-9) if it is reasonably possible that the estimates used could change within the next 12 months. To the extent it is concluded that a change in estimate has occurred, it should be noted that ASC 250-10-50-4 indicates that disclosure is required if the effect of the change is material.

Chapter 7:
Change in tax laws or rates

7.1 Chapter overview—change in tax laws or rates

ASC 740 requires that the tax effects of changes in tax laws or rates be recognized in the period in which the law is enacted. Those effects, both current and deferred, are reported as part of the tax provision attributable to continuing operations, regardless of the category of income in which the underlying pretax income/expense or asset/liability was or will be reported. This chapter contains illustrative examples of the concepts surrounding changes in tax laws or rates.

Excerpts from ASC 740

ASC 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.

ASC 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.

7.2 Determining the enactment date

ASC 740-10-45-15 requires that the effects of a change in tax law or rates be recognized in the period that includes the enactment date. While the date of enactment is not explicitly defined, we believe that “enactment” occurs when the law has been subjected to the full legislative process.

For US federal tax purposes, the enactment date is most often the date the President signs the bill into law. Enactment can occur in other ways, such as when Congress overrides a presidential veto. The key concept is that the full legislative process is complete (i.e., the law cannot be overturned without additional legislation). Future (i.e., not fully enacted) rate changes cannot be anticipated and should not be recognized.

Many foreign countries have requirements similar to those in the United States in that an official, such as the President, must sign legislation into law. For others, enactment occurs only after the law is published in an official publication.

In the United States, a change in federal tax law or rates may have significant state and local tax effects. The threshold state or local income tax question is whether and how a state or a local jurisdiction conforms to the Internal Revenue Code (IRC). How a particular state or a local jurisdiction adopts the IRC directly affects the application of enacted federal changes to its taxable income computation.

Some states simply begin the determination of state taxable income with federal taxable income (i.e., they do not specifically adopt or reject the IRC). Other states begin with federal taxable income, but generally adopt the IRC in one of three ways:

- Fixed date conformity: Conformity with the IRC remains fixed as of a specific date until the state legislature adopts a new date
- Rolling date conformity: State adoption of the IRC conforms to federal amendments automatically
- Adoption of select sections of the IRC

Companies need to evaluate the conformity rules for each state or local jurisdiction in order to determine the state or local tax effect and relevant income tax accounting.

7.3 *Accounting for changes in tax laws or rates*

The total effect of changes in tax laws or rates on deferred tax balances is recorded as a component of the income tax provision related to continuing operations for the period in which the law is enacted, even if the assets and liabilities relate to other components of the financial statements, such as discontinued operations, a prior business combination, or items of accumulated other comprehensive income.

As discussed in ASC 740-10-55-23 and ASC 740-10-55-129 through ASC 740-10-55-135, an enacted change in future tax rates often requires detailed analysis. Depending on when the rate change becomes effective, some knowledge of when temporary differences will reverse will be necessary in order to estimate the amount of reversals that will occur before and after the rate change.

As discussed in TX 4, the timing of reversals of temporary differences may not be the only consideration when determining the applicable rate to apply to those temporary differences. The applicable rate is the rate expected to be in effect in the year in which the reversal affects the amount of taxes payable or refundable. For example, assume that reversals are expected to occur in a future year after a change in enacted tax rates takes effect. Also assume an expectation that taxable results for that year will be a loss that will be carried back to a year before the rate change takes effect, and that the reversals will increase or decrease only the amount of the loss carryback. In those circumstances, the applicable rate is the rate in effect for the carryback period. Similarly, if rates changed in a prior year and carryback of a future tax loss to pre-change years is expected, then the pre-change tax rate will be the applicable rate for reversals, the effect of which will be to increase or decrease the loss carryback.

The calculation is more complicated if the reversing temporary differences reduce current-year taxable income and generate losses that are expected to be carried back to a pre-change year. Assuming graduated rates are not a significant factor, the tax effects of the reversals ordinarily should be determined on an incremental basis. Specifically, if the net reversing difference—the excess of deductible over taxable differences included in the expected tax loss—was less than or equal to the projected amount of the tax loss, the applicable rate would be the pre-change rate. The post-change rate would be applied to the amount of the net reversal that exceeded the projected tax loss. This concept is illustrated in Example TX 7-1.

In some cases, enacted tax legislation may involve a phase-in of several different rates over a period of time. The key questions in the analysis will be (1) when will the temporary differences reverse, and (2) will the reversals reduce taxes payable in the years of reversal or will they result in a carryback or carryforward that will generate a tax refund from an earlier year or reduce a tax payable in a future year, each of which has a different tax rate. ASC 740-10-55-129 through ASC 740-10-55-130 provides an example of a phased-in change in tax rates. Example TX 4-2 illustrates how to measure deferred taxes when there has been a change in tax rates and the applicable tax rate depends on whether

temporary differences will be realized via carryback refund or by offsetting taxable income earned in future years.

EXAMPLE TX 7-1

Determining the applicable rate when the reversal of temporary differences is expected to both reduce taxable income and generate losses expected to be carried back

Assume that as a result of new tax legislation, the statutory tax rate drops from 35% to 30% and that an entity estimates \$900 of pretax book income and \$1,000 of net reversals of deductible temporary differences resulting in a net tax loss of \$100 in the post-change period. Also assume that the entity expects to carry back this loss to a pre-change period.

What is the applicable tax rate to apply to the existing temporary differences?

Analysis

Because \$900 of the temporary difference reversals are expected to reduce taxable income in the post-change period, the post-change rate of 30% should be applied to those deductible temporary differences. As the remaining \$100 of deductible temporary differences is expected to be carried back to a pre-change period, the pre-change rate of 35% should be applied to that portion of the deductible temporary differences.

A similar, but opposite, approach may be appropriate when a pretax loss (before consideration of reversing temporary differences) is expected for a post-change year but net reversing taxable differences are expected to result in taxable income. If a tax loss in a future year could otherwise be carried back to a pre-rate change year, the future rate would apply only to the extent of the estimated taxable income for the year of reversal, and the current rate would be applied to the balance of the temporary differences. If a tax loss in the reversal year would be carried forward (i.e., no carryback capacity), the post-change rate expected to be in effect in the carryforward years would be the applicable rate for all the reversals.

7.3.1 Impact of tax law changes on valuation allowances

An enacted tax law or tax rate change entails reconsideration of the realizability of existing deferred tax assets. Consistent with ASC 740-10-45-15, all effects of a tax law change, including any creation of or adjustment to a valuation allowance, should be included in income from continuing operations for the period that includes the enactment date.

In some instances, tax rate changes may be enacted after year-end but before the financial statements are issued. In those situations, in accordance with ASC 740-10-45-15, any change in the valuation allowance would not be recognized until the period that includes the enactment date. Some might argue that the valuation allowance assessment should take into consideration all available evidence regarding the realizability of deferred tax assets. However, the guidance is clear that the entire effect of a change in tax rate or tax law should be reflected in the period of enactment, regardless of whether the financial statements for a prior period have been issued. Accordingly, a change in valuation allowance as a result of a change in tax law, which is enacted after year-end but before the financial statements are issued, would not be recorded at year-end. The financial statements should, however, disclose the expected impact as a subsequent event.

7.4 *Changes in tax laws and rates in an interim period*

As discussed in TX 7.2, the effect of a change in tax laws or rates on a deferred tax liability or asset must be reflected in the period of enactment.

When determining the effect of a tax law change, entities must consider the law change's effect on the deferred tax balances existing at the enactment date and, to the extent the law change is retroactive, its effect on taxable income through the enactment date. For entities that prepare quarterly financial statements, estimating the effect of the law using the most recent quarter end, adjusted for known material transactions between the enactment date and the quarter end, usually is sufficient. For other entities, calculating the effect of the law change may require additional work. The effect of reversals of beginning deferred tax balances for the period through the enactment date has to be considered, as well as the deferred tax effects of originating temporary differences. Computing this effect, however, requires measuring temporary differences and the related deferred taxes at an interim date, that is, the date of enactment. For determining the effect of a tax rate change, the deferred taxes actually accrued through the enactment date (by application of the estimated annual effective tax rate to year-to-date ordinary income and by discrete recognition of other tax effects) should be used (see more about computing deferred taxes for interim periods in TX 7.4.1).

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. The adjustment of the beginning-of-year deferred tax balances for the tax rate change would be reflected as a discrete item in the interim period of the enactment. However, the current year originating deferred tax balances are effectively adjusted through the new estimated annual effective tax rate which incorporates the new tax rate change.

When items other than ordinary income have been reported in prior interim periods, both their current and deferred tax effects would be adjusted in the interim period of the enactment.

Regardless of whether they are a component of ordinary income or some other aspect of the annual tax provision, all adjustments to reflect a tax rate change are measured as of the enactment date and reflected in income from continuing operations.

7.4.1 *Computing deferred taxes in an interim period*

When a change in tax law is enacted on a date that is not close to an entity's year-end, a question arises as to how temporary differences should be computed as of an interim date. We have identified three potential approaches:

- a) Assume that the entity files a short-period tax return as of the date of the law's enactment. The tax laws govern how annual deductions such as depreciation are allowed in a short-period return. The existing bookbases of the assets and liabilities would be compared with these "pro forma" tax bases to determine the temporary differences.
- b) Assume that net temporary differences arise and reverse evenly throughout the year. For example, if the beginning net temporary difference is \$100 and the projected ending net temporary difference is \$220, the temporary difference increases by \$10 a month as the year progresses.
- c) Assume that net temporary differences arise in the same pattern that pretax accounting income is

earned. That is, if pretax income is earned 10%, 20%, 30%, and 40% in the first through fourth quarters, respectively, then temporary differences would increase or decrease on that basis as well.

In terms of the asset-and-liability approach underlying ASC 740, the first alternative might be viewed as the most intuitive, but it is inconsistent with the principles of interim reporting, which treat an interim period as an integral component of the annual period, not as a discrete period. The second alternative would be practical; however, like the first alternative, it is inconsistent with how an entity estimates its quarterly tax provision and, thus, its deferred tax accounts. The third alternative avoids both of those inconsistencies and would be relatively easy to compute. Whichever method is chosen, it should be applied consistently.

7.4.2 *Retroactive tax rate change*

ASC 740-10-25-48 addresses the accounting for retroactive rate changes.

ASC 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.

Therefore, in addition to remeasuring taxes currently payable for the year, the reporting entity will need to roll forward its temporary differences to the date of enactment (as discussed in TX 7.4.1) to properly determine the retroactive effect of the tax law change. In addition, ASC 740-10-45-16 specifies that the cumulative tax effect of a retroactive rate change should be included in income from continuing operations.

ASC 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.

ASC 740-10-30-26 requires that the reported tax effect of items not included in income from continuing operations arising during the current 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. 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). The effect of a tax rate change is not to be backward traced.

Example TX 7-2 illustrates the computation of income tax expense when there is an enacted change in tax rates in an interim period.

EXAMPLE TX 7-2**Computation of income tax expense with an enacted change in tax rates in an interim period**

Company A recognized a net federal deferred tax liability of \$2,500 at December 31, 20X1 related to the temporary differences shown below. Assume that no valuation allowance was necessary for the deferred tax asset.

	Fixed assets	Inventory
Book basis [A]	\$20,000	\$9,000
Tax basis [B]	9,000	10,000
Temporary difference: [A – B = C]	11,000	(1,000)
Federal tax rate for all future years [D]	25%	25%
Federal deferred tax liability or (asset) [C × D]	2,750	(250)
Net Federal deferred tax liability at December 31, 20X1	\$2,500	

*For purposes of simplicity, the example ignores state income taxes.

Company A projected that, at December 31, 20X2, the net federal deferred tax liability would be \$3,250, based on a \$3,000 increase in its taxable temporary difference. Therefore, for 20X2, the projected deferred tax expense will be \$750 (\$3,250 – \$2,500).

Company A's income tax expense for the first quarter of 20X2 was calculated as follows:

Step 1: Estimated taxable income:		
Estimated annual pretax book income		\$100,000
Less:		
Dividends received deduction	(1,000)	
Tax over book depreciation	(3,000)	
Estimated taxable income		\$96,000

Step 2: Annual effective tax rate:

Estimated taxable income	\$96,000
Statutory federal income tax rate	25%
<hr/>	
Estimated current income taxes payable	24,000
Estimated federal deferred tax expense [\$3,000 increase in taxable temporary difference × tax rate of 25%]	750
<hr/>	
	24,750
Less: research and experimentation tax credit	(2,000)
<hr/>	
Estimated full-year income tax provision	\$22,750
Estimated annual effective tax rate [\$22,750/ \$100,000]	22.75%

Step 3: Income tax provision:

Year-to-date pretax income as of March 31, 20X2	\$20,000
Estimated full-year effective income tax rate	22.75%
Income tax provision—first-quarter 20X2	\$4,550

If an increase from 25% to 30% in the federal income tax rate was enacted on June 15, 20X2, retroactive to the beginning of the year, how would the effect of the change be reflected in income tax expense for the three and six months ended June 30, 20X2?

*Analysis***Step 1: Update estimate of taxable income:**

Remains unchanged from Step 1 above

Step 2: Recalculate annual effective tax rate:

Estimated taxable income	\$96,000
Statutory federal income tax rate	30%
Estimated current income taxes payable	28,800
Estimated federal deferred tax expense [\$3,000 increase in taxable temporary difference × tax rate of 30%]	900
	29,700
Less: research and experimentation tax credit	(2,000)
Estimated full-year income tax provision	\$27,700
Estimated annual effective tax rate [\$27,700/\$100,000]	27.7%

Step 3: Income tax provision:

Year-to-date pretax income as of June 30, 20X2	\$30,000
Estimated annual effective tax rate	27.7%
Year-to-date income tax provision on ordinary income	\$8,310
Less: first-quarter income tax provision	(4,550)
Second-quarter income tax provision	\$3,760
Adjustment to December 31, 20X1 deferred tax balances ¹	
Deferred tax liability (\$11,000 × [30% – 25%])	\$550
Deferred tax asset (\$1,000 × [30% – 25%])	(50)
Net increase in income tax expense	\$500
Plus: second-quarter tax expense	3,760
Total second-quarter tax expense	\$4,260
Total six months tax expense (\$8,310 + \$500)	\$8,810

¹ Assume no net changes in the temporary differences and the related deferred tax balances between December 31, 20X1 and immediately prior to the change in the enactment date of the new tax rate (i.e., June 15, 20X2).

Sometimes, tax law or rate changes occur in the same year that new accounting standards are adopted and the effect of the law or rate change may be retroactive and thereby coincide with the accounting standard adoption date. As set forth in ASC 740-10-45-18, if an entity adopted 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. Instead, the effect of the change in tax rate would be recognized in income from continuing operations for the period that included the enactment date. This would be true regardless of whether the change in tax laws or rates was retroactive to the earlier date.

***Chapter 8:
Change in the tax status of an
entity***

8.1 Chapter overview—change in the tax status of an entity

An entity's tax status may change from nontaxable to taxable, or vice versa. For instance, some entities, such as partnerships, certain limited liability companies, and Subchapter S corporations may change between nontaxable and taxable status as a result of changes in tax laws, changes in elections made by the entity, or changes in the manner in which the entity's activities are conducted with respect to applicable tax laws and regulations. In the remainder of this chapter, the term *nontaxable status* is used to describe the tax character of entities that generally are not subject to income taxes. The term *taxable status* is used to describe the tax character of entities that generally are subject to income taxes.

ASC 740-10-25-32 through ASC 740-10-25-34 and ASC 740-10-40-6 provide guidance for reflecting the tax effects of changes in tax status, which generally relate to the recognition or derecognition of deferred taxes at the time of the change.

8.2 General principle of changes in tax status

ASC 740-10-45-19 requires that the deferred tax effects of a change in tax status be included in income from continuing operations at the date the change in tax status occurs. Deferred tax assets and liabilities should be recognized for existing temporary differences when an entity changes its tax status to become subject to income taxes. Similarly, deferred tax assets and liabilities should be eliminated when a taxable entity ceases to be taxable. In both cases, the resulting adjustment is included in income from continuing operations even if the temporary difference relates to another category of earnings (e.g., discontinued operations).

ASC 740-10-25-32 and ASC 740-10-25-34 require that an election for a voluntary change in tax status be recognized in the financial statements on the approval date, or on the filing date if approval is not necessary. Alternatively, 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.

Example TX 8-1 illustrates accounting for deferred taxes on an available for sale debt security when a change in tax status occurs.

EXAMPLE TX 8-1

Accounting for deferred taxes on an available for sale debt security when a change in tax status occurs

Company A, a US entity with a December 31 fiscal year-end, filed a “check-the-box” election to convert Company B, its foreign subsidiary, into a US branch operation. The election is effective beginning on July 1, 20X2. During the first half of 20X2, Company B experienced an unrealized loss on an available-for-sale (AFS) debt security it held in the local country. The unrealized loss was recognized in other comprehensive income (OCI). The unrealized loss has no impact on Company B's local country taxes as Company B is located in a zero-rate jurisdiction, but will result in a tax deduction in the US when the loss is ultimately realized since Company B is now a branch of Company A. Should the tax benefit associated with establishing the US deferred tax asset related to the unrealized loss on the security on July 1, 20X2 be recorded in OCI or income from continuing operations?

Analysis

The tax benefit should be recognized in income from continuing operations. In this situation, even though the pretax event (i.e., the unrealized loss) was recognized in OCI, the initial tax effect from the unrealized loss was the direct result of the election made by Company A to convert Company B to a US branch operation and thereby change its tax status. In accordance with ASC 740-10-45-19, when deferred tax accounts are adjusted as a result of a change in tax status, the effect of recognizing or eliminating the deferred tax liability or asset is included in income from continuing operations.

Once the deferred tax asset is established upon the change in tax status, the tax effect of any subsequent changes in the value of the AFS debt security would be subject to normal intraperiod allocation rules. This may result in a disproportionate effect being lodged in OCI (since the establishment of the deferred tax asset was reflected in continuing operations). See TX 12.3.3.3 for a discussion on the disproportionate tax effects lodged in OCI.

8.3 *Timing of accounting for a change in tax status*

The impacts of a change in tax status may vary depending on whether a company is switching from a taxable to nontaxable status or vice-versa.

8.3.1 *Changing to nontaxable status*

As required by ASC 740-10-25-33, when a taxable entity switches to nontaxable status, the change in status should be recognized on the approval date if approval is necessary. If approval is not necessary, the change in status should generally be recognized at the filing date.

On the filing date (or approval date, if required), deferred taxes that will not be required after the effective date of the change to nontaxable status should be released to income. The entity will need to evaluate the expected reversal pattern of its temporary differences. Temporary differences that are expected to reverse prior to the effective date, while the entity is still taxable, should continue to be reflected in the financial statements. On the other hand, temporary differences that are expected to reverse subsequent to the effective date, when the entity will no longer be taxable, should be derecognized at the filing date if approval is not necessary. Deferred tax balances also may be required after the effective date if the entity is subject to the built-in gains tax (see TX 8.5).

8.3.2 *Changing to taxable status*

When a nontaxable entity switches to taxable status, or nontaxable status is retroactively revoked, the change in status should be recognized on the approval date, if approval is necessary. If approval is not necessary, the change in status should generally be recognized on the filing date. Deferred taxes should be provided on the filing date (or approval date, if required) for temporary differences (at that date) that will reverse after the effective date. Example TX 8-2 and Example TX 8-3 illustrate accounting for retroactive and prospective changes from nontaxable status.

EXAMPLE TX 8-2**Retroactive change from nontaxable status**

On February 28, 20X1, Omega Corp revoked its nontaxable status, changing to taxable status retroactive to January 1, 20X1. No approval is required for this change. The following information relates to temporary differences at February 28, 20X1 assuming a 21% tax rate:

	Book basis	Tax basis	Taxable/ (deductible) temporary difference	Deferred tax asset / (liability)
Accounts receivable	\$2,500	\$2,800	(\$300)	\$63
Land	600	500	100	(21)
Machinery and equipment	2,900	600	2,300	(483)
Warranty reserve	(1,000)	—	(1,000)	210
Totals	\$5,000	\$3,900	\$1,100	(\$231)

Omega Corp does not anticipate needing a valuation allowance at December 31, 20X1.

What is the impact of the retroactive change to taxable status?

Analysis

Omega Corp would record a net deferred tax liability of \$231 (\$1,100 at 21%) and a \$231 deferred tax provision to income from continuing operations. Further, a current tax provision for the taxable income for the two months ended February 28, 20X1 would be accrued at February 28, 20X1.

If Omega Corp had not yet issued its 20X0 financial statements by February 28, 20X1, those statements should disclose the change in tax status and the effects of the change, if material.

EXAMPLE TX 8-3**Prospective change from nontaxable status**

On September 30, 20X1, Company A revoked its election to be treated as a nontaxable entity, thereby changing to taxable status effective January 1, 20X2. No approval is required for this change. The information below relates to temporary differences that existed at September 30, 20X1, and that will reverse after January 1, 20X2. It is not expected that a valuation allowance will be needed. An applicable rate of 21% has been assumed.

The following information relates to temporary differences at September 30, 20X1.

	Book basis	Tax basis	Taxable / (deductible) temporary difference	Deferred tax asset / (liability)
Accounts receivable	\$2,200	\$2,500	(\$300)	\$63
Land	600	500	100	(21)
Machinery and equipment	3,000	800	2,200	(462)
Warranty reserve	(1,000)	—	(1,000)	210
Totals	\$4,800	\$3,800	\$1,000	(\$210)

The following information relates to temporary differences at December 31, 20X1.

	Book basis	Tax basis	Taxable / (deductible) temporary difference	Deferred tax asset / (liability)
Accounts receivable	\$2,500	\$2,800	(\$300)	\$63
Land	600	500	100	(21)
Machinery and equipment	2,900	600	2,300	(483)
Warranty reserve	(1,000)	—	(1,000)	210
Totals	\$5,000	\$3,900	\$1,100	(\$231)

How should Company A record the accounting impact of the prospective change in taxable status?

Analysis

As a result of the revocation, Company A would record a net deferred tax liability of \$210 (\$1,000 at 21%) as of September 30, 20X1 and a \$210 deferred tax provision to income from continuing operations.

Because the net deferred tax liability increased from September 30 (\$210) to December 31 (\$231), a deferred tax provision of \$21 was recognized in the 20X1 financial statements, even though Company A remained, in terms of actual tax status, a nontaxable entity during that period.

Example TX 8-4 discusses the timing of a retroactive “check-the-box” election.

EXAMPLE TX 8-4

When to consider the effect of a retroactive “check-the-box” election in accounting for US federal taxation of foreign subsidiary earnings

Company X, a calendar year US Corporation, owns a Dutch holding company (FS1) which in turn owns several foreign subsidiaries including two UK companies (FS2 and FS3). Company X has maintained an indefinite reinvestment assertion with respect to FS1 and FS2 and therefore has not recorded deferred tax liabilities for the excess of book-over-tax basis in FS1 and FS2. FS2 holds an intercompany note due from FS3. Additional facts are as follows:

- In November 20X1, Company X undertakes a global restructuring of its treasury operations which results in the distribution of the intercompany note from FS2 to FS1.
- After the distribution was made, Company X discovers that as a result of currency fluctuations, the distribution, when converted into the functional currency of FS1, represents an amount exceeding the outside tax basis of FS2. For US tax purposes, without further action, the resulting gain at the FS1 level from the distribution would trigger subpart F income to Company X.
- In December 20X1, however, Company X decides to make a retroactive “check-the-box” (CTB) election on FS2 to treat it as a branch of FS1 for US federal tax purposes which results in no subpart F income in 20X1.
- The CTB election is filed in January 20X2, retroactively effective to the day prior to the November transfer, and does not require approval by the IRS.
- Company X concludes that there is no uncertainty with respect to its position that there was no subpart F income in 20X1.

When should Company X consider the effect of the CTB election in its financial statements (i.e., Q4 20X1 or Q1 20X2)?

Analysis

In this specific fact pattern, we believe there are two acceptable approaches.

Under one view, the CTB election could be considered to result in a change of status of FS2 for all US tax purposes (i.e., converting from a controlled foreign subsidiary to a foreign branch of another legal entity) and therefore the change in status provisions in ASC 740 would determine the accounting. Company X would apply the guidance on changes in tax status in ASC 740-10-25-33 through ASC 740-10-25-34, which require recognition of the effect of an election for a voluntary change in tax status on the election filing date if approval is not necessary. Prior to the election filing date, the situation described above would result in the recognition by Company X of a current tax liability for subpart F income. Company X would recognize the current tax liability related to subpart F income in its 20X1 consolidated financial statements and then derecognize this liability in Q1 20X2 when the CTB election is filed. Company X should provide disclosure of the fact that the tax liability recorded in Q4 20X1 will be derecognized in Q1 20X2.

Alternatively, in this fact pattern, the CTB election on FS2 could be viewed as equivalent to many tax return elections that are available to Company X and therefore would be considered at year-end as

part of determining current year taxable income. In making this determination the following factors are relevant:

- Company X qualifies for and intends to make the election which does not require approval by the IRS.
- The election is primarily within Company X's control, and there are no significant costs or uncertainties as to its ability to make the election on a timely basis.

Under this view, in its 20X1 financial statements, Company X would take into account the expected CTB election, and therefore not recognize a current tax liability for subpart F income. Additional support for this view can be found in analogous situations, such as (1) an outside basis difference in a domestic subsidiary where the tax law provides a means to recover such basis difference tax free and the entity expects it will ultimately do so (see TX 11), or (2) an election for an automatic change from one permissible tax accounting method to another (see TX 6).

While the allocation and timing of recognition of a change in tax status guidance is specific, there may be judgment involved in some circumstances. For example, a check-the-box election may be leveraged as part of obtaining a worthless stock deduction. While a check-the-box election is generally considered a change in tax status, recognition of a tax benefit for a worthless stock deduction may occur when it becomes apparent that the existing temporary difference will reverse in the foreseeable future (rather than when the check-the-box election is made). See Example TX 11-3. Another example includes the impact of a change in connection with a business combination (see TX 8.6). Assessing all the facts and circumstances of a change is important to determining the appropriate timing and recognition of a change.

Finally, in general, the tax effects resulting from the initial qualification for a tax holiday should be treated in a manner similar to a change in tax status (i.e., when the election is filed or approved, if approval is necessary). See section TX 4.3.3.3 for further discussion of tax holidays.

8.4 *Built-in gains*

If a US entity converts from C corporation status to S corporation status (taxable to nontaxable), the IRS will impose a tax on any "built-in gains" recognized on sales of assets that occur within five years following the conversion date. A built-in gain represents the excess of the fair market value over the tax basis of an asset as of the conversion date. If an asset is sold within five years after the conversion date, even though the entity's income generally is not subject to tax, the portion of any gain from the sale that is attributable to the built-in gain at the date of conversion would be subject to income tax.

ASC 740-10-55-64 states that an entity converting from C corporation to S corporation status should continue to record a deferred tax liability to the extent it will be subject to the built-in gains tax. As the timing of realization of a built-in gain determines whether it will be taxable, actions and elections that are expected to be implemented should be considered in determining the deferred tax liability to be recorded. For example, if an entity expects that depreciable fixed assets will be retained in the operations of the business for at least five years following the conversion to S corporation status, no amount would be subject to the built-in gains tax.

8.4.1 Measurement of the DTL for built-in gains

When there is a net unrealized built-in gain at the date of conversion, it might be necessary, as discussed in ASC 740-10-55-65, to continue to recognize a deferred tax liability after the change to S corporation status—the question is how to determine the amount, if any. Only the assets and liabilities that have temporary differences at conversion need to be considered. Even though the actual built-in gain is based on fair market value at the date of conversion, no consideration would be given to any appreciation above the book value as of the conversion date.

Under the tax law, any actual tax liability for built-in gains is based on the lower of the net recognized built-in gain and taxable income (computed as a C corporation) for the year. As such, there would be no built-in gain tax if a company has no taxable income in such year; however, tax may be assessed in a later year if the company has taxable income in any of the remaining years of the 5 year recognition period. Even if a company expects future losses, a deferred tax liability on any built-in gains is recorded at the time of conversion because it is appropriate to anticipate tax consequences of future tax losses under ASC 740-10-25-38. The tax benefit of the future losses should be recognized as incurred in future years to the extent that the built-in-gains are absorbed by those losses.

Any built-in losses may be used to reduce built-in gains. Thus, when calculating the net built-in gain deferred tax liability in accordance with ASC 740-10-55-65, the *lesser* of the unrecognized built-in gain (loss) or the existing temporary difference (on an asset by asset basis) as of the conversion date is used. That is, the unrecognized built-in gain (loss) for each asset is limited to the existing temporary difference as of the conversion date. At each financial statement date, the deferred tax liability should be remeasured until the end of the recognition period. Changes in the liability should be recorded in income tax expense (benefit) in the period of the change.

Example TX 8-5 illustrates recording deferred taxes for built-in gains.

EXAMPLE TX 8-5

Recording deferred taxes for built-in gains

Assume that an entity's S corporation election became effective on January 1, 20X2. On December 31, 20X1, the entity had the following temporary differences and built-in-gains:

	Marketable securities	Inventory	Fixed assets
Expected to be used in operations and not sold within 5 years	No	No	Yes
Fair market value [A]	\$2,000	\$860	N/A
Tax basis [B]	1,800	900	
Book value [C]	1,900	850	
Built-in gain (loss) [A – B]	200	(40)	
Existing taxable / (deductible) temporary difference [C – B]	100	(50)	

Assume that (a) the marketable securities and inventory will be sold the following year, (b) the entity has no tax loss or credit carryforwards available at December 31, 20X1 to offset the built-in gains, and (c) the applicable corporate tax rate is 21%.

How would the S corporation calculate the deferred tax liability for the built-in gain at the date of conversion?

Analysis

The deferred tax liability for the built-in gain at January 1, 20X2, would be calculated as follows:

Built-in gain on marketable securities	\$100*
Built-in loss on inventory	(40)
Net unrecognized built-in gain	60
Applicable corporate tax rate	21%
Potential deferred tax liability for built-in gain	\$13

* The difference between the fair market value and tax basis is \$200, but in the calculation of the deferred tax liability, the built-in gain is limited to the amount of the book over tax temporary difference (\$1,900 - \$1,800).

The net deferred tax liability for built-in gain is \$13. This is the amount that should be reflected in the S corporation's accounts (which would replace the deferred tax liability for marketable securities and inventory on the books of the C corporation at the date of conversion).

8.4.2 Built-in gains—financial statement reporting

The calculation of any deferred tax liability is made and reflected in the financial statements as of the date of the election of S corporation status if approval is not necessary (i.e., the date of the change in tax status). When the election precedes the effective date of the change, projections of the book bases of assets expected to be on hand at the effective date (book basis) and estimates of their fair market values (tax basis) are necessary in order to determine the deferred tax liability. That analysis has to be updated in preparing subsequent balance sheets until the effective date.

In addition, the deferred tax liability will have to be reassessed at each balance sheet date subsequent to the conversion date. In addition to changes in the deferred tax liability that result from changes in expectations, the financial statements will reflect tax expense in the years when dispositions take place for differences between the built-in gain tax paid and the amount previously provided, including the tax applicable to unrecognized appreciation at the conversion date.

8.5 Conversion of a partnership to a corporation

Privately held entities are often organized as a nontaxable entity, such as a partnership. However, it is common, as part of a plan to go public, that an entity organized as a partnership effects a transaction that will result in its conversion to a C corporation. The change in tax status would require the recognition of a deferred tax asset or liability for the initial temporary differences between the book

bases and tax bases of the entity's assets and liabilities at the time of the change in status. The initial recognition of deferred tax assets is recorded in income from continuing operations.

If the partnership had net liabilities for tax purposes (i.e., the tax basis of the partnership's assets were less than the tax basis of its liabilities), the partners would report a taxable gain, calculated based on the value of the net liabilities assumed by the corporation upon conversion. As a result, the new C corporation would obtain a step-up in tax basis of the assets in an amount equivalent to the gain. The question arises whether this step-up in tax basis results from (a) the change in tax status, the effects of which are recognized currently in continuing operations under ASC 740-10-25-32 or (b) a transaction "with or among shareholders," the effects of which are recognized in equity in accordance with ASC 740-20-45-11.

We believe that the additional taxable gain recognized by the former partners, which prompted the step-up in tax basis, is a direct consequence of the change in tax status. Therefore, the deferred tax benefit from the recognition of that step-up in tax basis should be recorded in income from continuing operations, in accordance with ASC 740-10-45-19. In other words, the impact of the change in tax status that is recognized in continuing operations is determined after taking into account the step-up in basis that results from payments made by the individual partners. While an argument could be made for equity treatment in accordance with ASC 740-20-45-11, the original EITF consensus from which that guidance was codified specifically excluded changes in tax status from its scope.

Example TX 8-6 illustrates the accounting implications related to the conversion of a partnership to a corporation.

EXAMPLE TX 8-6

Conversion of a partnership to a corporation

Company A is a limited liability company. For tax purposes, Company A is treated as a partnership, and therefore does not pay tax at the entity level and has no deferred taxes. During the year, Company A contributed its assets and liabilities into a newly formed wholly-owned C corporation. The transfer is a tax-free transaction and Company A plans to operate in this manner for the foreseeable future. The financial reporting will continue to be done at Company A's level but will now include the assets, liabilities, and operations of the wholly-owned, consolidated C corporation subsidiary.

What are the accounting implications relating to the conversion?

Analysis

As a result of the contribution of assets and liabilities into a taxable entity, deferred taxes will need to be recognized by the C corporation for the difference between the initial tax bases in the assets and liabilities, generally carryover tax basis, and their respective carrying amounts in the financial statements (i.e., the carrying amount in Company A's financial statements prior to the contribution). The transaction is accounted for as a change in tax status, and under ASC 740-10-45-19 the effect of recognizing deferred taxes is included in income from continuing operations at the date the nontaxable enterprise becomes a taxable enterprise.

However, if the financial reporting was done at the C corporation level only, excluding the parent limited liability company, the initial recording of the deferred taxes would be recognized in shareholders' equity. The contribution of assets and liabilities into the C corporation would be recorded as a capital contribution. Therefore, pursuant to ASC 740-20-45-11(c), the tax effects should also be reported in equity. Thus, whether a transaction is a change in tax status or a capital

contribution from a shareholder has a significant impact on the manner of reporting the recognition of deferred taxes.

8.6 Impact of business combinations on tax status

Business combinations may give rise to changes in tax status of acquired entities. The accounting for the change in tax status varies depending on whether it is considered a voluntary or involuntary change.

8.6.1 Involuntary change as part of a business combination

If a C corporation acquires an S corporation in a transaction that will be accounted for as a business combination for financial reporting purposes, ownership by the C corporation may make the S corporation's election void. This raises the question which guidance applies to the deferred tax accounting for this event—the change in the tax status guidance in ASC 740-10-25-32 or the business combination guidance in ASC 805-740-25-3 through ASC 805-740-25-4.

We believe that if the S corporation election is invalidated by the acquisition of the entity, then business combination accounting is appropriate. Therefore, deferred tax assets and liabilities should be recorded in acquisition accounting for the differences between the assigned values for financial reporting and the tax bases of the assets acquired and liabilities assumed.

However, if the S corporation issued stand-alone financial statements without the application of “pushdown” accounting, the effect of the business combination (i.e., loss of S corporation status) should be accounted for as a change in the tax status of the entity. Accordingly, in the separate financial statements of the acquired entity, the effect of recognizing a deferred tax liability or asset should be included in income from continuing operations at the business combination date.

In some situations, the deferred taxes of the acquired entity are affected not only by the change in tax status, but also by changes in the individual tax bases of its assets and liabilities. This situation could arise where the acquiring entity made an IRC Section 338(h)(10) election under the US tax code. In the separate financial statements of the acquired entity, the tax effect of changes in the tax bases of the assets and liabilities are recorded in equity pursuant to ASC 740-20-45-11, while the tax effect of the change in tax status is recorded in continuing operations. The application of ASC 740-20-45-11 on separate financial statements of a subsidiary is discussed further in TX 14.6.

8.6.2 Voluntary change as part of a business combination

An acquirer may choose to change the tax status of an acquired entity. The question arises whether the tax effects of a “voluntary” status change of acquired entities (e.g., an election to change from a C corporation to an S corporation) should be recorded as part of the acquisition accounting or in continuing operations in accordance with ASC 740-10-45-19.

In general, a voluntary change in tax status of an acquired entity following an acquisition (even when occurring during the measurement period) should be accounted for in continuing operations in accordance with ASC 740-10-40-6. However, there may be circumstances where we believe it would be appropriate to account for a voluntary change in tax status as part of the acquisition. Items to consider when making this determination include whether:

- As of the acquisition date, the entity qualified for and intended to make the election. The acquirer should be able to demonstrate that the status change was part of the plans for acquiring the target and not based on factors occurring after the entities were acquired.
- The election is effective at (or applied retroactively to) the acquisition date.
- No consideration is paid to the taxing authority to effectuate the change in tax status.

8.6.3 Common-control merger involving an S corporation

If a C corporation acquires an S corporation in a transaction that will be accounted for as a merger of entities under common control, the combined financial statements for periods prior to the transaction should not be adjusted to include income taxes for the S corporation.

ASC 740-10-25-32 requires the recognition of deferred taxes at the date a nontaxable entity becomes a taxable entity, which is the date of the business combination. This adjustment should be included in income from continuing operations.

Although historical financial information cannot be tax-effected, it is generally appropriate to include pro-forma historical financial information that includes taxes for the S corporation as though it had been combined with the C corporation for all periods presented.

8.7 Real estate investment trusts

A real estate investment trust (REIT) is a corporation that meets a series of requirements regarding its income, assets, ownership, and distributions of earnings and elects to be taxed as a REIT. A REIT is generally not subject to tax on income it distributes currently to shareholders, and in practice, most REITs distribute substantially all of their income such that they are effectively nontaxable. If the entity fails to continue to meet the criteria to qualify as a REIT, it will become subject to corporate income taxes and various penalties, and could, in extreme cases, lose its REIT status altogether.

Some traditional C corporations may decide for various business reasons to convert to a REIT. Although some might argue that, in concept, such a conversion is no different than the other changes in tax status from taxable to nontaxable that are described earlier in this chapter, from a technical point of view, there is no blanket nontaxable status for a REIT. A REIT is not required to file an election to effect the change in tax structure; rather, the REIT first reports the conversion to the IRS by filing a specific tax form (1120-REIT) several months after the end of its initial tax year as a REIT. Further, such change does not require approval by the IRS.

The requirements for a REIT conversion to become effective include:

- Setting up the legal entity structure of the REIT,
- Purging accumulated earnings and profits from its operations as a C corporation through a distribution to shareholders (E&P Purge), and
- Filing its initial tax return as a REIT on Form 1120-REIT.

Given the somewhat unique nature of REITs and, in particular, the manner in which REIT “status” is effected, a question arises as to when the effects of the change in tax status (essentially the

derecognition of deferred tax assets and liabilities) should be recognized. Various timing considerations are addressed further in Question TX 8-1.

Question TX 8-1

A C corporation plans to convert into a REIT effective January 1, 20X6. When should the C corporation adjust its deferred tax accounts to reflect its new REIT status (i.e., when should it derecognize its existing deferred tax assets and liabilities)?

PwC response

This fact pattern is not explicitly addressed by ASC 740 or any other literature.

In our view, the conversion of a C corporation to a REIT is not a “change in tax status” as described in ASC 740-10-25-33. This is because a REIT is still technically a taxable entity under the Internal Revenue Code. A REIT’s earnings are taxable (although the amount subject to income taxes is reduced by a deduction for the amount of REIT taxable income distributed to shareholders).

Because we do not view the REIT conversion to be a change in tax status, we believe it would be appropriate to reflect the effects of the REIT conversion at the date when the C corporation (1) completed all significant actions necessary to qualify as a REIT and (2) committed to that course of action. This is consistent with the guidance in ASC 740-10-05-9, which addresses situations in which companies have “control” over the outcome of whether certain temporary differences will result in taxable amounts in future years.

The C corporation should account for the conversion to a REIT when it:

- Has committed itself to this course of action in such a way that it would be impossible or practically impossible to not convert to REIT status. Approval by the appropriate parties within the C corporation (e.g., board of directors) and a public announcement of the change might produce this result, provided that this truly constituted a commitment.
- Has obtained financing for the E&P purge (if necessary and considered significant).
- Is “REIT-ready” in all material respects such that the only legal and administrative actions necessary to qualify for REIT status is to file its tax return on Form 1120-REIT (i.e., any remaining steps are considered perfunctory).

At that time, tax assets or liabilities should be adjusted to reflect the change to REIT structure.

Chapter 9:
Income tax accounting for
financial instruments

9.1 Chapter overview—tax accounting for financial instruments

This chapter discusses the basic framework of accounting for temporary differences arising from debt and equity-linked financial instruments under ASC 740, *Income Taxes*. It also covers income tax accounting considerations related to certain financial instruments and the recognition of the related effects in a reporting entity's financial statements.

9.2 Classifying instruments as debt or equity—book vs. tax

To assess whether basis differences in financial instruments are temporary differences for which deferred taxes should be recognized, a reporting entity should determine the classification of the instrument for both financial reporting and tax purposes.

Instruments may be classified as debt (or another liability) for financial reporting purposes but as equity under the applicable tax law; the opposite—equity for financial reporting purposes, debt for tax purposes—may also occur. Also, hybrid instruments may be separated into a host contract and an embedded derivative under the guidance in ASC 815, *Derivatives and Hedging*, but remain as one instrument for tax purposes. Refer to PwC's guide to *Financing transactions* for more discussion of accounting classification for financial reporting purposes.

The separation and classification guidance under US GAAP frequently differs from the applicable treatment for tax purposes; this may result in a book-tax basis difference for which deferred taxes should be recognized. To determine whether there is a temporary difference resulting from the issuance of a debt or equity instrument, including equity-linked instruments such as convertible debt and warrants, a reporting entity should consider the following questions.

- Is the classification of the instrument as either a liability or equity consistent for book and tax purposes?
- If the security is classified as a liability for both book and tax purposes, does the carrying amount for financial reporting purposes differ from the tax basis?
- If the liability was hypothetically settled at its financial reporting carrying amount, would there be a tax consequence to the reporting entity? For example, would the settlement result in a taxable gain or loss?

A basis difference related to a financial instrument that has no tax effect upon reversal is not a temporary difference for which deferred taxes should be recognized. For example, a hybrid financial instrument classified as equity for tax purposes generally does not result in any tax consequences during its term or upon redemption. Consequently, if the instrument is classified as a liability for financial reporting purposes, any changes in fair value or interest expense recognized for financial reporting purposes would not have a corresponding tax consequence.

9.3 Tax accounting—debt instruments

Differences between the financial reporting and tax basis of debt instruments are fairly common. A reporting entity should assess any basis difference to determine whether there is a temporary difference for which a deferred tax asset or liability should be provided.

9.3.1 Tax accounting—original issuance discounts and premiums

When a debt instrument is issued at a discount or premium to the par or stated value, ASC 835, *Interest*, requires the discount or premium to be amortized to the income statement using the effective interest method. Therefore, for financial reporting purposes, the carrying amount of the debt will initially start at an amount below or above par value and accrete to par value over time.

The terms “discount” and “premium” are defined in the context of a borrower’s original issuance of a debt instrument as “original issue discount” (OID) and “bond issuance premium.” See FG 1.2.1 for information on the accounting for a debt discount or premium for financial reporting purposes. For book purposes, OID and bond issuance premium should be amortized over the term of the debt as interest expense. For tax purposes, OID and bond issuance premium are generally amortized over the term of the debt instrument (as determined under US federal income tax principles) as additional interest expense or as an offset to interest expense using the constant yield to maturity method.

The difference between the financial reporting basis and tax basis, inclusive of any recognized premium or discount, may give rise to a temporary difference for which deferred taxes should be recognized. For example, a temporary difference may exist when the amortization methodology or amortization period differ for financial reporting purposes and tax purposes. However, the use of different methodologies for financial reporting and income tax purposes will not automatically result in a temporary difference.

9.3.2 Tax accounting—debt issuance costs

A reporting entity will generally incur costs in connection with issuing a debt instrument. See FG 1.2.2 for information on the treatment of debt issuance costs for financial reporting purposes.

To determine the applicable tax treatment of debt issuance costs, a reporting entity should analyze which costs are deductible, as well as the relevant period and methodology for deducting the costs. For tax purposes, debt issuance costs are typically categorized as an ordinary and necessary business expense. Debt issuance costs are generally not classified as interest or OID for tax purposes even though the timing of deductions is often determined by reference to the tax OID rules. This is an important distinction for tax purposes because interest limitation provisions, which could defer or permanently disallow interest expense, generally do not apply to debt issuance costs.

Temporary differences may arise from a mismatch between the period in which debt issuance costs are deductible under the applicable tax law and the period in which they are recognized as interest expense for financial reporting purposes; these differences may result in the recognition of deferred taxes under ASC 740.

A permanent difference relating to debt issuance costs is unusual since debt issuance costs are generally considered deductible for federal income tax purposes.

9.3.3 Tax accounting—embedded derivatives

When an embedded conversion option is bifurcated from a convertible debt instrument, deferred taxes would generally be established for both the debt host and the bifurcated derivative. Bifurcation of an embedded derivative results in the allocation of proceeds to two separate instruments for financial reporting purposes (i.e., the host contract and the bifurcated derivative). For tax purposes, the convertible debt typically remains one instrument. Accordingly, deferred taxes should be established for the temporary differences related to both the host contract (compared to its tax basis) and the derivative (generally zero tax basis). While those deferred tax balances will typically offset at issuance, they will not remain equal because the derivative will be measured at fair value each period while the premium or discount on the host contract (debt component) will be amortized over time. See FG 6.5 for information on the accounting for convertible debt with a separated conversion option.

In situations in which there is no future tax effect associated with the settlement of the hybrid financial instrument, we would not expect deferred taxes to be recognized. This may be the case, for example, when a mandatorily redeemable preferred stock is accounted for as a liability under ASC 480, *Distinguishing Liabilities From Equity*, and includes an embedded derivative (e.g., payment indexed to the price of oil) that requires separate accounting as a derivative under ASC 815. For tax purposes, however, the instrument may be treated entirely as an equity instrument, meaning that there would be no tax consequences during its term or upon redemption. Therefore, no deferred taxes would be recognized for the host contract or the derivative. This would be consistent with the guidance in ASC 740-10-25-30, which describes certain basis differences that are not considered temporary differences and therefore deferred taxes are not recognized.

There may be situations when the settlement of a hybrid financial instrument for an amount greater than its tax basis does not result in a tax deduction (or in a deduction less than the full amount of the excess), but settlement at an amount less than its tax basis would result in a taxable gain. In these situations, we would generally not expect a net deferred tax asset (combined deferred tax effect of host and derivative) to be recognized for the hybrid instrument. However, a net deferred tax liability should be recognized when the combined financial reporting basis of the host contract and separated derivative is less than the tax basis. A thorough understanding of the applicable tax treatment for the settlement of a hybrid financial instrument is essential to understanding the potential deferred tax implications.

9.3.4 Tax accounting—debt with detachable warrants

Detachable warrants issued in a bundled transaction with debt are accounted for separate from the debt instrument. The allocation of the issuance proceeds between the debt instrument and the warrants depends on whether the warrants will be equity or liability classified. See FG 8.3.1 for information on warrants issued in connection with debt and FG 7.2 for information on the classification of equity-linked instruments. Allocation of the proceeds to both instruments creates a discount in the debt instrument that reduces the carrying amount of the debt for financial reporting purposes. When debt is issued together with other instruments (including warrants) as an investment unit, the non-debt components generally result in the issue price (i.e., the tax carrying value of the debt on issuance) being allocated away from the debt component based on relative fair market value, resulting in OID for federal income tax purposes. Allocation of the proceeds for financial reporting purposes may differ from the allocation for tax purposes; in that case, differences between the financial reporting carrying amount of the debt and the tax basis of the debt may result in a temporary difference for which deferred taxes should be recognized.

If the warrants are classified as equity, the initial recognition of deferred taxes on debt due to a book-tax basis difference created by the allocation of proceeds to warrants would be charged or credited to shareholders' equity in accordance with ASC 740-20-45-11(c).

Excerpt from ASC 740-20-45-11

The tax effects of the following items occurring during the year shall be charged or credited directly...to related components of shareholders' equity:

- c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock).

No deferred taxes should be recognized for the difference between the financial reporting carrying amount and the tax basis of the warrants if the warrants represent a right to convert the instrument into equity of the issuer. This is because the basis difference in the warrants will not have a tax effect upon reversal. However, the value attributed to the warrants under US GAAP may cause a temporary basis difference in the debt for which deferred taxes may need to be accrued.

If the warrants are classified as a liability, the initial recognition of deferred taxes on debt due to a book-tax basis difference created by the allocation of proceeds to the warrants should be recorded in the income statement through the provision for income taxes. Deferred taxes should also be recognized for the difference between the financial reporting carrying amount and the tax basis of the warrants if there is a possible future tax consequence related to the exercise of the warrants. Typically, however, the reversal of a warrant liability either through exercise, expiration, or cash payment does not result in a current or future tax consequence if the warrant is convertible into stock of the issuer or certain affiliates; in that case, consistent with the guidance in ASC 740-10-25-30, no deferred taxes should be recorded when the warrant liability is initially recognized or when subsequently marked to fair value through the income statement.

Subsequent to initial recognition, the temporary difference underlying the deferred tax asset or (more typically) liability associated with the debt reverses as the debt discount is amortized. This is the case regardless of whether the deferred taxes were initially recognized as an adjustment to shareholders' equity or through the provision for income taxes.

Example TX 9-1 illustrates the accounting for deferred taxes when a reporting entity issues debt with detachable warrants that are accounted for as a liability.

EXAMPLE TX 9-1

Accounting for tax effects of issuing debt with detachable warrants

Company A issued 5-year term debt with a par value of \$1 million with detachable warrants to purchase 100,000 shares of Company A stock for total proceeds of \$1 million. The debt bears interest at a stated rate of 2%. The warrants are puttable back to Company A. It was determined that the warrants would create OID for tax purposes.

As a result of the put feature, the warrants will be classified as a liability; thus, the \$1 million proceeds are allocated first to the warrants based on their fair value with the residual allocated to the debt instrument. (Note that this allocation would be different if the warrants were equity classified. See FG 8.3.1.) The fair value of the warrants is determined to be \$400,000 with the residual \$600,000 of the proceeds allocated to the debt instrument.

For purposes of this example, assume the amount allocated to the warrants was determined to be \$300,000 for tax purposes, which is treated as OID, and that the warrants are treated as a position in the issuer's equity. Thus, the reversal of the warrant liability recognized for financial reporting purposes, either through exercise, expiration, or cash payment will not result in a current or future tax consequence.

Company A is subject to a 25% tax rate and interest expense is deductible currently for tax purposes.

What are the deferred tax implications, if any, upon issuance of the debt with detachable warrants?

Analysis

Upon issuance, Company A would recognize deferred taxes for the temporary difference on the debt. No deferred taxes, however, would be recognized for the difference between the financial reporting carrying amount and tax basis of the warrants, as the reversal of the warrant liability will not result in a current or future tax consequence.

The financial reporting basis of the debt is \$600,000 (\$1 million less \$400,000 discount) and the tax basis of the debt would be \$700,000 (\$1 million less \$300,000 value of the warrants for tax purposes). Therefore, Company A would recognize a \$25,000 deferred tax liability $[(\$600,000 - \$700,000) \times 25\%]$ with the offsetting debit recognized in the income statement through its tax provision.

Note: If the warrants were instead classified as equity for financial reporting purposes, the tax effect would have been recorded as a charge to equity in accordance with ASC 740-20-45-11(c) instead of deferred tax expense.

In subsequent periods, the warrant liability will be remeasured to fair value with changes in fair value recognized in earnings. Because no temporary difference exists, no deferred tax benefit/expense will be recognized when changes in fair value of the warrant are recognized in net income.

At the end of year 1, assume the warrant liability has increased to \$450,000. For simplicity purposes, assume the debt discount will accrete over the 5-year period on a straight-line basis for financial reporting purposes (\$80,000 per year) and tax purposes (\$60,000 per year, noting this is solely for illustrative purposes, as straight line is not an appropriate OID accrual method). The following journal entries illustrate (amounts in thousands):

Company A would recognize \$100,000 in interest expense: the cash coupon of 2% (\$20,000) plus amortization of the debt discount (\$80,000). The warrant liability will be remeasured through earnings (\$50,000 expense) with no corresponding tax effect.

Dr. Other expense (warrant)	\$50,000	
Dr. Interest expense	100,000	
		Cr. Warrant liability
		50,000
		Cr. Debt discount
		80,000
		Cr. Interest payable
		20,000

As of December 31, 20X1, the temporary difference on the debt will have decreased by the \$20,000 difference in book and tax amortization of the discount. The corresponding reduction in the deferred tax liability of \$5,000 ($\$20,000 \times 25\%$) would be recognized as a tax benefit in the income statement.

A current tax benefit would be recognized for the cash coupon ($\$20,000 \times 25\%$) and amortization for tax purposes of the current period OID deduction ($\$60,000 \times 25\%$) for a total current tax benefit of \$20,000, assuming there are no limitations to deducting interest under the respective tax law.

In total for this instrument, a pre-tax expense of \$150,000 would be recognized with a total income tax benefit of \$25,000.

9.3.5 Tax accounting—debt measured using the fair value option

In certain circumstances, a reporting entity may elect to account for its debt at fair value in accordance with the guidance in ASC 825, *Financial Instruments*. When a reporting entity elects to carry its debt at fair value, the change in the carrying amount of the debt for financial reporting purposes will have no corresponding effect on the tax basis.

If a reporting entity has elected to account for its debt at fair value and the fair value of the debt drops below its tax basis, it should record a deferred tax liability. If, however, as a matter of tax law, settlement of the debt at an amount other than its tax basis does not result in taxable or deductible amounts, no temporary difference exists and no deferred taxes should be recognized, consistent with the guidance in ASC 740-10-25-30. In those circumstances, the change in fair value of the debt would have no corresponding tax effect, resulting in an impact to the reporting entity's effective tax rate (i.e., a permanent difference).

9.3.6 Tax accounting—debt extinguishment

A debt extinguishment can occur when a reporting entity settles its debt for cash, other assets, or equity. In accordance with ASC 470-50-40-2, an extinguishment gain or loss equal to the difference between the re-acquisition price and the net carrying amount of the debt instrument should be recognized in the income statement. See FG 3.7 for information on the accounting for debt extinguishments for financial reporting purposes.

In order to determine the related tax effects of a debt extinguishment, the applicable tax law will need to be considered. The extinguishment of debt at a premium (i.e., paying more than the tax basis) may result in an additional interest deduction equal to the payment in excess of the tax basis. For instance, the applicable tax law may allow a reporting entity that repurchases its debt at a premium to deduct the premium paid, in whole or in part, as interest expense. However, in some cases the premium paid to re-acquire debt in excess of its tax basis may be disallowed, in whole or in part, as a tax deduction. For example, if the premium paid relates to the conversion feature in convertible debt, the repurchase premium may not be deductible for tax purposes. In these circumstances, some or all of the extinguishment gain or loss recognized for financial reporting purposes would have no corresponding tax effect.

In the US, the extinguishment of debt for an amount less than the tax basis typically gives rise to cancellation of debt income (CODI) and is includable in taxable income.

Debt extinguishment gains and losses are recognized in the income statement; therefore, any related tax effects (current tax effect or deferred taxes that are eliminated or reversed upon the extinguishment) should also be recognized in the income statement, through the income tax provision.

9.3.7 *Tax accounting – debt modifications*

A debt modification for financial reporting may occur when a reporting entity modifies the terms of its outstanding debt by restructuring its terms or by exchanging one debt instrument for another. A debt modification may be accounted for as (1) the extinguishment of the existing debt and the issuance of new debt, or (2) a modification of the existing debt, depending on the extent of the changes. If a debt modification occurs and the lender remains the same, there is no gain or loss recorded on the transaction and the reporting entity recognizes a new effective interest rate based on the carrying value of the debt and the revised cash flows. See FG 3.2 and FG 3.4 for information on the accounting for debt modifications for financial reporting purposes.

The applicable tax law should be considered to determine the related income tax accounting. Generally, if a significant modification of the debt occurs, the existing debt is deemed to be exchanged for new debt for tax purposes. To the extent the original debt exceeds the fair market value of the “new” debt, a taxable gain may occur. The difference between the issue price of the new debt (or fair market value) and the original debt amount might also result in OID for income tax reporting, which may be deductible up front (for publicly traded debt and certain other situations) or over the remaining term of the debt.

The rules for debt modification for financial reporting and income tax reporting may not align. As such, deferred taxes may arise to the extent that there are differences.

9.3.8 *Tax accounting—debt purchased by a related party*

ASC 740 provides that certain current and deferred tax effects be recognized outside of the income statement. For example, ASC 740-20-45-11(g) relates to transactions among or with shareholders and may require the impacts for a change in tax bases be allocated to shareholders’ equity in certain circumstances.

Excerpt from ASC 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:

- 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...

Example TX 9-2 illustrates the income tax accounting effects in a reporting entity’s separate financial statements for the purchase of its outstanding debt at a discount by a related party.

EXAMPLE TX 9-2

Income tax accounting for the purchase of a reporting entity’s debt at a discount by a related party

OP Co is wholly-owned by PE Fund, a private equity fund. OP Co issues \$100,000 of public debt at face value. Subsequently, when the debt is trading at 80% of face value, PE Fund purchases the debt at a discount, as follows:

Face value of debt	\$100,000
Purchase price of debt	<u>80,000</u>
Discount	\$20,000

For book purposes, no transaction has occurred at OP Co, as the public debt was purchased by PE Fund in the secondary market in a transaction that did not involve OP Co.

Under US tax law, a borrower may realize cancellation of indebtedness income if their debt is purchased at a discount to its adjusted issue price by a related party. Accordingly, for tax purposes, the debt is deemed to be purchased at a discount, resulting in an immediate taxable gain to OP Co of \$20,000.

It is assumed for purposes of this example that the various exceptions provided in the tax law for exclusion of the taxable gain, such as insolvency or bankruptcy, are not applicable.

Under the relevant tax law, the debt is then considered to be re-issued by OP Co to the purchaser of the debt (i.e., PE Fund) with an OID of \$20,000. As a result, OP Co's tax carrying value in the debt is reduced from \$100,000 to \$80,000.

Ordinarily, OP Co would be entitled to deduct the OID as interest in future periods. However, assume that the debt is considered an Applicable High Yield Discount Obligation and that \$6,000 of the OID will be permanently disallowed under the tax law.

OP Co is subject to a 25% tax rate.

How should OP Co account for the income tax effects of this transaction in its separate financial statements?

Analysis

OP Co should account for the income tax effects of this transaction in its separate financial statements in accordance with ASC 740-20-45-11(g) and record the income tax effects in equity. OP Co would record the following entries (amounts in thousands):

Dr. Additional paid-in capital	\$5.0	
Cr. Income tax payable		\$5.0

To record the current tax consequences of the related party purchase of debt at a discount (\$20,000 taxable gain × 25%).

Dr. Deferred tax asset	\$3.5	
Cr. Additional paid-in capital		\$3.5

To record the deferred tax consequences of the related party purchase of debt at a discount [(\$100,000 financial reporting basis - \$80,000 tax basis - \$6,000 permanently disqualified portion of OID) × 25%].

9.4 **Tax accounting—convertible debt (after adoption of ASU 2020-06)**

When a reporting entity issues convertible debt, it will generally be accounted for as a liability upon issuance under US GAAP and for income tax purposes. Basis differences can arise upon or after issuance for a number of reasons, including differences in the existence and/or amount of OID, debt issuance costs, marking the debt to fair value if the fair value option is elected for the convertible debt, and embedded conversion options (i.e., a derivative liability). Refer to TX 9.3 for tax accounting considerations associated with these items.

New guidance

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)*. The new ASU eliminates the beneficial conversion and cash conversion accounting models for convertible instruments and supersedes the respective guidance within ASC 470-20 and ASC 740-10-55-51. With the elimination of the cash conversion and beneficial conversion feature models, more instruments will be accounted for as a single instrument rather than having their proceeds allocated between liability and equity accounting units.

The amendments in the ASU are effective for public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted at the beginning of an entity’s annual fiscal year, but no earlier than fiscal years beginning after December 15, 2020.

9.4.1 *Debt instruments with temporary differences (after adoption of ASU 2020-06)*

In most situations, convertible debt will not be bifurcated on the balance sheet, unless there is an embedded derivative or a substantial premium paid. Refer to TX 9.4.3 and TX 9.4.4, respectively, for tax accounting considerations in these situations.

When a reporting entity issues convertible debt at a discount, the discount is amortized (or the debt’s carrying amount is accreted) to face value for financial reporting purposes through a charge to interest expense over the life of the debt.

For tax purposes, unless the discount were to otherwise qualify as OID, amortization of the discount is generally not deductible on a periodic basis. In certain cases, the tax law allows deductions for the difference between the issuance proceeds and the ultimate repayment amount if the debt is extinguished by repurchase or repayment at maturity, but generally does not allow such deductions if the debt is converted into equity. Thus, any tax deduction may depend on the manner of settlement.

9.4.2 *Tax accounting—contingent payment convertible debt (after adoption of ASU 2020-06)*

Some forms of convertible debt provide for contingent payments, such as incremental interest payments once the issuer’s common stock reaches a target market price. When an arrangement is characterized as a contingent payment debt instrument, the tax law allows the company, in certain cases, to deduct interest equal to that of comparable nonconvertible fixed-rate debt in lieu of

deducting the stated rate of interest actually paid. If properly characterized under these rules, total interest deductions for tax purposes will generally exceed total interest expense recognized for financial reporting purposes. This can happen, for example, when the interest expense recognized for financial reporting purposes is equal to the stated rate of interest (i.e., coupon rate). However, interest deductions in excess of the stated rate will be recaptured for tax purposes, in whole or in part, if the debt is retired (either through early redemption or at maturity) or converted to stock with a fair value at the time of conversion that is less than the tax basis of the debt. Thus, the excess deductions of interest for tax purposes give rise to a taxable temporary difference.

A deferred tax liability should be recorded for the tax effects of redeeming the debt at its carrying amount. If the debt is settled for cash, the temporary difference, which encompasses the excess interest recapture, is also settled. If the debt is converted into equity and the additional interest deduction for tax purposes is ultimately not recaptured, the deferred tax liability should be reversed with a corresponding credit to additional paid-in capital in accordance with ASC 740-20-45-11(c).

9.4.3 Tax accounting—conversion option bifurcated as a derivative liability (after adoption of ASU 2020-06)

Convertible debt that contains a conversion option that meets the definition of a derivative and does not qualify for the ASC 815-10-15-74(a) scope exception for instruments indexed to a reporting entity's own equity should be separated into a debt host and a derivative liability. The derivative liability is carried at fair value and remeasured to fair value at each reporting period with changes in fair value recognized in the income statement. The allocation of the proceeds between the debt component (host contract) and the derivative liability results in a debt discount that is amortized over the life of the debt instrument. See FG 6.4 for additional information on evaluating whether the conversion option embedded in convertible debt requires separate accounting under ASC 815, and FG 6.5 for information on the accounting for convertible debt with a separated conversion option.

When the conversion option is accounted for as a derivative liability, and there are two liabilities (the debt and the derivative), two temporary differences arise. There is no explicit tax law for situations in which the conversion feature is bifurcated and accounted for as a separate derivative liability. In such cases, there is typically a difference between the financial reporting basis and tax basis of both the debt component and the derivative liability. These basis differences result from the convertible debt being accounted for as two separate instruments for financial reporting purposes (i.e., a debt instrument and a derivative liability) but as a single debt instrument for tax purposes (i.e., one unit of account).

The differences between the financial reporting basis and the tax basis of both the debt component and the derivative liability should be accounted for as a temporary difference in accordance with ASC 740. The tax basis of the debt will generally be in excess of the financial reporting basis due to the debt discount recognized for financial reporting purposes, which would typically give rise to a deferred tax liability. The financial reporting basis of the derivative liability will almost always exceed (it cannot be less than) its tax basis of \$0, which would give rise to a deferred tax asset. The deferred tax liability recognized for the debt component and the deferred tax asset for the derivative liability will typically offset at issuance. However, changes in fair value of the derivative liability and amortization of the debt discount will result in the deferred taxes no longer offsetting in subsequent periods.

In situations in which there will not be a future tax benefit for the settlement of the convertible debt (both the debt host and derivative liability are settled together) for an amount greater than the tax basis, we would not expect a net deferred tax asset to be recognized. That is, the deferred tax liability and the deferred tax asset recognized for the debt host and derivative liability should not result in the

recognition of a net deferred tax asset. This may be the case when, under the applicable tax law, settlement of the convertible debt (debt host and derivative liability) at an amount greater than the tax basis would not result in a tax deductible transaction. This would be consistent with the guidance in ASC 740-10-25-30 and the definition of a temporary difference in ASC 740-10-20.

9.4.4 Tax accounting—convertible debt issued at a substantial premium (after adoption of ASU 2020-06)

When a reporting entity concludes that a conversion option should not be separated from its host debt instrument under ASC 815, it should further evaluate whether the convertible debt was issued with a substantial premium. If a reporting entity concludes the convertible debt instrument was issued at a substantial premium, there is a presumption that the premium represents paid-in capital. In these cases, the convertible debt is reported by recording a liability at its principal or par amount, and the excess proceeds are reported as additional paid-in capital. Refer to FG 6.6 for more information on accounting for convertible debt with a substantial premium.

The tax treatment depends on why the premium was paid for the convertible debt. For example, if the premium is a result of a higher coupon rate, the premium is amortized for income tax purposes and treated as a reduction in the interest expense of the issuer, as discussed in TX 9.3.1. In this case, deferred taxes may need to be established through APIC for the different treatment between financial reporting purposes and income tax. Alternatively, if the premium arises because the conversion feature (e.g., the right to receive shares of the reporting entity) is “in the money” (e.g., the exercise price is less than the current fair market value of the shares), an analysis is required to determine the appropriate tax treatment and whether or not the instrument still qualifies as debt. Convertible debt issued at a substantial premium could result in the instrument being treated entirely as an equity instrument for tax purposes, with no tax consequences during its term or upon redemption. In situations where there is no future tax effect associated with the settlement of the convertible debt, we would not expect deferred taxes to be recognized.

9.4.5 Tax accounting—conversion of convertible debt (after adoption of ASU 2020-06)

If a convertible debt instrument (where the conversion option was not bifurcated) is converted into a reporting entity’s common or preferred stock pursuant to a conversion option in the instrument, it is not an extinguishment; the convertible debt is settled in exchange for equity and no gain or loss is recognized upon conversion. Refer to FG 6.8 for more information on accounting for debt conversions.

Any related tax effects upon conversion are accounted for in equity in accordance with ASC 740-20-45-11(c). From a tax perspective, if a borrower repurchases its own convertible debt (or the debt is converted by a holder) for an amount greater than the debt’s adjusted issue price, the excess may not be deductible. An exception to the general rule exists if the reporting entity can demonstrate that the premium is attributable to the cost of borrowing and is not attributable to the conversion feature.

While uncommon, a taxable gain could arise if the fair value of the stock provided upon conversion is less than the tax basis of the convertible debt. For example, in the US, the excess tax basis over the fair value of the stock provided upon conversion is treated as CODI and includable in taxable income.

9.4A Tax accounting—convertible debt (before adoption of ASU 2020-06)

The issuance of convertible debt may result in a temporary difference for which a deferred tax asset or liability would be required under ASC 740. Temporary differences often arise due to the differences between the financial reporting requirements and the applicable tax requirements for convertible debt.

The determination of whether a basis difference is a temporary difference will often depend on the manner in which a liability is expected to be settled and whether the settlement method is within the reporting entity's control.

New guidance

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)*. The new ASU eliminates the beneficial conversion and cash conversion accounting models for convertible instruments and supersedes the respective guidance within ASC 470-20 and ASC 740-10-55-51. With the elimination of the cash conversion and beneficial conversion feature models, more instruments will be accounted for as a single instrument rather than having their proceeds allocated between liability and equity accounting units.

The amendments in the ASU are effective for public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted at the beginning of an entity's annual fiscal year, but no earlier than fiscal years beginning after December 15, 2020.

9.4.1A Debt instruments with temporary differences (before adoption of ASU 2020-06)

When a company issues convertible debt at a discount, the discount is amortized (or the debt's carrying amount is accreted) to face value for financial reporting purposes through a charge to interest expense over the life of the debt. For some convertible debt issuances, the conversion option is not bifurcated and no amount is attributed to equity assuming that the conversion feature is not considered a beneficial conversion feature as defined in the FASB's Master Glossary. For book purposes, if the debt is converted to equity, it would be reclassified from debt to equity at its carrying amount on the conversion date. Refer to FG 6.9A for further details on the accounting for the conversion of convertible debt.

For tax purposes, unless the discount were to otherwise qualify as OID, amortization of the discount is generally not deductible on a periodic basis. In certain cases, the tax law allows deductions for the difference between the issuance proceeds and the ultimate repayment amount if the debt is extinguished by repurchase or repayment at maturity, but generally does not allow such deductions if the debt is converted into equity. Thus, any tax deduction may depend on the manner of settlement.

For cases in which the tax law provides for a deduction when the debt is settled, we believe that a temporary difference exists to the extent that debt has a different basis for book and tax purposes, irrespective of expectations that the holders are likely to convert. Analogizing to ASC 740-10-25-30 (basis differences that are not temporary differences) would not be appropriate in this situation. Although the example in that ASC paragraph refers to management's expectation of the manner of

settlement in the context of a company-owned life insurance policy, we believe an important distinction in that scenario is that management controls the manner of settlement. Because the holders of convertible debt (not management) control the outcome—settlement as debt or conversion as equity—it would not be appropriate to analogize this temporary difference to the cash surrender value of an officer’s life insurance.

Importantly, however, if the debt is ultimately converted to equity and no tax deduction arises, we believe the corresponding write-off of the deferred tax asset would be to shareholders’ equity in accordance with ASC 740-20-45-11(c).

9.4.2A Tax accounting—contingent payment convertible debt differences (before adoption of ASU 2020-06)

Some forms of convertible debt provide for contingent payments, such as incremental interest payments once the issuer’s common stock reaches a target market price. When the arrangement is characterized as a “contingent payment debt instrument,” the tax law allows the company, in certain cases, to deduct interest equal to that of comparable nonconvertible fixed-rate debt in lieu of deducting the stated rate of interest actually paid. If properly characterized under these rules, total interest deductions for tax purposes will generally exceed total interest expense recognized for financial reporting purposes. This can happen, for example, when the interest expense recognized for financial reporting purposes is equal to the stated rate of interest (i.e., coupon rate). However, interest deductions in excess of the stated rate will be recaptured for tax purposes, in whole or in part, if the debt is retired (either through early redemption or at maturity) or converted to stock with a fair value at the time of conversion that is less than the tax basis of the debt. Thus, the excess deductions of interest for tax purposes give rise to a taxable temporary difference.

A deferred tax liability should be recorded for the tax effects of redeeming the debt at its carrying amount. If the debt is settled for cash, the temporary difference, which encompasses the excess interest recapture, is also settled. If the debt is converted into equity and the additional interest deduction for tax purposes is ultimately not recaptured, the deferred tax liability should be reversed with a corresponding credit to additional paid-in capital in accordance with ASC 740-20-45-11(c).

9.4.3A Tax accounting—convertible debt with cash conversion option (before adoption of ASU 2020-06)

ASC 470-20 requires a reporting entity that issues convertible debt with a cash conversion option to bifurcate the debt into its liability and equity components in a manner that reflects interest expense at the interest rate of similar nonconvertible debt. See FG 6.6A for information on the accounting for convertible debt with a cash conversion option for financial reporting purposes.

From a tax accounting perspective, the application of ASC 470-20 often results in a basis difference associated with the liability (debt) component.

ASC 470-20-25-27

Recognizing convertible debt instruments within the scope of the Cash Conversion Subsections as two separate components—a debt component and an equity component—may result in a basis difference associated with the liability component that represents a temporary difference for purposes of applying Subtopic 740-10. The initial recognition of deferred taxes for the tax effect of that temporary difference shall be recorded as an adjustment to additional paid-in capital.

The basis difference is measured as the difference between the carrying amount of the liability component for financial reporting purposes and the convertible debt instrument's tax basis (which is generally its original issue price adjusted for any OID). Although the discount created in the debt instrument is amortized to interest expense for financial reporting purposes, it is not deductible for tax purposes. Consequently, the amortization of the debt discount creates a basis difference in the liability component that is a temporary difference.

At inception, a deferred tax liability should be recorded through additional paid-in capital pursuant to ASC 470-20-25-27. In subsequent periods, the deferred tax liability would be reduced and a deferred tax benefit would be recognized through the income statement as the debt discount is amortized to interest expense.

Example TX 9-3A illustrates accounting for the tax effects of issuing convertible debt with a cash conversion option.

EXAMPLE TX 9-3A**Accounting for the tax effects of issuing convertible debt with a cash conversion option**

Company A issues a convertible bond that will be settled upon conversion by delivering (1) cash up to the principal amount of the bond and (2) net shares equal to any value due to the conversion option being in the money. Company A concludes that the bond must be bifurcated into its debt and equity components pursuant to the guidance in ASC 470-20.

Using a present value calculation, Company A determines the initial carrying amount of the debt to be \$76 million. The embedded equity conversion option is \$24 million, the difference between the \$100 million proceeds and \$76 million debt liability.

Assume Company A is subject to a 25% tax rate and interest expense is deductible currently for tax purposes.

Company A calculates deferred taxes associated with bifurcating the convertible debt into its liability and equity components as the temporary difference between the book basis of the debt (\$76 million) and the tax basis of the debt (\$100 million) multiplied by Company A's tax rate of 25%, resulting in a deferred tax liability of \$6.0 million (\$24 million × 25%).

The following table illustrates the amortization of the debt discount and the resulting change in the deferred tax liability over the expected life of the convertible debt.

<i>(in millions)</i>	Issuance	Year 1	Year 2	Year 3	Year 4	Year 5
Carrying amount of debt	\$76.0	\$80.1	\$84.5	\$89.3	\$94.4	\$100.0
Amortization of discount	—	4.1	4.4	4.8	5.2	5.6

Tax basis of debt	100.0	100.0	100.0	100.0	100.0	100.0
Taxable temporary difference	(\$24.0)	(\$19.9)	(\$15.5)	(\$10.7)	(\$5.6)	\$—
Deferred tax liability	(\$6.0)	(\$5.0)	(\$3.9)	(\$2.7)	(\$1.4)	\$—

What journal entries should Company A record (1) upon issuance of its convertible debt and (2) during year 1?

Analysis

At issuance (amounts in millions):

Dr. Cash	\$100.0	
Dr. Debt discount	24.0	
Cr. Convertible debt		\$100.0
Cr. Additional paid-in capital		24.0
Dr. Additional paid-in capital	\$6.0	
Cr. Deferred tax liability		\$6.0

To record the issuance of the convertible debt and deferred tax liability.

During year 1 (amounts in millions):

Dr. Interest expense	\$6.1	
Cr. Cash		\$2.0
Cr. Debt discount		4.1

To recognize (a) the payment of the 2% cash coupon (\$100 million × 2%) and (b) the \$4.1 million amortization of the debt discount using the effective interest method (as per the table above).

Dr. Current tax payable	\$0.5	
Cr. Current tax benefit		\$0.5

To recognize the current tax benefit from the cash interest deduction (\$2 million × 25%).

Dr. Deferred tax liability	\$1.0	
Cr. Deferred tax benefit		\$1.0

To recognize the \$1.0 million (\$6.0 million - \$5.0 million) reduction of the deferred tax liability from the Year 1 discount amortization recorded through the income statement (\$4.1 million × 25%).

9.4.3.1A Tax accounting—convertible debt with a cash conversion option—issue costs (before adoption of ASU 2020-06)

ASC 470-20-25-26 requires transaction costs incurred with third parties other than investors that directly relate to the issuance of convertible debt instruments within the cash conversion subsections to be allocated to the liability and equity components in proportion to the allocation of proceeds to

those components. Allocated costs should be accounted for as debt issuance costs and equity issuance costs, respectively. See FG 1.2.2 for information on the accounting for debt issuance costs and FG 7 for information on the accounting for equity issuance costs.

Costs associated with the issuance of convertible debt with a cash conversion option are generally treated as debt issuance costs for tax purposes because the applicable tax treatment does not require bifurcation of the debt into liability and equity components (i.e., it is one unit of account for tax purposes). Therefore, all of the debt issuance costs attributed to the debt for tax purposes will generally be greater than the issuance costs allocated to the debt for financial reporting purposes. Thus, the future tax deductions associated with the issuance costs will exceed the amortization recognized for financial reporting purposes, resulting in a deferred tax asset. Based on the guidance in ASC 740-20-45-11(c), the deferred tax asset associated with the tax deductible costs related to the equity component should be initially recognized with a corresponding credit to shareholders' equity.

9.4.3.2A Tax accounting—derecognizing convertible debt with a cash conversion option (before adoption of ASU 2020-06)

ASC 470-20-40-20 provides that the accounting for derecognition of a convertible debt instrument with a cash conversion feature is the same whether the convertible debt is repurchased (extinguished) or converted into shares. In either case, the reporting entity should allocate the fair value of the consideration transferred (cash or shares) and any transaction costs incurred between (1) the debt component – to reflect the extinguishment of the debt and (2) the equity component – to reflect the reacquisition of the embedded conversion feature. An extinguishment gain or loss is recognized in earnings for the difference between the fair value of the debt and the carrying amount of the debt upon derecognition. See FG 6.6A for additional information on accounting for the extinguishment of convertible debt with a cash conversion option.

The related tax effects upon extinguishment should follow the basic intraperiod allocation model in ASC 740-20-45 for allocating income taxes between income from continuing operations and other financial statement components. This basic model (often referred to as the “with-and-without” calculation) is discussed in detail in TX 12. Example TX 9-4A further addresses some of the other complexities of intraperiod allocation that may exist.

EXAMPLE TX 9-4A

Accounting for the tax effects upon the repurchase of convertible debt with a cash conversion option resulting in a gain on extinguishment of debt

Company A issues a convertible bond that will be settled upon conversion by delivering (1) cash up to the principal amount of the bond and (2) net shares equal to any value due to the conversion option being in the money. Company A concludes that the bond must be bifurcated into its debt and equity components pursuant to the guidance in ASC 470-20. The principal amount of the debt was \$100 million with a coupon rate of 2%.

Assume Company A is subject to a 25% tax rate and that the 2% interest payment was determined to be deductible currently for tax purposes.

The following table illustrates the amortization of the debt discount and the resulting change in the deferred tax liability over the expected life of the convertible debt.

<i>(in millions)</i>	Issuance	Year 1	Year 2	Year 3	Year 4	Year 5
Carrying amount of debt	\$76.0	\$80.1	\$84.5	\$89.3	\$94.4	\$100.0
Amortization of discount	—	4.1	4.4	4.8	5.2	5.6
Tax basis of debt	100.0	100.0	100.0	100.0	100.0	100.0
Taxable temporary difference	(\$24.0)	(\$19.9)	(\$15.5)	(\$10.7)	(\$5.6)	\$—
Deferred tax liability	(\$6.0)	(\$5.0)	(\$3.9)	(\$2.7)	(\$1.4)	\$—

At the end of year 2, Company A repurchases the convertible debt for \$90 million in cash. Company A's deteriorating results prompted investors to accept the repurchase offer for an amount less than the stated par value.

The fair value of the debt immediately prior to extinguishment is determined to be \$81.5 million (based on current market conditions and Company A's deteriorating credit). Company A allocates the \$90 million cash consideration as follows: (1) \$81.5 million to extinguish the debt and (2) the remaining \$8.5 million to the reacquisition/retirement of the embedded equity conversion option.

For financial reporting purposes, a gain on extinguishment of \$3 million arises from the difference between (1) the fair value of the debt prior to conversion (\$81.5 million) and (2) the carrying amount of the debt at the end of year 2 (\$84.5 million).

For tax purposes, assume that cancellation of debt income is \$10 million (the \$100 million tax basis of the debt compared to the \$90 million paid to extinguish it).

How would Company A record the extinguishment?

Analysis

Repurchase at the end of year 2:

Company A would derecognize the convertible debt instrument (net carrying value of \$84.5 million, \$100 million par value less unamortized discount of \$15.5 million), recognize a cash payment of \$90 million, recognize a \$3 million gain on extinguishment (\$81.5 million of proceeds allocated to the fair value of debt compared to the \$84.5 million carrying amount of debt), and reduce additional paid-in capital by \$8.5 million (representing the retirement of the equity conversion option). Company A would record the following entry (in millions):

Dr. Convertible debt	\$100.0	
Dr. Additional paid-in capital	8.5	
Cr. Cash		\$90.0
Cr. Debt discount		15.5
Cr. Gain on extinguishment		3.0

In order to determine the amount of the tax benefit from the derecognition of the deferred tax liability that would be recognized in income and the portion that will be recognized in equity, Company A would follow the basic with-and-without model for allocating income taxes between financial statement components under ASC 740.

Company A would have a total tax benefit of \$1.4 million, the net of the \$3.9 million deferred tax benefit from the derecognition of the existing deferred tax liability, and a current tax expense of \$2.5 million on the cancellation of indebtedness income.

Assuming no other activity for the period other than the debt extinguishment, the tax expense allocated to continuing operations would be \$0.8 million (the pre-tax gain of \$3 million \times 25%).

In the final step, Company A would allocate the difference between the total tax (the “with” amount) and the amount allocated to continuing operations (the “without” amount), to the other components of income. Again, assuming no other components of income, the remaining net benefit of \$2.2 million would be allocated (credited) to additional paid-in capital as follows (in millions):

Step 1	Total tax provision / (benefit)	(1.4)
Step 2	Tax provision / (benefit) attributable to continuing operations	- 0.8
	Tax provision / (benefit) remaining to allocate to other components	(2.2)
Step 3	100% allocated to additional paid-in capital	(2.2)

9.4.4A **Tax accounting—convertible debt with beneficial conversion feature (before adoption of ASU 2020-06)**

When a reporting entity issues convertible debt with a beneficial conversion feature (BCF), the BCF should be separated from the convertible debt and recognized in additional paid-in capital. See FG 6.7A for information on the identification of BCFs and the accounting for instruments that contain a BCF.

Separation of the BCF creates a discount in the convertible debt for financial reporting purposes. For tax purposes, the tax basis of the convertible debt is the entire proceeds received at issuance of the debt. Thus, the book and tax bases of the convertible debt are different. ASC 740-10-55-51 addresses whether a deferred tax liability should be recognized for that basis difference.

ASC 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.

As the discount created by the recognition of the BCF is amortized, the temporary difference reverses.

9.4.5A Tax accounting—conversion option bifurcated as a derivative liability (before adoption of ASU 2020-06)

Convertible debt that contains a conversion option that meets the definition of a derivative and does not qualify for the ASC 815-10-15-74(a) scope exception for instruments indexed to a reporting entity's own equity should be separated into a debt host and a derivative liability. The derivative liability is carried at fair value and remeasured to fair value at each reporting period with changes in fair value recognized in the income statement. The allocation of the proceeds between the debt component (host contract) and the derivative liability results in a debt discount that is amortized over the life of the debt instrument. See FG 6.4 for additional information on evaluating whether the conversion option embedded in convertible debt requires separate accounting under ASC 815, and FG 6.5 for information on the accounting for convertible debt with a separated conversion option.

From an income tax accounting perspective, ASC 740-10-55-51 provides guidance on accounting for the tax effects of convertible debt instruments that contain a beneficial conversion feature that is bifurcated and accounted for as equity. Furthermore, ASC 470-20-25-27 provides guidance for situations in which a convertible debt instrument with a cash conversion option requires the conversion feature to be bifurcated and accounted for as equity. However, when the conversion option is accounted for as a derivative liability, and there are two liabilities (the debt and the derivative), two temporary differences arise. There is no explicit tax law for situations in which the conversion feature is bifurcated and accounted for as a separate derivative liability. In such cases, there is typically a difference between the financial reporting basis and tax basis of both the debt component and the derivative liability. These basis differences result from the convertible debt being accounted for as two separate instruments for financial reporting purposes (i.e., a debt instrument and a derivative liability) but as a single debt instrument for tax purposes (i.e., one unit of account).

The differences between the financial reporting basis and the tax basis of both the debt component and the derivative liability should be accounted for as a temporary difference in accordance with ASC 740. The tax basis of the debt will generally be in excess of the financial reporting basis due to the debt discount recognized for financial reporting purposes, which would typically give rise to a deferred tax liability. The financial reporting basis of the derivative liability will almost always exceed (it cannot be less than) its tax basis of \$0, which would give rise to a deferred tax asset. The deferred tax liability recognized for the debt component and the deferred tax asset for the derivative liability will typically offset at issuance. However, changes in fair value of the derivative liability and amortization of the debt discount will result in the deferred taxes no longer offsetting in subsequent periods.

In situations in which there will not be a future tax benefit for the settlement of the convertible debt (both the debt host and derivative liability are settled together) for an amount greater than the tax basis, we would not expect a net deferred tax asset to be recognized. That is, the deferred tax liability and the deferred tax asset recognized for the debt host and derivative liability should not result in the recognition of a net deferred tax asset. This may be the case when, under the applicable tax law, settlement of the convertible debt (debt host and derivative liability) at an amount greater than the tax basis would not result in a tax deductible transaction. This would be consistent with the guidance in ASC 740-10-25-30 and the definition of a temporary difference in ASC 740-10-20.

9.4.6A Tax accounting – conversion of convertible debt (before adoption of ASU 2020-06)

When convertible debt that does not require separate accounting for all or a portion of its conversion option (either as a derivative or as a separate component of equity) is converted into equity in accordance with its original conversion terms, ASC 470-20-40-4 requires the carrying amount of the debt, including any unamortized premium or discount, to be credited to the capital accounts to reflect the stock issued; no conversion gain or loss is recognized.

Any related tax effects upon conversion are also accounted for in equity in accordance with ASC 740-20-45-11(c). From a tax perspective, if a borrower repurchases its own convertible debt (or the debt is converted by a holder) for an amount greater than the debt's adjusted issue price, the excess may not be deductible. An exception to the general rule exists if the reporting entity can demonstrate that the premium is attributable to the cost of borrowing and is not attributable to the conversion feature.

While uncommon, a taxable gain could arise if the fair value of the stock provided upon conversion is less than the tax basis of the convertible debt. For example, in the US, the excess tax basis over the fair value of the stock provided upon conversion is treated as CODI and includable in taxable income.

9.5 Tax accounting—equity-linked financial instruments

Financial instruments that are characterized as equity for tax purposes will not typically result in any current or future tax effects throughout the instrument's life or upon settlement. However, financial instruments that are treated as equity for tax purposes may, in certain cases, be classified as a liability for financial reporting purposes. In circumstances in which, under the applicable tax law, the reversal of a book liability either through exercise, expiration, or cash payment will not result in a current or future tax consequence, no deferred taxes would be recognized. That is, the presence of any basis difference would not meet the definition of a temporary difference in accordance with ASC 740-10-25-30.

9.5.1 Tax accounting—preferred stock accounted for as a liability

A baseline example of differing classification for book and tax purposes is an issuance of mandatorily redeemable preferred stock. Pursuant to ASC 480, such stock may be required to be accounted for as a liability. As a result, the difference between its fair value at issuance and the redemption value will be accrued during its term as interest expense. This treatment generally departs from the tax treatment, whereby the security would typically be considered equity with no tax benefit to be realized either during its term or upon redemption. Accordingly, there would be no deferred taxes provided in relation to the liability, no tax benefit for interest accrued in periods leading up to redemption, nor any tax benefit associated with issuance costs. This type of financing generally results in an increased effective tax rate throughout its term.

Additionally, ASC 470-20 applies to certain convertible preferred stock that is mandatorily redeemable and classified as a liability for financial reporting purposes. For tax purposes, however, the instrument may be considered equity. In that case, the instrument may not result in a future tax liability in the event it is redeemed for the book carrying amount, nor would it provide tax deductions for accrued interest (which may constitute dividends for tax purposes). Consequently, deferred taxes would not be recognized because the liability's carrying amount (or book basis) is expected to reverse without a tax consequence.

9.5.2 Tax accounting—equity-linked warrants accounted for as a liability

A freestanding (i.e., non-embedded) warrant contract to purchase shares of stock typically allows the holder (investor) the option to acquire shares of stock of the reporting entity that sold the option contract. The holder pays a premium to the issuer for the right (option) to exercise the warrant contract based on terms stipulated at issuance. For financial reporting purposes, such equity-linked contracts can be classified as equity or as a liability. Refer to FG 7 for additional information related to assessing whether a warrant should be classified as equity or a liability for financial reporting purposes.

For tax purposes, warrants that are indexed to and settled in an issuer's own stock are generally characterized as a transaction in their own stock which are not subject to tax for the issuer. Accordingly, such equity-linked contracts generally result in no tax consequences throughout its life or upon settlement.

When an equity-linked warrant contract is classified as a liability for financial reporting purposes, any change in fair value that is recognized in earnings will impact pre-tax income with no corresponding tax effect.

Chapter 10:
Business combinations and
asset acquisitions

10.1 Chapter overview—*income tax accounting for acquisitions*

Business combinations often give rise to a variety of complicated issues when accounting for income taxes under ASC 740, *Income Taxes*. This chapter primarily focuses on the accounting for the income tax effects of business combinations. However, accounting for the income tax effects of an acquisition that does not qualify as a business combination is discussed in TX 10.12. Further information regarding the accounting for business combinations and accounting for transactions with noncontrolling interests can be found in the PwC publication, *Business combinations and noncontrolling interests*. Further information regarding the accounting for acquisitions that do not qualify as a business combination can be found in PwC's guide to *Property, plant, equipment and other assets* (see PPE 2).

Under ASC 805, *Business Combinations*, assets and liabilities acquired are accounted for at fair value. However, tax accounting associated with a business combination follows the guidance in ASC 740. In accordance with ASC 740, the acquirer should account for the potential tax effects of an acquiree's temporary differences associated with assets acquired and liabilities assumed, carryforwards, and income tax uncertainties that exist at the acquisition date or that arise as a result of the acquisition.

This chapter is structured to follow the process that would typically be completed in analyzing the income tax implications of a business combination. The following highlights the steps in the process that are generally performed:

- **Determine the tax structure of the transaction and tax status of the entities involved in the business combination.** Determine the legal structure and the tax status of the entities acquired (e.g., corporate entities, partnerships, limited liability corporations), and determine the tax structure of the transaction (i.e., taxable or nontaxable). In a taxable transaction, the tax bases of the assets acquired and liabilities assumed generally are adjusted to fair value based on the rules of the specific tax jurisdiction. In a nontaxable transaction, the historical tax bases of the assets and liabilities, net operating losses, and other tax attributes of the target generally carry over to the acquirer. See further discussion of the differences in the two structures in TX 10.2.
- **Determine financial statement and tax bases of the assets acquired and liabilities assumed.** ASC 805 requires the acquired net assets to be recorded at fair value, with certain exceptions. The tax bases of the identifiable assets acquired and liabilities assumed are determined based on each specific tax jurisdiction and related tax laws and regulations. See TX 10.3 for further discussion.
- **Identify and measure temporary differences and acquired tax benefits.** Identify the temporary differences related to the book bases and tax bases of the acquired identifiable assets and assumed liabilities. Determine whether the temporary differences are deductible temporary differences or taxable temporary differences, and recognize the appropriate deferred tax assets or deferred tax liabilities in accordance with ASC 805-740-25-2. Determine whether there are any acquired net operating losses (NOLs), credit carryforwards, or other relevant tax attributes that should be recorded as part of the business combination. See TX 10.4 for further discussion of the evaluation of deferred tax assets and acquired tax benefits in a business combination.
- **Perform realization assessment for deferred tax assets recorded in acquisition accounting.** Determine whether a valuation allowance is required to reduce deferred tax assets if

they are not considered to be realizable. See TX 10.5 for further discussion of the evaluation of the realizability of deferred tax assets in a business combination.

- **Consider the treatment of tax uncertainties and indemnifications.** Identify and determine the accounting requirements for uncertain tax positions and indemnifications under ASC 805-740-25-2. See TX 10.7 for further discussion.
- **Consider deferred taxes related to goodwill.** Determine whether a deferred tax asset should be recognized for temporary differences associated with tax-deductible goodwill. See TX 10.8 for further discussion of recognizing deferred taxes related to goodwill.

10.2 Determining the tax structure of the business combination

The legal structure and tax status of the entities acquired and the tax structure of the transaction should be considered to determine the appropriate deferred tax balances to record in acquisition accounting.

10.2.1 Determining whether the business combination is taxable

The tax laws in most jurisdictions generally differentiate between taxable and nontaxable business combinations. The distinction is important because the type of transaction determines the tax bases of the acquired assets and assumed liabilities. The acquisition of a business through the direct purchase of its assets and assumption of its liabilities generally is treated as a taxable transaction (often referred to as an “asset acquisition” for tax purposes), while the acquisition of a business through the purchase of its corporate shares (often referred to as a “share” or “stock” acquisition for tax purposes) generally is treated as a nontaxable transaction. In some jurisdictions, a stock acquisition can be treated as an asset acquisition for tax purposes if the appropriate tax election is made and approved by the relevant taxing authorities.

10.2.2 Identifying the tax status of the entities involved

Business combinations may involve the acquisition of taxable entities (e.g., corporations), nontaxable entities (e.g., partnerships and multimember LLCs), or a combination of both. The acquired entity’s tax status will determine the deferred tax assets and liabilities to be recorded in acquisition accounting.

When the acquiree is a corporation, the acquirer generally recognizes deferred taxes on each of the acquiree’s identifiable assets and liabilities, including tax carryforwards and credits (referred to as “inside basis differences”). When the acquiree is a partnership, however, the acquirer generally recognizes deferred taxes only for differences between the financial statement carrying amount of the acquirer’s investment and its tax basis (referred to as “outside basis differences”). This is the case regardless of whether the partnership is accounted for as a consolidated entity or as an investment for financial reporting purposes.

Sometimes a portion of the outside basis difference in a partnership acquiree is attributable to assets for which deferred taxes generally would not be recognized if the acquiree was a corporation (e.g., nondeductible goodwill and the partnership’s investment in foreign subsidiaries). In these situations, an acquirer should apply a policy to either (1) look through the outside basis of the partnership and

exclude from the computation of deferred taxes basis differences arising from items for which there is a recognition exception under ASC 740, or (2) not look through the outside basis of the partnership and record deferred taxes based on the entire difference between the financial reporting and tax bases of its investment. If the acquirer has already selected one of these policies with regards to existing partnership investments, it should apply that policy consistently when recording deferred tax accounting to acquired partnership interests as well. Refer to TX 11.7 for a more detailed discussion on outside basis differences related to partnerships and other flow-through entities.

10.3 Determine book and tax bases of the net assets acquired

The recognized tax bases (the amount that is attributable for tax purposes) of the assets and liabilities are compared to the financial reporting values of the acquired assets and assumed liabilities (book bases) to determine the appropriate temporary differences.

10.3.1 Determining tax bases in a taxable transaction

In a taxable transaction (e.g., an asset acquisition or a stock acquisition treated as an asset acquisition), the acquirer records the tax bases of the assets acquired and liabilities assumed at their fair values based on the applicable tax law. The allocation methodology for determining tax bases is often similar to the requirements of ASC 805. Sometimes the acquisition price exceeds the fair value of identifiable assets acquired and liabilities assumed. The excess often is treated as goodwill for tax purposes and may be tax-deductible. However, there could be differences in the allocation methodology for tax and financial reporting purposes because the tax allocation follows the relevant tax law. For example, the US federal tax code requires a specific allocation method to determine the new tax bases in a taxable transaction. The allocation methodologies for book and tax purposes may differ when the aggregate fair value of the net assets acquired exceeds the consideration transferred, because bargain purchases may not be recognized for tax purposes in some jurisdictions.

Differences between assigned values for financial reporting and tax purposes should be analyzed. Regulatory bodies in various jurisdictions could question differences in the allocation of values for book and tax purposes. An inaccurate determination of fair value for tax purposes could impact the financial statements. For example, an improper tax valuation allocation between amortizable intangible assets and goodwill could result in inaccurate deferred taxes being recorded for those jurisdictions in which goodwill is not tax-deductible, and may also be an uncertain tax position requiring assessment for recognition and measurement. See TX 10.7 for more on acquisition accounting and uncertain tax positions.

The purchase price for financial reporting purposes may also differ from the purchase price for tax purposes. This may occur for several reasons, including the existence of contingent consideration (see TX 10.4.5) and the treatment of transaction costs (TX 10.4.7).

10.3.2 Determining tax bases in a nontaxable transaction

In a nontaxable transaction (e.g., stock acquisitions), the historical tax bases of the acquired assets and assumed liabilities, net operating losses, and other tax attributes of the acquiree carry over from the acquired company. No new tax goodwill is created. However, tax goodwill of the acquiree that arose in a previous acquisition may carry over and will need to be considered in determining temporary differences. See TX 10.8.2 for further information.

10.4 Identify and measure deferred tax assets and liabilities

The acquirer should identify and measure the deductible and taxable temporary differences of the acquired business and record the resulting deferred tax assets and liabilities.

10.4.1 Acquired temporary differences and tax benefits

In accordance with ASC 805-740-25-3, recognition of deferred tax assets and liabilities is required for substantially all temporary differences and acquired tax carryforwards and credits. Exceptions include temporary differences for nondeductible goodwill (see TX 10.8.3), and, in certain circumstances, the acquired basis difference between the parent's carrying amount of the subsidiary's net assets (or investment) in the financial statements and its basis in the shares of the subsidiary (also referred to as the outside basis difference) (see TX 11). The exception for nondeductible goodwill does not extend to identifiable intangible assets with an indefinite life. These assets may seem similar to goodwill, but are significantly different in their nature because, unlike goodwill, they do not represent residual values. Therefore, differences between the book bases and tax bases of all acquired identifiable intangible assets are temporary differences for which deferred taxes should be provided.

Example TX 10-1 provides an example for recognizing and measuring deferred taxes on acquired temporary differences.

EXAMPLE TX 10-1

Recording deferred taxes on acquired temporary differences

Company Z acquires Company X in a nontaxable stock acquisition for total consideration of \$1,000. The fair value of the acquired identifiable net assets is \$800. The carryover historical tax bases of the acquired net identifiable assets is \$500. The tax rate is 25%.

What deferred taxes should be recorded by Company Z in acquisition accounting?

Analysis

Company Z should record the following journal entries in acquisition accounting:

Dr. Net asset	\$800	
Dr. Goodwill	\$275 ¹	
Cr. Cash		\$1,000
Cr. Net deferred tax liability		\$75 ²

¹ Goodwill is calculated as the residual after recording the identifiable net assets acquired and associated deferred tax assets and liabilities ($\$1,000 - (\$800 - \$75)$).

² The net deferred tax liability is calculated as the difference between the book bases (in this case, the fair value) of the identifiable net assets acquired and the carryover tax bases at the applicable tax rate ($(\$800 - \$500) \times 25\%$).

10.4.2 *Expected manner of recovery or settlement*

The carrying amount of an asset will generally be recovered through use, sale, or both. The tax consequences of using an asset or settling a liability are sometimes different from selling net assets and may directly affect the tax that would be payable in the future. There may be different tax rates for ordinary income and capital gain income. Assets may sometimes be revalued or indexed to inflation for tax purposes only if the asset is sold (i.e., the tax basis is increased for the purpose of determining capital gain income but not ordinary income). Moreover, the ability to file consolidated, combined, or unitary tax returns, and elections or post-acquisition transactions may affect the tax that would be payable from the recovery of an asset. In some jurisdictions, recovery of assets through use will have no tax consequences, while recovery through sale will have tax consequences. The expected manner of recovery needs to be considered to determine the future tax consequences and corresponding deferred taxes in acquisition accounting.

ASC 740-10-25-20 notes that, inherent in an entity's statement of financial position is the assumption that the reported amounts of assets will be recovered and the reported amounts of liabilities will be settled. Consequently, in the case of financial statement assets that do not have a corresponding tax basis (e.g., intangible assets established in a nontaxable business combination), there is the presumption that, if the asset were to be recovered at its book carrying value, the gain on the sale proceeds would represent a future tax effect that must be accounted for.

Refer to TX 3.3.3 for further discussion of the impact of indexing for tax purposes on the calculation of deferred taxes and TX 8.6.2 on the accounting for a change in tax status as part of a business combination.

10.4.3 *Identifying the applicable tax rate for deferred taxes*

In determining deferred taxes, the identification of the applicable tax rate for each jurisdiction (and in some cases for each individual type of temporary difference) is important. An acquirer should consider the effects of the business combination when determining the applicable tax rate. As described in ASC 740-10-30-9, this may be important in jurisdictions in which graduated rates were historically significant for the business because the combined business' operations may require the application of a different statutory rate. See TX 10.5.4 for further information on recording the impact of an expected change in the applicable tax rate on the acquirer's deferred tax balances.

The applicable rate is determined based on enacted tax rates, even if the parties included apparent or expected changes in tax rates in their negotiations. ASC 740-10-45-15 requires that rate changes be reflected in the period when enacted. Further, a change in enacted rates subsequent to the acquisition date may result in an immediate positive or negative impact on the tax provision in the post-combination period.

Companies may elect to apply pushdown accounting, whereby the parent's basis in the investment is pushed down to the legal entities acquired. Regardless of whether pushdown accounting is applied, the applicable tax rate used to measure deferred taxes should be determined based on the relevant rate in the jurisdictions where the acquired assets will be recovered and the assumed liabilities settled, as discussed in Example TX 10-2.

EXAMPLE TX 10-2

Determining applicable tax rate

A holding company acquires 100% of the shares of another business in a nontaxable transaction. The holding company is incorporated in a jurisdiction that does not impose income taxes, and the acquired business is in a jurisdiction where income is subject to income taxes. The holding company identifies temporary differences between the fair value (as determined under ASC 805) for financial reporting purposes and the tax bases of the individual assets acquired and liabilities assumed.

Should deferred taxes be recorded for temporary differences resulting from the acquisition?

Analysis

Yes. The consolidated financial statements should include deferred taxes related to the book versus tax basis differences of the acquired net assets. The deferred taxes should be measured at the enacted income tax rate applicable to the acquired business. The tax rate applied should consider the jurisdiction in which the acquired assets will be recovered and the assumed liabilities settled, even if the parent's basis in the investment has not been pushed down to the separate financial statements of the acquired business.

10.4.4 *Deferred taxes related to outside basis differences*

A business combination may include the acquisition of certain temporary differences for which ASC 740-10-25-3 provides an exception for recording deferred taxes. For example, when the tax basis in the shares of certain entities differs from the financial reporting basis (i.e., there is an outside basis difference), no deferred tax liability is required for the outside basis difference if the parent can establish the intent and ability to indefinitely delay reversal of the difference. This exception applies to foreign subsidiaries and foreign corporate joint ventures (that are essentially permanent in duration). For domestic subsidiaries, according to ASC 740-30-25-7, if the parent has the intent and can demonstrate an ability to eliminate the outside basis difference in a tax-free manner, then no deferred tax liability is required to be recorded.

A company meets the indefinite reversal criteria if it can assert the intent and ability to indefinitely reinvest earnings abroad and not repatriate the earnings. The determination of whether deferred taxes related to the outside basis differences should be recorded at the acquisition date is based on the acquirer's intent regarding the acquired investments. For example, if the acquirer intends to repatriate earnings from the acquired entity and cause a reversal of the outside basis difference, then a deferred tax liability should be recognized in acquisition accounting because the liability existed at the acquisition date and was assumed by the acquirer. This is true even if the acquiree had previously not recorded deferred taxes on its outside basis differences.

The impact of the acquirer's intent related to assets already owned by the acquirer should be evaluated separately from the acquirer's intent related to assets acquired. The effect of a change in the assertion related to an acquirer's intent and ability to indefinitely delay the reversal of temporary differences related to subsidiaries it owned prior to the acquisition is recorded outside of acquisition accounting.

The outside tax basis of an investment may exceed the book basis. ASC 740-30-25-9 prohibits the recognition of a deferred tax asset for an investment in a subsidiary or corporate joint venture that is

essentially permanent in duration unless the temporary difference is expected to reverse in the foreseeable future.

10.4.4.1 Considerations related to unborn foreign tax credits

An acquirer and acquiree may have “unborn” foreign tax credits (FTCs). That is, foreign taxes that have been paid or accrued by the foreign subsidiary but which are not yet eligible as a credit to the parent because the earnings remittance, or other tax triggering event, has not yet occurred. These unborn FTCs do not currently exist as a separate tax asset, but will be generated upon reversal of an outside basis difference (e.g., remittance of earnings). See TX 11.5.1 for further discussion of unborn FTCs.

The impact of the acquirer’s unborn FTCs should be considered in measuring the deferred tax liability recorded in acquisition accounting on the outside basis in acquiree’s foreign subsidiaries. The result would be different if the acquirer’s FTCs have been generated and exist as a separate tax asset. For example, if the acquisition results in the acquirer changing its assessment of the realizability of its deferred tax asset for FTC carryforwards (i.e., for credits that have already been generated), the benefit from releasing a valuation allowance would be recorded outside of acquisition accounting. The distinction is that FTC carryforwards are a separate tax return attribute for which a deferred tax asset is recorded, whereas an unborn FTC is not a separate tax asset and is only considered in measuring other deferred taxes (e.g., an acquiree’s outside basis difference). See TX 10.5.4 for further discussion of changes in the acquirer’s deferred tax balances related to acquisition accounting.

Similarly, the impact of the acquiree’s unborn FTCs should be considered in measuring the acquirer’s deferred tax liability on its existing outside basis differences. If the acquiree’s unborn FTCs change the measurement of the acquirer’s existing deferred tax liability, the reduction in the acquirer’s deferred tax liability is recorded outside of acquisition accounting.

An acquiree may have a deferred tax asset for FTC carryforwards (i.e., for credits that have already been generated). The deferred tax asset would be recorded in acquisition accounting. In this situation, even though the FTC carryforwards may reduce the amount of tax paid when the acquirer’s taxable temporary difference reverses, the FTC carryforward is a separate tax asset acquired in the business combination, and therefore, should be reflected in acquisition accounting. This is true even if the acquiree previously had a valuation allowance against the FTC carryforward deferred tax asset but the acquirer determines a valuation allowance is not required.

An acquisition of a business may also affect the amount of the acquirer’s Global Intangible Low-Taxed Income (GILTI) tax in the year of acquisition and the related GILTI FTCs that can be utilized against GILTI income. Question TX 10-1 addresses whether an asset should be recorded for these GILTI FTCs in acquisition accounting.

Question TX 10-1

Company X accounts for GILTI as a period cost. In Q2 of the current year, Company X purchased Company Y and plans to include Company Y in its US consolidated tax return. Company Y historically generates more GILTI FTCs than it can use. However, as a result of the acquisition, Company X expects that the GILTI FTCs that will arise in the current year from Company Y’s operations prior to the acquisition date will be able to offset GILTI taxes of the Company X consolidated group (including

Company Y) in the year of acquisition. Should Company X reflect the benefit of these Company Y GILTI FTCs as part of acquisition accounting?

PwC response

Yes, we believe it is appropriate for Company X to reflect the benefit of these GILTI FTCs in acquisition accounting. The GILTI FTCs that will arise in the current year from Company Y's operations prior to the acquisition date are based on the foreign income earned and the taxes paid (accrued) through that date. Therefore, if Company X will be able to use those GILTI FTCs to reduce its GILTI tax, the GILTI FTCs should be recognized as a reduction to taxes payable (or an increase to taxes receivable) at the acquisition date.

10.4.5 *Deferred taxes—assumed liabilities and contingencies.*

Acquisition accounting under ASC 805 includes the recognition of assumed liabilities, acquired contingent assets under ASC 450, assumed contingent liabilities under ASC 450, and contingent consideration under ASC 805, all of which affect the amount of book goodwill or other assets recorded at the acquisition date. However, these items generally are not recognized for tax purposes until the amounts are fixed and reasonably determinable or, in some jurisdictions, until they are paid. These conditions often are not met until a future financial statement period. As a result, these items would not have tax basis on the acquisition date. In a taxable transaction, the tax basis in the newly created goodwill generally does not include an incremental amount related to these items (there is no tax-deductible goodwill created in a nontaxable transaction). Therefore, the difference in treatment for these items could give rise to temporary differences for which deferred taxes should be recognized at the date of acquisition and adjusted in subsequent periods as the assumed liability, contingency, or contingent consideration is adjusted for financial reporting purposes or ultimately settled or resolved.

According to the principle in ASC 740-10-25-20(b), a temporary difference for which deferred taxes should be recorded generally exists if the resolution of the contingency or settlement of the assumed liability or contingent consideration will result in a future tax consequence (i.e., deduction or income). The tax consequence is affected by whether the business combination was a taxable or nontaxable transaction. The resolution of a contingent liability acquired in a nontaxable transaction may result in a tax deduction, in which case a deferred tax asset should be recorded on the acquisition date. In a taxable transaction, the settlement of an assumed liability may affect the amount of tax-deductible goodwill, in which case whether deferred taxes are recognized depends on whether book or tax-deductible goodwill is greater. See TX 10.8 for further information on deferred taxes related to goodwill.

If the resolution of the contingency or settlement of the assumed liability will impact the amount of tax-deductible goodwill we believe an acquirer may take one of two acceptable approaches to account for the related deferred taxes.

1. Consider the impact of the future settlement or resolution on tax-deductible goodwill in the initial comparison to book goodwill as if the assumed liability, contingency, or contingent consideration was settled at its book basis at the acquisition date.
2. Treat the assumed liability, contingency, or contingent consideration as a separately deductible item. A deferred tax asset would be recorded in acquisition accounting because the liability, when settled, will result in a future tax deduction. That is, a deferred tax asset is recognized at the acquisition date since there is a basis difference between book and tax related to the liability. The deferred tax asset would be calculated by multiplying the

temporary difference by the applicable tax rate. Under this approach, the initial comparison of book goodwill to tax-deductible goodwill for this particular component simply reflects the book goodwill and tax-deductible goodwill that exists at the acquisition date (i.e., the contingency is included in book goodwill but not in tax-deductible goodwill) even though the liability will be added to tax-deductible goodwill when settled.

The resolution of the contingency or settlement of the assumed liability in some cases can also impact other acquired assets. The available accounting approaches for the related deferred taxes are similar to those available when the resolution or settlement impacts tax-deductible goodwill.

Figure TX 10-1 summarizes the deferred tax accounting associated with the most common scenarios for assumed liabilities, contingencies, and contingent consideration in a taxable transaction, using the first approach described above (treatment as if settled at book basis on the acquisition date), as well as deferred tax accounting scenarios in a nontaxable transaction. See TX 10.4.5.1 for further information and examples related to taxable transactions and TX 10.4.5.2 for further information related to nontaxable transactions.

Figure TX 10-1

Deferred taxes related to assumed liabilities, contingencies, and contingent consideration

Deferred tax considerations			
Topic	Financial reporting	Taxable transaction	Nontaxable transaction
Assumed liabilities	<p><i>Acquisition date:</i></p> <p>Record at fair value¹ as determined by applying ASC 805, <i>Business combinations</i>.</p>	<p>If settlement would result in tax-deductible goodwill, then the recorded amount of the liability is added to the tax basis goodwill balance. A deferred tax asset would be recorded for any excess tax-deductible goodwill (as adjusted) over book goodwill.</p> <p>If settlement would result in a tax-deductible asset (other than goodwill), then the recorded amount of the liability is added to the tax basis of such asset. Record deferred taxes on the resulting book versus tax basis difference if required under ASC 740.</p>	<p>If settlement would result in a tax deduction or tax-deductible asset (other than goodwill), then a deferred tax asset should be recorded.</p>
	<p><i>Subsequent adjustment:</i></p> <p>Adjust the liability periodically, as required under relevant accounting guidance (various).</p>	<p>If settlement would result in tax-deductible goodwill, then record deferred taxes on the amount of the adjustment. Do not reperform the acquisition date comparison of tax-deductible goodwill to book goodwill.</p> <p>If settlement would result in a tax-deductible asset (other than goodwill), then the amount of the adjustment is added to the tax basis of the asset.</p> <p>In both instances, any deferred tax effect is reflected in income tax expense in the income statement.</p>	<p>If settlement would result in a tax-deductible asset (other than goodwill), then a deferred tax asset should be recorded.</p>

¹ ASC 805-20-25-17 and ASC 805-20-30-12 provide a summary of exceptions to the recognition and fair value measurement principles in ASC 805.

Deferred tax considerations

Topic	Financial reporting	Taxable transaction	Nontaxable transaction
	<p><i>Settlement:</i></p> <p>Reverse the liability through payment or other settlement.</p>	<p>Apply the same treatment as for “subsequent adjustment” if settled at an amount different than previously recorded.</p>	<p>Apply the same treatment as for “subsequent adjustment” if settled at an amount different than previously recorded.</p>
Contingencies	<p><i>Acquisition date:</i></p> <p>Record at fair value if determinable¹ or if not, at an amount determined by applying ASC 450, <i>Contingencies</i>.</p>	<p>If settlement would result in tax-deductible goodwill, then the recorded amount of the contingency is added to the tax basis goodwill balance. A deferred tax asset would be recorded for any excess tax-deductible goodwill (as adjusted) over book goodwill.</p> <p>If settlement would result in a tax-deductible asset (other than goodwill), then the recorded amount of the contingency is added to the tax basis of such asset. Record deferred taxes on the resulting book versus tax basis difference if required under ASC 740.</p>	<p>If settlement would result in a tax deduction or tax-deductible asset (other than goodwill), then a deferred tax asset should be recorded.</p>
	<p><i>Subsequent adjustment:</i></p> <p>Adjust the contingency periodically, as required.</p>	<p>If settlement would result in tax-deductible goodwill, then record deferred taxes on the amount of the adjustment. Do not reperform the acquisition date comparison of tax-deductible goodwill to book goodwill.</p> <p>If settlement would result in a tax-deductible asset (other than goodwill), then the adjustment is added to the tax basis of the asset.</p> <p>In both instances, any deferred tax effect is reflected as part of income tax expense in the income statement.</p>	<p>If settlement would result in a tax-deductible asset (other than goodwill), then a deferred tax asset should be recorded.</p>
	<p><i>Settlement:</i></p> <p>Reverse the contingency through payment or other settlement.</p>	<p>Apply the same treatment as for “subsequent adjustment” if settled at an amount different than previously recorded.</p>	<p>Apply the same treatment as for “subsequent adjustment” if settled at an amount different than previously recorded.</p>
Contingent consideration²	<p><i>Acquisition date:</i></p> <p>Record at fair value¹ as determined by applying ASC 805, <i>Business combinations</i>.</p>	<p>If settlement would result in tax-deductible goodwill, then the recorded amount of the contingency is added to the tax basis goodwill balance. A deferred tax asset would be recorded for any excess tax-deductible goodwill (as adjusted) over book goodwill.</p>	<p>If settlement would result in an increase in the tax basis of the shares (i.e., outside basis), then the recorded amount of the liability would be added to the tax basis of the shares to determine the outside basis temporary difference. Deferred taxes would not be recognized</p>

² Contingent consideration generally represents an obligation of the acquirer to transfer additional assets or equity interests to the selling shareholders if certain future events occur or conditions are met.

Deferred tax considerations

Topic	Financial reporting	Taxable transaction	Nontaxable transaction
		If settlement would result in a tax-deductible asset (other than goodwill), then the recorded amount of the contingency is added to the tax basis of the asset. Record deferred taxes on the resulting book versus tax basis difference if required under ASC 740.	unless deferred taxes are otherwise provided on the outside basis difference.
	<i>Subsequent adjustment:</i> Record at fair value each period except for equity-classified arrangements.	If settlement would result in tax-deductible goodwill, then record deferred taxes on the amount of the adjustment. Do not reperform the acquisition date comparison of tax-deductible goodwill to book goodwill. If settlement would result in a tax-deductible asset (other than goodwill), then the adjustment is added to the tax basis of the asset. In both instances, any deferred tax effect is reflected as part of income tax expense in the income statement.	If settlement would result in an increase in the tax basis of the shares (i.e., outside basis), then deferred taxes should not be adjusted unless deferred taxes are already being recorded on the outside basis difference.
	<i>Settlement:</i> Reverse the contingency through payment or other settlement.	Apply the same treatment as for “subsequent adjustment” if settled at an amount different than previously recorded.	Apply the same treatment as for “subsequent adjustment” if settled at an amount different than previously recorded.

10.4.5.1 Assumed liabilities/contingencies—taxable transactions

In a taxable business combination, the settlement of an assumed liability, contingency, or contingent consideration will often impact the ultimate amount of tax-deductible goodwill.

Initial recognition including measurement period adjustments

Following the first approach described in TX 10.4.5, the recorded amount of the assumed liability, contingency, or contingent consideration is added to the tax-deductible goodwill balance as if it were settled at the acquisition date. A deferred tax asset should be recorded if the amount of that hypothetical tax-deductible goodwill (as adjusted for the liability or contingency) exceeds the amount of book goodwill. Because the deferred tax asset is related to goodwill, an iterative calculation is required to determine the amount of the deferred tax asset. However, no deferred tax liability is recorded if book goodwill exceeds the hypothetical tax goodwill (ASC 805-740-25-9). See TX 10.8 for further information on recording deferred taxes on goodwill.

Example TX 10-3 illustrates the described approach for determining deferred tax balances related to contingent consideration at the acquisition date in a taxable business combination.

EXAMPLE TX 10-3**Acquisition date deferred taxes related to contingent consideration in a taxable business combination**

Assume contingent consideration is valued on the acquisition date in a taxable business combination at \$1,000. Goodwill for book purposes (including the recognition of contingent consideration) is \$3,000. Tax-deductible goodwill is \$1,800, which excludes any amount of contingent consideration not yet paid. The applicable tax rate for all periods is 25%. For tax purposes, when the contingent consideration is settled, it will become part of the tax basis of goodwill.

Should deferred taxes be recorded in acquisition accounting related to the contingent consideration?

Analysis

It depends. To determine deferred taxes at the acquisition date, consider the tax consequence that will result if the contingent consideration is settled at its recorded amount for book purposes. Because the amount of contingent consideration would be added to tax-deductible goodwill when settled, it is added to the existing balance of tax-deductible goodwill to determine whether there is an excess of tax or book goodwill. The goodwill balances are analyzed as follows:

Book goodwill		\$ 3,000
Tax-deductible goodwill	\$ 1,800	
Contingent consideration	<u>1,000</u>	
Tax-deductible goodwill (as adjusted)		<u>2,800</u>
Excess of book over tax-deductible goodwill		<u>\$ 200</u>

Because book goodwill exceeds tax-deductible goodwill, no deferred taxes would be recognized. However, if the tax-deductible goodwill (as adjusted) exceeded book goodwill, a deferred tax asset would be recognized. For example, if the contingent consideration was valued at \$1,500 at the acquisition date, the tax-deductible goodwill (as adjusted) would have been \$3,300. The excess over the book goodwill of \$300 would have resulted in a deferred tax asset. See TX 10.8.2.1 for further information on how the deferred tax asset is calculated.

The same approach applies to assumed liabilities and contingencies in a taxable business combination.

Subsequent adjustments other than measurement period adjustment

In general, adjustments in subsequent periods to assumed liabilities, contingencies, and contingent consideration are recorded in earnings. The appropriate deferred tax treatment related to these adjustments is determined by considering the expected tax consequences, assuming settlement at book carrying amounts. The related deferred tax asset is adjusted if the adjustment to the assumed liability, contingency, or contingent consideration would cause a tax consequence (e.g., increase or decrease a deductible expense or asset).

The acquisition date comparison of book goodwill to tax-deductible goodwill should not be reperformed subsequent to the acquisition date. For example, a deferred tax asset should be recognized or adjusted along with the related income tax expense or benefit when contingent consideration is increased subsequent to the acquisition date for a change in fair value, and the

settlement of the contingent consideration would increase tax-deductible goodwill. This is true even if no deferred tax asset was recorded at the date of acquisition (i.e., tax goodwill did not exceed book goodwill at the acquisition date).

Similarly, a decrease in the contingent consideration liability subsequent to the acquisition date due to a change in fair value causes a decrease in the tax-deductible goodwill. The tax impact of the decrease in the contingent consideration liability will be recorded by either (1) recording a deferred tax liability (i.e., when book goodwill exceeded tax-deductible goodwill at the acquisition date), or (2) reducing a deferred tax asset (i.e., when tax-deductible goodwill exceeded book goodwill at the acquisition date).

Example TX 10-4 illustrates accounting for the deferred tax effects of an adjustment to contingent consideration in a taxable business combination.

EXAMPLE TX 10-4

Deferred tax effects of an adjustment to contingent consideration in a taxable business combination

Assume contingent consideration in a taxable business combination is valued on the date of acquisition at \$1,000. At the acquisition date, goodwill for book purposes (including the initial recognition of contingent consideration) is \$3,000. Tax-deductible goodwill is \$1,800 (not considering contingent consideration). Once the contingent consideration is settled, it will be included in tax-deductible goodwill. At the acquisition date, book goodwill of \$3,000 exceeded tax-deductible goodwill of \$2,800 (\$1,800 plus the assumed settlement of the contingent consideration at book basis of \$1,000); therefore, no deferred tax was recorded for contingent consideration.

In year two, the fair value of the contingent consideration increases by \$700 to \$1,700. In year three, contingent consideration is settled at \$1,700. The applicable tax rate for all periods is 25%. For simplicity, the effects of amortization of tax goodwill are excluded from the example.

How are deferred taxes impacted as a result of the contingent consideration adjustment and settlement?

Analysis

When settled, the additional consideration will result in additional tax-deductible goodwill. Therefore, a deferred tax asset related to the increase in fair value in year two would be recorded, even though no deferred tax related to tax-deductible goodwill was recorded at the acquisition date. This is because the acquisition date comparison of book to tax goodwill is not revisited.

The following entry would be recorded:

Dr. Expense	\$700	
Dr. Deferred tax asset	\$175 ¹	
Cr. Contingent consideration liability		\$700
Cr. Deferred tax expense		\$175

¹ \$700 x 25%

The same treatment would apply if there were a decrease in the contingent consideration. For example, if the contingent consideration had decreased by \$700, a deferred tax liability of \$175 would have been recorded.

Because the contingent consideration is settled for the amount previously recorded, there is no further impact on earnings or deferred taxes in year three. The deferred tax asset is not adjusted because the contingent consideration was settled at the recorded amount for book purposes, but it has not yet been deducted for tax purposes (i.e., the deduction will occur over time as goodwill is amortized).

The same treatment would apply for an assumed or contingent liability in a taxable business combination.

Equity-classified contingent consideration

For financial reporting purposes, a contingent consideration arrangement that is equity-classified is not remeasured after the acquisition date for any subsequent changes in fair value. However, in most cases, for tax purposes, the contingent consideration will be ultimately measured (and create tax basis) at the fair value on the date of settlement. When settled and additional tax basis arises, it may be appropriate to recognize a deferred tax consequence at that point. We believe the appropriate accounting for any deferred tax consequences from an equity-classified contingent consideration arrangement is to reflect the deferred tax affects as an increase in contributed capital pursuant to ASC 740-20-45-11(g).

Example TX 10-5 illustrates the income tax accounting implications of equity-classified contingent consideration.

EXAMPLE TX 10-5

Accounting for tax effects from the settlement of equity-classified contingent consideration

Assume an equity-classified contingent consideration arrangement is valued and measured on the date of acquisition in a taxable business combination at \$100,000. The contingent consideration will be settled by issuing stock to the seller when certain performance conditions are met, at which time the fair value of the equity consideration issued will be included in tax-deductible goodwill. At acquisition, book goodwill exceeds tax goodwill by \$100,000, and, therefore, no deferred tax is recorded for the equity-classified contingent consideration. The fair value of the contingent consideration increases by \$50,000 to \$150,000 in year two when the shares are issued to the seller. The applicable tax rate is 25%.

How should the tax effects from the settlement of the equity-classified contingent consideration be recorded?

Analysis

There would be a reclassification within equity (of the original acquisition date fair value) to reflect actual issuance of the securities. The settlement would have no other pre-tax consequence to the assets, liabilities, income, or equity of the company. However, the settlement results in additional tax basis in goodwill of \$50,000, which will be amortized along with the initial \$100,000 basis in future periods. The tax benefit from the additional tax basis, net of any valuation allowance, should be recognized in equity.

The following entry would be recorded:

Dr. APIC-contingent consideration	\$100,000	
Dr. Deferred tax asset	\$12,500 ¹	
Cr. Common stock		\$100,000
Cr. APIC		\$12,500

¹ \$50,000 x 25%

10.4.5.2 **Assumed liabilities/contingencies—nontaxable transactions**

Because no tax-deductible goodwill is created in a nontaxable transaction, the tax implications of the settlement of an assumed liability, contingency, or contingent consideration differs from that in a taxable transaction.

Assumed liabilities or contingent liabilities

The amount paid to settle an assumed or contingent liability recorded in a nontaxable business combination may result in a tax deduction. A deferred tax asset should be recorded in acquisition accounting for the assumed liability or contingency if the applicable tax laws would allow for a deduction when the assumed or contingent liability is settled. This concept is illustrated in Example TX 10-6.

EXAMPLE TX 10-6

Deferred tax impact of contingent liabilities in a nontaxable business combination

Assume a contingent liability is recorded at fair value of \$1,000 on the date of acquisition in a nontaxable business combination. The tax basis in the contingent liability is zero. When the liability is settled, the company will receive a tax deduction for the amount paid. The tax rate is 25%.

Should deferred taxes be recorded in acquisition accounting related to the contingent liability?

Analysis

Yes. The contingent liability is a temporary difference at the acquisition date because it has zero tax basis and will result in a tax deduction when settled. The following entry would be recorded at the acquisition date:

Dr. Deferred tax asset	\$250	
Dr. Goodwill	\$750	
Cr. Contingent liability		\$1,000

The deferred tax asset should be adjusted in subsequent periods as the amount of the contingent liability changes. Both adjustments would be recorded in the income statement.

Contingent consideration

The settlement of contingent consideration in a nontaxable business combination often will be added to the outside tax basis as part of the amount paid for the acquiree. Therefore, the contingent consideration would be added to the outside tax basis for purposes of determining the difference between outside tax basis and book basis. However, deferred taxes would not be affected by the contingent consideration at the acquisition date or upon adjustment to the amount of contingent consideration in subsequent periods unless a company is providing deferred taxes on outside basis differences. When deferred taxes are not affected, any subsequent changes in the fair value of the contingent consideration could impact an entity's effective tax rate because the pre-tax effect would be recorded in the income statement without a corresponding tax effect. See TX 10.4.4 for further information on recording deferred taxes on outside basis differences.

10.4.6 *Deferred taxes for research and development activities*

Research and development activities (R&D) acquired in a business combination will be capitalized as tangible or intangible assets based on their nature. The capitalized in-process R&D (IPR&D) activities are accounted for as indefinite-lived intangible assets, subject to impairment testing until completion or abandonment of the projects. The acquirer estimates the useful life of the asset once each project is complete (ASC 805-20-35-5).

Deferred taxes should be recorded for temporary differences related to R&D intangible assets as of the business combination's acquisition date. If the tax basis of the R&D intangible asset is less than the book basis, as will generally be the case in a nontaxable business combination, a deferred tax liability will be recorded based on the difference.

Deferred tax liabilities related to indefinite-lived assets typically are not used as a source of income to support realization of deferred tax assets in jurisdictions where tax attributes expire (e.g., jurisdictions where net operating loss carryforwards expire) unless the deferred tax liability is expected to reverse prior to the expiration of the tax attribute. See TX 5.5.1 for additional discussion. The acquirer should determine whether the deferred tax liability related to R&D will reverse in a period that would allow for realization of the deferred tax assets.

Example TX 10-7 illustrates the approach for considering whether a deferred tax liability for R&D activities should be considered a source of income for realizing deferred tax assets.

EXAMPLE TX 10-7

Whether a deferred tax liability for R&D activities should be considered a source of income for realizing deferred tax assets

Company A acquires Company B in a nontaxable business combination. Company A recognizes an acquired R&D intangible asset for \$100 and records an associated deferred tax liability of \$25. Under ASC 805, the R&D intangible asset is classified as indefinite-lived until the project is either abandoned or completed, at which time a useful life will be determined. Company A plans to file a consolidated tax return with Company B. Company A had a pre-existing deferred tax asset of \$20 for NOLs that will expire in 10 years (for simplicity, assume this is the Company's only deferred tax asset). Prior to the acquisition, Company A had a valuation allowance against the deferred tax asset.

Should the deferred tax liability related to an acquired R&D intangible asset be considered a source of income for realizing deferred tax assets?

Analysis

It depends. Company A must estimate both when the R&D project will be completed and the expected useful life of the resulting intellectual property intangible asset in order to determine whether the deferred tax liability related to the R&D intangible asset can be used as a source of taxable income. If Company A expects the project to be completed within two years and expects the useful life of the intangible asset to be three years, then the deferred tax liability should be used as a source of income in assessing the realization of the deferred tax asset because the deferred tax liability is expected to reverse (over years three to five) before the NOL carryforward expires. Any benefit recognized if Company A reverses all or a portion of its valuation allowance would be recorded outside of acquisition accounting in continuing operations.

10.4.7 *Deferred taxes related to acquisition-related costs*

Under ASC 805, acquisition-related costs are not part of the fair value of the consideration that is transferred. Such costs are expensed as incurred by the acquirer. However, acquisition-related costs may be treated one of several ways for tax purposes depending on the tax jurisdiction and the type of costs. For example, these costs could be expensed as incurred, capitalized as a separate intangible asset, included in the basis of the shares acquired, included in the basis of other assets, or included in tax-deductible goodwill.

Transaction-related costs incurred by the seller are generally expensed as incurred. However, similar to buyers' costs, these costs may also be capitalized as a separate asset, included in the basis of the shares sold, or included in the basis of assets sold.

If the acquisition costs are not immediately deductible for tax purposes, a potential temporary difference is created. We believe there are two acceptable alternatives for determining the appropriate deferred tax treatment for acquisition costs.

One alternative is to consider whether the acquisition costs would result in a future tax deduction if the business combination was not consummated. If so, then the acquisition costs represent a deductible temporary difference for which a deferred tax asset should be recognized when the costs are expensed for financial reporting. This approach is considered acceptable because the consummation of a business combination is generally not anticipated for accounting purposes. When the acquisition is consummated, companies will need to revisit the appropriate accounting for the temporary difference and consider whether the deferred tax asset should be reversed. Depending on how the acquisition costs are treated for tax purposes (e.g., added to the outside basis of the shares), it may no longer be appropriate to record deferred taxes on such acquisition costs. Reversal of a deferred tax asset would be reflected in the income statement and would affect the effective tax rate in the period the acquisition is consummated.

Another alternative is to consider the expected ultimate tax consequence of the costs. For example, the acquirer may expect the costs to be included in the outside basis of the shares for tax purposes, as is typically the case in a nontaxable business combination. In this case, no deferred tax asset would be established related to the acquisition costs unless the acquirer expects to record deferred taxes on the outside basis temporary difference. Therefore, the acquisition costs would be expensed with no

corresponding tax effect, which would affect the effective tax rate in the period the acquisition costs are expensed. Deferred taxes would be provided on the acquisition costs if those costs are expected to be included in a tax-deductible asset (e.g., tax-deductible goodwill). This approach is considered acceptable because it is appropriate to consider the expected tax consequence of the reversal of the temporary difference in the recognition and measurement of deferred taxes (according to ASC 740-10-25-20). This approach requires a continuous evaluation of expectations at each reporting date and recognition of deferred tax adjustments consistent with revised expectations.

Tax-deductible goodwill is compared to book goodwill at the acquisition date to determine whether a deferred tax asset should be recorded. Under either approach described above, acquisition costs incurred by the acquirer are not included in the tax goodwill amount for purposes of the comparison of tax-deductible goodwill to book goodwill, because the acquisition costs are not included in book goodwill. See TX 10.8 for further information on recording deferred taxes on goodwill.

Since these costs will not be reflected in acquisition accounting for financial reporting purposes, associated deferred taxes that are recorded or later reversed will be reflected in the income statement.

The costs to issue debt or equity securities are recognized in accordance with other applicable GAAP (e.g., ASC 805-10-25-23). Costs to issue debt or equity securities are not part of acquisition accounting. As such, any associated tax effect will be reflected in the income statement or directly in equity, but not in acquisition accounting.

See TX 16.7 for a discussion of acquisition costs in calculating an estimated annual effective tax rate.

Example TX 10-8 illustrates an approach by an acquirer for considering deferred taxes on transaction costs incurred by a target company.

EXAMPLE TX 10-8

Accounting for transaction costs incurred by a target company that are capitalized for tax purposes

Target incurred transaction costs in connection with a recent acquisition of its shares by Buyer. Target is required to capitalize these costs as a separate asset for tax purposes in Jurisdiction A. The resulting tax basis in these capitalized costs survives the acquisition; however, such amounts cannot be amortized for tax purposes and cannot be separately sold. Such costs may be deductible at some indefinite future date, which may occur when the assets that constitute the related trade or business are sold or if and when it is determined that the capitalized costs no longer have any future value. Furthermore, these transaction costs will generally not be deductible if Target is liquidated. If liquidated, the related tax basis will carry over to Buyer.

Should Buyer record a deferred tax asset in acquisition accounting for the difference between the book basis (zero) and tax basis of Target's capitalized transaction costs?

Analysis

Generally, no. If a specific event must occur in order for Target to claim a tax deduction for the transaction costs and that event will not occur until some indefinite future date, we believe that it would be inappropriate to recognize a deferred tax asset until it is apparent that the temporary difference will reverse in the foreseeable future.

Although the transaction costs in this example appear to be similar to the organizational costs described in ASC 740-10-25-25, for which deferred taxes would be recognized, we believe an important distinction exists. The organization costs contemplated in ASC 740-10-25-25 are deductible for tax purposes over a specified period. The transaction costs in this example are not deductible except through specified transactions that are tantamount to a sale or complete impairment of Target. Thus, even though the transaction costs technically are not part of the tax basis in the stock of Target, we believe they are analogous to an excess of outside tax basis over book basis. Accordingly, we believe it is appropriate to analogize to the guidance in ASC 740-30-25-9, which prohibits the recognition of a deferred tax asset for an excess of the tax basis over the book basis of a subsidiary unless it is apparent that the temporary difference will reverse in the foreseeable future.

10.4.8 *Deferred taxes—exception on foreign exchange matters*

If an entity's functional currency differs from its local currency, certain of the entity's assets and liabilities (e.g., nonmonetary assets) will be remeasured in future periods at historical currency rates. The historical rate for assets and liabilities acquired in a business combination is the rate at the date of the combination. The exception in ASC 740-10-25-3(f) that prohibits recognition of deferred taxes for differences that arise from changes in exchange rates or indexing for tax purposes on assets and liabilities that are remeasured at historical exchange rates does not apply at the acquisition date. Therefore, the difference between the fair value of acquired assets and liabilities measured in the functional currency at the acquisition date and the tax basis is a temporary difference for which a deferred tax asset or liability would be established on the acquisition date.

The exception in ASC 740-10-25-3(f) does apply to changes in the temporary difference post-acquisition. See TX 2.4.3 for further discussion of the exception on recording deferred taxes on certain foreign exchange amounts.

10.4.9 *Changes in measurement of the acquired deferred taxes*

The acquirer should consider whether changes in the acquired deferred tax balances are due to new information about facts and circumstances that existed at the acquisition date (measurement period adjustments) or are due to events arising in the post-combination period. For example, the impact of a subsequent business combination occurring during the measurement period of a prior acquisition would likely not qualify as a measurement period adjustment. Therefore, if a subsequent business combination triggers the release of a valuation allowance established in a prior acquisition, such release would typically be recorded as a decrease in income tax expense. The guidance in ASC 805 related to measurement period adjustments for acquired deferred tax balances is consistent with the guidance for changes in other acquired assets and liabilities. See BCG 2.9 for further information on measurement period adjustments.

Adjustments to acquired assets and assumed liabilities during the measurement period are reflected in the reporting period in which the adjustment is determined. In general, changes to deferred tax balances that result directly from measurement period adjustments would be recognized at the same time. Example TX 10-9 illustrates this guidance.

EXAMPLE TX 10-9**Measurement period adjustments related to deferred taxes**

Company A acquired Company B in a nontaxable business combination in the first quarter of 20X1. One of Company B's more significant assets was an office building that had no remaining tax basis. Company A recorded the office building at a provisional fair value of \$1,000 and recorded a corresponding deferred tax liability of \$250 (25% rate) at the acquisition date. Company A had pre-existing deferred tax assets of \$600, for which there was a full valuation allowance in prior periods. Solely as a result of the taxable temporary differences recognized in the business combination, Company A released \$250 of its valuation allowance and recognized the benefit in the income statement at the acquisition date in accordance with ASC 805-740-30-3.

In the second quarter of 20X1, Company A completed its measurement of the acquisition date fair value of the office building when it received a third-party appraisal report. The appraisal indicated that the fair value of the building at the acquisition date was only \$700, resulting in a deferred tax liability of \$175 (and not the \$250 previously recorded).

How should Company A record the deferred tax consequences of the subsequent change to the acquisition-date fair value of the office building?

Analysis

Company A would recognize a reduction in the value of the building and a corresponding reduction to depreciation expense recognized since the date of acquisition. Company A would also recognize a reduction in the deferred tax liability associated with the building and an adjustment to the amount of the valuation allowance released as of the acquisition date. The following journal entries would be recorded.

Dr. Goodwill	\$225	
Dr. Deferred tax liability	75	
Cr. Property, plant & equipment		\$298
Cr. Depreciation expense		2

To recognize the reduction in the fair value of the building and the cumulative adjustment to depreciation expense (assumes one quarter previously taken based on provisional value and a 40-year life for the building), the corresponding deferred tax effects at the acquisition date, and the offsetting adjustment to goodwill.

Dr. Deferred tax expense	\$75	
Cr. Deferred tax asset valuation allowance		\$75

To re-establish the valuation allowance on deferred tax assets due to the reduced taxable temporary difference upon finalization of the valuation of the building.

10.4.10 *Effects of post-acquisition elections*

Business combinations often involve a considerable amount of business, legal, and tax planning. Tax effects can arise from events ranging from tax-specific elections to more complex reorganizations and business integration actions. These events may alter the income taxes expected to be incurred on recovery of acquired temporary differences. When such events relate to actions contemplated by the acquirer at or prior to the acquisition date, careful analysis is required to determine whether the tax effects should be included as part of acquisition accounting or should be accounted for outside of acquisition accounting as a separate transaction.

The fair value accounting guidance in the business combination standard is based upon market-participant assumptions, which exclude the effects of buyer-specific decisions and transactions. However, the standard identifies income taxes as an exception to the fair value recognition and measurement principles. The acquirer should record all deferred tax assets, liabilities, and valuation allowances in accordance with ASC 740.

Neither ASC 805-740 nor ASC 740 directly address whether the tax effects of post-acquisition elections or transactions should be included in acquisition accounting. This determination requires consideration of specific facts and circumstances and the relevant tax laws.

The determination might be straightforward when, for example, the seller and buyer agree to make a tax election to treat a stock purchase as an asset purchase for tax purposes, thus providing a step-up in the inside tax bases of acquired assets. The buyer is thus able to acquire, through the acquisition negotiations, assets with stepped-up tax bases and should account for the tax election effects in acquisition accounting. However, there are circumstances when the determination is not straightforward and may require significant judgment and analysis.

We believe the following factors should generally be considered.

- Whether the election or transaction is available and contemplated as of the acquisition date, or within the measurement period based on information and facts that existed at the acquisition date (even if the final decision to implement it occurs after the acquisition date). Actions that are based on information that was not known or knowable, or circumstances that did not exist as of the acquisition date, are based upon new information and their effects should be accounted for outside of acquisition accounting.
- Whether the election or transaction is primarily within the acquirer's control with no significant complexities or uncertainties as to whether the transaction will actually be completed. If implementation is contingent on obtaining third-party approval (including a tax ruling) or meeting legal or regulatory requirements, it generally is not primarily within the acquirer's control.
- Whether the acquirer is required to make a payment (separate from consideration exchanged for the business) or forgo tax attributes to obtain the tax benefits; in this regard, the mere realization or settlement of an acquired deferred tax liability is not considered a separate payment. If a separate payment (or sacrifice of tax attributes) is required to obtain tax benefits, the effects would generally be recorded outside of acquisition accounting.

- Whether other significant costs will be incurred to implement the transaction. If significant costs other than payment to a taxing authority must be incurred to implement the transaction, it may indicate that, consistent with the expensing of such costs, the tax effects should also be expensed.

Example TX 10-10 illustrates the accounting for the tax effects of a post-acquisition restructuring.

EXAMPLE TX 10-10

Deferred tax accounting when a planned post-acquisition restructuring will impact the ability to benefit from acquired net operating losses

Company X acquires 100% of the stock of Company Y in a nontaxable transaction. Company Y has state NOLs at the acquisition date in the single state in which it operates. The change in control of Company Y does not impact the utilization of the NOLs under state law. Company X has no presence in that state, which is a non-unitary separate filing state. There is sufficient evidence as of the acquisition date that the NOLs can be realized in the future based on the operations of Company Y; however, Company X has a definitive plan to move Company Y's headquarters and operations to another state shortly after the acquisition. Because of this planned post-acquisition restructuring action, Company X does not expect the NOLs related to Company Y's previous state of domicile to be realized.

Should the change in valuation allowance resulting from the restructuring be recorded in acquisition accounting?

Analysis

In these specific facts, we believe there are two alternative views:

View A—Record a DTA for the full amount of acquired state NOLs as part of acquisition accounting and record a valuation allowance and related deferred tax expense in continuing operations for the portion of the NOLs not expected to provide a future tax benefit immediately after the acquisition. Under this view, the buyer is precluded from considering the effects of restructuring actions it expects to take after the acquisition by analogy to the guidance in ASC 805-20-25-2, which requires that restructuring costs the buyer expects but is not obligated to incur to be recorded outside of acquisition accounting.

View B—Record a DTA and a valuation allowance for the portion of the NOLs not expected to provide a future tax benefit as part of acquisition accounting. Under this view, Company X's expected manner of recovery should be considered in assessing recoverability of acquired DTAs. In that regard, all available evidence should be considered, including planned actions that are primarily within Company X's control and would affect its ability to realize a benefit from acquired state NOLs.

While both views are acceptable positions based on the facts presented, there may be situations when only one view would be supportable. For example, View A may be the only supportable answer if Company X did not have any intention of relocating Company Y at the acquisition date but decided to do so as a result of having been subsequently offered significant government economic incentives.

In some circumstances, these two views may also be applicable in choosing the jurisdictional tax rate to be applied to acquired temporary differences when a post-acquisition relocation is anticipated. For example, if the acquirer plans to relocate an acquiree's operation from State A to State B, the view

chosen would determine how to account for the effect of the difference in the states' tax rates on acquired temporary differences.

In situations when either view is supportable, appropriate financial statement disclosures should be provided.

10.4.11 Post-acquisition step-up in tax basis of goodwill (after adoption of ASU 2019-12)

When a step-up in the tax basis of tax-deductible goodwill is obtained after the acquisition date, it should be determined whether the step-up relates to the business combination or a separate transaction.

ASC 740-10-25-54 provides factors that should be considered in making this determination.

ASC 740-10-25-54

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 tax 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.

Example TX 10-11 illustrates the accounting for the tax effects of a post-acquisition tax-free merger.

EXAMPLE TX 10-11

Accounting for the income tax effects of a post-acquisition tax-free merger

Company X, a US multinational, has acquired, through a wholly-owned acquisition holding company in Country A, the stock of Company Y, a foreign company domiciled in Country A. The acquisition is treated as a nontaxable acquisition in Country A, and Company Y's tax bases carry over to the holding company.

Pursuant to tax law in Country A, affiliated entities located in Country A can combine legal entities and operations generally without incurring a tax cost. There are often business and tax motivations for such mergers, including streamlined operations, reduced administrative and legal costs, and a tax basis step-up in the acquired assets. These mergers can be executed any time after an acquisition and, from a tax law perspective, are typically considered more-likely-than-not to be sustained, provided the entities have business substance. No formal approval or ruling from the taxing authority is required, and external approvals (e.g., obtaining certain business permits) generally are considered perfunctory.

During the initial due-diligence process, Company X explored the merits of a merger in Country A but had not made a definitive decision at the acquisition date. Subsequently, Company X concludes that it will merge the holding company in Country A into Company Y (i.e., downstream merger). The decision is based on further analysis of information and facts that existed at the acquisition date. The merger transaction results in a tax basis step-up in Company's Y assets, including acquired tax-deductible goodwill.

Should the income tax effects of the merger be recorded in acquisition accounting?

Analysis

The factors provided in ASC 740-10-25-54(a) through ASC 740-10-25-54(f) should be considered in order to determine if the tax basis relates to the business combination or a separate transaction. Under this fact pattern, we believe the anticipated deferred income tax benefit from a tax basis step-up should be incorporated into the recognition and measurement of acquired deferred taxes. This is because the merger transaction and its intended favorable tax consequences are available and considered by Company X as of the acquisition date. That is, the merger transaction and its expected tax effects are based on information and facts existing as of the acquisition date. It is also primarily within Company X's control and ability as there is no substantive approval or review process. Additionally, Company X is not required to make a separate tax payment or incur significant costs separate from the consideration exchanged to acquire Company Y.

10.4.11A Post-acquisition step-up in tax basis of goodwill (before adoption of ASU 2019-12)

When a step-up in the tax basis of tax-deductible goodwill is obtained through a transaction that occurs after an acquisition, a deferred tax asset is recorded if the new tax basis exceeds the book basis in the goodwill; however, a deferred tax liability is not recorded if the book basis exceeds the new tax basis. We are aware of another acceptable view under which the newly arising tax goodwill is viewed as a separate unit of account and is not compared to the pre-existing book goodwill. Under that view, a deferred tax asset is recorded through the income tax provision for the full tax basis. The view applied for such a tax basis step-up in goodwill constitutes an accounting policy that should be followed consistently in similar circumstances.

Example TX 10-11A illustrates the accounting for the tax effects of a post-acquisition tax-free merger.

EXAMPLE TX 10-11A

Accounting for the income tax effects of a post-acquisition tax-free merger

Company X, a US multinational, has acquired, through a wholly-owned acquisition holding company in Country A, the stock of Company Y, a foreign company domiciled in Country A. The acquisition is treated as a nontaxable acquisition in Country A, and Company Y's tax bases carry over to the holding company.

Pursuant to tax law in Country A, affiliated entities located in Country X can combine legal entities and operations generally without incurring a tax cost. There are often business and tax motivations for such mergers, including streamlined operations, reduced administrative and legal costs, and a tax basis step-up in the acquired assets. These mergers can be executed any time after an acquisition and, from a tax law perspective, are typically considered more-likely-than-not to be sustained provided the entities have business substance. No formal approval or ruling from the taxing authority is required, and external approvals (e.g., obtaining certain business permits) generally are considered perfunctory.

During the initial due diligence process, Company X explored the merits of a merger in Country A but had not made a definitive decision at the acquisition date. Subsequently, Company X concluded that it will merge the holding company in Country A into Company Y (i.e., a downstream merger). The decision is based on further analysis of information and facts that existed at the acquisition date. The merger transaction results in a tax basis step-up in Company's Y assets, including acquired tax-deductible goodwill.

Should the income tax effects of the merger be recorded in acquisition accounting?

Analysis

Under this fact pattern, we believe the anticipated deferred income tax benefit from a tax basis step-up should be incorporated into the recognition and measurement of acquired deferred taxes. This is because the merger transaction and its intended favorable tax consequences are available and considered by Company X as of the acquisition date. That is, the merger transaction and its expected tax effects are based on information and facts existing as of the acquisition date. It is also primarily within Company X's control and ability as there is no substantive approval or review process. Additionally, Company X is not required to make a separate tax payment or incur significant costs separate from the consideration exchanged to acquire Company Y.

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. This guidance clarifies when a step-up in the tax basis of goodwill should be considered part of the business combination in which the book goodwill was originally recognized and when it should be considered a separate transaction. ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. If an entity chooses to early adopt, it must

adopt all changes as a result of the ASU. The transition provisions vary by amendment. See TX 10.4.11 for applicable guidance after adoption of ASU 2019-12.

10.5 Valuation allowance assessment at acquisition

An acquirer that will include the acquiree in a consolidated tax return should consider the deferred tax assets and liabilities and future taxable income of the combined business when assessing whether both the acquirer's and the acquiree's deferred tax assets are realizable. In some cases, the combined entity may determine that a valuation allowance will not be necessary for the acquired deferred tax assets even though the target company may have previously recorded a valuation allowance in its historical financial statements. For example, deductible differences or carryforwards of the acquiree may be realizable because the acquirer has sufficient taxable temporary differences that will generate future taxable income, or because the acquirer anticipates having sufficient other future taxable income to ensure realization.

New sources of future taxable income from the perspective of the combined business (in the form of additional taxable temporary differences or increased forecasts of future taxable income) means that more deferred tax assets may be realizable for the combined business at the date of acquisition.

Combined tax attributes or income may also provide evidence as to the realizability of the acquirer's own deferred tax assets at the date of acquisition. However, changes in the assessment of realizability of the acquiring company's deferred tax assets are not included in acquisition accounting. See TX 10.5.4 for further information on changes in the acquirer's deferred tax balances related to acquisition accounting.

10.5.1 Future combined results after the business combination

To determine the need for a valuation allowance at the date of acquisition, it is necessary to consider all available evidence. In jurisdictions where a consolidated tax return will be filed (i.e., acquiring and acquired business consolidated), it may be necessary to consider the expected future taxable income of the combined business.

To perform the evaluation, past results, as well as expected future results, should be considered. It may be appropriate to consider certain pro forma adjustments to the historical operating results of the acquired entity to provide an indication of the future earnings capabilities of the acquired entity after acquisition. For example, if a significant amount of debt is created at the acquired entity in conjunction with the acquisition, it would be appropriate to consider the past results of the acquired entity adjusted to reflect the interest expense that will be incurred on the debt. Conversely, if significant overhead or debt is eliminated from the target, it may be appropriate to adjust the historical operating results in order to provide a more accurate depiction of the business' future performance.

Temporary differences at the date of acquisition will be measured based on the differences between the carryover tax basis (in a nontaxable acquisition) and the fair values assigned in acquisition accounting. If the fair values are higher, the reversals of resulting taxable differences may themselves ensure realization of future tax benefits. Judgment will have to be applied in reviewing the available evidence to arrive at a meaningful outcome.

In all cases, when assessing the realizability of deferred tax assets, the greatest emphasis should be placed on information that is objectively verifiable. For example, anticipated synergies that are

expected to result from the business combination may not be objectively verifiable until they can be demonstrated. On the other hand, it may be appropriate to reduce or exclude certain historical operating costs to the extent they relate to identified redundancies such as duplicate accounting systems that will be eliminated post combination.

10.5.2 Acquirer's taxable differences as a source of realization

The acquirer's own deferred tax liabilities may provide a source for the realization of deferred tax assets acquired in a business combination and, therefore, may be an important component in assessing the need for a valuation allowance for the deferred tax assets that arise from the acquisition. As a result, the acquirer may need to determine its temporary differences at the date of acquisition, which may be difficult if the acquisition occurs at an interim date. The acquirer's temporary differences on the date of the acquisition should be determined in each jurisdiction. There may be more than one reasonable approach to determine the acquirer's temporary differences at the acquisition date. For example, the acquirer might assume it files a short-period tax return as of the acquisition date, following tax laws governing how annual deductions are determined in a short period return. The existing book bases of the assets and liabilities would be compared with the proforma tax bases to determine the temporary differences. Other possible approaches might include the acquirer assuming that its temporary differences arise evenly throughout the year or in the same pattern that pre-tax accounting income is earned. The acquirer should determine the approach most suitable to its facts and circumstances.

10.5.3 Limitation of tax benefits by law

In certain business combination transactions, the acquired business and its tax attributes may be integrated into the consolidated tax returns and positions of the acquirer. However, depending on the specific tax jurisdiction, there may be various limitations on the use of acquired tax benefits. Some examples of these limitations include:

- Utilization of certain attributes, such as NOLs or tax credits, may be limited due to a change in corporate ownership, structure, or a significant change in business operations. These limitations might be expressed as an absolute amount, a formula-based limitation (e.g., annually changing percentage of the acquired tax benefit), or a relationship to taxable income (e.g., 30% of taxable income can be offset by acquired NOLs).
- Use of acquired loss carryforwards may be limited to post-acquisition taxable income of the acquired business.

All restrictions should be considered in assessing whether the deferred tax assets for acquired tax benefits are realizable.

10.5.4 Changes in acquirer's deferred taxes due to acquisition

The impact on the acquiring company's deferred tax assets and liabilities caused by an acquisition is recorded in the acquiring company's financial statements outside of acquisition accounting. Such impact is not a part of the fair value of the assets acquired and liabilities assumed.

For example, in jurisdictions with a graduated tax rate structure, the expected post-combination results of the company may cause a change in the tax rate expected to be applicable when the deferred

tax assets and liabilities reverse. The impact on the acquiring company's deferred tax assets and liabilities is recorded as a change in tax rates and reflected in earnings.

Additionally, the acquirer's financial statements may have included a valuation allowance before the transaction for its deductible differences or loss carryforwards and other credits. After considering the transaction, the projected combined results, and available taxable temporary differences from the acquired business, the acquirer may be able to release all or part of its valuation allowance. While this adjustment is a result of the acquisition, ASC 805-740-30-3 requires that the benefits be recognized in income or equity, as applicable, and not as a component of acquisition accounting. This benefit is related to the acquirer's existing assets and should not be considered in the determination of the fair values of the assets acquired and liabilities assumed.

ASC 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 allowances 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]).

Acquired deferred tax liabilities could be a source of income to support recognition of acquired deferred tax assets or the acquirer's existing deferred tax assets, or both. Accordingly, in circumstances in which some but not all of the combined deferred tax assets are supported by acquired deferred tax liabilities, the acquirer will need to determine which balances are being supported. We believe there are two acceptable accounting policies. One policy is to consider the recoverability of deferred tax assets acquired in the acquisition before considering the recoverability of the acquirer's existing deferred tax assets. Another policy is to consider relevant tax law ordering rules for utilization of tax assets to determine whether the acquired or pre-existing deferred tax assets are considered realizable.

Example TX 10-12 illustrates the application of the alternative accounting policies on a valuation allowance assessment in acquisition accounting.

EXAMPLE TX 10-12

Accounting policy for considering whether acquired deferred tax liabilities support realization of acquired or acquirer's deferred tax assets

Company X and Company Y each have \$2,000 of deferred tax assets related to net operating loss (NOL) carryforwards generated in the last four years. Other deferred tax assets and liabilities are de minimis. Company X has historically maintained a valuation allowance against its deferred tax assets. In the current period, Company X acquires the shares of Company Y in a nontaxable transaction and the combined business will file a consolidated tax return. As part of the acquisition, deferred tax liabilities of \$1,500 related to Company Y are recorded. Although the earnings of the combined entity are not objectively verifiable, the acquired deferred tax liabilities will reverse prior to any NOL

expirations and are, therefore, a source of future taxable income that can support the realization of deferred tax assets.

There are no tax law limitations on future realization of the NOL carryforwards. Consequently, Company X determines it needs a valuation allowance of \$2,500 (combined deferred tax assets of \$4,000 less reversing deferred tax liabilities of \$1,500).

In Company X's financial statements, which deferred tax assets (i.e., acquirer's or acquiree's) are supported by the deferred tax liabilities recorded upon acquisition of Company Y?

Analysis

Deferred taxes are recorded in acquisition accounting for the acquired entity's temporary differences and operating loss/credit carryforwards. However, any changes in the acquirer's deferred taxes as a result of a business combination should be recorded currently in income.

In this fact pattern, we believe there are two alternative methods to account for the benefit that can be recognized in Company X's financial statements:

View A—The deferred tax liabilities should first be considered as a source of taxable income in relation to the acquired company's deferred tax assets, with any residual amount applied to the acquirer's deferred tax assets. This view is premised on the sequence of events, starting with the acquisition, followed by the consideration of impacts on the acquirer. In this example, a \$500 valuation allowance would be recorded in acquisition accounting (i.e., \$1,500 of the \$2,000 acquired deferred tax assets are expected to be realized), and there would be no recognition of the acquirer's pre-existing deferred tax assets. The existing valuation allowance against the acquirer's deferred tax assets (\$2,000) would not change.

View B—Realization of the deferred tax assets should be based on underlying tax law ordering for the jurisdiction (e.g., looking first to older NOLs if that is consistent with the tax law in the relevant jurisdiction). The objective would be to determine the reversal pattern of tax attributes and deductible temporary differences under the tax law. However, when the order in which tax attributes and deductible temporary differences will be used is not determinable, the entity should develop a systematic, rational, and consistent methodology for allocating the benefit resulting from the deferred tax liabilities.

Either view is acceptable as an accounting policy election to be applied consistently. Appropriate financial statement disclosure should be made, including specific disclosure of any benefits or expenses recognized for changes in the acquirer's valuation allowance.

10.5.5 *Change to valuation allowance for acquired assets*

The release of a valuation allowance that does not qualify as a measurement period adjustment is subject to the normal intraperiod allocation rules and is not part of acquisition accounting. The release of a valuation allowance within the measurement period resulting from new information about facts and circumstances that existed at the acquisition date is reflected first as an adjustment to goodwill, then as a bargain purchase.

10.6 *Business combinations achieved in stages*

Business combinations are sometimes completed in stages. When this occurs, entities may need to consider the accounting for holding gains and outside basis differences, the interplay of acquisition accounting and inside basis differences, and holding gains associated with partnerships.

10.6.1 *Holding gains and outside basis differences (after adoption of ASU 2019-12)*

An acquirer sometimes obtains control of an acquiree in which it held an equity interest prior to the acquisition date. In a business combination achieved in stages, the acquirer should remeasure its previously held equity interest in the acquiree at its acquisition date fair value and recognize the resulting gain or loss (i.e., the difference between its fair value and carrying value) in earnings. If changes in the fair value of the equity interest were previously recorded in other comprehensive income (OCI), the amount of unrealized gains or losses should be reclassified from OCI and included in the measurement of the gain or loss on the acquisition date. The recognition of a gain or loss at the acquisition date represents the recognition of the economic gain or loss that is present in the previously held equity interest.

Prior to obtaining control, any deferred taxes that needed to be recorded under ASC 740 would have been based on the difference between the carrying amount of the investment in the financial statements and the tax basis in the shares of the investment (i.e., outside basis difference). Unless a current tax is triggered, remeasuring the previously held equity interest to fair value will increase the book basis with no corresponding increase in the tax basis, thus changing the outside basis difference and associated deferred tax. Since the acquirer's gain or loss from remeasuring the acquirer's previously held investment is reflected in net income, the corresponding tax effect of the change in outside basis difference caused by such gain or loss should be reflected in the acquirer's income tax expense from continuing operations. The gain or loss associated with a previously held equity interest might include the effects of reclassifying amounts from accumulated other comprehensive income to net income (e.g., unrealized gains or losses on available for sale securities and cumulative translation adjustment). Generally, the corresponding reclassification adjustment from OCI to net income will also include any related income tax expense or benefit that was previously recognized in OCI.

Upon obtaining control, the acquirer may no longer need to recognize deferred taxes on the outside basis of the investment under one of the exceptions in ASC 740-30-25 (e.g., there is a means for tax-free recovery of the investment). If the subsidiary is domestic and the parent has the intent and ability under the tax law to recover its investment in a tax-free manner (see TX 11.9.2.4) or if the subsidiary is foreign and the parent has asserted the indefinite reversal exception (see TX 11.9.2.1), the entire deferred tax liability related to the outside basis difference on the previously held investment is reversed. The effect of reversing the deferred tax is recorded in the acquirer's income tax expense from continuing operations and does not impact acquisition accounting. The gain or loss associated with a previously held equity interest might include the effects of reclassifying amounts from accumulated other comprehensive income to net income. Generally, the corresponding reclassification adjustment to OCI will also include any related income tax expense or benefit that was recognized in OCI.

Example TX 10-13 illustrates the impact on the outside basis difference from remeasuring a previously held investment.

EXAMPLE TX 10-13

Impact on outside basis difference from remeasuring a previously held investment

Company A has a 20% equity-method investment in Company B with a carrying value of \$1,000 and a tax basis of \$800. Company A has recorded a corresponding deferred tax liability of \$50 ($(\$1,000 - \$800) \times 25\%$). Company A acquires the remaining 80% of Company B. The fair value of Company A's previously held investment in Company B is \$1,500 at the acquisition date.

Should Company A record the deferred taxes related to the outside basis difference in Company B as a result the acquisition, assuming Company A is not asserting indefinite reinvestment?

Analysis

Yes. Company A would remeasure its investment in Company B to \$1,500 and record a gain of \$500 for financial reporting purposes. Company A's book versus tax basis difference in the previously owned shares of Company B would increase from \$200 ($\$1,000 - \800) to \$700 ($\$1,500 - \800) at the acquisition date. Assuming a 25% tax rate, Company A would record an entry to increase the deferred tax liability from \$50 to \$175. The \$125 is calculated as the increase in outside basis difference of \$500 \times 25% tax rate.

10.6.1A Holding gains and outside basis differences (before adoption of ASU 2019-12)

An acquirer sometimes obtains control of an acquiree in which it held an equity interest prior to the acquisition date. In a business combination achieved in stages, the acquirer should remeasure its previously held equity interest in the acquiree at its acquisition date fair value and recognize the resulting gain or loss (i.e., the difference between its fair value and carrying value) in earnings. If changes in the fair value of the equity interest were previously recorded in other comprehensive income (OCI), the amount of unrealized gains or losses should be reclassified from OCI and included in the measurement of the gain or loss on the acquisition date. The recognition of a gain or loss at the acquisition date represents the recognition of the economic gain or loss that is present in the previously held equity interest.

Prior to obtaining control, any deferred taxes that needed to be recorded under ASC 740 would have been based on the difference between the carrying amount of the investment in the financial statements and the tax basis in the shares of the investment (i.e., outside basis difference). Unless a current tax is triggered, remeasuring the previously held equity interest to fair value will increase the book basis with no corresponding increase in the tax basis, thus changing the outside basis difference and associated deferred tax. Since the acquirer's gain or loss from remeasuring the acquirer's previously held investment is reflected in net income, the corresponding tax effect of the change in outside basis difference caused by such gain or loss should be reflected in the acquirer's income tax expense from continuing operations. The gain or loss associated with a previously held equity interest might include the effects of reclassifying amounts from accumulated other comprehensive income to net income (e.g., unrealized gains or losses on available for sale securities and cumulative translation adjustment). Generally, the corresponding reclassification adjustment from OCI to net income will also include any related income tax expense or benefit that was previously recognized in OCI.

Example TX 10-13A illustrates the impact on the outside basis difference from remeasuring a previously held investment.

EXAMPLE TX 10-13A

Impact on outside basis difference from remeasuring a previously held investment

Company A has a 20% equity-method investment in Company B with a carrying value of \$1,000 and a tax basis of \$800. Company A has recorded a corresponding deferred tax liability of \$50 $((\$1,000 - \$800) \times 25\%)$. Company A acquires the remaining 80% of Company B. The fair value of Company A's previously held investment in Company B is \$1,500 at the acquisition date.

Should Company A record the deferred taxes related to the outside basis difference in Company B as a result the acquisition, assuming Company A is not asserting indefinite reinvestment?

Analysis

Yes. Company A would remeasure its investment in Company B to \$1,500 and record a gain of \$500 for financial reporting purposes. Company A's book versus tax basis difference in the previously owned shares of Company B would increase from \$200 $(\$1,000 - \$800)$ to \$700 $(\$1,500 - \$800)$ at the acquisition date. Assuming a 25% tax rate, Company A would record the following tax entry to increase the deferred tax liability from \$50 to \$175. The \$125 is calculated as the increase in outside basis difference of \$500 \times 25% tax rate.

Upon obtaining control, the acquirer may no longer need to recognize deferred taxes on the outside basis of the investment under one of the exceptions in ASC 740-30-25 (e.g., there is a means for tax-free recovery of the investment). In these cases, the accounting for the deferred tax related to the previously held investment depends on whether the subsidiary is foreign or domestic.

If the subsidiary is domestic and the parent has the intent and ability under the tax law to recover its investment in a tax-free manner, the entire deferred tax liability related to the outside basis difference on the previously held investment is reversed. The effect of reversing the deferred tax is recorded in the acquirer's income tax expense from continuing operations and does not impact acquisition accounting. The gain or loss associated with a previously held equity interest might include the effects of reclassifying amounts from accumulated other comprehensive income to net income. Generally, the corresponding reclassification adjustment to OCI will also include any related income tax expense or benefit that was recognized in OCI.

If the subsidiary is foreign, then a portion of the deferred tax liability related to the outside basis difference on the previously held investment must generally be retained. ASC 740 requires that a deferred tax liability continue to be recorded for the temporary difference related to the investor's share of the undistributed earnings of a foreign investee prior to the date it becomes a subsidiary. The deferred tax liability should remain as long as 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 (see ASC 740-30-25-16). Effectively, the deferred tax liability at the acquisition date for the outside basis temporary difference caused by undistributed earnings of the foreign investee is "frozen" until that temporary difference reverses.

Outside basis differences can arise from activities other than from undistributed earnings (e.g., currency translation adjustments). In such cases, it is unclear what portion of the deferred tax liability should be retained. One view is that upon gaining control of an investee, the deferred tax liability for the entire outside basis difference, including any basis difference resulting from adjusting the

investment to fair value, is frozen until that temporary difference reverses. A second view is that only the portion of the deferred tax liability that relates to undistributed earnings of the investee as of the date control is obtained is frozen. In some jurisdictions, the recovery of an investment in a foreign equity investee does not have tax consequences to the investor. In those circumstances, a deferred tax liability for holding gains would not be recognized (and then frozen) when control is obtained as such gains would never be taxable and therefore do not constitute temporary differences.

New guidance

In December 2019, the FASB issued ASU 2019-12, Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes. This guidance removes exceptions to the general principles in ASC 740-30 that resulted in “frozen” outside basis differences for foreign equity method investments and subsidiaries.

ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. If an entity chooses to early adopt, it must adopt all changes as a result of the ASU. The transition provisions vary by amendment. The amendments should be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.

10.6.2 *Step-acquisitions and inside basis differences*

Upon gaining control of the investee, the acquirer will apply acquisition accounting and recognize the assets acquired and liabilities assumed, including goodwill. The acquirer must then identify and measure associated deferred tax assets and liabilities. Consider a situation in which the acquiring company obtains a step-up in tax basis in the net assets acquired for the portion most recently purchased but does not obtain a step-up in tax basis for the portion previously held. The method for calculating tax bases would result in larger inside book-over-tax-basis differences as a result of the acquirer’s previously held investment, which, in turn, would impact the amount of goodwill recorded in acquisition accounting. Example TX 10-14 illustrates this concept.

EXAMPLE TX 10-14

Impact on inside basis differences from a previously held investment

Company A has a 20% equity-method investment in Company B, with a carrying value of \$1,000 and a tax basis of \$800. Company A acquires the remaining 80% of Company B for \$8,000 and elects, under the tax law, to obtain a step-up of the inside tax bases of the net assets acquired for the 80% purchased (i.e., elected to treat the transaction as taxable). The fair value of the previously held 20% investment at the acquisition date is \$2,000.

How should Company A record the deferred taxes on the inside basis differences in Company B as a result of the acquisition?

Analysis

The resulting inside tax bases would be a combination of the 20% carryover tax basis and the 80% fair value ($\$800 + \$8,000 = \$8,800$).

For financial reporting, the net assets acquired would be recorded at fair value. The total net assets held, including goodwill, would be recorded at \$10,000 (\$8,000 consideration transferred for 80% implies fair value of \$10,000 for 100%).

The aggregate book bases exceed the aggregate tax bases by \$1,200 (\$10,000 – \$8,800). The excess would be attributable to the carryover inside tax bases resulting from the 20% previously held investment (fair value of 20% previously held investment less carryover tax bases \$2,000 - \$800 = \$1,200). Therefore, a deferred tax liability generally would be recorded as part of acquisition accounting, although consideration would need to be given to the prohibition against recording a deferred tax liability on excess book over tax-deductible goodwill (see TX 10.8.3).

10.6.3 *Holding gains and partnerships*

An acquirer sometimes obtains control of a partnership in which it held an equity interest prior to the acquisition date. Example TX 10-15 illustrates the impact on the outside basis difference upon acquiring control of a partnership.

EXAMPLE TX 10-15

Deferred tax accounting on holding gains recognized when a company acquires control of a partnership

Company A owns a 50% noncontrolling interest in a US partnership and has a carrying value and tax basis of \$100 and \$80, respectively, which resulted in recognition of an outside-basis deferred tax liability of \$5 (tax rate of 25% times outside basis difference of \$20). In the current period, Company A acquires the remaining partnership interest for \$150. The staged acquisition results in recognition of a holding gain of \$50 because Company A's previously held equity interest is remeasured at fair value. (The \$50 holding gain is calculated as the fair value of the previously held 50% (which would be the same as the purchased 50%) of \$150 less its carrying value of \$100.)

For US federal tax purpose, the partnership terminates when Company A becomes the sole owner of the entity (i.e., the acquired entity effectively becomes a taxable division of Company A). Consequently, Company A's outside basis in the partnership is no longer tax relevant and Company A would instead only account for inside basis differences. After the transaction, the book value of the acquired net assets is \$300 (\$150 for 50% implies \$300 for 100%).

After the acquisition of the remaining 50%, there is nondeductible goodwill in the partnership of \$10. The tax basis is \$230 (\$80 historical basis in 50% previously owned plus \$150 in new tax basis from the acquisition). Therefore, the total inside basis temporary differences is \$70 (\$300 basis for financial reporting and \$230 of tax basis). In accordance with ASC 805-740-25-9, no deferred taxes are recognized for the excess of financial reporting goodwill over the tax-deductible amount of goodwill at the acquisition date (refer to TX 10.8.3). Thus, the total inside basis difference of \$70 is reduced by the \$10 related to nondeductible goodwill. The remaining difference of \$60 yields a deferred tax liability of \$15 (\$60 x 25%).

Should the deferred tax consequences of the purchase be recognized entirely in acquisition accounting or in income?

Analysis

The incremental deferred tax should be recognized in income. We believe that when a partnership terminates and becomes a taxable division of the owner, the outside tax basis simply "rolls" into the inside tax basis in individual assets and liabilities. It is not appropriate to reverse the incremental deferred tax into earnings only to re-establish it in acquisition accounting. Additionally, the tax charge is more appropriately connected to the deemed sale of the preexisting equity interest rather than the acquisition of the controlling interest. Since the gain on the deemed sale of the preexisting equity interest was recorded in the income statement, the related tax charge should be recorded in the income statement as well.

Because a deferred tax liability of \$5 has already been recognized prior to the acquisition, a \$10 deferred tax liability would be recognized in the period of the purchase of the remaining 50% and there would be no deferred tax effects in acquisition accounting since under this approach the entity has not recorded any tax effects of the non-deductible goodwill. This view would only be appropriate under a 'look through' approach (see TX 11.7).

An alternative view is that a deferred tax expense of \$12.5 (25% of the "holding gain" of \$50) should be recognized as if the preexisting interest had been sold for fair value consideration. In that case, because a deferred tax liability cannot be recognized for the nondeductible goodwill, the deferred tax liability would be reduced by \$2.5 in acquisition accounting resulting in a corresponding reduction in goodwill.

10.7 Consider the treatment of tax uncertainties

An acquirer may take positions in a taxable business combination (e.g., in allocating the acquisition price and in filing subsequent tax returns) that it expects the taxing authority to challenge. Similarly, there may be uncertainties about the tax basis of individual assets or the pre-acquisition tax returns of the acquired business in nontaxable business combinations. Both types of situations are considered to be uncertain tax positions. See TX 15 for more discussion of accounting for tax uncertainties.

10.7.1 Changes in tax uncertainties after a business combination

Adjustments to uncertain tax positions made subsequent to the acquisition date are recognized in earnings, unless they qualify as measurement period adjustments. Measurement period adjustments are recorded first as an adjustment to goodwill, then as a bargain purchase.

A change in an income tax uncertainty that is based upon facts and circumstances that existed as of the acquisition date is recorded as a measurement period adjustment (as described in ASC 805-10-25-13 through ASC 805-10-25-14). For example, during the initial due diligence, the acquirer may have identified uncertain tax positions of the acquiree and made a preliminary estimate of the amount, if any, of the related liability. That preliminary estimate would be recorded in acquisition accounting. If, during the measurement period, the acquirer performs a more detailed analysis of information that existed at the acquisition date and determines that an adjustment is necessary, the adjustment should be recorded as a measurement period adjustment in the reporting period in which the adjustment amount is determined.

Similarly, if, during the measurement period, the acquirer discovers an uncertain tax position that was not identified in its due diligence, but which existed at the acquisition date, the accounting for that

position should be recorded as a measurement period adjustment in the reporting period in which the adjustment amount is determined.

See TX 10.5.4 and BCG 2.9 for additional discussion of measurement period adjustments.

10.7.2 Income tax indemnifications

ASC 805 provides guidance on the recognition and measurement of an indemnification asset and requires what is sometimes referred to as “mirror image” accounting for indemnifications. The indemnified party recognizes an indemnification asset at the same time that it recognizes the indemnified item and measures the asset on the same basis as the indemnified item. Accordingly, an indemnification asset related to an uncertain tax position is recognized at the same time and measured on the same basis as the related liability, subject to collectability or contractual limitations on the indemnified amount. The liability is recognized and measured using the ASC 740 guidance. Indemnification assets recognized on the acquisition date continue to be measured on the same basis as the related indemnified item until they are collected, sold, cancelled, or expire.

Mirror image accounting assumes that the terms of the indemnification arrangement fully cover the related exposure. When that is not the case, there can be accounting differences, such as in the following scenarios:

- An income tax uncertainty relates to the timing of a deduction. For example, a tax deduction was claimed in year 1, but there is risk that the deduction should be taken over 15 years. When the indemnification covers the implied interest cost associated with spreading the deduction over a longer period, the indemnification asset would not equal the related liability. Rather, in this case, the indemnification receivable would presumably equal only the outstanding interest accrual.
- The indemnification covers any tax exposure that exceeds a specified dollar amount. In this situation, the mirror image will apply only to the excess over the specified amount.

There also may be scenarios in which the terms of the indemnification fully cover the tax exposure, but the related amounts recorded for accounting purposes appear to differ, such as in the following scenarios:

- A company does not classify interest and penalties in the same line as the liability for an income tax exposure. In this situation, mirror image accounting may apply (assuming that interest and penalties are covered by the indemnification); however, the indemnification asset would mirror the total of the tax liability and the related interest and penalty accruals.
- The company records a reserve against the indemnification asset due to collection risk.

There may also be scenarios in which the seller provides a blanket indemnification for taxes owed in prior years, but no specific tax positions are reserved. If no liability is required under the uncertain tax position guidance in ASC 740, an indemnification asset should not be recognized. Accordingly, the indemnification asset would be zero, which is the mirror image of the tax liability.

Another scenario to consider is when the income tax uncertainty increases a loss carryforward. In this situation, the guidance in ASC 740 requires a net presentation (i.e., the company should not record a deferred tax asset for the loss carryforward and a liability for the tax uncertainty). However, if the tax liability is covered by an indemnification, the indemnification asset would mirror the tax liability even

though no tax liability is recorded. For example, assume that a buyer acquires a \$100 loss carryforward (tax-effected). The buyer determines that \$20 of the loss carryforward is an unrecognized tax benefit and, therefore, reduces the loss carryforward to \$80. If the seller indemnifies the buyer for the related tax exposure, the buyer would record a \$20 indemnification asset.

Companies should ensure that the disclosures required by ASC 740-10-50-15 reflect the unrecognized tax benefits with no offset or netting for an indemnification. It may also be necessary to provide additional disclosure in regard to the terms of any indemnification arrangements so that financial statement readers can appropriately assess the net economic exposure to the entity.

See BCG 2.5.14 for further information on indemnifications that arise as part of a business combination. For indemnification of tax uncertainties outside of a business combination, see TX 15.8.

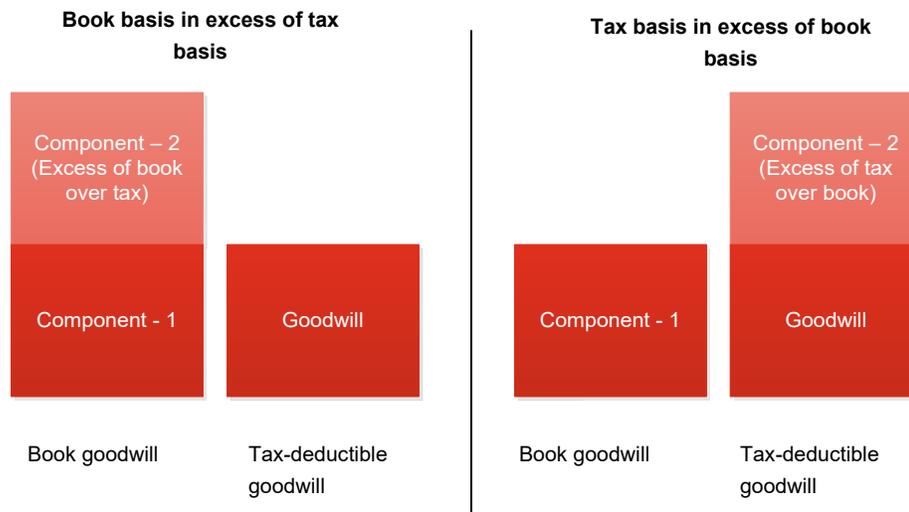
10.8 *Deferred taxes related to goodwill*

Goodwill for financial reporting purposes is a residual amount. Acquired goodwill for financial reporting purposes is recognized as an asset and is generally not amortized. Some business combinations, particularly taxable business combinations, can generate goodwill that is deductible for tax purposes (also referred to as “tax-deductible goodwill”).

The amount assigned to goodwill for book and tax purposes could differ, due to different valuation and allocation rules and differences in determining the amount of consideration transferred (e.g., different treatment of contingencies or costs incurred for the transaction). ASC 740 describes the separation of goodwill into components to assist in determining the appropriate deferred tax accounting related to goodwill at the acquisition date. The first component (component 1) equals the lesser of (1) goodwill for financial reporting or (2) tax-deductible goodwill. The second component (component 2) equals the remainder of each, that is, (1) the remainder, if any, of goodwill for financial reporting in excess of tax-deductible goodwill or (2) the remainder, if any, of tax-deductible goodwill in excess of the goodwill for financial reporting (ASC 805-740-25-8).

Figure TX 10-2 displays the concept of component-1 and component-2 goodwill.

Figure TX 10-2
Goodwill components



10.8.1 *Business combinations in multiple jurisdictions*

Business combinations may involve multiple jurisdictions (or multiple tax-paying components within a jurisdiction). Tax-deductible goodwill in each jurisdiction will need to be compared to book goodwill allocated to each jurisdiction to determine the related temporary differences. ASC 740-10-30-5 requires that deferred taxes, including goodwill, be determined separately for each tax-paying component (an individual entity or group of entities that are consolidated for tax purposes) in each jurisdiction. ASC 350, *Intangibles-Goodwill and Other*, generally requires goodwill for financial reporting purposes to be assigned to reporting units. As part of the assignment to reporting units, the book goodwill may also be identified as being associated with a particular jurisdiction (see BCG 9.2). Because the assignment of goodwill for book and tax purposes are governed by different guidance, the reporting units to which goodwill is assigned under ASC 350 may not align with the tax-paying components for tax purposes (e.g., a reporting unit might consist of more than one tax-paying component or a tax-paying component might exist across more than one reporting unit). We believe that goodwill for financial reporting should be allocated to tax-paying components and tax-deductible goodwill for tax-paying components should be allocated to reporting units on a systematic and rational basis that is consistently applied. Once goodwill has been allocated, the tax-deductible goodwill in each tax-paying component will need to be compared to book goodwill allocated to each tax-paying component for purposes of separating goodwill into component -1 and component -2.

Example TX 10-16 illustrates goodwill allocation for a reporting unit with more than one tax-paying component.

EXAMPLE TX 10-16

Comparison of book goodwill to tax-deductible goodwill involving multiple jurisdictions

Company A buys Subsidiary B in a nontaxable business combination. Subsidiary B has operations in the US and Germany. As a result of the transaction, Company A recorded \$600 of book goodwill. Subsidiary B represents a new reporting unit and Company A determines \$500 of the book goodwill is associated with US operations, while the remaining \$100 relates to German operations. Carryover tax-deductible goodwill acquired in the transaction is \$500; \$200 is associated with legal entities in the US and \$300 is associated with legal entities in Germany.

What are the book and tax-deductible goodwill of Subsidiary B?

Analysis

Goodwill at a jurisdictional level would be as follows:

	US goodwill		German goodwill	
	Book	Tax	Book	Tax
Component-1	\$200	\$200	\$100	\$100
Component-2	300	—	—	200
Total goodwill	\$500	\$200	\$100	\$300

At the acquisition date, the acquirer would not record a deferred tax liability for goodwill associated with the US jurisdiction because book goodwill exceeds the tax-deductible goodwill. However, for goodwill associated with the German jurisdiction, the acquirer would record a deferred tax asset in acquisition accounting because tax-deductible goodwill exceeds book goodwill (see TX 10.8.2.1 for further discussion of measuring the deferred tax asset).

10.8.2 Excess of tax-deductible goodwill over book goodwill

An excess of tax-deductible goodwill over goodwill for financial reporting is a temporary difference for which a deferred tax asset is recognized.

In a nontaxable transaction when the historical tax bases of the acquired business carry over to the acquirer, there may be tax-deductible goodwill from prior acquisitions of the acquiree that carries over in the current acquisition. In this instance, a question arises as to how to treat the carryover tax-deductible goodwill in determining deferred taxes. We believe that the carryover tax-deductible goodwill should be compared to the book goodwill arising in the current transaction for purposes of determining whether a recognizable temporary difference exists.

In analyzing component-1 and component-2 goodwill, the expected impact on tax-deductible goodwill of assumed liabilities, contingent liabilities, and contingent consideration should be considered. See TX 10.4.5 for further information on the comparison of book goodwill to tax-deductible goodwill when there are assumed liabilities, contingent liabilities, or contingent consideration. See TX 10.4.7 for further information on the treatment of acquisition-related costs in the comparison of book goodwill to tax-deductible goodwill.

10.8.2.1 Deferred tax asset for excess tax-deductible goodwill

ASC 805 prescribes the recognition of a deferred tax benefit resulting from tax-deductible goodwill that is in excess of book goodwill. The tax benefit of the excess tax goodwill is recognized as a deferred tax asset at the acquisition date, which increases the values assigned to the acquired net assets and correspondingly decreases book goodwill. This, however, further increases (1) the difference between book goodwill and tax-deductible goodwill and (2) the corresponding deferred tax balance (as described in ASC 805-740-55-9 through ASC 805-740-55-13). To deal with this iterative process, the computation of the deferred tax asset can be reduced to the following simultaneous equation:

$(\text{Tax rate} / (1 - \text{tax rate})) \times \text{preliminary temporary difference (PTD)} = \text{deferred tax asset}$

The resulting amount of deferred tax asset reduces book goodwill. If book goodwill is reduced to zero, any additional amounts recognized will result in a bargain purchase gain. Example TX 10-17 provides an example of the iterative calculation.

EXAMPLE TX 10-17

Recording a deferred tax asset for excess tax-deductible goodwill, no bargain purchase gain

A taxable acquisition results in initial book goodwill of \$450 million. A separate determination for taxes results in tax-deductible goodwill of \$600 million. The gross preliminary temporary difference between book and tax goodwill is \$150 million. The applicable tax rate is 25%.

How should the deferred tax asset for excess tax-deductible goodwill be determined?

Analysis

The deferred tax asset for the excess tax-deductible goodwill is (in millions):

$(25\% / (1 - 25\%)) \times \$150 = \text{deferred tax asset of } \50

The acquirer would record a deferred tax asset for \$50 million with a corresponding decrease in book goodwill. Therefore, final goodwill for financial reporting purposes would be \$400 million, and a deferred tax asset of \$50 million would be established. The resulting deferred tax asset appropriately reflects the temporary difference related to goodwill, as illustrated below (in millions):

$(\text{Tax goodwill} - \text{book goodwill}) \times 25\% = \text{deferred tax asset}$

$(\$600 - \$400) \times 25\% = \$50$

10.8.2.2 Nuances associated with the iterative formula

Use of the equation described in TX 10.8.2.1 is not appropriate in every situation. Complexities may arise that require modification of the formula and, in some cases, preclude its use altogether. These complexities may include the following situations:

- The formula uses a single statutory tax rate. However, there may be situations when the temporary differences arising in the acquisition would be tax-effected at different rates (e.g., when there are different rates in a carryback period or a rate change has been enacted for future years, or where the temporary differences give rise to more than one type of taxable income). In these situations, successive calculations may be required to determine the deferred tax asset.
- To the extent that a valuation allowance is required for all or part of the deductible temporary differences, there may be no or only a partial iterative effect on goodwill. Again, successive calculations may be required to determine the deferred tax asset.

Example TX 10-18 illustrates a situation in which the formula used to determine the deferred tax asset related to excess tax-deductible goodwill requires modification.

EXAMPLE TX 10-18**Recording a deferred tax asset for excess tax-deductible goodwill with bargain purchase gain**

A taxable acquisition results in initial book goodwill of \$120 million and tax-deductible goodwill of \$600 million. The gross preliminary temporary difference (PTD) between book and tax goodwill is \$480 million. Assume an applicable tax rate of 25%.

How should the deferred tax asset for excess tax-deductible goodwill be determined and recorded?

Analysis

The initial calculation of the deferred tax asset for excess tax-deductible goodwill is (in millions):

$$(25\% / (1 - 25\%)) \times \$480 = \text{deferred tax asset of } \$160$$

However, the deferred tax asset is in excess of book goodwill. Recording a deferred tax asset of \$160 million would result in a complete elimination of the book goodwill and a tax benefit of \$40 million. In this case, the deferred tax asset would not appropriately reflect the temporary difference related to goodwill, as illustrated here (in millions):

$$\begin{aligned} (\text{Tax goodwill} - \text{book goodwill}) \times 25\% &= \text{deferred tax asset} \\ (\$600 - \$0) \times 25\% &= \$150, \text{ which does not equal the } \$160 \text{ deferred tax asset previously calculated} \end{aligned}$$

The following formula can be used to determine the amount of PTD which would eliminate all book goodwill (in millions):

$$\begin{aligned} (25\% / (1 - 25\%)) \times \text{PTD} &= \$120 \text{ (book goodwill)} \\ \text{Solving for PTD} &= \$360 \end{aligned}$$

A deferred tax asset would be recorded and goodwill would be adjusted to the extent of the calculated limit of PTD, calculated as follows (in millions):

$$(25\% / (1 - 25\%)) \times \$360 = \$120$$

The remaining amount of deferred tax asset would be recorded as a bargain purchase gain. The following formula can be used to determine the amount of the gain (in millions):

$$\begin{aligned} (\text{PTD original result} - \text{PTD revised limit}) \times 25\% &= \text{gain} \\ (\$480 - \$360) \times 25\% &= \$30 \end{aligned}$$

When the initial calculation of the deferred tax asset related to goodwill exceeds the amount of book goodwill, the total deferred tax asset to be recognized will be equal to the tax effect of tax-deductible goodwill (i.e., tax-deductible goodwill less book goodwill of zero). Therefore, the company will record a deferred tax asset of \$150 million (i.e., (\$600 million tax goodwill - \$0 book goodwill) x 25%). A portion of the deferred tax asset recognized in acquisition accounting will reduce initial book goodwill to zero.

The remaining amount of the deferred tax asset is recorded as a bargain purchase gain.

The following entry would be recorded (in millions):

Dr. Deferred tax asset	\$150	
Cr. Goodwill		\$120
Cr. Bargain purchase gain		\$30

The resulting deferred tax asset appropriately reflects the temporary difference related to goodwill, as illustrated below (in millions):

$$\begin{aligned} (\text{Tax goodwill} - \text{book goodwill}) \times 25\% &= \text{deferred tax asset} \\ (\$600 - \$0) \times 25\% &= \$150 \end{aligned}$$

10.8.2.3 Changes to deferred taxes for component-2 tax goodwill

In periods subsequent to the acquisition, when component-2 goodwill is an excess of tax-deductible goodwill over book goodwill, future changes in the tax or book goodwill balances will impact the deferred tax balance associated with goodwill. When goodwill is amortized for tax purposes or reduced for book purposes through impairment or amortization (under ASC 350-20-35-63), the result should be a corresponding adjustment to the temporary difference. For example, future amortization of tax-deductible goodwill will reduce the corresponding deferred tax asset until the tax basis is equal to the book basis and create a deferred tax liability for the basis difference created by tax amortization thereafter (see ASC 805-740-25-9). In situations where there is a book goodwill impairment and goodwill is tax deductible, the goodwill impairment must be allocated between component-1 and component-2 book goodwill. See BCG 9.9.6 for a discussion of the allocation of a goodwill impairment to the different components for tax purposes, including examples that illustrate the accounting in various scenarios

Refer to TX 10.8.3 for discussion of the accounting subsequent to the acquisition when component-2 goodwill is an excess of book goodwill over tax-deductible goodwill.

10.8.3 Excess of book goodwill over tax-deductible goodwill

When there is an excess of book goodwill over tax goodwill as of the acquisition date, no deferred tax liability is recorded for the excess book goodwill. Establishing a deferred tax liability would further increase the amount of goodwill, as it would decrease the value of the net assets acquired. This would, in turn, require an increase in the deferred tax liability, which would again increase goodwill, etc. As a consequence, it would result in the grossing up of goodwill and the deferred tax liability. As such, in accordance with ASC 740-10-25-9, no deferred tax liability is recorded at the acquisition date or in future years for the excess of book goodwill over the tax-deductible amount of goodwill. Subsequent changes related to the component-2 book goodwill (typically resulting from a book goodwill impairment or amortization of goodwill under the private company alternative (see TX 10.8.4)) are considered a permanent difference in the tax provision.

In contrast, in periods subsequent to the acquisition, a change in the book or tax basis of component-1 goodwill would yield a deferred tax asset or liability. This may occur due to amortization of tax-deductible goodwill, or due to reductions to book basis from impairment or book goodwill

amortization under the private company alternative (see TX 10.8.4). Refer to TX 10.8.2.3 for discussion of the deferred tax accounting for a book goodwill impairment or amortization.

Deferred tax liabilities associated with goodwill may or may not serve as a source of income for purposes of realizing deferred tax assets. See TX 5.5.1 for more information.

10.8.4 *Private companies—alternative accounting for goodwill*

ASC 350-20-35-63 provides private companies with an accounting alternative to amortize goodwill on a straight-line basis over ten years, or less than ten years if the company demonstrates that another useful life is more appropriate. However, this alternative does not impact whether the goodwill is component-1 or component-2, nor does it impact the income tax accounting requirements for recording deferred taxes as a result of, and subsequent to, a business combination.

Companies that elect to apply the goodwill alternative may have to consider the potential effect on their valuation allowance assessment. See TX 5.5.2.

10.8.5 *Deferred tax considerations in goodwill impairment testing*

Goodwill is allocated to organizational units called reporting units for financial reporting purposes. BCG 9.3.5 includes considerations for assigning specific assets or liabilities to a reporting unit, including separate discussions and examples related to assigning net operating losses (NOLs), credit carryforwards, and other deferred taxes to reporting units.

Goodwill is also subject to periodic and trigger-based impairment tests. See BCG 9.5 for a detailed discussion of goodwill impairment. Additionally, BCG 9.9.1 discusses how an entity should consider deferred tax balances that relate to differences between the book and tax bases of assets and liabilities assigned to reporting units when testing for goodwill impairment. Specific considerations include how deferred taxes impact a reporting unit's fair value and carrying amount when performing a goodwill impairment test.

10.8.6 *Tax accounting—disposal of goodwill*

In many jurisdictions, goodwill is associated with the stock of a specific legal entity, whereas for book purposes, goodwill is associated with a reporting unit. The reporting unit may include several legal entities or be limited to a portion of a legal entity. This can result in differences between the book and tax accounting for goodwill upon the disposal of a business.

If the disposed business is a legal entity, any tax-deductible goodwill associated with that entity would be included in the determination of the taxable gain or loss. If the disposed operations are a business, ASC 350-20-40-3 requires the allocation of a reporting unit's goodwill to (1) the business that was disposed of and (2) the remaining parts of the reporting unit, based on their relative fair values on the date of disposal. Once goodwill is characterized as component-1 or component-2, it retains this characterization as long as a reporting entity retains that goodwill. Therefore, upon disposal of a business that includes some or all of a reporting entity's goodwill, a deferred tax adjustment would generally be required for disposal of component-1, but not for disposal of component-2 goodwill. Example TX 10-19 and Example TX 10-20 illustrate the disposal of a business, including a portion of component-1 goodwill, resulting in a deferred tax adjustment to the reporting entity.

Example TX 10-21 illustrates the disposal of a business, including a portion of component-2 goodwill, resulting in no deferred tax adjustment to the reporting entity.

EXAMPLE TX 10-19

Disposal of tax-deductible goodwill with retention of book goodwill

Entity A acquired Entity B in a taxable business combination (i.e., Entity A treated the purchase as an asset acquisition for tax purposes), which gave rise to book and tax-deductible goodwill in equal amounts of \$100. The business of Entity B and the associated goodwill are fully integrated into one of Entity A's reporting units.

In a later period, Entity A decides to dispose of the shares of Entity B, including Entity B's operations. For tax purposes, the entire remaining tax-deductible goodwill of \$70 (\$100 initial basis less assumed tax amortization of \$30) is included in the disposal. For book purposes, assume goodwill of \$20 should be allocated to the disposed operation on a relative fair value basis. As a result, \$80 of the book goodwill is retained by the surviving reporting unit within Entity A (\$100 initial value less \$20 included in the disposed operation).

What is the deferred tax effect of a disposal of tax-deductible goodwill with a retention of book goodwill?

Analysis

The disposal would result in a basis difference in the goodwill retained by Entity A, with book goodwill exceeding tax-deductible goodwill by \$80. This would give rise to a deferred tax liability for the entire \$80 taxable basis difference (i.e., Entity A would compare nil tax-deductible goodwill to book goodwill of \$80) because book goodwill remains component-1 goodwill consistent with the initial determination made at the acquisition date.

EXAMPLE TX 10-20

Disposal of book goodwill with retention of tax-deductible goodwill

Entity A acquired Entity B in a taxable business combination (i.e., Entity A treated the purchase as an asset acquisition for tax purposes), which gave rise to book and tax-deductible goodwill in equal amounts of \$100. The business of Entity B and the associated goodwill are fully integrated into one of Entity A's reporting units.

In a later period, Entity A decides to dispose of a significant portion of its operations but not its shares in Entity B. For tax purposes, there is \$70 of tax-deductible goodwill remaining (\$100 initial basis less assumed tax amortization of \$30). The tax-deductible goodwill associated with the shares of Entity B would remain with Entity A. For book purposes, assume \$80 of goodwill is allocated to the disposed operations on a relative fair value basis and included in the determination of the disposal gain or loss. Book goodwill of \$20 remains in the reporting unit.

What is the deferred tax effect of a disposal of book goodwill with a retention of tax-deductible goodwill?

Analysis

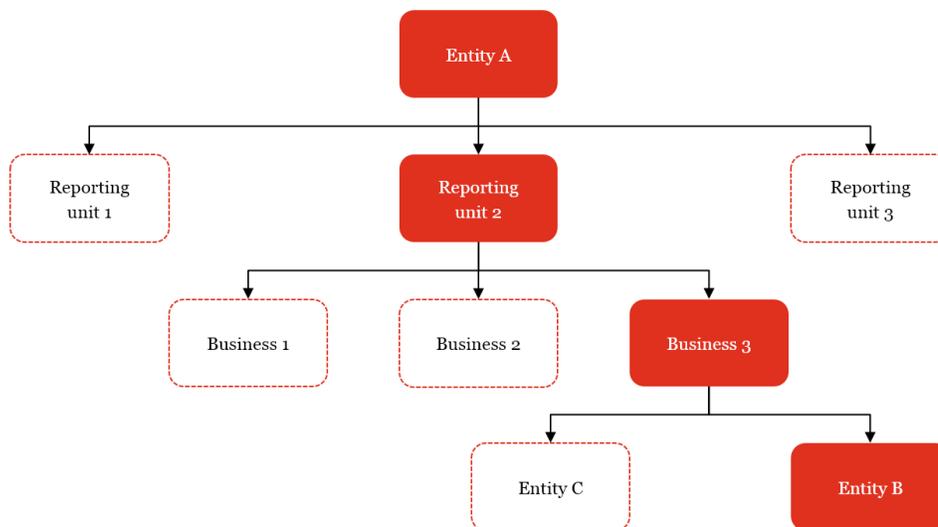
The disposal of component-1 goodwill will result in a basis difference in goodwill retained by Entity A, consisting of the remaining tax goodwill (\$70) exceeding book goodwill (\$20) by \$50, which will give rise to a deferred tax asset (subject to the measurement criteria of ASC 740). This is a result of book goodwill remaining component-1 goodwill consistent with the initial determination made at the acquisition date.

EXAMPLE TX 10-21

Evaluating deferred tax assets for temporary differences on component-2 goodwill after disposition of the entity that generated the goodwill

Entity A acquired Entity B in a nontaxable business combination. For tax purposes, the transaction resulted in a carryover basis in Entity B's assets and liabilities. Because the tax basis carried over and Entity B's assets for tax purposes did not contain any tax-deductible goodwill, all of the goodwill recorded in acquisition accounting (\$500) was component-2 book goodwill (as defined in ASC 805-740-25-9).

Entity A has three reporting units. Entity A's reporting unit composition is as follows:



The component-2 goodwill from the acquisition of Entity B was all allocated to Reporting Unit 2.

In the current year, Entity A sold Business 3, which includes Entity B. The goodwill in Reporting Unit 2 was allocated to Business 3, based on the relative fair value of Business 3 and the retained operations of Reporting Unit 2, pursuant to ASC 350-20-40-3. This resulted in only \$100 of book goodwill being allocated to the business sold (Business 3).

Should Entity A record a deferred tax liability on the book to tax difference of \$400 associated with the remaining book goodwill of Entity B in Reporting Unit 2 subsequent to the sale of Entity B?

Analysis

No deferred tax liability should be recognized in this instance. On the date Entity A acquired Entity B, the entire amount of book goodwill would have been classified as component-2 goodwill as there was no tax goodwill in the transaction, and no deferred tax liability was recorded pursuant to ASC 740-10-25-3(d). The fact that only a portion of that goodwill was subsequently attributed to Entity B when it was disposed of does not change that component-2 characterization. Thus, the goodwill remaining in Reporting Unit 2 after the sale of Entity B would continue to be component-2 goodwill, for which no deferred tax liability would be recorded.

10.8.7 Tax accounting—bargain purchase

Bargain purchase refers to a situation in which the fair value of the net assets acquired exceeds the fair value of consideration transferred. Such excess is sometimes referred to as “negative goodwill.” In these situations, the acquirer must reassess whether it has correctly identified all of the assets acquired and liabilities assumed and review the procedures used to measure the components of the acquisition to ensure all available evidence as of the acquisition date has been considered. When the aggregate amount of fair value assigned to the acquired net assets exceeds the acquisition consideration, it results in a bargain purchase gain (which is discussed in ASC 805-30-25-2). See BCG 2.6.2 for more information on accounting for a bargain purchase.

The tax rules for each separate jurisdiction may require a different treatment for bargain purchases than that required under ASC 805. Tax rules often require the allocation of negative goodwill to certain assets through the use of the residual method, resulting in decreased tax bases. In the United States, for example, for tax purposes, the acquisition price is assigned to assets categorized in seven distinct asset classes, first to the assets in Class I and then successively through to Class VII. The consideration transferred is not allocated to a successive class until it has been allocated to the assets in the previous class based on their full fair values. This methodology can result in several classes of assets without tax bases and in temporary differences for a significant portion of all assets. The allocation of negative goodwill to reduce the tax bases of acquired net assets causes the book bases to exceed their respective tax bases, resulting in the recognition of deferred tax liabilities.

Deferred taxes are recognized as part of the identifiable assets acquired and liabilities assumed. Therefore, the amount of the financial statement bargain purchase gain is directly affected by any such deferred taxes. See Example TX 10-19 for a situation where the recording of a deferred tax asset related to goodwill causes a bargain purchase gain. While not directly addressed in ASC 805, we believe the gain should be presented on a single line in pre-tax income from continuing operations. The deferred taxes included in the determination of the bargain purchase gain should not be shown on the income tax line (i.e., the bargain purchase gain should not be grossed-up to exclude deferred taxes). Therefore, the recognition of deferred tax liabilities results in a reduction in the bargain purchase gain for financial reporting and may result in the recognition of goodwill. Example TX 10-22 illustrates the recording of deferred tax balances in a bargain purchase situation.

EXAMPLE TX 10-22**Recording deferred tax balances in a bargain purchase (US tax jurisdiction)**

Company A acquires Company B in a taxable acquisition. Total acquisition consideration amounted to \$230 million, and the acquired fair value of the net assets equals \$290 million, which results in the following allocation (in millions). The applicable tax rate is 25%.

	Fair value	Tax basis
Class I – Cash	\$50	\$50
Class II – CDs	10	10
Class III – Accounts receivable	60	60
Class IV – Inventory	80	80
Class V – Tangible property	50	30
Class VI – Intangibles	40	0
Class VII – Goodwill	0	0
	\$290	\$230

Tangible property consists of three pieces of equipment, as follows (in millions):

	Fair value	Tax basis
Equipment A	\$10	\$6
Equipment B	15	9
Equipment C	25	15
	\$50	\$30

For financial statement purposes, this transaction is a bargain purchase. Therefore, the assets are recorded at their fair value determined under the ASC 805, and the bargain element of the transaction is recorded in earnings.

How should deferred taxes be recorded in a bargain purchase?

Analysis

The differences between the book and tax bases of the net assets acquired result in the recognition of deferred tax liabilities of \$15 million ($(\$290 \text{ million} - \$230 \text{ million}) \times 25\% \text{ tax rate}$). Therefore, the total amount of net assets recorded in acquisition accounting is \$275 million ($\$290 \text{ million} - \15 million). The bargain purchase gain would be calculated as follows (in millions):

Fair value of net assets acquired	\$275
Less: consideration transferred	(230)
Bargain purchase gain	\$45

10.9 Tax effects of transactions with noncontrolling shareholders

Once a parent controls a subsidiary, changes can occur in the ownership interests in that subsidiary that do not result in a loss of control by the parent. For example, a parent may purchase some of the subsidiary's shares or sell some of the shares that it holds, a subsidiary may reacquire some of its own shares, or a subsidiary may issue additional shares. These changes should be accounted for as equity transactions.

A noncontrolling interest (NCI) is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to the parent. In a transaction that results in a change in the parent's ownership interest but the parent retains its controlling financial interest, the carrying amount of the NCI is adjusted to reflect the change in its ownership interest in the subsidiary's net assets. Any difference between the fair value of the consideration received or paid and the amount by which the NCI is adjusted is recognized in equity attributable to the parent. See BCG 6 for further information on the accounting for transactions with noncontrolling shareholders.

The direct tax effect of a transaction with noncontrolling shareholders that does not cause a change in control generally is recorded in equity in accordance with ASC 740-20-45-11(c). However, care should be taken to distinguish between direct and indirect tax effects, because the treatment in the financial statements may differ for each, and sometimes the tax effect of a transaction comprises both direct and indirect components. We consider the direct effects to be those resulting from application of the relevant tax law to the transaction. Direct effects do not include those resulting from a change in an accounting assertion, election, or assessment, even though such a change may have been undertaken by the reporting entity in contemplation of the transaction.

10.9.1 Transactions with noncontrolling interest—direct effects

In accordance with ASC 740-20-45-11(c), the direct tax effect of a transaction with noncontrolling shareholders that does not cause a change in control is generally recorded in equity. We believe that any related valuation allowance would also be recorded in equity.

Example TX 10-23 illustrates the recording of a direct tax effect of a transaction with noncontrolling shareholders.

EXAMPLE TX 10-23

Recording the direct tax effect of a transaction with noncontrolling shareholders

Parent owns 100% of Company B, which has net assets of \$200 million. Parent's tax basis in its investment in Company B is \$200 million (equal to the book basis). Company B issues additional

shares to Company C, an unaffiliated third party, for cash of \$80 million. The issuance of the additional shares dilutes Parent's interest to 80%. After issuance of the additional shares, the ownership interests in the net assets of Company B are as follows (in millions). The tax rate is 25%.

	Total net assets	Ownership interest	Net assets attributable
Parent - consolidated	\$280 ¹	80%	\$224
Company C	\$280	20%	\$56
		100%	\$280

¹ \$200 initial net assets + \$80 share proceeds

How should the tax effects of the transaction with the noncontrolling shareholder be recorded?

Analysis

The transaction caused a \$24 million increase in the book basis of Parent's investment in Company B, but no change in the tax basis, thus creating a taxable temporary difference of \$6 ((\$224 book basis - \$200 tax basis) x 25%)million.

Unless Parent can establish its intent and ability to indefinitely delay reversal of the difference, Parent would record a deferred tax liability for the taxable temporary difference. Since the transaction is recorded directly in equity, the tax effect of the transaction, assuming a 25% tax rate, is also recorded directly in equity.

Complexities can arise when accounting for the tax effects of a transaction with noncontrolling shareholders that are recorded in both consolidated and separate company financial statements. Example TX 14-8 illustrates the recording of the deferred tax effects of the acquisition of a noncontrolling interest in a consolidated pass-through entity in a consolidated and separate company financial statement.

10.9.2 Transactions with noncontrolling interest—indirect effects

It is important to distinguish between direct and indirect tax effects of a transaction with noncontrolling shareholders because the treatment in the financial statements may differ for each. For example, the purchase by a parent company of an additional interest in a controlled subsidiary may allow the parent for the first time to file a consolidated tax return. The ability to file a consolidated tax return may allow the company to change its assessment regarding its ability to realize existing deferred tax assets, causing the company to release all or a portion of its valuation allowance. Even though a transaction with noncontrolling shareholders may have caused the change in circumstances that allows the parent to realize (or conclude it may not realize) its deferred tax assets in the future, the change in valuation allowance results from management's decision to file a consolidated return and the related impact of that decision on its assessment regarding the realization of deferred tax assets. Therefore, the change in valuation allowance is an indirect effect of the transaction. The tax effect of a change in judgment about the realization of deferred tax assets in future years generally is reflected in earnings, but it is subject to the intraperiod allocation requirements (see TX 12).

Some transactions may cause a direct and an indirect tax effect. Example TX 10-24 illustrates the recording of the direct and indirect tax effects of a transaction with noncontrolling shareholders.

EXAMPLE TX 10-24

Recording the tax effects of a transaction with noncontrolling shareholders

Parent owns and controls 100% of Company B, which is domiciled in a foreign jurisdiction. Parent's book basis and tax basis in its investment in Company B is \$300 million and \$200 million, respectively. The difference between the book basis and tax basis is attributable to the undistributed earnings of Company B. Parent has not historically recorded a deferred tax liability on the taxable temporary difference because of its intent and ability to indefinitely delay reversal of the difference. Parent sells 20% of Company B for \$240 million. The sale of Parent's investment is taxable at a rate of 25%. The noncontrolling interest is \$60 million (book basis of \$300 million x 20%).

How should the direct and indirect tax effects of the transaction with the noncontrolling shareholder be recorded?

Analysis

Parent's current tax consequence from the tax gain on the sale of its investment in Company B is \$50 million (((\$240 million selling price – (\$200 million tax basis × 20% portion sold)) × 25% tax rate). The total tax consequence of \$50 million is comprised of two components:

1. \$5 million, which is the difference between the book basis and the tax basis (i.e., undistributed earnings of Company B) of the portion sold (((\$300 million book basis – \$200 million tax basis) × 20% portion sold × 25% tax rate). This component is an indirect tax effect of the transaction. The tax consequence results from a change in assertion regarding the indefinite delay of the reversal of the outside basis difference, which is triggered by the decision to sell a portion of the investment in Company B. The outside basis difference is attributable to undistributed earnings of Company B and the tax effect of the change in assertion related to the outside basis difference would be recorded in earnings. In fact, the tax liability related to the unremitted earnings of the subsidiary may be required to be recorded in a period preceding the actual sale transaction, because the liability should be recorded when the company's assertion regarding indefinite reinvestment changes.
2. \$45 million, which is the difference between the selling price and the book basis for the portion sold (((\$240 million selling price – (\$300 million book basis × 20% portion sold)) × 25% tax rate). This component represents the economic gain on the sale and is a direct tax effect of the transaction. Because the difference between fair value and carrying amount of NCI is recorded in equity, the direct tax effect should also be recorded in equity.

The change in assertion related to the indefinite delay of the reversal of the outside basis difference will impact the effective tax rate in the period in which the change occurs.

In light of the disposal of a portion of the Parent's investment in Company B, Parent should also reassess its intent and ability to indefinitely delay reversal of the remaining outside basis difference in the portion retained and assess whether a deferred tax liability should be recorded on such difference.

10.10 Transactions under common control

Common control transactions occur frequently, particularly in the context of group reorganizations, spin-offs, and initial public offerings. Combinations between entities that are under common control are excluded from the scope of business combinations. However, the guidance on accounting for common control transactions did not change and is carried forward in ASC 805-50.

Common control transactions are generally accounted for based on the nature of the transaction. For example, transactions involving the transfer of an asset (such as a building) are accounted for at historical carrying values. Transactions involving the transfer of a business will result in a change in reporting entity for the entity receiving the assets and require the application of the procedural guidance in ASC 805-50. Transfers of net assets, depending upon whether its nature is considered to be similar to assets or a business, will be accounted for either at historical carrying values or based on the procedural guidance. Companies will need to use judgment to determine the nature of the transaction. The accounting for common control transactions is discussed in BCG 7.

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests should initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of the transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because push-down accounting had not been applied, then the financial statements of the receiving entity should reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

10.10.1 Presentation for a change in reporting entity

If a transaction combines two or more commonly controlled entities that historically have not been presented together, the resulting financial statements are, in effect, considered those of a different reporting entity. This results in a change in reporting entity, which requires retrospectively combining the entities for all periods presented as if the combination had been in effect since inception of common control (see ASC 250-10-45-21). Certain adjustments to the financial statements of the new reporting entity may be required. The types of adjustments that may be necessary are discussed in ASC 805-50.

US GAAP does not specifically address the accounting for the deferred tax consequences that may result from a transfer of net assets or the exchange of equity interests between entities under common control. The retrospective combination of the entities for all periods must be considered when determining whether any adjustment to the new reporting entity's historical valuation allowance conclusion is necessary.

In the periods prior to the combination date, a combining entity's deferred tax assets (e.g., operating loss carryforward) cannot offset the other entity's taxable income unless allowed under the tax law. However, future taxable income of the combined operations subsequent to the combination date should be considered in assessing the need for a valuation allowance in the restated periods prior to the combination date. Similarly, any tax law limitations on the use of combined attributes subsequent to the transfer or exchange date should also be considered. Accordingly, in restating periods prior to the transfer or exchange, a valuation allowance against deferred tax assets that is necessary for the combined entity may be more or less than the sum of the valuation allowance in the entities' separate

financial statements before the transfer or exchange. If the transfer or exchange causes any change in the combined entities' valuation allowance, the reduction or increase should be recognized as part of the adjustment to restate the entities' prior-period financial statements on a combined basis subject to the intraperiod allocation rules.

For purposes of restating periods prior to the transfer or exchange, hindsight is required to take into account (1) that the transfer or exchange has occurred and (2) the amount of any resulting tax law limitations on the use of carry-over tax benefits after the transfer or exchange. However, hindsight is precluded for purposes of assessing pre-transfer or exchange estimates of future taxable income. In other words, any reduction in the valuation allowance for either entity's deferred tax assets would be reflected in the years that the deductible differences or carryforwards arose, provided that one of the following conditions exists:

- The other entity's taxable differences existing at that time will generate sufficient future post-transfer or exchange taxable income to ensure realization of the deferred tax assets.
- Estimates that would have been made at the time of future combined taxable income (i.e., after the transfer or exchange, other than reversing differences and carryforwards of the other entity) would have been sufficient for realization of the deferred tax assets.
- A valid tax-planning strategy ensures realization of the deferred tax assets.

If none of these conditions were met in the year that the deductible differences and carryforwards arose, the reduction in the valuation allowance will be reflected in the first subsequent year in which one or more of these conditions are met.

In addition to adjustments that may be required to restate prior periods, new tax bases of assets and liabilities may be established in a taxable transfer or exchange. Because a new basis is not established for book purposes, taxable temporary differences may be reduced or eliminated, and deductible temporary differences may be increased or created. As of the transfer or exchange date, the tax effects attributable to any change in tax basis (net of valuation allowance, if necessary) should be charged or credited to contributed capital, as per ASC 740-20-45-11(g). If a valuation allowance is provided against the deferred tax assets at the combination date, any subsequent release of the valuation allowance should be reported as a reduction of income tax expense and reflected in continuing operations, unless the release is based on income recognized during the same year and classified in a category other than continuing operations, consistent with the guidance at TX 12.3.2.3.

Example TX 10-25 illustrates the assessment of a valuation allowance for a transfer of entities under common control.

EXAMPLE TX 10-25

Assessing a valuation allowance when there is a transfer of entities under common control

Parent controls both Entity Y and Entity Z. Entity Y acquires Entity Z in a nontaxable acquisition. The acquisition is accounted for in Entity Y's financial statements in a manner similar to how the entity would have accounted for a pooling of interests. Entity Y's prior-period financial statements will be restated retroactively for the effects of the "acquisition" (i.e., transfer of entities under common control).

Historically, Entity Y has been profitable. Entity Z has not had a history of profitability, and before the acquisition it had a full valuation allowance on its deferred tax assets. Following the acquisition/combination, Entity Y will file a consolidated tax return that includes the results of Entity Z.

In Entity Y's restatement of its prior-period financial statements to include Entity Z, how should the need for a valuation allowance relative to Entity Y and Entity Z's deferred tax assets be assessed?

Analysis

The deferred tax assets should be evaluated for realizability in accordance with ASC 740 at the time of the combination and for prior periods. The fact that the companies will file a consolidated tax return for periods after the legal combination should be taken into consideration.

By analogy to the historical guidance on recording the tax effects of pooling-of-interest transactions, in determining the need for a valuation allowance for prior periods, the estimated combined future taxable income of Entity Y and Entity Z after their legal combination should be considered. If the valuation allowance is reduced as a result of the common control transaction, the reduction should be recorded as a decrease in income tax expense in the period that it became apparent that future taxable income could be a source of recovery, which could potentially be a period prior to the period of the actual legal combination/transfer. In determining the appropriate period for reversal, hindsight is precluded for purposes of assessing estimates of future taxable income.

10.11 Business combinations—other tax considerations

Other transactions requiring special considerations include fresh start accounting and the transfer of assets other than cash as part of the consideration in a business combination.

10.11.1 Fresh start accounting

A company emerging from bankruptcy should prepare its financial statements in accordance with ASC 852, *Reorganizations* (i.e., “fresh-start” accounting). Refer to BLG 4.4.7 in PwC's guide to *Bankruptcies and liquidations* for additional guidance on the topic.

10.11.2 Exchanges of assets between companies

An acquirer may transfer assets other than cash as part of the consideration transferred in a business combination. The difference between the fair value and the carrying value of the transferred asset is recognized as a gain or loss in earnings unless the assets remain in the combined group (as discussed in BCG 2.6.3.2).

The tax consequences to the acquirer from transferring assets as part of consideration paid are recorded in the acquirer's financial statements outside of acquisition accounting. However, sometimes the transfer is tax-free, in which case no income tax effect is recorded. Example TX 10-26 illustrates the income tax accounting for a tax-free transfer of an equity interest in exchange for control of a subsidiary.

EXAMPLE TX 10-26**Income tax accounting for a tax-free transfer of an equity interest in exchange for control of a subsidiary**

Entity X owns 15% of Entity Y, which is a private enterprise. Entity Y's securities do not have a readily determinable fair market value. As a result, Entity X appropriately elects to account for its investment at cost less impairment. The two companies enter into an agreement whereby Entity Y exchanges a wholly owned subsidiary (Sub S) in return for Entity X's 15% ownership interest in Entity Y.

Both the carrying value and the tax basis of Entity X's investment in Entity Y is \$300. The fair value is \$1,000. The fair value of Sub S is less than the fair value of the Entity Y shares held by Entity X. Therefore, Entity Y infuses cash into Sub S just prior to the exchange to equalize the value. After the cash infusion, the fair value of Sub S is \$1,000. The fair value of Sub S's identifiable assets and liabilities is \$700. The tax bases of the assets and liabilities are equal to \$500.

The exchange of Entity X's investment in Entity Y for Entity Y's investment in Sub S is tax-free. Entity X's tax basis in its investment in Entity Y (\$300) will become Entity X's tax basis in its investment in Sub S. There is no uncertainty relative to the tax-free nature of the transaction.

After the transaction, Entity X has the intent and ability to recover its investment in Sub S in a tax-free liquidation and therefore will not record a deferred tax liability for any resulting book-over-tax outside basis difference in its investment in Sub S. Entity X's tax rate is 25%.

How should Entity X record the tax-free transfer of its equity interest in Entity Y?

Analysis

Entity X would record the following entries in acquisition accounting:

Dr. Net assets	\$700 ¹	
Dr. Goodwill	\$350 ²	
Cr. Deferred tax liability		\$50 ³
Cr. Gain on investment		\$700 ⁴
Cr. Investment in Entity Y		\$300 ⁵

¹ Fair value of the identifiable assets and liabilities of Sub S

² Goodwill is calculated as the residual after recording the identifiable net assets acquired and associated deferred tax assets and liabilities ($\$1,000 - (\$700 - \$50)$).

³ The deferred tax liability is calculated as the difference between the book bases of the identifiable net assets acquired and the carryover tax bases at the applicable tax rate ($(\$700 - \$500) \times 25\%$).

⁴ The gain on investment is the difference between the fair value and the carrying value of Entity X's investment in Entity Y ($\$1,000 - \300).

⁵ Carrying value of Entity X's investment in Entity Y.

There would be no tax consequence from the exchange of Entity X's investment in Entity Y for Entity Y's investment in Sub S. Therefore, the gain from transferring the investment in Entity Y would impact Entity X's effective tax rate in the amount of \$175 ($\$700 \times 25\%$) as a favorable permanent adjustment.

10.12 *Business combinations – asset acquisitions*

When a reporting entity acquires an asset or group of assets that does not meet the definition of a business under ASC 805-10, the transaction is accounted for as an asset acquisition in accordance with ASC 805-50, unless other GAAP applies (e.g., ASC 845 or ASC 610-20). The tax accounting for these asset acquisitions varies depending on whether the asset was acquired through a monetary exchange or a non-monetary exchange.

10.12.1 *Asset acquisitions – monetary exchanges*

In a typical acquisition of an asset in a transaction involving a monetary exchange, the book and tax bases of the asset are equal to the monetary purchase price (historical cost). Therefore, there is generally no temporary difference or related deferred tax to record at the acquisition date.

However, sometimes a group of assets may be purchased in a transaction that is not accounted for as a business combination under ASC 805, usually because the group of assets does not meet the definition of a business. In those cases, a difference between the book and tax bases of the assets may arise. ASC 740-10-25-51 prohibits any immediate income tax expense or benefit from the recognition of those deferred taxes, and, instead, requires the use of simultaneous equations to determine the assigned value of the asset and the related deferred tax asset or liability.

ASC 740-10-25-51 further provides that there may be instances when the simultaneous equation could, in theory, reduce the basis of an asset to less than zero. Under ASC 740, this is not allowed and instead, a deferred credit is generated. The deferred credit is not a temporary difference under ASC 740. The deferred credit is amortized to income tax expense in proportion to the utilization of the DTA arising from the realization of the tax benefits that gave rise to the deferred credit.

In the event that subsequent to the acquisition it becomes necessary to record a valuation allowance on the deferred tax asset, ASC 740-10-45-22 requires that the effect of such adjustment be recognized in continuing operations as part of income tax expense. ASC 740-10-45-22 further requires that a “proportionate share of any remaining unamortized deferred credit balance arising from the accounting shall be recognized as an offset to income tax expense. The deferred credit shall not be classified as part of deferred tax liabilities or as an offset to deferred tax assets.”

ASC 740-10-55-171 through ASC 740-10-55-191 provides examples of the accounting for asset acquisitions that are not accounted for as business combinations in the following circumstance:

- The amount paid is less than the tax basis of the asset (Example 25 Case A)
- The amount paid is more than the tax basis of the asset (Example 25 Case B)
- The transaction results in a deferred credit (Example 25 Case C)
- A deferred credit is created by the acquisition of a financial asset (Example 25 Case D)

In addition to acquiring other assets, an entity may purchase future tax benefits from a third party other than a government acting in its capacity as a taxing authority, such as NOLs. ASC 740-10-25-52 provides that the acquired tax benefits should be recorded using the simultaneous equation with no immediate impact to income tax expense or benefit. This is illustrated in Example 25, Case F, in ASC 740-10-55-199.

Conversely, according to ASC 740-10-25-53, "[t]ransactions 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)."

Asset acquisitions may result in the recognition of a DTA that is not expected to be realized (i.e., a full valuation allowance is required). Accounting for the recognition of the valuation allowance in these cases may not be straight forward. Example TX 10-27 illustrates accounting for deferred tax valuation allowances in a purchase of assets.

EXAMPLE TX 10-27

Accounting for deferred tax valuation allowances in a purchase of assets

Company A purchases two assets from an unrelated third party in a transaction considered to be an asset acquisition (not a business combination). Total consideration is \$8 million in cash. The assets acquired consist of (1) a 20% equity interest in an entity that will be accounted for using the equity method and (2) a marketing-rights intangible allowing Company A to market the products and services of the investee entity in certain territories. The intangible asset has an estimated economic life of five years. The tax rate is 25%.

Under ASC 805-50-30, the purchase price is allocated \$6 million to the stock investment and \$2 million to the intangible asset. For tax purposes, the \$8 million purchase price is allocable in its entirety to the equity interest. The differences in purchase price allocation for book and tax creates two temporary differences: a deductible temporary difference of \$2 million related to the equity method investment and a taxable temporary difference of \$2 million related to the intangible asset.

Company A has determined that the ultimate manner of recovering its equity method investment is through disposal (i.e., dividends are not expected to be paid) and therefore the deductible temporary difference of \$500,000 (\$2,000,000 @25%) is expected to result in a capital loss. Company A has no other existing sources of capital gain income and, therefore, will need to recognize a valuation allowance against the DTA.

How should Company A account for the valuation allowance?

Analysis

The recognition of the valuation allowance would result in the immediate recognition of a deferred income tax expense, which appears to contradict the specific prohibition against immediate income statement recognition in ASC 740-10-25-51.

We believe the prohibition in ASC 740-10-25-51 extends to any valuation allowance related to deferred tax assets arising in the asset acquisition. As a result, the deferred tax asset of \$500,000 would be recorded along with a valuation allowance, rather than using a simultaneous equation to calculate the deferred tax asset and a corresponding adjustment to the asset. As a result of recording the deferred tax asset and valuation allowance, there is no net impact on the provision.

The remaining deferred tax effect is the recognition of the deferred tax liability related to the marketing intangible. The calculation of the deferred tax liability will be through a simultaneous equation. Under the gross up approach, the recognition of the deferred tax liability related to the

marketing intangible would, in turn, increase the book basis of the asset. As such, the amount of the deferred tax liability and adjustment to the carrying amount of the asset is determined by using a simultaneous equation:

$$\text{DTL} = \frac{\text{Tax Rate}}{(1 - \text{Tax Rate})} \times (\text{Tax Basis} - \text{Initial Book Basis})$$

In this example,

$$\text{DTL} = \frac{25\%}{(1 - 25\%)} \times (0 - \$2,000,000) = (\$666,667)$$

Thus, Company A would record the following journal entry:

Dr. Equity method investment	\$6,000,000
Dr. Intangible asset – marketing rights	2,666,667
Dr. Deferred tax asset – equity method investment	500,000
Cr. Cash	\$8,000,000
Cr. Deferred tax liability – marketing rights intangible	666,667
Cr. Deferred tax asset – valuation allowance	500,000

To record the asset acquisition and the related deferred taxes.

In-process research and development (IPR&D) acquired in an asset acquisition is expensed if it has no alternative future use. Such write-off occurs on the acquisition date prior to the measurement of deferred taxes. Accordingly, deferred taxes are not provided on the initial differences between the amounts assigned for financial reporting and tax purposes, and IPR&D is charged to expense on a gross basis.

10.12.2 Asset acquisitions—nonmonetary exchanges

Both the GAAP treatment and tax treatment of nonmonetary exchange transactions may differ from the corresponding treatment of monetary exchange transactions. In most cases, the GAAP accounting requires recognition of the assets acquired at their fair value, but in some cases they may be recorded at the cost of the asset surrendered. In some jurisdictions, the tax law allows the acquirer to essentially substitute the tax basis in the asset disposed for the asset received (e.g., a like-kind exchange). To the extent that the tax basis in the acquired asset differs from the new book basis, a temporary difference exists that gives rise to deferred taxes. In those circumstances, we believe that the recognition of deferred taxes should be reflected immediately in the income statement. The rationale for this view is that the basis difference does not arise from the initial recognition of the asset but, rather, because of the deferral of the tax on the asset disposal.

To the extent that the assets were recorded at carryover basis (instead of fair value) for book purposes, and, as a result, there was no gain or loss on the transaction, ASC 740-10-25-51 would apply, which requires the use of simultaneous equations to determine the value of the asset and the related deferred tax asset as described in Example TX 10-28.

Example TX 10-28 illustrates the income tax accounting for a tax-free exchange of nonmonetary assets.

EXAMPLE TX 10-28

Income tax accounting for a tax-free exchange of nonmonetary assets

Entity X acquires Asset B in exchange for Asset R. The fair value of Asset B is \$150. Entity X's carrying amount of Asset R prior to the exchange is \$100 and its tax basis is \$80. The tax rate is 25%. For tax purposes, the transaction is structured such that Entity X can defer the taxable gain (i.e., the fair value of Asset B of \$150 less the basis of Asset R of \$80) on the exchange. The tax basis in Asset R of \$80 will become the tax basis in Asset B.

Assume that the nonmonetary exchange has commercial substance and is not an exchange transaction to facilitate sales to customers. Therefore, the exchange is measured at fair value for book purposes.

How would Entity X record the exchange?

Analysis

Entity X would record a gain of \$50 on disposal of Asset R based on the difference in the fair values of Asset B (\$150) and the carrying amount of Asset R (\$100) and a corresponding deferred tax provision of \$12.5 ($\$50 \times 25\%$) on the gain.

Prior to the sale of the asset, Entity X had a deferred tax liability of \$5 in connection with Asset R (carrying value of Asset R of \$100 versus tax basis of $\$80 \times 25\%$). The total deferred tax liability related to Asset B is \$17.5 ($(\$150 \text{ book basis} - \$80 \text{ tax basis}) \times 25\% = \17.5). The \$12.5 deferred provision above recognizes the increase in the deferred tax liability as a result of the recognition of the gain.

Accounting for IPR&D acquired in an asset acquisitions as part of a nonmonetary exchange is consistent with that of IPR&D acquired in an asset acquisition that included a monetary exchange. Refer to TX 10.12.1 for further details.

Chapter 11:
Outside basis differences and
other special areas

11.1 Chapter overview—outside basis differences

This chapter focuses on the accounting for “outside basis” differences. Outside basis differences are differences between the book and tax basis of an investment, such as the stock of a corporation (whether wholly-owned, majority-owned/controlled, or less-than-majority-owned/noncontrolled) or an interest in a partnership. It also addresses unique challenges associated with partnerships, foreign branch operations, foreign corporations that generate US subpart F income, and US taxation of global intangible low-taxed income (GILTI).

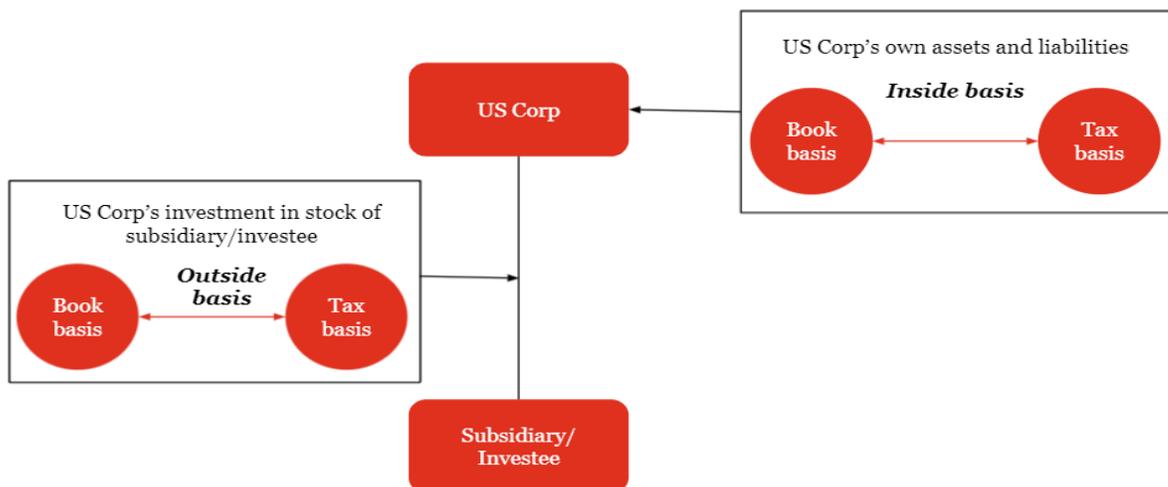
11.2 Accounting for the outside basis of investments

The determination of whether a temporary difference should be recorded for outside basis differences depends on a number of factors. These include the legal form of the investee/subsidiary entity and its tax status (e.g., partnership, branch, controlled foreign corporation), whether it is domestic or foreign, and, in some cases, the reporting entity’s (investor’s) intentions with respect to its investment in the entity.

11.2.1 Distinguishing outside and inside bases

A company’s basis in its own assets and liabilities (e.g., accruals, intangible assets, property, plant, and equipment) is referred to as “inside basis.” A parent’s basis in the stock of its subsidiary is considered “outside basis.” An outside basis difference is the difference between a parent’s tax basis in the stock of the subsidiary and the book basis in its investment. In considering the parent’s outside basis in a subsidiary, it is important to note that “parent” does not necessarily mean the ultimate parent. The parent could be a subsidiary that owns another subsidiary. Outside basis differences need to be considered at every level of an organization’s legal entity structure. Figure TX 11-1 further demonstrates the concept of outside basis difference.

Figure TX 11-1
Outside versus inside basis differences



An outside basis difference may be created as a result of unremitted earnings. The parent's book basis in the subsidiary is increased by the subsidiary's earnings that have been included in consolidated net income, but that have not been remitted to the parent. There is generally no corresponding increase in the parent's tax basis in the subsidiary's stock if the subsidiary is not consolidated for tax purposes unless the tax law provides for taxation of the subsidiary's earnings immediately (for example, in the US, Subpart F and GILTI are aspects of the tax law that immediately tax a foreign subsidiary's earnings). The resulting excess book-over-tax basis is a temporary difference if it will result in taxable income upon its reversal. Typically, reversal of the outside basis difference will occur through the subsidiary's payment of dividends, the parent's sale of the subsidiary's stock, liquidation of the subsidiary, or a merger of the subsidiary into the parent. Even though the parent's investment in the consolidated subsidiary does not appear as a separate asset in the parent's consolidated balance sheet, for the purposes of applying ASC 740, any outside basis difference must still be considered.

In addition to unremitted earnings, other events and transactions can result in an outside basis difference. These may include, but are not limited to, cumulative foreign currency translation adjustments (CTA), changes in a parent's equity in the net assets of a subsidiary resulting from transactions with noncontrolling shareholders (i.e., the subsidiary's capital transactions and transactions between parent and noncontrolling shareholders), movements in other components of the subsidiary's other comprehensive income, such as unrealized gains or losses on available-for-sale debt securities, changes in the outside tax basis that sometimes arise in business combinations and reorganizations, and other changes in the subsidiary's equity.

11.2.2 *Domestic or foreign classification—outside basis differences*

The classification of a subsidiary as either foreign or domestic can impact the accounting for the outside basis difference of a subsidiary or corporate joint venture. For example, ASC 740-30-25-5 and ASC 740-30-25-7 require that deferred taxes be provided on a book-over-tax (taxable) outside basis difference in a domestic subsidiary unless "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." However, deferred taxes on a book-over-tax outside basis difference in a foreign subsidiary or foreign corporate joint venture that is permanent in duration must be recorded unless the entity can substantiate an assertion that this basis difference will not reverse in the foreseeable future (see ASC 740-30-25-17 to ASC 740-30-25-18).

We believe that companies should look to the relevant tax law in the jurisdiction of the parent that holds the investment to determine whether the investment should be classified as foreign or domestic. For example, if a subsidiary of a US parent is treated as a domestic subsidiary under US tax law, it should be accounted for under ASC 740 as a domestic subsidiary regardless of where it is physically domiciled.

11.2.2.1 *Tiered foreign subsidiaries—outside basis differences*

Whether a subsidiary is domestic or foreign is determined at each level in the corporate structure. Accordingly, a second-tier foreign subsidiary owned by a first-tier foreign subsidiary in the same country would be a domestic subsidiary for purposes of applying the recognition provisions in ASC 740-30. Thus, a first-tier foreign subsidiary would have to provide deferred taxes for the outside basis

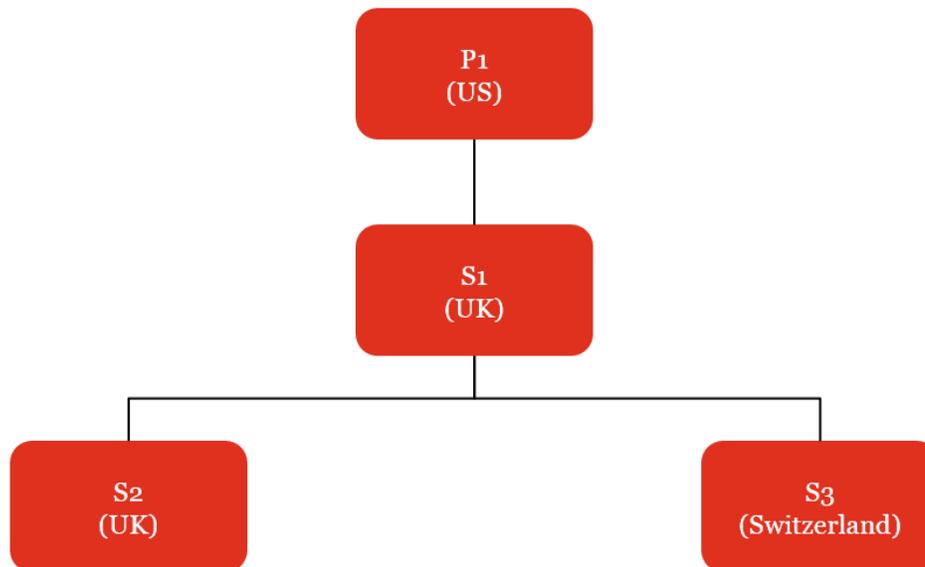
difference of a second-tier subsidiary domiciled in the same country, assuming it does not meet any of the exceptions applicable to a domestic subsidiary.

Example TX 11-1 illustrates the determination of whether a subsidiary is domestic or foreign in a tiered foreign subsidiary structure.

EXAMPLE TX 11-1

Differentiating domestic and foreign subsidiaries

US Parent P1 owns 100% of UK subsidiary S1. UK subsidiary S1 owns 100% of UK subsidiary S2 and Swiss subsidiary S3.



Are S1, S2 and S3 domestic or foreign subsidiaries?

Analysis

S1 is a foreign subsidiary with respect to P1. An outside basis difference related to P1's investment in S1 represents an outside basis in a foreign subsidiary and the accounting for the outside basis difference should be evaluated using the exceptions available to foreign subsidiaries (see TX 11.4).

S2 is a domestic subsidiary of S1. Therefore, the exceptions to comprehensive recognition of outside basis differences related to domestic subsidiaries applies to S1's investment in S2 (see TX 11.3).

S3 is a foreign subsidiary of S1. An outside basis difference related to S1's investment in S3 represents an outside basis in a foreign subsidiary and the accounting for the outside basis difference should be evaluated using the exceptions available to foreign subsidiaries (see TX 11.4).

11.2.3 Corporate joint ventures—outside basis differences

The indefinite reversal exception in ASC 740-30-25-17 for the temporary difference arising from earnings in foreign subsidiaries that have not yet been remitted (paid as a dividend or otherwise distributed) to their parent (commonly referred to as “unremitted earnings”) also applies to a taxable outside basis temporary difference in a foreign corporate joint venture that is essentially permanent in duration. In order to qualify as “essentially permanent in duration,” the joint venture cannot have a life limited based on the terms of joint venture agreement or resulting from the nature of the venture or other business activity. See ASC 323-10-20 for the definition of a corporate joint venture.

11.2.4 Overview of deferred taxes for outside basis differences

The following tables summarize the recognition of deferred taxes on outside basis differences.

Subsidiary	Deferred tax asset	Deferred tax liability
Domestic ¹	Recognize a deferred tax asset only if it is apparent that the temporary difference will reverse in the foreseeable future. See TX 11.5 ² .	Recognize a deferred tax liability unless the reported amount of the investment can be recovered tax-free without significant cost, and the entity expects to ultimately use that means of recovery. See TX 11.3.2 ² .
Foreign	Recognize a deferred tax asset only if it is apparent that the temporary difference will reverse in the foreseeable future. See TX 11.5 ² .	Recognize a deferred tax liability unless the parent has the ability to, and asserts its intent to, indefinitely prevent the reversal of the outside basis difference. See TX 11.4 and TX 11.4.1 ² .

¹ Different accounting applies to outside basis differences that arose in fiscal years prior to December 15, 1992. See TX 11.3.

² In cases where an entity’s status changes from equity method investee to subsidiary, refer to TX 11.9.2 for guidance on any previously recognized deferred tax asset or liability.

Corporate joint venture	Deferred tax asset	Deferred tax liability
Domestic ¹	Recognize a deferred tax asset only if it is apparent that the temporary difference will reverse in the foreseeable future. See TX 11.5.	Recognize a deferred tax liability. See TX 11.3.
Foreign	Recognize a deferred tax asset only if it is apparent that the temporary difference will reverse in the foreseeable future. See TX 11.5.	Avoiding recognition of a deferred tax liability depends primarily on whether (1) the corporate joint venture is permanent in duration and (2) the parent has the ability and asserts its intent to indefinitely prevent the reversal of the temporary difference. If both of these circumstances exist, no deferred tax liability should be recorded. See TX 11.4 and TX 11.4.1.

¹ Different accounting applies to outside basis differences that arose in fiscal years prior to December 15, 1992. See TX 11.3.

Investment (other than a joint venture)	Deferred tax asset	Deferred tax liability
Equity method	Recognize a deferred tax asset. See TX 11.6 ² .	Recognize a deferred tax liability. See TX 11.6 ² .
Fair value method	Differences between the fair value and the tax basis of the investment represent normal temporary differences for which deferred taxes should be provided.	
Measurement alternative ³	Differences between the carrying amount and the tax basis of the investment represent normal temporary differences for which deferred taxes should be provided.	

² In cases where an entity's status changes from a subsidiary, refer to TX 11.9.2 for guidance with respect to any previously unrecognized deferred tax asset or liability.

³ May only be used when the equity method is not applied, and there is not a readily determinable fair value.

Partnership or other flow-through entity

Foreign or domestic	A deferred tax asset or liability should generally be recorded. See TX 11.7.
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Foreign operations—special considerations

Foreign branches	Generally, income and losses generated by a foreign branch are subject to taxation in both the foreign and domestic jurisdictions currently. When this is the case, deferred taxes should be recorded for both jurisdictions. The deferred taxes recorded in the parent's domestic jurisdiction should also include the domestic tax effects of the foreign temporary differences, similar to the federal tax effect on state deferred taxes. See TX 11.10.1.
Subpart F income	The US subpart F rules can result in current US taxation of certain amounts of otherwise unremitted earnings of a foreign subsidiary. Accordingly, for a foreign subsidiary that generates subpart F income, US deferred taxes should be recognized for temporary differences that will generate subpart F income upon reversal. See TX 11.10.2.
GILTI	The US GILTI provisions result in a current taxable inclusion of certain foreign earnings. Entities can elect to recognize deferred taxes for basis differences that are expected to reverse as GILTI in future years. See TX 11.10.3.

11.3 Domestic subsidiaries and corporate joint ventures

ASC 740-30-25 reflects the general rule that book-over-tax (taxable) outside basis differences, whether attributable to undistributed earnings or other factors, related to a subsidiary or corporate joint venture should be presumed to reverse in the foreseeable future.

ASC 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.

ASC 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.

ASC 740-30-25-18 provides an exception for any book-over-tax basis difference attributable to a domestic subsidiary or to a corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. That exception is essentially the same as the “indefinite reversal” exception applicable to outside basis differences in foreign subsidiaries that exists today. The remainder of this chapter assumes any temporary differences in question arose in fiscal years beginning after December 15, 1992.

11.3.1 *Book-over-tax outside basis difference—domestic sub/joint venture*

ASC 740-30-25-7 states that an excess book-over-tax outside basis difference “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.” See TX 11.3.2 for discussion of the implications when a reporting entity has the ability to recover an investment in a tax-free manner. The guidance in ASC 740-30-25-5 specific to domestic subsidiaries should also be considered when evaluating whether a reporting entity would be required to record a deferred tax liability on the outside book-over-tax basis difference of a domestic corporate joint venture that is essentially permanent in duration.

11.3.2 *Tax-free recovery of investment*

In the case of a US subsidiary that is at least 80% owned, US tax law provides several means by which the investment can be recovered tax-free, including liquidating or merging the subsidiary into the parent, spin-offs, split-offs, and other forms of reorganization. As long as the US parent has the ability to use a tax-free means of recovery and expects to ultimately use that means to recover its outside basis difference, it should not record a deferred tax liability for the book-over-tax basis difference.

The ability to recover the investment utilizing one of the tax-free alternatives must be within the control of the reporting entity. For example, assume that a US parent corporation has a wholly-owned US subsidiary that is a regulated entity. A tax-free liquidation or merger of that entity into the parent may not be possible without regulatory approval. If regulatory approval is more than perfunctory, the parent corporation cannot assert that its basis in the subsidiary can be recovered on a tax-free basis.

Other jurisdictions may have similar tax-free liquidation and merger rules that should be considered in assessing whether outside basis in a same-jurisdiction subsidiary can be recovered tax-free. Importantly, the assessment must be performed with respect to each subsidiary to determine if the applicable tax law provides a means of recovering the outside basis difference tax-free.

If a subsidiary is less than 80% owned, but more than 50% owned, the parent may still be able to assert that the basis difference can and is expected to be recovered tax-free if the parent is able to (and expects to) effectuate the acquisition of the additional ownership necessary to avail itself of any tax-free means to recover the outside basis difference. Note that the parent must be able to acquire the additional ownership at no significant additional cost (see TX 11.3.2.1) and must continue to reassess that ability at each reporting date. If, at any point, the parent determines that it is not able to acquire the additional interest without significant cost, a deferred tax liability would be recorded on the outside basis difference in the current period.

Example TX 11-2 illustrates a circumstance when the tax-free recovery of an investment in a domestic subsidiary is not available.

EXAMPLE TX 11-2

Recording an outside basis deferred tax liability when an investment in a domestic subsidiary is impaired for tax purposes

Company A, a Luxembourg company, owns 100% of the stock of Company B, which is also a Luxembourg company. For local statutory and income tax reporting purposes, Company A is required to annually determine the fair value of its investment in Company B and recognize an impairment if the fair value is lower than the statutory carrying value. Company A performs this assessment in the current year and concludes that its investment in Company B is impaired. The resulting write-down is currently deductible for Luxembourg income tax purposes. Based on the underlying net assets of the entity and applicable US GAAP, however, no asset impairments are recognized for book purposes. This write-down represents the only difference between the book and tax basis in Company A's investment in Company B (i.e., its outside basis).

Ordinarily, under Luxembourg tax law, a parent company may liquidate or dispose of a subsidiary and receive dividends in a tax-free manner. However, the tax deductible write-down is subject to recapture if the value of the investment increases in future periods. That is, to the extent the investment value increases, the write-down must be recaptured into taxable income. Company A has no intention of selling its investment in Company B or liquidating the subsidiary. In fact, Company A will continue to operate Company B and hopes to "turn around" the investment.

Does Company A need to record a deferred tax liability for the excess book-over-tax basis in its investment in Company B?

Analysis

Yes. ASC 740-30-25-5 and ASC 740-30-25-7 require that deferred taxes be provided on a book-over-tax outside basis difference in a domestic subsidiary unless 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. In this situation, Company A is planning to continue operating Company B and, therefore, it does not have the ability to avoid potential recapture of the tax benefit claimed for the tax write-down of the investment in Company B. Accordingly, Company A should record a deferred tax liability on its US GAAP books for the outside basis difference related to its investment in Company B. This is consistent with the assumption in ASC 740-10-25-20 that assets and liabilities are expected

to be recovered or settled at their financial statement carrying amount. If the investment in Company B were recovered at its financial statement carrying amount, there would be a tax consequence.

11.3.2.1 Tax-free recovery of basis—meaning of “significant cost”

Under ASC 740-30-25-8, if a parent corporation does not own the requisite percentage of a domestic subsidiary’s stock to effectuate a tax-free recovery of the outside basis, the parent may still be able to assert that it expects to recover its outside basis difference in the subsidiary tax-free, as long as it can do so without incurring “significant cost.”

ASC 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.

A cost to purchase a noncontrolling interest that significantly exceeds its book value would represent a significant cost. Essentially “significant cost” means any significant fair value premium over book value to acquire the noncontrolling interest. In an “end of life” scenario, once the subsidiary’s net assets have been converted to cash and it has no significant unrecorded intangible assets or contingent liabilities, the cost to acquire the noncontrolling interest in the subsidiary would generally approximate its book value. At that time, acquisition of the noncontrolling interest would not involve a significant cost. As a result, when making the assessment, even in a period prior to the period in which “end of life” is reached, the parent corporation could likely conclude that it could acquire the requisite noncontrolling interest without significant cost and avail itself of a tax-free liquidation or merger. As such, the parent would not need to record the tax impact of any book-over-tax outside basis difference. If a parent has not provided deferred taxes based on such an “end of life” scenario, the entity would need to monitor for changes in facts and expectations and consider whether it must provide deferred taxes on its outside basis difference as a result of those changes.

11.3.2.2 Potential state tax considerations—outside basis differences

It is possible that the outside basis difference of a US subsidiary may constitute a temporary difference for state tax purposes, even if it is not a temporary difference for federal tax purposes. However, if the US parent is able to project that the outside basis difference will ultimately be recovered in a liquidation that is tax-free for federal purposes, it may be able to avoid a provision for state taxes.

Note that while this section refers specifically to state taxes in a US context, the principles would be applicable for similar sub-jurisdiction (e.g., provincial, cantonal, local) taxes in other countries.

In some cases, a tax-free liquidation may not be available in all states in which the parent files returns. Nevertheless, the outside basis may not be a temporary difference for certain states. For example, a temporary difference does not arise if the unremitted earnings are eventually expected to be remitted as dividends in a jurisdiction where there is a dividends-received deduction or where the parent and subsidiary file on a combined or consolidated basis and intercompany dividends are eliminated.

If it is expected that unremitted earnings will be received through a sale of the subsidiary's shares, state tax will generally be avoided if the parent's tax basis for state tax purposes has been increased by the subsidiary's taxable income (i.e., no difference between inside and outside tax bases). This would be the case in states in which the parent files a combined or consolidated return with the subsidiary in which the federal consolidated return rules are followed.

The measurement of the deferred tax liability for unremitted earnings in a particular state would need to consider (1) whether the state permits or requires a combined method of reporting (and, if so, whether the subsidiary is engaged in a unitary business); (2) whether the dividends or gain on sale or liquidation will be treated as business or nonbusiness income; (3) which expected apportionment factor should be applied; and (4) whether a dividends-received deduction is available.

11.3.2.3 Consideration of lower-tier foreign subsidiaries

TX 11.3.2 discusses a scenario in which a parent can assume an ultimate tax-free liquidation of a domestic subsidiary that is less than 80% owned. However, if the domestic subsidiary owns a lower-tier foreign subsidiary, the parent must additionally consider whether its domestic subsidiary has asserted the indefinite reversal exception with respect to the lower-tier foreign subsidiary. If the domestic subsidiary has asserted indefinite reversal with respect to its foreign subsidiary, the parent would not be able to recover its investment in the domestic subsidiary without triggering the tax on the foreign subsidiary's undistributed earnings or other outside basis differences.

11.4 Foreign subsidiaries and corporate joint ventures

Unless the indefinite reversal criteria in ASC 740-30-25-17 are met, a deferred tax liability is generally required for a book-over-tax outside basis differences attributable to a foreign subsidiary or corporate joint venture, except when the basis difference will be recovered in a tax-free liquidation. Regardless of whether an entity is asserting indefinite reinvestment, it should track its outside basis differences for purposes of complying with required disclosure requirements related to the amount of outside basis differences and the amount of any unrecognized deferred tax liability (see FSP 16.3.4). Refer to TX 11.3.2 for considerations in assessing the ability and intent to recover the outside basis in a tax-free manner.

Under the indefinite reversal exception, a deferred tax liability does not need to be recognized for the excess outside book basis of an investment in a foreign subsidiary, or foreign corporate joint venture that is essentially permanent in duration, until it becomes apparent that the basis difference will reverse in the foreseeable future.

ASC 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.

11.4.1 Indefinite reversal exception—foreign sub/joint venture

As noted in ASC 740-30-25-17, the non-recognition of a deferred tax liability for outside basis differences that meet the indefinite reversal criteria is an exception to ASC 740's model for the comprehensive recognition of deferred taxes for temporary differences. Therefore, an enterprise availing itself of that exception must assert its intent to indefinitely reinvest its outside basis difference. Specifically, management must have the ability and the intent to indefinitely prevent the outside basis difference of a foreign subsidiary from reversing with a tax consequence.

The indefinite reversal exception only applies to the transfer of unremitted earnings across national boundaries, and not for transfers of unremitted earnings between entities within the same foreign country. As a result, management needs to consider book-over-tax outside basis differences within each legal entity in the organization to ensure proper compliance with ASC 740.

The ability to assert indefinite reversal needs to be assessed as of each balance sheet date with respect to each foreign subsidiary or foreign corporate joint venture.

Entities that are unable to assert indefinite reinvestment must record a deferred tax liability for any taxable temporary differences that would be incurred when the outside basis difference reverses. In order to calculate or measure the tax effect of an outside basis difference, a realistic and reasonable expectation as to the time and manner of the expected recovery must be determined. Taxes provided should reflect the expected form of recovery (e.g., dividend, sale, liquidation) and the character of taxable income that the repatriation will generate (e.g., ordinary versus capital gain). For example, if the basis difference is expected to be recovered through distributions, a deferred tax liability would generally be needed for the parent's tax consequences of the distribution (including consideration of potential foreign tax credits (FTCs) and dividend received deductions). This includes the tax consequences of any foreign currency gains or losses, federal and state taxes, and foreign withholding taxes. If, however, the basis difference is expected to reverse through sale, the parent entity would need to consider whether capital gain rates would apply. Refer to TX 11.8.

Besides unremitted earnings, there are other transactions that may contribute to an outside basis difference, such as changes in a parent's equity in the net assets of a subsidiary resulting from transactions with noncontrolling shareholders, movements in other components of the subsidiary's other comprehensive income (e.g., unrealized gains or losses on available-for-sale debt securities),

changes in the outside tax basis that sometimes arise in business combinations and reorganizations, and other changes in the subsidiary's equity.

We believe that the difference between the book and tax basis represents a single outside basis difference, even if portions of the total outside basis difference originated from different events. This does not preclude an entity from asserting that a portion of the single outside basis difference qualifies for any of the recognition exceptions for outside basis differences.

11.4.2 *Partial reinvestment assertion*

The indefinite reversal criteria may apply to only a portion of an outside basis difference (whether caused by unremitted earnings or other factors). Thus, partial recognition of a deferred tax liability would be appropriate for that portion of the liability for which the criteria are not met. However, if an entity makes only a partial indefinite reversal assertion, the nature of the "evidence" and "plans" (ASC 740-30-25-17) should be consistent from year-to-year unless there is a clear business rationale for a change in intent. Companies also need to consider how the tax law might impact a company's assertion. For example, it is common for an entity to assert that the historical earnings of its foreign subsidiaries are indefinitely reinvested, but that current year earnings are not indefinitely reinvested. In this situation the entity would not record a deferred tax liability on historical outside basis differences but would be required to record a tax liability for any outside basis differences created in the current year. It is also possible for an entity to not assert indefinite reinvestment on historical earnings, but to assert indefinite reinvestment on prospective earnings.

There may also be circumstances when a foreign subsidiary has unremitted earnings, but, for other reasons, the overall outside tax basis in the subsidiary actually exceeds the book basis (i.e., deductible temporary difference or potential deferred tax asset). See TX 11.5 for a discussion of the accounting for a tax-over-book basis difference.

11.4.3 *Evidence required for indefinite reversal assertion*

ASC 740-30-25-17 requires management to compile evidence to support its assertion that the indefinite reversal criteria are met. Merely having a history of not distributing foreign earnings does not constitute evidence of specific reinvestment plans. The specific plans for reinvestment must be documented and must support the assertion that the reversal of the outside basis difference can and will be postponed indefinitely.

The following evidence, among others, should be considered:

- The forecasts and budgets of the parent and subsidiary for both the long and short term
- The financial requirements of both the parent and subsidiary for the long and short term, including:
 - Projected working capital and other capital needs in locations where the earnings are generated; and
 - Reasons why any excess earnings are or are not needed by the parent and/or another subsidiary somewhere else in the chain
- Past history of dividends

- Tax consequences of a decision to remit or reinvest
- Remittance restrictions in a lease or loan agreement of a subsidiary
- Remittance restrictions imposed by foreign governments

11.4.4 *Effect of change in an indefinite reversal assertion*

In accordance with ASC 740-30-25-19, if there is a change in judgment regarding the indefinite reversal assertion, the parent entity should adjust income tax expense in the period of change.

ASC 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.

In determining the period in which an indefinite reversal assertion changed, management should consider the nature and timing of the factors that influenced their change in plans.

In most cases the initial recognition of a deferred tax liability for the temporary difference accumulated in prior periods as a result of a change in the indefinite reversal assertion will be reflected entirely in continuing operations. Conversely, any adjustment to the deferred tax liability resulting from the current-year movements in the temporary difference should be allocated to the respective category of income (e.g., discontinued operations, other comprehensive income) in accordance with the intraperiod allocation rules. See TX 12.3.2.2 and 12.5.2.2.

11.4.5 *Indefinite reversal assertion and purchase accounting*

In a business combination, the acquirer must make its own determination regarding indefinite reversal in connection with any outside basis differences of the acquired entity. If the acquirer does not meet or does not assert the indefinite reversal criteria at the time of the acquisition with respect to the outside basis difference in an acquired foreign subsidiary, deferred taxes should be recognized in acquisition accounting, regardless of the prior owner's assertion (see TX 10.4.4 for more details).

A reporting entity may determine it is not able to assert indefinite reversal on acquired outside basis differences, and therefore, recognize the deferred tax liability in acquisition accounting. However, it is important that the assertion (or lack thereof) implicit in the acquisition accounting is consistent with the entity's broader reinvestment plans. In addition, the reasons for any subsequent change in assertion with respect to future earnings of those acquired subsidiaries must be reconcilable with the position taken in purchase accounting. Accordingly, a reporting entity should carefully consider any decision to provide deferred taxes in purchase accounting if it intends to assert indefinite reinvestment with respect to future earnings.

An acquisition may also impact the acquirer's intent and ability to delay reversal of a taxable temporary difference related to subsidiaries it owned prior to the acquisition. As discussed in TX

10.4.4, the tax effects of the change in assertion related to the acquirer's previously owned subsidiaries is not part of the acquisition transaction and would be recorded in the period in which management's assertion changes, as noted in TX 11.4.4.

11.4.6 *Going-concern uncertainty—indefinite reversal assertion*

The existence of a going-concern uncertainty may suggest that management is no longer able to control the decision to indefinitely reinvest foreign earnings. In fact, the financial uncertainty that often exists in these cases may create a presumption that unremitted foreign earnings will be needed to meet existing obligations and keep the business afloat. In this regard, the facts and circumstances of each individual going-concern situation should be evaluated to understand whether maintaining an indefinite reinvestment assertion is still possible.

11.4.7 *Bankruptcy—indefinite reversal assertion*

Even before entering bankruptcy, reporting entities facing financial difficulties might find that they are no longer able to sustain an indefinite reinvestment assertion. As the assertion is generally based upon the reporting entity's ability and intent to indefinitely reinvest the earnings of a foreign subsidiary, a reporting entity having liquidity issues may find it difficult to support such an assertion. Once the reporting entity files for bankruptcy, and control of the reporting entity is moved from management to the bankruptcy court, it may be even more difficult to continue to make such an assertion.

11.4.8 *Gain recognition agreement*

Under US tax law, certain transfers of stock or securities of a foreign corporation by a US transferor to a foreign subsidiary are not taxed to the extent the US transferor agrees to recognize the gain realized on the transfer if certain "gain recognition events" occur during a 5-year period following the year of the transfer. This is known as a gain recognition agreement (GRA).

A question arises as to whether a tax liability should be recorded when a US transferor transfers shares of a subsidiary subject to a GRA. We believe that whether a tax liability is recorded on the difference between the fair market value and the book basis of the property transferred will depend on whether the entity has the intent and ability to indefinitely defer the tax consequences—in other words, whether the US transferor can prevent any gain recognition events from occurring prior to the expiration of the 5-year period.

We believe this is analogous to the guidance when an entity converts from C corporation to S corporation status and the consideration of whether the entity should continue to record a deferred tax liability to the extent it will be subject to the built-in gains tax (see TX 8.4). To the extent the transferor can support the ability and intent to defer the tax consequences (i.e., not engage in "gain recognition events" during a 5-year period following the year of the transfer), we do not believe a tax liability should be recorded.

If at any time prior to the expiration of the 5-year period, the entity's ability and intent changes, the entity would be required to record the tax liability.

11.5 *Deferred tax assets related to outside basis*

An excess of outside tax basis over outside book basis in a subsidiary or corporate joint venture that is essentially permanent in duration may give rise to a deductible temporary difference for which a

deferred tax asset may need to be recognized. In these circumstances, under ASC 740-30-25-9, a deferred tax asset is recognized “only if it is apparent that the temporary difference will reverse in the foreseeable future.” The “foreseeable future” as used in ASC 740-30-25-9 is a finite horizon, in contrast to the indefinite reversal criteria of ASC 740-30-25-17. Although ASC 740 does not specifically define foreseeable future, we believe that it would generally be within the next year. Thus, to record a deferred tax asset for a foreign excess outside tax basis, management should be fully committed to a plan that would result in the reversal of the temporary difference, and not just exploring it as a possibility. In the case of a sale of a subsidiary, we believe that in most cases, such a deferred tax asset should be recognized when the held-for-sale conditions of ASC 360-10-45-9 are met.

It should be noted that the generation of future profits does not constitute “reversal” of an excess tax outside basis difference. ASC 740-10-25-20 defines a deductible temporary difference as a temporary difference that results in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. Thus, “reversal” of a deductible temporary difference provides a tax deduction when the related asset is recovered. Future earnings may reduce the deferred tax asset but do not result in a tax deduction or benefit in the parent’s tax return.

Example TX 11-3 discusses the recognition of a deferred tax asset for a worthless stock deduction.

EXAMPLE TX 11-3

When to recognize a tax benefit for a worthless stock deduction

Company A, a US corporation, has a wholly-owned foreign subsidiary (FS). At December 31, 20X1, Company A’s book basis in FS was zero due to significant prior year losses; its tax basis in the shares of FS stock was \$100 million. During Q4 of 20X1, discussions occurred concerning the viability of FS’s business plans leading to a decision to cease operations and liquidate FS. It was expected that the liquidation of FS would be consummated within the next year. In Q1 20X2, Company A made a “check-the-box” (CTB) election to treat FS as a disregarded entity retroactively effective on the last day of 20X1. The CTB election resulted in a deemed liquidation of FS for US federal income tax purposes, leading Company A to claim its \$100 million tax basis in FS as a worthless stock deduction on the 20X1 tax return. The CTB election has no other US or foreign tax implications and FS has no inside basis temporary differences. At December 31, 20X1, management concluded that without the CTB election (or other process of liquidation), Company A would not have met the more-likely-than-not recognition threshold to recognize the (uncertain) tax benefit from the worthless stock deduction.

When should Company A recognize the tax benefit from the worthless stock deduction (Q4 20X1 or Q1 20X2)?

Analysis

The tax effects of excess tax-over-book basis in the stock of a subsidiary should be recognized when it becomes apparent that the temporary difference will reverse in the foreseeable future. In the context of a worthless stock deduction, this criterion would generally be met in the earliest period in which the investment is considered “worthless” for federal income tax purposes. There are various measures used to determine whether stock is worthless, as well as specific events that confirm stock worthlessness, including a bankruptcy, appointment of a receiver by a court, and liquidation. If the occurrence of one of these events is necessary to meet the more-likely-than-not recognition threshold under ASC 740-10-25-6, the ability of the company to control the occurrence of that event must be considered in assessing whether it is apparent that the temporary difference will reverse in the

foreseeable future. The relevant question in this example, therefore, is whether Company A could have concluded that the FS stock was worthless absent the CTB election or could presume completion of the “confirming” event. If the stock was otherwise considered worthless as of December 31, 20X1, the fact that the CTB election was filed in Q1 20X2 as opposed to 20X1 should not change the timing of when the benefit is recognized. Absent regulatory or other restrictions, the liquidation of FS via a CTB election would be considered primarily within Company A’s control.

The filing date of the CTB election and the selected effective date are not determinative if the stock was otherwise considered worthless as of December 31, 20X1, and the company expected to complete all relevant administrative procedures shortly thereafter. If the company had selected an effective date in 20X2, it would still not change the fact that as of December 31, 20X1, it was apparent that the excess tax basis would reverse (i.e., become deductible) within the next year.

11.5.1 *Deferred tax assets for potential foreign tax credits*

One of the implications from repatriating foreign earnings is that the repatriations may trigger FTCs, which may be used by the entity to reduce its taxes in the year of the repatriation or carried forward as a tax credit to be used in a subsequent year.

However, a deferred tax asset generally should not be recognized for FTCs that are not yet includible on a tax return, even though they are expected to be generated by the future reversal of a taxable temporary difference. These credits, sometimes referred to as “unborn FTCs” are inherent in the measurement of the deferred tax liability but are not separately recognizable as deferred tax assets. A deferred tax asset for unborn FTCs would not be recognized if there is neither a temporary difference nor a tax attribute for the FTC as the conditions to establish the FTCs have not been met.

There may be an exception to this concept when, except for the actual repatriation of cash, all of the conditions (including a payment or liability for the foreign tax and the existence of sufficient earnings and profits) have been met to establish the credits. Even in this case, an entity must be able to assert that the FTCs will be generated in the foreseeable future, as stipulated in ASC 740-30-25-9 (i.e., the entity is committed to making the repatriation in the near term). Only then should an entity record a deferred tax asset related to the FTC prior to its actual generation on the tax return.

11.6 *Equity method investments*

Investments accounted for under the equity method for financial reporting purposes, pursuant to ASC 323, *Investments—Equity Method and Joint Ventures*, are generally recorded at cost basis for tax purposes. As a result, as the investor’s share of an investee’s earnings are accrued for book purposes through application of the equity method, a temporary difference arises between the book and tax bases for these investments.

ASC 740-30-25-5(b) requires recognition of a deferred tax liability for the excess book-over-tax basis of an investment in a 50%-or-less-owned investee. Therefore, the outside book-over-tax basis in the investment should result in a deferred tax liability. In addition, because the additional “reverse in the foreseeable future” criterion in ASC 740-30-25-9 (see TX 11.5) does not apply to foreign or domestic unconsolidated investees, the outside tax-over-book basis for such an investment should generally result in a deferred tax asset.

ASC 740-30-25-18 provides an exception to recording a deferred tax liability for an outside basis difference in a corporate joint venture that is essentially permanent in duration. However, a corporate joint venture that is not permanent in duration is substantively the same as any other equity investment.

Based on ASC 740-10-55-24, the measurement of deferred tax liabilities and assets depends on the expected type of taxable or deductible amounts in future years. That is, it depends on how the investment will ultimately be realized (e.g., through dividends, sale, or liquidation). In providing deferred taxes, understanding the expected form of realization by the investor—dividends vs. capital gains—is often critical. See TX 11.8.2 for further discussion.

The outside basis difference is calculated by comparing the tax basis of the stock to the book basis of the investment. While determining the tax basis (i.e., cost) of the stock is generally straightforward, complexities often arise when applying the equity method to determine the book basis. EM 3.3 provides further guidance on this allocation process and determining the underlying equity in the net assets of the investee.

Even though the results of the equity method investee are generally reported in investor's financial statements net of the investee's tax expense, the income tax provision of an investor in an equity investment should only include the investor's tax consequences from the investment—i.e., the current and deferred tax effects associated with its share of the investee's earnings. As these tax effects are those of the investor, not the investee, they should be recognized in the investor's tax provision, not offset within the investor's equity in net earnings of the investee.

11.7 Partnerships and other flow-through entities

ASC 740 contains minimal explicit guidance on the accounting for deferred taxes associated with investments in partnerships or other “flow-through” entities (e.g., LLCs). We believe that deferred taxes related to an investment in a foreign or domestic partnership (and other flow-through entities that are taxed as partnerships, such as multi-member LLCs) should be based on the difference between the financial statement amount of the investment and its tax basis (i.e., its outside basis difference). This is the case regardless of whether the book investment in the partnership is accounted for using the fair value or equity method, or is subject to full or proportionate consolidation. Broadly, the rationale for this view is that the entity itself is not subject to tax so the notion of providing deferred taxes on the “inside” basis differences of the underlying assets and liabilities is inconsistent with the nature of the entity. Deferred taxes should be based on the tax consequences associated with the investor's/partner's expected method of recovering its book investment in the partnership. Furthermore, if an entity is treated as a partnership or other pass-through entity by its parent for tax purposes, the parent cannot utilize the indefinite reversal exception in ASC 740-30-25-17 to avoid recording a deferred tax liability on the outside basis difference unless the partnership applies the look through approach. Refer to section TX 11.7.1 for further details.

11.7.1 Exceptions for partnership and other flow-through entities

Different views exist regarding if and when deferred taxes should be provided on the portion of an outside basis difference in a partnership that is attributable to nondeductible goodwill in the partnership. For example, assume that an entity contributes the net assets of one of its subsidiaries to a partnership, and that those assets include nondeductible goodwill. Because nondeductible goodwill, by definition, has no tax basis, a portion of the “outside” basis difference is essentially a permanent

difference—i.e., it will reverse without a tax consequence. Some believe that deferred taxes should be recognized on the entire outside basis difference consistent with the general model for recognizing deferred taxes for investments in these entities. Others believe that the portion attributable to nondeductible goodwill should be excluded from the deferred tax liability recorded on the outside basis difference because no deferred tax liability was recognized for that goodwill prior to its contribution to the partnership (i.e., a look through approach). Still others take the view that the look through approach would only apply in cases where the partnership is controlled and consolidated by the investor. Acknowledging this diversity in practice and that each view has merit, we do not object to any of these practices.

Other exceptions to the comprehensive model of recognition should also be evaluated if a look through approach is being applied. These may include the indefinite reversal exception in ASC 740-30-25-17 or the exception to recognizing a deferred tax asset in ASC 740-30-25-9, both of which might be applied with regard to a foreign subsidiary owned by a partnership.

Questions have arisen as to whether the “reverse in the foreseeable future” guidance in ASC 740-30-25-9 applies to potential deferred tax assets for outside basis differences in a partnership investment. Read literally, this guidance would not apply because it is limited to a subsidiary or corporate joint venture that is essentially permanent in duration. However, in situations in which the investor entity controls the partnership, it may be appropriate to consider this guidance by analogy. For example, if all or a portion of the outside excess tax basis in the partnership is expected to be realized only through sale of the investment, it may be appropriate to suspend recognition of the related deferred tax asset until a sale is contemplated in the foreseeable future. The decision to analogize to ASC 740-30-25-9 should be applied consistently.

When assessing the realizability of a deferred tax asset related to an investment in a partnership, it is important to remember that the deferred tax asset represents a potential future tax loss that is often capital in nature. Under existing US tax law, future taxable income of a similar nature (i.e., capital gains) would be necessary to realize the benefit of the capital loss that underlies the deferred tax asset.

11.8 *Measuring the tax effects of outside basis differences*

ASC 740-10-55-23 to ASC 740-10-55-24 provide guidance with respect to measuring the tax effect of an outside basis difference.

ASC 740-10-55-23

The tax rate or rates that are used to measure deferred tax liabilities and deferred tax assets are the enacted tax rates expected to apply to taxable income in the years that the liability is expected to be settled or the asset recovered. Measurements are based on elections (for example, an election for loss carryforward instead of carryback) 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 for the current year are used if no changes have been enacted for future years. An asset for deductible temporary differences that are expected to be realized in future years through carryback of a future loss to the current or a prior year (or a liability for taxable temporary differences that are 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, that is, the year for which a refund is expected to be realized based on loss carryback provisions of the tax

law. See Examples 14 through 16 (paragraphs 740-10-55-129 through 55-138) for illustrations of this guidance.

ASC 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.

All facts and circumstances should be considered when determining whether temporary differences should be measured using the enacted tax rates applicable to a capital gain or a dividend. This is not an accounting policy election. The assumed manner of recovery and related tax consequences should be determined / re-assessed each reporting period. Among other factors, consideration should generally be given to:

- History of paying dividends (from accumulated earnings)
- Ability to control or influence dividend payments
- Intentions for the investment and any history of disposing of comparable investments
- Other significant shareholders with an ability or influence to either force a disposal of the investment or dividend payments
- Entity's liquidity and capital requirements
- Legal considerations and the availability of market disposal options
- Tax planning opportunities that would influence the disposal structure/consequences
- Whether the investment represents an integral component of the overall business or long-term strategic plans

In order to calculate or measure the tax effect of an outside basis difference, a realistic and reasonable expectation as to the time and manner in which such a difference is expected to be recovered must be determined. Taxes provided should reflect the expected form of repatriation (e.g., dividend, sale or liquidation, or loan to the parent), the character of taxable income that the repatriation will generate (e.g., ordinary versus capital gain), and the effect of any foreign tax credits that the repatriation would generate.

11.8.1 Considerations for domestic and foreign outside basis differences

When outside basis differences of domestic subsidiaries, foreign subsidiaries, and corporate joint ventures do not qualify for any of the exceptions for recording deferred taxes in ASC 740 (e.g., tax-free recovery of investment, indefinite reversal criteria, etc.), all tax effects of reversal should be included

in the parent company's deferred tax computations. The deferred tax liability for the outside basis difference should be based on the tax treatment resulting from the expected manner of recovery. Therefore, if the company expects to recover all or a portion of the outside basis difference through distributions, the company must consider the applicable provisions in the tax law (e.g., a dividend received deduction, state taxes, withholding taxes, net of available FTCs) in the calculation of the deferred tax liability. The US federal and state outside basis differences may also include foreign currency gains/losses on previously taxed income (PTI) or other currency translation that could be taxable (collectively, "taxable foreign currency gains/losses") which also need to be considered.

Some jurisdictions apply a different tax rate to earnings based on whether the earnings are retained or distributed. The guidance related to these dual-rate jurisdictions should be considered and applied consistently when measuring deferred taxes related to the foreign entity's inside basis differences and the parent's outside basis difference (see TX 4.3.3.6). Additionally, if the outside basis difference is expected to be recovered through sale, the applicable tax law that applies to sale transactions (e.g., capital gains tax treatment) should be considered in the calculation of the deferred tax liability.

As previously mentioned, withholding taxes and realizable FTCs should generally be considered when measuring the deferred tax liability on outside basis differences. That is, a net amount should be presented, instead of reflecting both a deferred tax liability for withholding taxes and a deferred tax asset for future FTCs on the withholding taxes. Conversely, reporting entities that do not expect to be able to realize any tax benefit from FTCs that are created as a result of paying withholding tax in the future should not include them in measuring the deferred tax liability. Refer to TX 13.3.1 for discussion of taxes on foreign currency transaction gains and losses.

Example TX 11-4 discusses the recognition of a deferred tax liability for withholding taxes when an entity does not assert indefinite reinvestment.

EXAMPLE TX 11-4

Accounting for a deferred tax liability related to withholding taxes

On January 1, 20X1, Company A, a US corporation, acquired 100% of Subsidiary B, a foreign corporation, for \$100 million. On the date of acquisition, the outside book and tax basis of the investment were equal at \$100 million. During 20X1, Subsidiary B generated \$10 million of financial reporting income for US GAAP purposes. During 20X1, Subsidiary B has \$8 million in earnings for both local statutory purposes and US tax purposes (i.e., US earnings and profits or E&P). The difference in the US GAAP and statutory income is attributable to a timing difference. On December 31, 20X1, Company A has a \$110 million outside GAAP basis in Subsidiary B and \$100 million in tax basis resulting in a gross outside basis temporary difference of \$10 million.

Company A does not assert indefinite reinvestment in Subsidiary B. Company A's expected manner of recovery of the basis difference in Subsidiary B is through dividend distributions.

The foreign jurisdiction assesses a 10% withholding tax on dividend distributions from Subsidiary B to Company A based on the amount of dividends distributed. In the foreign jurisdiction, dividend distributions cannot be made if the distribution is in excess of distributable reserves (e.g., local statutory basis). Due to this limitation, the company's intent is to repatriate \$10 million in the future only after the \$2 million temporary difference reverses. No additional US tax will be incurred by Company A upon dividend distribution. Company A accounts for GILTI as a period cost.

How should Company A measure the outside basis difference in Subsidiary B?

Analysis

We believe Company A should recognize a deferred tax liability of \$1 million (\$10 million x 10%) for withholding taxes.

Company A's financial statements are prepared under US GAAP and Company A's expected recovery of the basis difference in Subsidiary B is through dividend distributions. In future periods, local retained earnings will "catch up" to US GAAP retained earnings. ASC 740-10-25-20 provides that the deferred tax accounting model is predicated on the assumption that assets will be recovered at their carrying amounts. Since the earnings subject to withholding taxes have already been recognized on a US GAAP basis, the measurement of the outside basis difference of Subsidiary B should also include those earnings.

11.8.2 Considerations for equity method investments

Deferred taxes should be provided with respect to the entire outside basis difference, including unremitted earnings, of investments accounted for under the equity method. Refer to TX 11.6 for further discussion. For the unremitted earnings of an equity method investee, the assumed pattern and type of future taxable income should be based on the expected method of recovery (i.e., dividends or sale). If the payment of dividends is unlikely, the investor may have to assume recovery through sale of the investment. Accordingly, the investor would need to consider whether the gain or loss on disposal would be capital or ordinary in nature. This may result in deductible temporary differences and/or capital loss carryforwards that would be realizable only if sufficient capital gains can be expected.

If an equity investee has paid dividends in excess of current year earnings in the past and that practice is expected to continue in the future, it may be appropriate to assume that the basis difference will reverse through dividend distributions. Accordingly, if an investor is in a jurisdiction where dividends are not taxable due to a dividend received deduction or are, in effect, a return of capital not subject to tax, it may be appropriate not to record a deferred tax liability. However, if the investee has not paid dividends, or has always paid dividends only from current year earnings, and there is no indication that the practice will change in the future, it may be appropriate to assume that the basis difference will reverse through a disposal. In that case, the investor would measure the deferred tax liability at the capital gains rate, even if it has no intention of disposing of the equity investment in the foreseeable future.

Calculating the deferred taxes using the tax rate applicable to dividends would typically be appropriate only in relation to the underlying earnings and profits of the investee (this could include E&P accumulated prior to the investor's purchase), adjusted for anticipated changes in E&P that will result from reversals of the investee's temporary differences prior to the distributions.

Any difference (positive or negative) between the investor's cost and the value of the underlying net assets of the investee would be amortized by the investor as part of its equity method accounting. To the extent that such amortization represents eventual capital gain (i.e., negative amortization which increases the investor's book basis), investor taxes should be provided. To the extent that amortization represents an ultimate reduction in capital gain or an increase in capital loss (i.e., amortization that decreases the investor's book basis), it is possible that a deferred benefit could be recognized. If

investor taxes are being provided on underlying earnings, assuming capital gain treatment, reduction of such taxes to reflect accumulated amortization of excess investor cost would be appropriate.

As facts and expectations change, evidence may accumulate over time supporting a shift from a dividend to disposal assumption or vice versa. Disclosure of the reversal assumption along with the possibility of near-term changes that could have a significant accounting or liquidity impact may be appropriate.

11.9 Other considerations—outside basis differences

This section discusses other considerations related to the accounting for outside basis differences, including:

- Variable interest entities
- Changes from investee to subsidiary and from subsidiary to investee
- Changes in a parent’s equity in the net assets of a subsidiary resulting from transactions with the noncontrolling shareholders
- Tax-to-tax (inside versus outside) basis differences

11.9.1 Variable interest entities—outside basis differences

Under US GAAP, a reporting entity must consolidate any entity in which it has a controlling financial interest. Under the voting interest model, generally the investor that has voting control (usually more than 50% of an entity’s voting interests) consolidates the entity. Under the variable interest entity (VIE) model in ASC 810, *Consolidation*, the party that has the power to direct the entity’s most significant economic activities and the ability to participate in the entity’s economics consolidates the entity. This party could be an equity investor, some other capital provider, or a party with contractual arrangements. A reporting entity that consolidates a VIE is known as the primary beneficiary.

The impact of a consolidated VIE entity on the accounting for income taxes must be evaluated in each individual circumstance. The ASC Master Glossary defines subsidiary as “an entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)” Hence, the income tax accounting guidance for subsidiaries applies to consolidated VIEs that are taxpaying entities.

In assessing the deferred tax consequences of outside basis differences in a consolidated VIE, we believe that the primary beneficiary’s ability to control reversal of the difference will be a significant factor in the analysis. Even though the implication of being a primary beneficiary in the VIE model is that the primary beneficiary has a controlling financial interest, in the deferred tax context, a more specific assessment of the primary beneficiary’s ability to control distributions or other transactions that would cause a taxable event to occur is necessary. We believe that an entity must be able to prevent distributions or other transactions that would cause a taxable event to occur in order to assert indefinite reversal of an outside basis difference. In many VIE scenarios, the primary beneficiary may control the most important aspects of the entity’s economics but may not have a majority shareholding that is often necessary to approve (or not approve) the payment of dividends or other distributions. Thus, in assessing an investor’s ability and intent to control the timing of the events that cause basis

differences to reverse under ASC 740-30-25-17, an entity cannot assume control as it might in the case of a consolidated subsidiary under the voting interest model.

This same logic would apply to the exception to recognizing deferred tax assets in ASC 740-30-25-9. That is, the primary beneficiary must have the ability to control the timing of the events that cause the temporary difference to reverse in a taxable manner.

Entities with interests in VIEs for which they conclude that they are not the primary beneficiary should apply the equity method accounting guidance for equity method investments in TX 11.8.2.

11.9.2 Changes between investee and subsidiary

Deferred tax assets and liabilities must be recorded for outside basis differences in equity method investees. Determining if a change in an investment from an investee to a subsidiary (or vice versa) will give rise to an adjustment to deferred tax assets and liabilities can be impacted by whether the outside basis difference relates to a foreign or domestic entity. The change between investee and subsidiary can result from the investor/parent's purchase or sale of stock held by other investors, as well as the investee/subsidiary's transactions in its own shares.

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. This guidance removes certain exceptions to the general principles of ASC 740 and simplifies several other areas. ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. If an entity chooses to early adopt, it must adopt all changes as a result of the ASU. The transition provisions vary by amendment.

Two amendments within ASU 2019-12 remove exceptions to the general principles in ASC 740-30 that resulted in "frozen" outside basis differences for foreign equity method investments and subsidiaries. The amendments should be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. See TX 11.9.2.1A and TX 11.9.2.2A for applicable guidance before adoption of ASU 2019-12.

11.9.2.1 Change from investee to foreign subsidiary (after adoption of ASU 2019-12)

When an investee becomes a foreign subsidiary in a business combination achieved in stages, the acquirer's previously held equity interest is remeasured to fair value at the date the controlling interest is acquired and a gain or loss is recognized in the income statement (see BCG 5.3). The requirement to record the previously held equity interest at fair value may increase the outside basis difference.

When an investee becomes a foreign subsidiary through a business combination achieved in stages and a deferred tax liability can be released (based on the ability to assert the indefinite reversal exception as discussed in TX 11.4.1), the corresponding income tax benefit should be reflected in continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

If the acquirer does not assert the indefinite reversal exception, the deferred tax liability for an excess book outside basis difference in its investment in a foreign subsidiary acquired through a business combination achieved in stages cannot be released. In such cases, the tax effect of the corresponding change in outside basis difference caused by the requirement to record the pre-existing equity interest at fair value should also be recorded in income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

If a deferred tax asset has been established for the excess outside tax basis of an investee and the investee subsequently becomes a foreign subsidiary through a business combination achieved in stages, it is likely that the deferred tax asset will no longer qualify for recognition (i.e., if the temporary difference will not reverse in the foreseeable future as required in ASC 740-30-25-9). In this case, the deferred tax asset should be derecognized with the charge reflected in continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

11.9.2.1A *Change from investee to foreign subsidiary (before adoption of ASU 2019-12)*

In general, ASC 740-30-25-16 requires that the deferred tax liability provided for unremitted earnings of a prior investee that becomes a foreign subsidiary be frozen, regardless of whether the investment currently meets the indefinite reversal criteria. The frozen deferred tax liability would not be reversed until (1) dividends from the subsidiary exceed the parent's share of the subsidiary's earnings subsequent to the date on which it became a subsidiary or (2) the parent disposes of its interest in the subsidiary.

ASC 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.

When an investee becomes a foreign subsidiary in a business combination achieved in stages, the acquirer's previously held equity interest is remeasured to fair value at the date the controlling interest is acquired and a gain or loss is recognized in the income statement (see BCG 5.3). The requirement to record the previously held equity interest at fair value may increase the outside basis difference. A question arises about whether the additional temporary difference also needs to be frozen. Because of the lack of clarity in the guidance, we believe there is more than one acceptable view. One view is that the deferred tax liability for the entire outside basis difference (refer to TX 11.4.1 for meaning of "entire outside basis difference") should be frozen until the temporary difference reverses. Alternatively, the parent investor may elect to freeze only the portion of the deferred tax liability that relates to undistributed earnings of the investee as of the date control is obtained.

When a deferred tax asset was previously recognized for an equity method investment, we believe the deferred tax asset should be written off unless the temporary difference is expected to reverse in the foreseeable future. If the deferred tax asset is written off, the charge should be recorded in income

from continuing operations, except for any portion related to current year activity that is required to be recorded in other comprehensive income.

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. The new guidance removes two exceptions to the general principles in ASC 740-30 that resulted in “frozen” outside basis differences for foreign equity method investments and subsidiaries. See TX 11.9.2 and TX 11.9.2.1 for additional information on ASU 2019-12, including effective dates, transition requirements, and post-adoption guidance.

11.9.2.2 *Change from foreign subsidiary to investee (after adoption of ASU 2019-12)*

If deferred taxes were not provided on the taxable outside basis difference of a foreign subsidiary because of the indefinite reversal exception provided in ASC 740-30-25-17, deferred taxes generally would need to be provided on the taxable outside basis difference upon the subsidiary’s change in status to investee. We believe that the charge to recognize the deferred tax liability in these cases would be recorded in income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation). The charge should be recorded when the entity’s intentions change and it no longer anticipates that it can assert indefinite reinvestment. An entity may determine this prior to the period in which the change in status from subsidiary to investee actually occurs.

11.9.2.2A *Change from foreign subsidiary to investee (before adoption of ASU 2019-12)*

If a foreign subsidiary becomes an investee, ASC 740-30-25-15 indicates that the amount of outside basis difference of the foreign subsidiary for which deferred taxes were not provided on the basis of the indefinite reversal exception is effectively frozen until it becomes apparent that any of those undistributed earnings (prior to the change in status) will be remitted. However, given the need to be able to control the timing and manner of reversal of any such basis difference, it may be difficult to continue to assert the indefinite reversal criteria are met once an entity no longer controls the investee.

ASC 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.

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. The new guidance removes two exceptions to the general principles in ASC 740-30 that resulted in “frozen” outside basis differences for foreign equity method investments and subsidiaries. See TX 11.9.2 and TX 11.9.2.2 for additional information on ASU 2019-12, including effective dates, transition requirements, and post-adoption guidance.

11.9.2.3 *Change from domestic subsidiary to investee*

If deferred taxes were not provided on the taxable outside basis difference of a prior domestic subsidiary on the basis of the scenario suggested by ASC 740-30-25-7, deferred taxes generally would need to be provided on the subsidiary’s change in status to investee. We believe that the charge to recognize the deferred tax liability in these cases would be recorded in income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation). It is also important to remember that the charge would occur when the entity’s intentions changed and it no longer anticipated that it would be able to recover the investment tax-free. An entity may determine this prior to the period in which the change in status from subsidiary to investee actually occurs.

11.9.2.4 *Change from investee to domestic subsidiary*

The requirement to record a pre-existing interest at fair value also applies when an investee becomes a domestic subsidiary. When an investee becomes a domestic subsidiary through a business combination achieved in stages and a deferred tax liability can be released (based on the ability to recover the investment in a tax-free manner, see TX 11.3.2), the corresponding income tax benefit should be reflected in continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

Sometimes the scenario suggested in ASC 740-30-25-7 does not apply and the acquirer cannot release a deferred tax liability for an excess book outside basis difference in its investment in a domestic subsidiary acquired through a combination achieved in stages. In such cases, the tax effect of the corresponding change in outside basis difference caused by the requirement to record the pre-existing equity interest at fair value should also be recorded in income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

If a deferred tax asset has been established for the excess outside tax basis of an investee and the investee subsequently becomes a domestic subsidiary through a business combination achieved in stages, it is likely that the deferred tax asset will no longer qualify for recognition (i.e., if the temporary difference will not reverse in the foreseeable future as required in ASC 740-30-25-9). In this case, the deferred tax asset should be derecognized with the charge reflected in continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

11.9.3 *Changes in a parent’s ownership interest in a subsidiary*

A parent’s ownership interest in a subsidiary can change while its controlling financial interest in the subsidiary is retained. For example, the parent might buy additional interests or sell interests in the subsidiary and/or the subsidiary might reacquire some of its ownership interest or issue additional ownership interests. Under ASC 810-10-65-1, these events are considered equity transactions that have no effect on consolidated net income of the parent/investor. Accordingly, the difference between

the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted is recognized in equity. A further discussion of these transactions and their tax accounting consequences is included in TX 10.9.

11.9.4 Tax-to-tax (inside versus outside) basis differences

In addition to the outside basis differences and inside basis differences discussed in TX 11.2.1, differences may exist between the tax basis of the capital stock of a subsidiary (i.e., the parent's tax basis in the shares of the subsidiary) and the subsidiary's tax basis in the underlying net assets. These differences are generally referred to as "tax-to-tax differences" or "inside versus outside tax basis differences." Temporary differences are differences between an asset or liability's tax basis and the reported amount in the financial statements. Consequently, tax-to-tax differences are not temporary differences as defined by ASC 740, and recognition of a deferred tax asset for an outside tax basis difference over an inside tax basis difference is prohibited.

11.10 Branch operations, subpart F income, and GILTI

This section addresses the special considerations related to the accounting for branch operations, subpart F income, and GILTI.

11.10.1 Income tax accounting for branch operations

A branch operation generally represents the operations of an entity conducted in a country that is different from the country in which the entity is incorporated. Accordingly, for a US entity, a branch represents the portion of the US entity's operations that are located in and taxed by a foreign jurisdiction. For US entities, a branch can also take the form of a wholly-owned foreign corporation that has elected for US tax purposes to be treated as a disregarded entity of its parent corporation.

Branch operations are often subject to tax in two jurisdictions: (1) the foreign country in which the branch operates and (2) the entity's home country. Accordingly, we would expect the entity to have two sets of temporary differences that give rise to deferred tax assets and liabilities: one for the foreign jurisdiction in which the branch operates and one for the entity's home jurisdiction. The temporary differences in the foreign jurisdiction will be based on the differences between the book basis and the related foreign tax basis of each related asset and liability. The temporary differences in the home country jurisdiction will be based on differences between the book basis and the home country tax basis in each related asset and liability.

In order to mitigate the effects of double taxation that can result from branch operations being taxed in both the home tax return and in the foreign jurisdiction tax return, the US tax law allows for US corporations to take a foreign tax credit or deduct the foreign income taxes paid in the foreign jurisdiction. Therefore, in addition to recording deferred taxes in the foreign jurisdiction and the entity's home country, the entity should also record deferred taxes in its home country for the effects the foreign deferred tax assets and liabilities would be expected to have on the home country's future FTCs. When a deferred foreign tax liability is settled, it increases foreign taxes paid, which may decrease the home country taxes paid as a result of additional FTCs or deductions for the additional foreign taxes paid. As a result, deferred tax liabilities of foreign branches may generate deferred tax assets in the US jurisdiction. Conversely, when a deferred foreign tax asset in the foreign jurisdiction is recovered, it reduces foreign taxes paid, which may increase the home country taxes as a result of

lower foreign tax credits or deductions for foreign taxes paid. See ASC 740-10-55-20, which describes a similar concept in the context of deductible state income taxes.

For branch operations, this generally means there are three deferred tax items:

1. The deferred taxes in the foreign country in which the branch operates;
2. The deferred taxes in the entity's home country; and
3. The home country deferred tax effect of the foreign deferred taxes (i.e., the impact of either future foreign tax credit or tax benefit from deducting foreign taxes).

11.10.1.1 Home country deferred tax effect of foreign branch deferred taxes

In considering the amount of deferred taxes to record in the home country related to foreign deferred tax assets and liabilities, an entity must consider how those foreign deferred taxes, when paid, will interact with the tax computations in the home country tax return.

In the US, for example, a taxpayer makes an annual election to either deduct foreign taxes paid or claim them as a credit against its US tax liability. Although the deduction of foreign taxes paid is less beneficial than claiming a credit, there are limitations on the use of foreign tax credits, and unutilized FTCs have a limited carryforward period. Also, in deciding whether to deduct or credit foreign taxes paid, a taxpayer will need to consider the interaction of the income and taxes of the foreign branch with the income and taxes of the entity's other branches.

If the taxpayer expects to take a credit for the foreign taxes to be paid, it should record a home country deferred tax asset or liability for each related foreign deferred tax liability or asset for the amount of the foreign deferred taxes that are expected to be creditable. When determining the amount of any foreign taxes that will be creditable, tax law limitations should be considered. If the foreign taxes that will be paid as the deferred taxes reverse are not expected to be fully creditable, further analysis is necessary. In the US, the federal US corporate tax rate of 21% and FTC limitations for foreign branch income may limit an entity's ability to claim an FTC for the foreign taxes paid by the foreign branch. For example, FTC availability may be limited when the foreign tax rate exceeds the US tax rate and the company does not have other foreign branch source income to utilize the FTC.

If a US deferred tax asset has been recorded for future FTCs, it may be appropriate to reduce it for the portion of any net foreign deferred taxes that, when paid, are expected to generate FTCs that will expire unutilized. When the aggregate tax rate on foreign branch income exceeds the US corporate tax rate, this would result in the US deferred tax asset being capped at the US corporate tax rate since FTCs would not be available for more than the US tax rate. Other limitations may also continue to impact the amount of the deferred tax asset. For example, the allocation of expenses to the branch basket of income could reduce the amount of FTCs that can be utilized.

A similar situation can occur when there is a deferred tax asset that exists in the foreign jurisdiction. The foreign deferred tax asset signifies a reduction in foreign taxable income, which inherently will result in the foreign entity paying less tax in the foreign jurisdiction. In this fact pattern, the foreign deferred tax asset is representative of the fact that the US company will forego an FTC that would otherwise have been available had more tax been paid in the foreign jurisdiction. As a result, companies also need to consider whether US deferred tax liabilities should be recorded for the forgone FTCs resulting from foreign branch deferred tax assets based on the aggregate tax rate of its foreign

branches. Similar to US deferred tax assets, to the extent the aggregate tax rate on foreign branch income exceeds 21%, the US deferred tax liability should not exceed the 21% US corporate tax rate and should reflect only the forgone FTCs that could have actually been utilized had they been generated.

If the entity expects to deduct (rather than take a credit for) foreign taxes paid, it should establish deferred taxes in the home country jurisdiction on the foreign deferred tax assets and liabilities at the home country enacted rate expected to apply in the period during which the foreign deferred taxes reverse. In some fact patterns, scheduling the reversal of the foreign deferred taxes may be required if the company's ability to utilize FTCs would be affected by the timing of these reversals.

Generically, a deferred foreign tax asset of a branch is a taxable temporary difference for US tax purposes, and a deferred foreign tax liability is a deductible temporary difference. But the applicable rate may be:

- 100% of the US tax rate on a post-tax basis if foreign taxes are expected to be fully creditable for US tax purposes;
- Less than 100% of the US tax rate on a post-tax basis if FTCs are expected to be limited; or
- Equal to the US tax rate (currently 21%) if foreign taxes are expected to be deducted.

Example TX 11-5 and Example TX 11-6 illustrate how to account for inside basis differences of a foreign branch.

EXAMPLE TX 11-5

Deferred tax accounting on inside basis differences of a foreign branch – higher home country rate

Company P is a US entity with a branch in Country X where the statutory tax rate is 20%. In the current year, the branch has pre-tax income of \$10,000. For Country X and US tax purposes, the branch has a \$3,000 deductible temporary difference for inventory reserves that are not currently deductible for tax purposes and a \$5,000 taxable temporary difference for PP&E due to tax depreciation in excess of book depreciation. For US purposes, income from the branch is taxed at 25%. Taxes paid to Country X will be claimed as a foreign tax credit. No expenses have been allocated to the branch income basket.

How and for which jurisdictions should deferred taxes be recorded on the inventory and PP&E temporary differences?

Analysis

Because the branch is taxed in both Country X and the United States, the taxable and deductible temporary differences in each jurisdiction must be computed. A deferred tax asset (DTA) and deferred tax liability (DTL) in Country X should be recorded as follows:

Country X		
Inventory reserves DTA	\$600	(\$3,000 × 20%)
PP&E DTL	(1,000)	(\$5,000 × 20%)
Branch DTA/(DTL), net	(\$400)	

The same temporary differences exist in the US; however, the deferred taxes are recorded at the US rate of 25%. The net deferred tax liability of \$400 in Country X will increase foreign taxes paid when settled, resulting in an increase in future FTCs in the US. In this case, the FTCs would not be limited based on the tax rate or expense allocation because the US tax rate is higher than the tax rate of Country X and no expenses have been allocated to the branch in come basket. In addition to the temporary differences for the PP&E and inventory reserves, a \$400 deferred tax asset should be recorded in the US to reflect the future FTCs related to the foreign deferred taxes. Deferred taxes in the US should be recorded as follows:

US		
Inventory reserves DTA	\$750	(\$3,000 × 25%)
PP&E DTL	(1,250)	(\$5,000 × 25%)
Future branch FTCs	400	(\$400 × 100%)
US DTA/(DTL), net	(\$100)	

If there were more than one branch in this example, Company P would need to consider the branches in the aggregate when determining the impact of any limitations on the applicable rate used to measure any anticipatory or foregone FTCs.

EXAMPLE TX 11-6

Deferred tax accounting on inside basis differences of a foreign branch – lower home country rate

Company P is a US entity with a branch in Country X where the statutory tax rate is 30%. In the current year, the branch has pre-tax income of \$10,000. For Country X and US tax purposes, the branch has a \$3,000 deductible temporary difference for inventory reserves that are not currently deductible for tax purposes and a \$5,000 taxable temporary difference for PP&E due to tax depreciation in excess of book depreciation. For US purposes, income from the branch is taxed at 25%. Taxes paid to Country X will be claimed as a foreign tax credit. No expenses have been allocated to the branch income basket.

How and for which jurisdictions should deferred taxes be recorded on the inventory and PP&E temporary differences?

Analysis

Because the branch is taxed in both Country X and the United States, the taxable and deductible temporary differences in each jurisdiction must be computed. Deferred taxes in Country X should be recorded as follows:

Country X		
Inventory reserves DTA	\$900	(\$3,000 × 30%)
PP&E DTL	(1,500)	(\$5,000 × 30%)
Branch DTA/(DTL), net	(\$600)	

The same temporary differences exist in the US; however, the deferred taxes are recorded at the US rate of 25%. The net deferred tax liability in Country X of \$600 will increase foreign taxes paid when settled, resulting in an increase in future FTCs in the US. In this case, the FTCs will be limited because the US tax rate is lower than the tax rate of Country X. Only \$500 of the FTCs can be utilized on the US tax return (25% US rate divided by 30% foreign rate times \$600 net branch deferred tax liability). If expenses were allocated to the branch basket of income, further limitations would also need to be considered in determining the applicable rate. In addition to the temporary differences for the PP&E and inventory reserves, a \$500 deferred tax asset should be recorded in the US to reflect the future FTCs related to the foreign deferred taxes. Deferred taxes in the US should be recorded as follows:

US		
Inventory reserves DTA	\$750	(\$3,000 × 25%)
PP&E DTL	(1,250)	(\$5,000 × 25%)
Future branch FTCs	500	(\$600 × 83.33%)
USDTA/(DTL), net	-	

If there were more than one branch in this example, Company P would need to consider the branches in the aggregate when determining the impact of any limitations on the applicable rate used to measure any anticipatory or foregone FTCs.

Example TX 11-7 illustrates the complexity that could arise as a result of having multiple branches.

EXAMPLE TX 11-7**US deferred taxes for a loss related to one of multiple foreign branches**

Company A is a US entity with branches in two separate foreign tax jurisdictions. Assume that there are no temporary differences prior to the current year in either jurisdiction. The tax rate is 25% in both the United States and in foreign jurisdiction B. The tax rate in foreign jurisdiction C is 20%.

Company A has domestic income of \$800, Foreign Branch B has income of \$300, and Foreign Branch C has a loss of (\$100), resulting in \$1,000 of consolidated income for Company A.

Company A claims US foreign tax credits for its foreign taxes paid. The US tax law limits the FTC claimed to an amount equal to the US taxes on the branch income before consideration of the FTCs (FTC limitation percentage in chart below). With regard to Foreign Branch B and C, there is no carryback potential, but both loss and credit carryforwards are allowed in each foreign jurisdiction.

How should deferred taxes be recorded in relation to the branch operations?

Analysis

US federal tax, based on \$1,000 consolidated income at the 25% tax rate, is \$250.

The following illustrates the calculation of FTC availability:

	Net income	Tax paid
Branch B	\$300	\$75
Branch C	(100)	0
Total	\$200	\$75
Total Company A income	\$1,000	
FTC limitation percentage (\$200 / \$1,000)	20%	
US federal tax	\$250	
FTC limitation (\$250 tax * 20% limitation)	\$50	

Although Branch B paid \$75 of foreign taxes, only \$50 can be claimed as a tax credit in the current year's return based on the FTC limitation. The remaining \$25 would be carried forward. Given that excess FTCs have limited carryforward potential in the United States and have limitations under US tax law, the carryforward needs to be assessed for realizability. Further income in Branch B will generate additional FTCs, so realization of the FTC would need to be based on the generation of income in Branch C, which is in a lower tax jurisdiction. If, for example, losses are anticipated in Branch C through the US FTC carryforward period, a valuation allowance may be necessary on the \$25 of excess FTCs.

Also, with respect to the Branch C's deferred tax asset of \$20 related to its \$100 NOL, Company A will need to consider whether a valuation allowance should be established on the foreign country deferred tax asset. If a valuation allowance is not recorded, a corresponding deferred tax liability of \$20 for the future FTC impact should be recorded in the US jurisdiction taking into account all relevant considerations (e.g., tax rate and expense allocation).

11.10.2 *US subpart F income*

Subpart F of the Internal Revenue Code was enacted to discourage US companies from forming a foreign subsidiary to defer the US taxation of certain types of foreign earnings. Under subpart F, certain types of income are currently taxable to the extent of the foreign subsidiary's current tax basis earnings and profits. Subpart F income, when taxable, is treated as a deemed dividend, followed by an immediate contribution of the deemed dividend to the foreign subsidiary. The contribution increases the US parent's tax basis in the foreign subsidiary. If a subsequent distribution is made from the foreign subsidiary, the amounts that have already been subjected to tax under the subpart F rules can be repatriated without further taxation (other than potential withholding taxes and any tax consequences applicable to foreign currency gains or losses). The subsequent distribution would reduce the US parent's tax basis in the subsidiary.

A controlled foreign corporation (CFC) is a foreign corporation where greater than 50% of the voting power or value of the foreign corporation's stock is owned by a US shareholder. A CFC may have certain temporary differences that, upon reversal, will represent subpart F income. US deferred taxes may need to be recorded for such foreign temporary differences that will impact subpart F income (and thus US taxes) when they reverse.

In some circumstances, all of a foreign subsidiary's income may be subject to subpart F. Foreign subsidiaries with subpart F income that represents more than 70% of the entity's gross income are considered "full inclusion" entities (meaning, all of their income is considered subpart F income). Foreign subsidiaries engaged in certain financing activities may also be subject to current US taxation on their entire income in the absence of a statutory exception for "active" financing activities. In circumstances when a company expects to consistently be a full inclusion entity, recognition of US deferred taxes for temporary differences of the subsidiary is appropriate since the subsidiary is effectively the tax equivalent of a branch. Because a "full inclusion" subsidiary is analogous to a branch, the temporary differences for US tax purposes should be based on the differences between the US E&P tax basis and book basis in the assets and liabilities of the subsidiary. In circumstances when a company does not expect to consistently be a full inclusion entity, an inside basis or outside basis unit of account should be selected and applied in measuring subpart F deferred taxes. This expectation should be consistently reassessed as a change in expectations, or a reality that is different from initial expectations (e.g., the foreign subsidiary is consistently a full inclusion entity), can significantly impact the accounting for deferred taxes.

Some reporting entities may assert that earnings of their foreign subsidiary are indefinitely reinvested. To utilize the indefinite reversal exception in ASC 740-30-25-17, the parent must have the ability and intent to indefinitely defer the reversal of the temporary difference with a tax consequence. To the extent that activities occurring at the foreign subsidiary level or below will cause the recognition of subpart F income by the US parent, the underlying facts and circumstances must be examined to determine whether recording US deferred taxes is appropriate.

With respect to foreign subsidiaries that are not full inclusion and for which an indefinite reversal assertion is made, it is important to determine the unit of account to be applied in measuring subpart F deferred taxes. We believe either of the following views is acceptable:

View A (an inside basis unit of account): Under this view, deferred taxes would be recorded regardless of whether an outside basis difference exists and regardless of whether the outside basis is in a book-over-tax or tax-over-book position. The reversal of applicable temporary differences at a foreign subsidiary will create subpart F income when the underlying asset is recovered. Therefore, the

equivalent of an inside basis US taxable temporary difference exists for which a US deferred tax liability should be recognized.

Similarly, deferred subpart F income would create the equivalent of an inside basis US taxable temporary difference. Therefore, a temporary difference exists for deferred subpart F income as it would for other deferred taxable income. While future losses at the foreign subsidiary could further delay the taxation of subpart F income, the concepts underpinning ASC 740 do not allow companies to avoid the recognition of a deferred tax liability because of anticipated losses.

View B (an outside basis unit of account): Subpart F income (both unrealized and realized but deferred for US tax purposes), as a component of the subsidiary's book earnings, is encompassed in the outside basis of the parent's investment. Therefore, outside basis would be the unit of account for purposes of determining the relevant temporary difference. Unlike other portions of the outside basis difference for which the US parent may be able to control the timing of taxation simply by avoiding repatriations of cash, a company may not be able to delay the taxation of subpart F income. Therefore, under this view, deferred taxes would be recorded when subpart F income is recognized in book income, but only to the extent that subpart F income does not exceed the parent's book-over-tax outside basis difference. In effect, deferred taxes recorded are limited to the hypothetical deferred tax amount on the portion of the parent's outside book-over-tax basis difference that cannot be avoided as a result of the indefinite reinvestment assertion. Whichever view is selected by the company should be applied consistently.

If a CFC has no current E&P, the subpart F income may be deferred for US tax purposes. In this case, the deferred subpart F income would be recognized in taxable income when the CFC generates current E&P. We believe the accounting consequences of subpart F income are the same whether the income is (1) realized but deferred for US tax purposes or (2) unrealized (e.g., unrealized gains on AFS debt securities that will create subpart F income when realized). Example TX 11-8 illustrates the US deferred taxes that may be required to be recorded due to foreign temporary differences that will result in subpart F income.

EXAMPLE TX 11-8

Foreign temporary differences that will give rise to future subpart F income

A French subsidiary of a US company holds an appreciated available-for-sale debt security that is accounted for under ASC 320, Investments—Debt Securities. When sold, the gain on the sale of the debt security will constitute subpart F income in the United States. The US parent company has a book-over-tax outside basis difference in the French subsidiary that is greater than the unrealized gain in the security; however, it has asserted indefinite reversal as it does not intend to repatriate any of the subsidiary's undistributed earnings.

Should US deferred taxes be recorded on the potential subpart F income resulting from the appreciated debt security?

Analysis

Yes. To the extent subpart F income is expected to be generated on the reversal of the temporary difference associated with the debt security, US deferred taxes should be provided even when the company has made an assertion of indefinite reversal related to its overall outside basis difference.

This is because the company is not able to control or indefinitely defer the reversal of the related portion of its outside basis difference.

11.10.2.1 Subpart F qualified deficit

As noted in TX 11.10.2, when a foreign subsidiary has a current-year earnings and profit deficit (i.e., a loss measured under applicable tax law), subpart F taxation is deferred until there is current-year E&P. A qualified subpart F deficit is the amount of a current-year E&P deficit attributable to activities that, when profitable, give rise to certain types of subpart F income. The qualified deficit is available to reduce income from activities in the future that would otherwise be taxable under the subpart F rules.

Consistent with our discussion of the unit of account considerations in TX 11.10.2, we believe a consistent approach should be used to determine whether a US deferred tax asset should be recorded for a subpart F qualified deficit. We believe either of the following views is acceptable:

View A (inside basis unit of account): Under this view, a qualified deficit creates an inside basis difference for which a US deferred tax asset would be recorded. This view considers a qualified deficit to be a tax attribute akin to a carryforward or deductible temporary difference that can reduce income of the same category in the future that would otherwise be taxable under the subpart F rules.

View B (outside basis unit of account): Under this view, a qualified deficit is considered a component of the subsidiary's book earnings, and therefore inherent in the outside basis of the parent's investment. Accordingly, the recognition requirement applicable to a deductible outside basis difference would apply. A deferred tax asset would be recorded only if it is apparent that reversal of the qualified deficit is anticipated to occur in the foreseeable future (ASC 740-30-25-9) and only to the extent of the parent's tax-over-book outside basis difference. If subpart F income is anticipated in future periods and the qualified deficit is expected to eliminate the associated US tax cost (cash or utilization of a loss or credit carryforward), a deferred tax asset would be recognized based on the amount of subpart F loss that does not exceed the parent's tax-over-book outside basis difference.

Under either View A or View B, a valuation allowance may be required if it is more-likely-than-not that some portion or all of the recognized deferred tax asset will not be realized.

11.10.2.2 Indefinite reversal and previously taxed income

Previously taxed income (PTI) occurs when foreign earnings and profits have been subject to US federal taxation prior to an actual distribution to the US Subpart F income, as well as the one-time "toll tax" on unremitted E&P as part of the 2017 Act and global intangible low-taxed income inclusions, may give rise to PTI. A US parent can generally receive distributions of PTI without incurring further US federal income tax. Such distributions, however, may be subject to the tax consequences applicable to any foreign currency gain or loss as well as state taxes, foreign withholding taxes, and potential US foreign tax credits. Therefore, management still needs to declare its intentions with respect to whether PTI is indefinitely reinvested.

TX 13.4 on branch operations and deferred taxes related to CTA discusses the rationale for an indefinite reversal assertion applied to PTI. When a company analyzes its intentions under ASC 740-30-25-17, which will often include the tax consequences of remitting undistributed earnings, it may be more difficult to overcome the presumption that the undistributed earnings that underlie the PTI are indefinitely reinvested because the earnings have already been taxed and the impact of translation and withholding taxes may be minimal.

11.10.3 **GILTI**

Under the 2017 Act, a US shareholder of a controlled foreign corporation is required to include its global intangible low-taxed income in US taxable income. At a high level, the amount of GILTI included in US taxable income is based on the relationship between two elements: (1) the US company's aggregate share of the net tested income of its CFCs and (2) a net deemed tangible income return.

Tested income is the total gross income of a CFC reduced by certain exceptions and allocable deductions. Net tested income is the US shareholder's pro rata share of all of its CFCs' tested income in excess of their tested losses. The net deemed tangible income return is generally equal to 10% of the US shareholder's aggregate share of qualified business asset investment (QBAI), which is defined as the company's basis in tangible depreciable business property of the CFCs that generated tested income, adjusted for certain expenses. If the aggregate share of net CFC tested income exceeds the net deemed tangible income return, that excess is the amount of GILTI included in US taxable income (the GILTI inclusion).

The US tax cost of GILTI may be reduced by 50% (the Section 250 deduction, reduced to 37.5% for tax years beginning after December 31, 2025). However, the Section 250 deduction may be limited based on the level of US taxable income.

Additionally, there is a foreign tax credit of up to 80% of foreign taxes attributable to the GILTI inclusion that may reduce the US tax cost. These GILTI FTCs can only reduce US taxes owed on GILTI and are not eligible for carryforward.

The FASB staff issued a Q&A in response to the Tax Cuts and Jobs Act (FASB Staff Q&A #5), which indicated they do not believe ASC 740 is clear as it relates to the accounting for GILTI. Therefore, the FASB staff concluded that reporting entities can make an accounting policy election to either: (1) treat GILTI as a period cost (i.e., recognized as incurred); or (2) record deferred taxes for basis differences that are expected to reverse as GILTI in future years. FASB Staff Q&A #5 also indicates that an entity must disclose its accounting policy related to GILTI in accordance with ASC 235, *Notes to Financial Statements*.

Reporting entities with a GILTI inclusion in their US taxable income may realize reduced (or no) cash tax savings from NOLs due to the mechanics of the GILTI calculation. Regardless of the accounting policy chosen for whether or not to measure deferred taxes considering GILTI, reporting entities must make a separate accounting policy election as to whether to consider the potential reduction/loss in cash tax savings from their NOLs due to GILTI as part of their valuation allowance assessments (see TX 5.7.3.5).

11.10.3.1 **GILTI deferred tax election**

For reporting entities electing to recognize deferred taxes for basis differences that are expected to have a GILTI impact in future years (GILTI deferred taxes), we believe the approach set forth herein is one acceptable model based on the broad principles of ASC 740. The approach begins with a two-step model: (1) "looking-through" each CFC to the underlying assets and liabilities and (2) considering any residual outside basis differences. The impacts of the net deemed tangible income return, the Section 250 deduction, and FTCs should also be considered. The subsections that follow provide additional details on the two-step model and additional considerations.

Recording GILTI deferred taxes

GILTI is measured on a US shareholder basis. The US shareholder's pro rata share of its CFCs' net tested income in excess of its tested losses is included in its taxable income.

We anticipate that a reporting entity will only recognize GILTI deferred taxes if it expects to have a GILTI inclusion in the future. Otherwise, any basis differences that might exist would not have a GILTI impact upon reversal. Situations when a GILTI inclusion may not be expected to occur in the future include:

- Net deemed tangible income return will routinely exceed CFCs net tested income
- CFCs are expected to consistently produce tested losses
- CFCs are not expected to have tested income because their net income is already taxed in the US on a current basis (e.g., effectively connected income, subpart F income)

Two-step model for measuring GILTI deferred taxes

When recording GILTI deferred taxes, a reporting entity must consider both the inside and outside basis differences of its CFCs.

Step 1: "Look-through" each CFC to the underlying assets and liabilities

Similar to accounting for branch operations (as discussed in TX 11.10.1), the assets and liabilities of CFCs may result in two sets of temporary differences that give rise to deferred tax assets and liabilities: one for the foreign jurisdiction and one for the GILTI impact in the US.

Foreign deferred taxes recorded for temporary differences in the local jurisdiction in which the CFC operates would follow the provisions of ASC 740. For GILTI deferred taxes, the US shareholder should "look through" each CFC and compare the book basis of its assets and liabilities to the US tax basis determined under the GILTI provisions (GILTI basis) to determine if basis differences exist. If the GILTI basis differences will impact tested income/loss of the CFC upon reversal, they should be included in the measurement of GILTI deferred taxes. GILTI deferred taxes should be recorded for inside basis differences regardless of whether the total outside basis difference is in a book-over-tax or tax-over-book position or whether an outside basis difference exists at all.

Example TX 11-9 illustrates the application of Step 1.

EXAMPLE TX 11-9

Application of GILTI deferred tax model Step 1 – "Look-through" each CFC

Company A (US shareholder) has one CFC (CFC1). CFC1 has intellectual property (IP) with a book basis of \$1,500 that will be amortized over 10 years. The IP has a tax basis in the foreign jurisdiction of \$1,000 that will also be amortized over 10 years. In determining the tested income of CFC1 under US tax law, the intellectual property has a GILTI basis of \$600 that will be amortized over 15 years.

Which bases are relevant in the measurement of GILTI deferred taxes related to CFC1's IP?

Analysis

Company A should “look-through” CFC1, noting that a \$900 basis difference exists between the book basis (\$1,500) and the GILTI basis (\$600). As this inside basis difference reverses, it will have an impact on tested income. For example, assuming no other book-tax differences in the first year, CFC1’s tested income will be equal to pre-tax income plus \$110 [book amortization of \$150 compared to US GILTI tax amortization of \$40].

Additionally, there is a \$500 basis difference between book and tax basis in the foreign jurisdiction that will give rise to a deferred tax liability for CFC1. Upon reversal, the deferred tax liability will result in additional foreign taxes that might be creditable in the calculation of GILTI and may reduce the GILTI tax cost in the year in which the deferred tax liability reverses (i.e., anticipatory FTCs). US deferred taxes for anticipatory FTCs (discussed later in this section) may only be recorded for the local jurisdiction deferred tax assets or liabilities of the CFC.

Example TX 11-10 illustrates GILTI deferred tax considerations for CFCs with tested losses.

EXAMPLE TX 11-10**Temporary differences for CFCs with tested losses**

Company A (US shareholder) has two CFCs: CFC1 and CFC2. CFC1 is expected to consistently generate tested income that exceeds CFC2’s tested losses. CFC1 has a \$100 taxable temporary difference that will increase the GILTI inclusion upon reversal. CFC2 also has a \$100 taxable temporary difference that would contribute to a GILTI inclusion upon reversal.

If Company A has elected to record GILTI deferred taxes, should the measurement of the GILTI deferred taxes include the taxable temporary differences for both CFC1 and CFC2?

Analysis

Yes. The taxable temporary difference of CFC2 would not be ignored just because CFC2 is expected to have a tested loss that would not result in a GILTI inclusion if calculated on a stand-alone basis. Company A’s net share of the tested income or loss for CFC1 and CFC2 would be aggregated to calculate the GILTI inclusion.

Step 2: Consider residual outside basis differences

After “looking-through” the CFC to determine the inside basis differences, a residual outside basis difference between the inside and outside tax basis may remain. The residual outside basis difference may reverse in a sale, distribution, or liquidation, as it would have prior to the enactment of the GILTI provisions and should be evaluated in accordance with ASC 740-30-25-17 (see TX 11.4 and 11.5).

Special considerations in GILTI deferred accounting*Net deemed tangible income return*

Because the net deemed tangible income return is dependent on future events, such as investments in specified tangible property and interest expense of CFCs, we believe it is acceptable to account for the

related tax benefit in the period it arises, similar to a “special deduction” as described in TX 4.3.3.2. Using this approach, the net deemed tangible income return would not be considered in the measurement of GILTI deferred taxes.

An alternative approach is to estimate the net deemed tangible income return in order to determine an average tax rate expected to apply in the period the temporary difference reverses. This average tax rate would be used to measure the GILTI deferred taxes. This approach is similar to accounting for graduated tax rate structures, discussed in TX 4.3.1. A reporting entity following this approach would need to develop an expectation of tested income and QBAI in order to calculate the average rate and would need to update its estimate each reporting period as facts and circumstances change.

A reporting entity’s selected approach as it relates to the net deemed tangible income return should be applied on a consistent basis.

Section 250 deduction

Because of the mechanics of the Section 250 deduction and taxable income limitations, a reporting entity’s eligible Section 250 deduction could be less than 50% (or 37.5% for tax years beginning after December 31, 2025) of the GILTI inclusion. We believe it is generally appropriate to presume that the Section 250 deduction will not be limited in determining the tax rate applied to measure GILTI deferred taxes.

Example TX 11-11 illustrates considerations related to accounting for the Section 250 deduction.

EXAMPLE TX 11-11

Section 250 deduction

Company A (US shareholder) has one CFC (CFC1). CFC1 has identified a \$1,000 GILTI taxable temporary difference related to its intellectual property (IP). The difference is expected to reverse and increase tested income by a total of \$600 in taxable years when the Section 250 deduction is 50% and a total of \$400 in taxable years when the Section 250 deduction is 37.5%. Company A expects to be able to apply the full GILTI deduction in all years and has elected to account for the net deemed tangible income return in the period that it arises.

How should Company A account for the Section 250 deduction when measuring GILTI deferred taxes?

Analysis

Company A could presume the full Section 250 deduction in determining the tax rate that applies in the measurement of its GILTI deferred taxes as illustrated below.

	50%	37.5%	Total
Expected reversal	\$600	\$400	\$1,000
Section 250 deduction	(300)	(150)	(450)
Impact on taxable income	\$300	\$250	\$550

Because of the Section 250 deduction, only \$550 of the \$1,000 taxable temporary difference is expected to have a GILTI impact in the future. Company A's GILTI deferred tax liability before consideration of anticipatory FTCs would be \$115.50 (\$550 multiplied by 21%).

As an alternative approach, a reporting entity could consider whether it expects to be able to apply the Section 250 deduction to reduce GILTI in the year in which a GILTI temporary difference reverses. A reporting entity's Section 250 deduction may be limited, for example, if a reporting entity expects US-sourced losses to offset any GILTI inclusions, or it expects to utilize NOLs or other tax attributes to offset taxable income in future periods. To the extent a reporting entity does not expect to be able to benefit from some or all of the applicable Section 250 deduction in the relevant year, it would measure the temporary difference at a tax rate that excludes the portion of the Section 250 deduction that is expected to be lost.

In cases when limitations on the Section 250 deduction are considered in assessing the realization of NOLs (see TX 5.7.3.5), reporting entities should be consistent when considering the limitation. Reporting entities that follow the incremental cash tax savings approach for purposes of assessing realization of their NOLs should include the Section 250 deduction in measuring GILTI deferred taxes in all cases. Reporting entities that follow the tax-law ordering approach for purposes of assessing realization of their NOLs should exclude the Section 250 deduction in measuring GILTI deferred taxes for temporary differences that reverse during the relevant periods in which NOLs are utilized.

Whichever approach is selected would need to be applied consistently.

Foreign tax credits

FTCs may be used to reduce the US tax cost of GILTI. The measurement of GILTI deferred taxes should reflect the expected impact of "anticipatory" FTCs similar to the manner in which deferred taxes are recorded for the home country tax effect of foreign taxes incurred by a branch operation (see TX 11.10.1). When a foreign deferred tax liability is settled, it increases foreign taxes paid, which may increase GILTI FTCs available to reduce the GILTI tax cost in that year (i.e., additional "anticipatory" FTCs). Conversely, when a foreign deferred tax asset is recovered, it reduces foreign taxes paid, which may decrease GILTI FTCs available to reduce the GILTI tax cost in that year (i.e., less "anticipatory" FTCs). US deferred taxes for "anticipatory" FTCs may only be recorded for the local jurisdiction deferred tax assets or liabilities of the CFC. In other words, the "anticipatory" FTCs considered in the measurement of GILTI deferred taxes should not consider FTCs that are attributable to future earnings. Under the tax law, GILTI FTCs are subject to a number of limitations. At a minimum, for a reporting entity that did not expect to be subject to other FTC limitations, such as expense allocation, the "anticipatory" GILTI FTCs would be limited to 80% of the in-country foreign deferred tax asset or liability since, in all cases, GILTI FTCs are subject to the 80% limitation. However, a reporting entity would need to consider all limitations that may reduce the amount of the "anticipatory" FTCs.

Example TX 11-12 addresses whether to consider GILTI FTCs in the measurement of an outside basis deferred tax liability when the reporting entity accounts for GILTI as period cost.

EXAMPLE TX 11-12

Consideration of GILTI- basket FTCs when measuring an outside basis deferred tax liability

Assume that a reporting entity has elected to account for GILTI as a period cost and does not assert indefinite reinvestment for a CFC for which a book over tax outside basis difference exists. Presume that the CFC generates GILTI and any future remittance is expected to generate withholding tax. As a result, the reporting entity must accrue a deferred tax liability for withholding taxes that would be triggered when those underlying foreign earnings are distributed from the foreign subsidiary to the US. The reporting entity expects to be able to claim on its US tax return a GILTI-basket FTC for the withholding taxes paid on those earnings and foresees no limitation on its ability to realize the benefit of that FTC. When measuring the deferred tax liability for withholding taxes, should the reporting entity reduce the deferred tax liability to reflect the tax benefit for the GILTI FTC that will be generated upon payment of the withholding tax?

Analysis

Yes, the US reporting entity should recognize the tax benefit of the GILTI FTC as part of the measurement of its deferred tax liability on the outside basis difference. The deferred tax liability for undistributed earnings of a foreign subsidiary should incorporate the effects of FTCs. We do not believe that consideration of the expected GILTI FTC is inconsistent with the reporting entity's policy to account for GILTI as a period cost.

Chapter 12:
Intraperiod tax allocation

12.1 Chapter overview—intraperiod tax allocation

ASC 740 provides rules for allocating the total tax expense (or benefit) for a year among the various financial statement components, including components of net income (i.e., continuing operations and discontinued operations), components of comprehensive income that are excluded from net income (i.e., OCI), and other items reflected directly in contributed capital or retained earnings. This process of allocation is referred to in ASC 740 as “intraperiod allocation.”

In this chapter, we discuss the accounting model for intraperiod allocation and some of the intricacies in the model’s application.

12.2 Intraperiod allocation—level of application

While ASC 740 does not explicitly state the level of application of the intraperiod allocation rules, implicitly the intraperiod allocation rules should be applied at the jurisdictional level when only one return is filed within a jurisdiction and at the tax-return level when more than one tax return is filed within a jurisdiction (e.g., where a consolidated tax return is not filed). See ASC 740-10-30-5. Applying the intraperiod allocation rules at the proper level can require a significant amount of attention for multi-jurisdictional entities, especially when a valuation allowance is increased or decreased during the year within a jurisdiction.

12.3 Intraperiod allocation—the basic model

Although ASC 740 outlines the basic model for intraperiod allocation in only a few paragraphs (primarily ASC 740-20-45-1 through ASC 740-20-45-14), application of the guidance can be complex and, at times, counterintuitive. When ASC 740 does not specifically allocate all or a portion of the total tax expense to a specific financial statement component or components, it allocates taxes based on what often is referred to as the “with-and-without” or “incremental” approach. The intraperiod tax allocation is performed once the overall tax provision is computed and simply allocates that overall provision to components of the income statement, OCI, and stockholders’ equity (e.g., the intraperiod tax allocation does not change the overall provision). This basic approach can be summarized in the following three steps:

Step 1: Compute the total tax expense or benefit (both current and deferred) for the period.

Step 2: Compute the tax effect of pre-tax income or loss from continuing operations, without consideration of the current-year pre-tax income or loss from other financial statement components. To this amount, the tax effects of the items that ASC 740 specifically allocates to continuing operations (as listed in TX 12.3.2.1) should be added.

Step 3: Allocate among the other financial statement components, in accordance with the guidance in ASC 740-20-45-12 through ASC 740-20-45-14, the portion of total tax that remains after the allocation of tax to continuing operations (the difference between the total tax expense (computed in Step 1) and the amount allocated to continuing operations (computed in Step 2)). If there is more than one financial statement component other than continuing operations, the allocation is made on a pro rata basis in accordance with each component’s incremental tax effects.

It is important to note that before adoption of ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*, ASC 740-20-45-7 provides an exception to the intraperiod tax allocation approach. The exception commonly allocates a tax benefit to continuing operations when there is combined pre-tax income from all other components. See TX 12.4 for a discussion of the ASC 740-20-45-7 exception and the impact of ASU 2019-12 (which removes the exception).

12.3.1 Intraperiod allocation—compute total tax expense or benefit

The first step in the intraperiod allocation process is to compute the total tax expense or benefit (both current and deferred) recognized in the financial statements. This includes the tax effects of all sources of income (or loss)—that is, the tax effects attributable to continuing operations, discontinued operations, items of OCI, certain changes in accounting principles, transactions among or with shareholders, and the effects of valuation allowance changes.

There are, however, specific tax allocation rules for the tax effect of certain transactions. For example, the tax effect of certain changes within the measurement period for a business combination that affect recognition of acquired tax benefits would be recorded in goodwill (see ASC 805-740-45-2(a) and TX 10). In addition, the tax effects of the specific transactions detailed in ASC 740-20-45-11 may require special considerations (see TX 12.3.3.3).

12.3.2 Intraperiod allocation—compute tax for continuing operations

Computing the tax effects to be allocated to continuing operations begins with the quantification of the tax effect for the year for continuing operations without consideration of the tax effects (both current and deferred) of current-year income from all other financial statement components. The tax effect of current-year income from pre-tax continuing operations should consider all of the information available at the end of the reporting period.

Example TX 12-1 illustrates allocation of the tax provision between continuing operations and discontinued operations and is adapted from ASC 740-20-55-14.

EXAMPLE TX 12-1

Determining the tax effects of pre-tax income from continuing operations with a loss from discontinued operations and NOL carryforward

In 20X1, Company A has \$10,000 of income from continuing operations and a \$10,000 loss from discontinued operations. At the beginning of the year, the reporting entity has a \$20,000 NOL carryforward for which the DTA is offset by a full valuation allowance. Company A did not reduce that valuation allowance during the year. The tax rate is 25%.

How should the tax provision for 20X1 be allocated between continuing operations and discontinued operations?

Analysis

ASC 740's intraperiod allocation rules require that the amount of tax attributable to the current-year income from continuing operations be determined by a computation that does not consider the tax effects of items that are excluded from income from continuing operations. In this

instance, without the current-year loss from discontinued operations of \$10,000, no tax expense would be allocated to continuing operations because of the availability of the loss carryforward at the beginning of the year (which at the time had a valuation allowance recorded against it).

The tax effect on pre-tax continuing operations is computed before the tax effects of other financial statement components (in this case, before consideration of the loss from discontinued operations). Because a loss carryforward from the prior year was available for utilization, and there was income from continuing operations available to realize that carryforward, income from continuing operations is considered to “realize” the previously unrecognized NOL carryforward.

This result was arrived at as follows:

Step 1: Compute total tax expense or benefit	
20X1 pre-tax income/(loss) – Continuing operations	\$10,000
20X1 pre-tax income/(loss) – Discontinued operations	(10,000)
Pre-tax income/(loss)	—
Tax rate	25%
Expected tax provision/(benefit) before valuation allowance	—
Change in valuation allowance	—
20X1 Total tax provision/(benefit)	\$—
Step 2: Compute tax attributable to continuing operations	
20X1 pre-tax income/(loss) – Continuing operations	\$10,000
Tax rate	25%
Expected tax provision/(benefit) before valuation allowance	2,500
Change in valuation allowance	(2,500)
20X1 Total tax provision/(benefit)	\$—

As discussed in TX 12.3.3, the third step would be to allocate the remaining tax to the other components.

Step 3: Allocate tax to categories other than continuing operations

Total tax provision/(benefit) (Step 1)	\$—
Tax provision/(benefit) allocated to continuing operations (Step 2)	—
Tax provision/(benefit) allocated to discontinued operations	\$—

Example TX 12-2 illustrates allocation of the tax provision between continuing operations and discontinued operations when there is not an NOL carryforward.

EXAMPLE TX 12-2

Determining the tax effects of pre-tax income from continuing operations with a loss from discontinued operations and no NOL carryforward

In 20X1, Company A has \$10,000 of income from continuing operations and a \$10,000 loss from discontinued operations. Company A has no NOL carryforwards, and there is no valuation allowance. The tax rate is 25%.

How should the tax provision for 20X1 be allocated between continuing operations and discontinued operations?

Analysis

Intraperiod allocation would be performed in the following manner:

Step 1: Compute total tax expense or benefit

20X1 pre-tax income/(loss) – Continuing operations	\$10,000
20X1 pre-tax income/(loss) – Discontinued operations	(10,000)
Pre-tax income/(loss)	—
Tax rate	25%
Expected tax provision/(benefit) before valuation allowance	—
Change in valuation allowance	—
20X1 total tax provision/(benefit)	\$—

Step 2: Compute tax provision/(benefit) attributable to continuing operations

20X1 pre-tax income/(loss) – Continuing operations	\$10,000
Tax rate	25%
Expected tax provision/(benefit) before valuation allowance	2,500
Change in valuation allowance	—
20X1 total tax provision/(benefit)	\$2,500

As discussed in TX 12.3.3, the third step would be to allocate the remaining tax to the other components.

Step 3: Allocate tax to categories other than continuing operations

Total tax provision/(benefit) (Step 1)	—
Tax provision/(benefit) allocated to continuing operations (Step 2)	2,500
Tax provision/(benefit) allocated to discontinued operations	\$(2,500)

As a result of the application of the incremental approach, tax of \$2,500 was allocated to continuing operations (the tax on the \$10,000 of income) even though the \$10,000 current-year loss from discontinued operations would serve to offset the \$10,000 of income from continuing operations. The difference between the total tax expense of zero and the tax expense of \$2,500 attributable to continuing operations is a \$2,500 tax benefit. This \$2,500 tax benefit is allocated to discontinued operations.

Example TX 12-3 illustrates allocation of the tax provision between continuing operations and discontinued operations when a current-year loss is recognized in the year generated.

EXAMPLE TX 12-3**Example of a current-year loss that is recognized in the year it was generated**

USA Corp has pre-tax income from continuing operations of \$10,000 and a pre-tax loss of \$20,000 from discontinued operations for the year-ended December 31, 20X1. USA Corp historically has been profitable and expects to continue to be profitable. USA Corp has concluded that no valuation allowance is required at December 31, 20X1, based on projections of future taxable income. The tax rate is 25% for all years.

How should the current-year tax benefit be allocated between continuing operations and discontinued operations?

Analysis

Intraperiod allocation would be performed as follows:

Step 1: Compute total tax expense or benefit	
20X1 pre-tax income/(loss) – Continuing operations	\$10,000
20X1 pre-tax income/(loss) – Discontinued operations	<u>(20,000)</u>
Pre-tax income/(loss)	(10,000)
Tax rate	25%
Expected tax provision/(benefit) before valuation allowance changes	<u>(2,500)</u>
Valuation allowance change	—
20X1 total tax provision/(benefit)	<u>\$(2,500)</u>

Step 2: Compute tax provision/(benefit) attributable to continuing operations

20X1 pre-tax income/(loss) – Continuing operations	\$10,000
Tax rate	<u>25%</u>
Expected tax provision/(benefit) before valuation allowance change	2,500
Change in valuation allowance	—
20X1 total tax provision/(benefit) attributable to continuing operations	<u>\$2,500</u>

As discussed in TX 12.3.3, the third step would be to allocate the remaining tax to the other components.

Step 3: Allocate tax to categories other than continuing operations

Total tax provision/(benefit) (Step 1)	\$(2,500)
Tax provision/(benefit) allocated to continuing operations (Step 2)	<u>2,500</u>
Tax provision/(benefit) allocated to discontinued operations	<u>\$(5,000)</u>

12.3.2.1 Tax allocation of specific items to continuing operations

In addition to the tax effect of the current-year income from pre-tax continuing operations, certain components of total income tax expense or benefit for the year to be included in the tax provision/(benefit) from continuing operations include:

Tax effects of changes in tax laws or rates (discussed below)	ASC 740-10-45-15 ASC 740-20-45-8(b)
Tax effects of changes in tax status (discussed below)	ASC 740-10-45-19 ASC 740-20-45-8(c)
Tax effects of change in assertion related to prior years' unremitted earnings of foreign subsidiaries (TX 12.3.2.2) ¹	ASC 740-30-25-19
The effect of a changed assessment about the realizability of DTAs that existed at the beginning of the year because of a change in the expectation of taxable income available in future years that does not relate to source-of-loss items (TX 12.3.2.3)	ASC 740-10-45-20
Tax-deductible dividends paid to shareholders	ASC 740-20-45-8(d)
Tax effects of changes in unrecognized tax benefits for which backward tracing is not required nor elected (TX 15.7)	
Clearing of disproportionate tax effects lodged in OCI (TX 12.3.3.3)	

¹ Refer to TX 12.5.2.2 for guidance related to outside basis differences in a discontinued operation.

Changes in tax laws, rate, or an entity's tax status

Adjustments to deferred tax balances are necessary when tax laws or rates change or an entity's tax status changes. All such deferred tax adjustments, including those elements of deferred tax that relate to items originally reported in other financial statement components (such as OCI), are required to be reflected entirely in continuing operations.

The current and deferred tax effects of a retroactive change in tax laws are included in income from continuing operations as of the date of enactment. Tax effects of items previously included outside of continuing operations that are impacted by the retroactive tax law change should be adjusted to reflect the tax law change in income from continuing operations. See TX 7 for information on changes in tax laws or rates and TX 8 for information on changes in tax status.

12.3.2.2 Tax allocation of changes in indefinite reversal assertion

The tax effects that result from a change in an entity's assertion about its intent to indefinitely reinvest prior undistributed earnings of foreign subsidiaries, or foreign corporate joint ventures that are permanent in duration, should be reported in continuing operations in the period in which the change in assertion occurs. Thus, if a company concluded that it could no longer assert that it would indefinitely reinvest its prior-years' undistributed foreign earnings, it would not be appropriate to "backwards trace" the accrual of the tax consequences of the previously

accumulated foreign CTA within OCI—even if that is where the amounts would have been allocated if the company had never asserted indefinite reinvestment of those earnings in those prior periods.

It should be noted, however, that the tax effects on CTA arising in the current year are subject to the rules of ASC 740-20-45-11(b). That paragraph states that the tax effects of gains and losses included in OCI, but excluded from net income, that occur during the year should be charged or credited directly to OCI. As a result, it is important to distinguish the tax effects of the change in assertion between current-year and prior-years' items.

The tax effect of an entity's change in assertion may be reported in continuing or discontinued operations if the change is due to the disposition of an entity. Refer to TX 12.5.2.2 for additional guidance.

Example TX 12-4 illustrates intraperiod allocation considerations related to a change in the indefinite reinvestment assertion.

EXAMPLE TX 12-4

Change in indefinite reinvestment assertion

USA Corp has a profitable foreign subsidiary, Deutsche AG, with \$900 of book-over-tax outside basis difference as of December 31, 20X1 for which it asserts indefinite reinvestment under ASC 740-30-25-17. Accordingly, as of that date, USA Corp had not recorded a DTL related to the potential reversal of this difference.

- Deutsche AG's functional currency is its local currency; thus, translation adjustments that result from translating Deutsche AG's financial statements into USA Corp's reporting currency (US dollars) are reported in OCI.
- At December 31, 20X1, \$180 of the \$900 outside basis difference arose from cumulative net CTA gains reported in OCI.
- During the second quarter of 20X2, because of increased liquidity needs in the US, USA Corp no longer intends to indefinitely reinvest its accumulated foreign earnings. As a result of this change in circumstances, the exemption in ASC 740-30-25-17 from providing deferred taxes is no longer available with respect to USA Corp's book-over-tax basis difference in Deutsche AG.
- During the first six months of 20X2, pre-tax income from continuing operations is zero, and exchange rate movements result in a pre-tax gain of \$120 reported in OCI. As a result, the accumulated CTA balance at June 30, 20X2, prior to recording any DTL, is a credit of \$300 (\$180 plus \$120).

What are the intraperiod tax effects of the change in indefinite reinvestment assertion?

Analysis

USA Corp should measure the tax on the reversal of the outside basis difference of \$1,020 (\$900 plus \$120) at June 30, 20X2. Of this amount, the tax effect of the reversal of the outside basis difference that arose in prior years, \$900 in this case, would be allocated to continuing operations

as a current-period expense. The tax liability associated with current year-to-date CTA movement of \$120 would be allocated to OCI.

12.3.2.3 Intraperiod allocation for changes in valuation allowances

ASC 740-10-55-38 and ASC 740-20-45-3 set forth various rules for allocation of the benefits of previously-unrecognized losses and loss carryforwards. In addition, ASC 740-10-45-20 discusses the proper intraperiod allocation for changes in valuation allowances. We believe that these rules also apply to deductible temporary differences for which a tax benefit has never been recognized (i.e., in cases when a valuation allowance has been provided against the related DTA from its inception).

Excerpt from ASC 740-10-55-38

- a. The tax benefit of an operating loss carryforward that resulted from a loss on discontinued operations in a prior year and that is first recognized in the financial statements for the current year:
 1. Is allocated to continuing operations if it offsets the current or deferred tax consequences of income from continuing operations
 2. Is allocated to a gain on discontinued operations if it offsets the current or deferred tax consequences of that gain
 3. Is allocated to continuing operations if it results from a change in circumstances that causes a change in judgment about future realization of a tax benefit.
- b. The current or deferred tax benefit of a loss from continuing operations in the current year is allocated to continuing operations regardless of whether that loss offsets the current or deferred tax consequences of a gain on discontinued operations that:
 1. Occurred in the current year
 2. Occurred in a prior year (that is, if realization of the tax benefit will be by carryback refund)
 3. Is expected to occur in a future year.

ASC 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).

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 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.

Under these rules, the intraperiod allocation depends on whether the benefit of the loss or deduction is recognized or realized in the year in which it is generated and whether the income to allow for the realization of the loss relates to the current year or future years. In situations when a reporting entity has recorded a valuation allowance on its beginning-of-year tax attributes, such as net operating losses, capital loss carryforwards, or other DTAs that can be realized in the current year by income from continuing operations, the benefit of this realization is generally allocated to continuing operations rather than to the financial statement component that gave rise to the attribute in the earlier year.

These rules can be summarized as follows:

- When there is an increase or decrease in the valuation allowance applicable to beginning-of-year DTAs that results from changes in circumstances that cause the assessment of the likelihood of realization of these assets by income in future years to change, the effect is reflected in continuing operations. An increase or decrease can include the initial recording of a valuation allowance, a change in measurement of a previously recorded valuation allowance, or a full release of a valuation allowance. This is true except for the initial recognition of source-of-loss items, as discussed in TX 12.3.2.4. See TX 12.3.3.2 for a discussion of valuation allowance changes as a result of NOL carryforward limitations after an initial public offering.
- When income in the current year allows for the release of a valuation allowance, the resulting benefit is allocated to the current-year component of income that allows for its recognition (subject to certain exceptions, such as ASC 740-20-45-7 and the initial recognition of source-of-loss items, see TX 12.4 and TX 12.3.2.4). See TX 12.4 for a discussion of the ASC 740-20-45-7 exception and the impact of ASU 2019-12 (which removes the exception).
- When the tax benefit of a loss in the current year is recognized and would have been realizable absent taxable income in another component, it is allocated to the component that generated the loss regardless of the financial statement source of the taxable income that allows for its recognition. This principle is the same whether the source of income is (a) taxable income in the current year, (b) taxable income in a prior year to which the current-year loss can be carried back, or (c) taxable income that is expected to occur in future years.

Example TX 12-5, Example TX 12-6, and Example TX 12-7 illustrate the general rules for the recording of changes in valuation allowances.

EXAMPLE TX 12-5**Change in valuation allowance on beginning-of-year DTAs resulting from current year income and changes in projections of income in future years**

In 20X2, USA Corp has \$1,200 of pre-tax income from continuing operations and \$600 of pre-tax income from discontinued operations. At the beginning of the year, USA Corp has a \$2,000 net operating loss carryforward (which was generated in prior years by what are now discontinued operations) that has been reflected as a DTA of \$500 less a valuation allowance of \$500 (i.e., no net DTA has been recognized).

At year-end 20X2, based on the weight of available evidence, management concludes that the ending DTA is realizable based on projections of future taxable income. The statutory tax rate for all years is 25%.

How should the tax provision for 20X2 be allocated between continuing operations and discontinued operations?

Analysis

Intraperiod allocation would be performed in the following manner:

Step 1: Compute total tax expense or benefit

20X2 pre-tax income/(loss) – Continuing operations	\$1,200
20X2 pre-tax income/(loss) – Discontinued operations	600
Pre-tax income/(loss)	1,800
Tax rate	25%
Expected tax provision/(benefit) before valuation allowance release	450
Valuation allowance release	(500)
20X2 total tax provision/(benefit)	(\$50)

Step 2: Compute tax provision/(benefit) attributable to continuing operations

20X2 pre-tax income/(loss) – Continuing operations	\$1,200
Tax rate	25%
Expected tax provision/(benefit) before valuation allowance release	300
Change in valuation allowance	
Resulting from current year income	(300)

Resulting from projections of future year income	(200)
20X2 total tax provision/(benefit) attributable to continuing operations	(\$200)

Since the determination of tax allocated to continuing operations is made first, and because we generally regard all income from projections of taxable income in future years to be attributed to continuing operations, valuation allowance changes usually are recorded in continuing operations. In making this determination, we believe that changes in judgment regarding the projections of future-year income should be attributed to continuing operations, even when the change in estimate about the future is affected by another financial statement component.

Without consideration of the current-year income from discontinued operations of \$600, continuing operations would have realized a \$300 DTA relating to net operating loss carryforwards that had a valuation allowance recorded against them at 12/31/X1. In addition, the valuation allowance on the \$200 DTA relating to the remaining carryforward would have been realized through the projection of future pre-tax income from continuing operations. ASC 740-10-45-20 indicates that the release of the valuation allowance based on income expected in future years should be allocated to continuing operations despite the fact that the losses previously had been generated from what are now discontinued operations.

As discussed in TX 12.3.3, the third step would be to allocate the remaining tax to the other components.

Step 3: Allocated tax to categories other than continuing operations

Total tax provision/(benefit) (Step 1)	(\$50)
Tax provision/(benefit) allocated to continuing operations (Step 2)	(200)
Tax provision/(benefit) allocated to discontinued operations	\$150

Because the entire DTA could be supported by the current-year income from continuing operations and by projections of future income, none of the valuation allowance release has been allocated to discontinued operations.

EXAMPLE TX 12-6

Example of decreases in valuation allowance resulting from current-year income

At December 31, 20X1, USA Corp has a net DTA of \$1,000, including a DTA for net operating loss carryforwards of \$1,200 and a DTL for the excess of book basis over tax basis in fixed assets of \$200. Because of the existence of significant negative evidence at December 31, 20X1, and the lack of positive evidence of sufficient quality and quantity to overcome the negative evidence, a full valuation allowance was recorded against this \$1,000 net DTA.

During 20X2, USA Corp generated pre-tax income from continuing operations of \$100 and pre-tax income from discontinued operations of \$800. Assume a tax rate of 25%. At December 31, 20X2, based on the weight of available evidence, a full valuation allowance on the existing DTA of \$775 (\$1,000 of beginning-of-year DTA less \$225 (25% of the sum of pre-tax income from both continuing and discontinued operations of \$900)) was still required.

What is the intraperiod allocation of the valuation allowance release of \$ 225 that resulted from the current-year realization of net DTAs?

Analysis

Intraperiod allocation would be performed in the following manner:

Step 1: Compute total tax expense or benefit	
20X2 pre-tax income/(loss) – Continuing operations	\$100
20X2 pre-tax income/(loss) – Discontinued operations	800
	<hr/>
Pre-tax income/(loss)	900
Tax rate	25%
	<hr/>
Expected tax provision/(benefit) before valuation allowance release	225
Valuation allowance release	(225)
	<hr/>
20X2 total tax provision/(benefit)	\$—

Step 2: Compute tax provision/(benefit) attributable to continuing operations

20X2 pre-tax income/(loss) – continuing operations	\$100
Tax rate	25%
	<hr/>
Expected tax provision/(benefit) before valuation allowance release	25
Valuation allowance release	(25)
	<hr/>
20X2 total tax provision/(benefit) attributable to continuing operations	\$—

Absent effects of the income from discontinued operations, the provision for continuing operations would be zero, composed of \$25 of tax on the \$100 of pre-tax income offset by the \$25 benefit from the reversal of the valuation allowance on the DTA related to the net operating losses that would have been utilized. The remaining reversal of the valuation allowance of \$200 is solely due to an item occurring outside of continuing operations and not a change in judgement related to future realizability.

As discussed in TX 12.3.3, the third step would be to allocate the remaining tax to the other components.

Step 3: Allocate tax to categories other than continuing operations

Total tax provision/(benefit) (Step 1)	\$—
Tax provision/(benefit) related to continuing operations (Step 2)	—
Tax provision/(benefit) allocated to discontinued operations	\$—

As a result of the application of the incremental approach, there is \$0 tax expense to allocate to discontinued operations. The \$800 of income from discontinued operations and associated tax expense of \$200 (\$800 multiplied by the 25% tax rate) is fully offset by a release of the valuation allowance, resulting in \$0 tax expense from discontinued operations.

EXAMPLE TX 12-7**Example of increase in valuation allowance resulting from current year losses in continuing operations and OCI**

USA Corp, a calendar-year company, has the following activity:

- USA Corp disposed of land and incurred a 20X2 pre-tax capital loss in continuing operations of \$150,000. In the US, capital losses can be used to offset only capital gain income, and excess capital losses may be carried back three years and forward five years.
- During 20X2, there was an additional \$250,000 pre-tax loss recognized in OCI related to AFS debt securities which results in a deductible temporary difference that is capital in nature.
- At both December 31, 20X1 and 20X2, USA Corp has \$200,000 of capital gains available in the carryback period.
- At December 31, 20X1, USA Corp has a deductible temporary difference of \$25,000 related to AFS debt securities. The deferred tax components for 20X1 and 20X2 appear below:

In ('000s)	12/31/X1	Change	12/31/X2
Deductible temporary difference attributable to AFS debt securities	\$25,000	\$250,000	\$275,000
Capital loss carryforward on sale of land	—	150,000	150,000
Net	25,000	400,000	425,000
Tax rate	25%	25%	25%
DTA/(DTL) before valuation allowance	6,250	100,000	106,250
Valuation allowance	—	(56,250)	(56,250)
Net DTA	\$6,250	\$43,750	\$50,000

- At December 31, 20X1, no valuation allowance was recorded because USA Corp had sufficient capital gains in the carryback period to utilize the DTAs attributable to the AFS debt securities.
- At December 31, 20X2, as only \$200,000 of capital gains are available, \$225,000 of the deductible temporary differences (or \$56,250 tax-effected at 25%) will need a valuation allowance.

How should the tax provision for 20X2 be allocated between continuing operations and OCI?

Analysis

Step 1: Compute total tax expense or benefit

20X2 pre-tax income/(loss) – Continuing operations	\$(150,000)
20X2 pre-tax income/(loss) – OCI	(250,000)
Pre-tax income/(loss)	(400,000)
Tax rate	25%
Expected tax expense/(benefit) before valuation allowance	(100,000)
Increase/(decrease) in valuation allowance	56,250
20X2 total tax provision/(benefit)	\$(43,750)

Step 2: Compute tax provision/(benefit) attributable to continuing operations

20X2 pre-tax income/(loss) – Continuing operations	\$(150,000)
Tax rate	25%
Expected tax provision/(benefit) before valuation allowance	(37,500)
Increase/(decrease) in valuation allowance	—
20X6 total tax expense/(benefit)	(\$37,500)

The current-year loss in continuing operations is fully benefited because, in this fact pattern, absent the 20X2 loss reported in OCI, no valuation allowance would have been required due to existing capital gains in the carryback period.

As discussed in TX 12.3.3, the third step would be to allocate the remaining tax to the other components.

Step 3: Allocate tax to categories other than continuing operations

Total tax expense/(benefit) (Step 1)	(\$43,750)
Tax provision/(benefit) allocated to continuing operations (Step 2)	(37,500)
Tax expense/(benefit) allocated to OCI	(\$6,250)

Following the incremental approach, the entire \$56,250 valuation allowance recorded during the year was allocated to OCI because, absent the current-year pre-tax loss on the AFS debt securities reported in OCI, no valuation allowance would have been required.

12.3.2.4 Intraperiod application of the source-of-loss rule

Regardless of when it occurs, the initial recognition of the tax benefits of certain deductible differences and carryforwards is classified on the basis of the source of loss that generated them, rather than on the basis of the source of income that utilizes, or is expected to utilize them. This aspect of intraperiod allocation sometimes is referred to as “backwards tracing.” ASC 740-20-45-3 prohibits backwards tracing except for items specifically included in ASC 740-20-45-11(c) through ASC 740-20-45-11(f). Those specific items should be allocated directly to the related components of shareholder’s equity regardless of the source of income that allows for their realization.

The treatment as source-of-loss items only applies to the initial recognition of the tax benefit. If the benefit of a loss carryforward attributable to a tax deduction received in connection with issuing capital stock was previously recognized in equity, but a valuation allowance is recorded subsequently against that item, it would lose its identity as a source-of-loss item. Accordingly, the subsequent re-recognition of the benefit of the carryforward would be recorded based on the “with and without” intraperiod allocation process. That is, the benefit would be allocated based on the general rules for changes in valuation allowances, as noted at TX 12.3.2.3.

Example TX 12-8 illustrates application of the source-of-loss rule.

EXAMPLE TX 12-8**Application of the source-of-loss rule**

In 20X1, USA Corp has \$1,000 of income from continuing operations. The applicable tax rate is 25%. USA Corp has a net operating loss carryforward of \$1,200 relating to deductible expenditures reported in contributed capital, resulting in a beginning-of-year DTA of \$300 ($\$1,200 \times 25\%$). This \$300 DTA has a full valuation allowance recorded against it that was established at the date of a capital-raising transaction and was not subsequently reduced (making the DTA a source-of-loss item).

USA Corp concluded that a full valuation allowance is required at year-end. There are no permanent or temporary differences (either current year or cumulative) other than the net operating loss carryforward noted above.

How should tax expense/benefit be allocated?

Analysis

In Step 1, total tax expense would be zero because the tax effect of the \$1,000 pre-tax income at a 25% statutory tax rate would be offset by the reversal of \$250 of the \$300 valuation allowance that had been recorded on the DTA. Because the tax benefit was initially recognized after the period in which it was generated (by means of utilizing \$1,000 of the carryforward to offset the pre-tax income of \$1,000), the reversal of the valuation allowance should be backward traced to equity.

As a result, the entry to allocate tax for the year would be as follows:

Dr. Deferred tax provision – continuing operations	\$250	
Dr. Valuation allowance	\$250	
Cr. DTA		\$250
Cr. Equity		\$250

12.3.2.5 Determining the source of a realized tax benefit

The general rules for allocating the effects of changes in valuation allowances discussed at TX 12.3.2.3 apply to most changes in valuation allowances. However, because of the source-of-loss exceptions for the initial recognition of certain tax benefits and because a deductible temporary difference may reverse and be utilized on a tax return but be replaced with another deductible temporary difference within the same year (thus not realizing a tax benefit), the determination of which carryforward or deductible temporary difference produced a realized tax benefit during the year may become important when applying the intraperiod allocation rules.

When there are both DTAs at the beginning of the year and DTAs arising in the current year from sources other than continuing operations, a change in the valuation allowance must be “sourced” to the assets that gave rise to the change.

In determining whether the reversal of a particular deductible temporary difference or carryforward provided a benefit, one must consider the interaction of originating temporary differences with loss and other carryforwards. Just because a net operating loss carryforward was utilized (used on the tax return), it does not mean that a benefit was realized. ASC 740-10-55-37 indicates that the reversal of a deductible temporary difference as a deduction or through the use of a carryforward does not constitute realization when reversal or utilization resulted because of the origination of a new deductible temporary difference. This is because the DTA that has been utilized has simply been replaced by the originating DTA without providing for realization. Accordingly, ASC 740-10-55-37 indicates that the “source” of the benefit of the originating deductible temporary difference would not be the component of income in which the originating deductible temporary difference arose; rather, it would take on the source of the deduction or carryforward that it replaced.

The specific example in ASC 740-10-55-37 is in regard to deferred revenue, but the reference to ASC 740-20-45-3 makes it clear that the same rationale applies when an origination or increase of a deductible temporary difference during the year allows for the utilization of a deduction or

carryforward that originated in equity (e.g., the tax benefit and related valuation allowance are recorded in equity, consistent with ASC 740-20-45-11(c) and (f)).

Example TX 12-9 illustrates a reduction in an NOL from an equity transaction that is replaced by a subsequent originating DTA.

EXAMPLE TX 12-9

Example of a reduction in an NOL from an equity transaction that is replaced by a subsequent originating DTA

On December 31, 20X1, USA Corp raised new capital from its investors. USA Corp recorded a DTA related to a \$2,000 loss carryforward arising from a large expenditure related to the capital-raising transaction, for which a full valuation allowance was also recognized and recorded in equity.

In 20X2, USA Corp generated a pre-tax loss from continuing operations of \$1,000. Included in this \$1,000 loss was \$3,000 of warranty reserve expense that is not deductible until paid for income tax purposes. Taxable income for the year of \$2,000 was offset by the utilization of a net operating loss carryforward, resulting in net taxable income of \$0 as shown below.

Pre-tax loss from continuing operations	(\$1,000)
Originating deductible temporary differences	3,000
Usage of loss carryforward, which was originally recorded in equity	(2,000)
Taxable income	\$—

Was the utilized loss carryforward realized (such that the source of loss exception would allocate the tax benefit to equity) or was it merely transformed into a deductible temporary difference?

Analysis

Even though the \$2,000 net operating loss carryforward was utilized during the year, no realization of DTAs occurred because the loss from pre-tax continuing operations only served to increase the net DTA (and related valuation allowance). As a result, while the \$2,000 net operating loss carryforward was “consumed” on the tax return, it was not realized; rather, it was transformed into the deductible temporary difference for the warranty reserve. The carryforward did not result in incremental cash tax savings.

Deductible temporary differences that reverse and manifest themselves into an originating temporary difference (or an NOL carryforward) have not been realized. Instead, that portion of the originating temporary difference (i.e., the warranty reserve) takes on the character of the reversing DTA related to the NOL, and a \$2,000 tax benefit would be allocated to equity, in accordance with ASC 740-20-45-3, once the tax benefit of the loss carryforward is recognized in a future period.

Example TX 12-10 demonstrates how ASC 740-10-55-37 can affect the ordering in intraperiod allocation.

EXAMPLE TX 12-10

Determining the impact of originating temporary differences on the application of source of loss rules

USA Corp has the following taxable income/(loss):

Income/(loss) from continuing operations	\$1,000
Income/(loss) from discontinued operations	(1,000)
Reversing deductible temporary differences originally recorded in equity	(1,000)
Net operating loss	\$(1,000)

- Coming into the year, there are no available carryforwards or income available in carryback years.
- The deductible temporary difference that is reversing was originally established in equity with a full valuation allowance of \$1,000 against it. This valuation allowance has not been reduced subsequently.
- The DTA at the end of the current year requires a full valuation allowance, despite income in the current year, because the company is projecting losses.
- The statutory tax rate is 25%.

How should the source of loss rules be applied in the allocation of tax expense for the year?

Analysis

The total tax expense for the year is zero because there was no pre-tax income for the year (\$1,000 income from continuing operations less \$1,000 loss from discontinued operations), and the reversing equity-related deductible temporary differences created a taxable loss of \$1,000 for which the related DTA requires a full valuation allowance.

ASC 740's intraperiod allocation rules would allocate a tax expense of \$250 to continuing operations and a tax benefit of \$250 to discontinued operations. No tax benefit is allocated to the reversing equity-related deductible temporary differences because the DTA that arose in equity has merely been transformed into a DTA relating to an NOL carryforward. Said another way, while the equity-related deductible temporary differences reversed, they did not provide for incremental cash tax savings and thus were not realized. A tax benefit will be allocated to equity, in accordance with ASC 740-20-45-3, once the NOL DTA is realized in a future period.

Had the loss from discontinued operations in this example instead been \$300, then \$700 of the reversing equity-related deductible temporary differences would have been realized (resulting in incremental cash tax savings). As a result, the total tax expense of zero would be allocated as follows:

Tax expense/(benefit) allocated to continuing operations	\$250 [1,000 × 25%]
Tax expense/(benefit) allocated to discontinued operations	\$(75) [(300) × 25%]
Tax expense/(benefit) allocated to equity in accordance with ASC 740-20-45-3	\$(175) [(700) × 25%]

12.3.3 *Intraperiod allocation of remaining tax to other components*

The portion of total tax that remains after allocation of tax to continuing operations (i.e., the difference between the total tax expense computed in Step 1 and the amount allocated to continuing operations computed in Step 2) is then allocated among the other financial statement components in accordance with the guidance in ASC 740-20-45-11, ASC 740-20-45-12, and ASC 740-20-45-14.

ASC 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 740-20-45-12

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 is allocated to that item.

ASC 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.

12.3.3.1 Determining the intraperiod tax effects of other components

We believe that the individual effects on income tax expense or benefit of a specific financial statement component represent that component's incremental tax effect (on a jurisdiction-by-jurisdiction basis) on consolidated tax expense or benefit. Accordingly, we believe that this amount should be quantified by means of comparing the difference between the total tax expense or benefit computed for the year that includes all sources of income and loss and the total tax expense or benefit for the year computed with all sources of income and loss except for the financial statement component being quantified.

While that amount may not be the amount that ultimately is allocated to the respective financial statement component, it represents the individual incremental effect of the item for purposes of applying the allocation procedure outlined in ASC 740-20-45-14. All items (other than continuing operations) should be given equal priority for purposes of intraperiod tax allocation, unless there is specific guidance that provides otherwise.

12.3.3.2 Intraperiod allocation for equity items other than OCI

ASC 740 specifically allocates to shareholders' equity the tax effects of changes during the year of the following items:

- Cumulative effect adjustments to beginning retained earnings for changes in accounting principle or error correction (ASC 740-20-45-11(a)); see TX 12.5.4 for additional discussion);

- Increases or decreases in contributed capital (ASC 740-20-45-11(c)), including the tax effect of items that are classified in equity for financial statement purposes such as:
 - Issuance costs that are recorded as a reduction of proceeds received on equity issuances for book purposes but which are deductible for tax purposes; and
 - The tax effects of the exercise of a financial instrument classified as equity (other than stock-based compensation under ASC 718) by the issuer;
- Deductible temporary differences and carryforwards that existed, but for which a valuation allowance was required, at the date of a quasi reorganization (ASC 740-20-45-11(f)); and
- 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 DTAs. Changes in valuation allowances occurring in subsequent periods shall be included in the income statement (ASC 740-20-45-11(g)).

Question TX 12-1 discusses intraperiod tax allocation considerations for changes in a deferred tax asset balance, or a valuation allowance, that are a result of limitations in future utilization of a NOL carryforward due to an initial public offering.

Question TX 12-1

Should the tax consequences of reducing a deferred tax asset (or increasing a valuation allowance) related to NOL carryforwards for which future utilization is limited as a result of the tax change in ownership rules after completing an initial public offering be charged to contributed capital or recognized in the income statement?

PwC response

The effects of writing off a deferred tax asset (or recording a valuation allowance) in these circumstances should be recognized in the income statement. ASC 740-10-45-21 states that changes in valuation allowances due to changed expectations about the realization of deferred tax assets caused by transactions among or with shareholders should be included in the income statement. The guidance further concludes that the write-off of a preexisting deferred tax asset in these circumstances should be charged to income, because the same net effect results from eliminating a deferred tax asset or increasing a valuation allowance to 100% of the amount of the related deferred tax asset. This guidance differs from the guidance for changes in tax bases of assets and liabilities that are caused by transactions with or among shareholders for which ASC 740-20-45-11(g) concludes the related tax effects should be included in equity.

12.3.3.3 *Intraperiod allocation for OCI items*

Certain gains and losses are included in comprehensive income but excluded from net income. Such items, when recognized, are reflected directly in OCI, a component of shareholders' equity. Generally, the tax effect of gains and losses recorded in OCI should also be recorded in OCI (ASC 740-20-45-11(b)). These gains and losses include:

- Foreign currency translation gains and losses reflected in the CTA account within OCI for foreign operations using a foreign functional currency or the foreign currency transaction gain or loss on a nonderivative instrument (ASC 830);
- Unrealized gains and losses on AFS debt securities (ASC 320);
- Net unrecognized gains and losses and unrecognized prior service cost related to pension and other postretirement benefit arrangements (ASC 715); and
- The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedge instrument (ASC 815).

When a jurisdiction (and in some cases a separate filing when entities within a jurisdiction do not file a consolidated return) includes more than one item of OCI (e.g., derivatives under ASC 815 and AFS debt securities under ASC 320), each item should be treated as a separate component of the financial statements, at a level no higher than the separate components presented in the statement of comprehensive income as discussed in ASC 220-10-45-13 for purposes of the application of intraperiod allocation. As a result, the incremental tax effect of each separate component of OCI income should be considered. We also believe that both favorable and unfavorable adjustments (for changes in uncertain tax positions assessments) to deferred taxes recorded in OCI should, depending on the accounting policy election, either be (1) backwards traced to OCI or (2) recognized in income tax from continuing operations (refer to TX 15.7 for additional discussion on uncertain tax positions and intraperiod allocation).

CTA

Some pre-tax transaction gains and losses (ASC 830-20-35-2) and all translation adjustments (ASC 830-30-45-21) are recorded directly in the CTA account. ASC 830-20-45-5 requires the tax effects of these items to be attributed to the CTA account.

Allocation to the CTA account is required for both current and deferred taxes on transaction gains and losses recorded in the CTA account and for deferred taxes on translation adjustments. With respect to deferred taxes provided by a parent or investor for an “outside basis” temporary difference, the method of allocating the tax effect on the current year change in this outside basis temporary difference between continuing operations and other items (such as CTA) must be considered. Refer to TX 13.9 for additional information on intraperiod tax allocation for CTA.

If withholding taxes are accrued as part of the outside basis temporary difference, the treatment of foreign currency movements will likely differ from the treatment of amounts reported as part of CTA. Refer to TX 13.3.

Unrealized gains and losses on AFS debt securities (ASC 320)

ASC 320 requires that debt investments classified as AFS be carried at fair value. This would generally result in temporary differences because the laws in most tax jurisdictions defer the recognition of gains and losses from investments until the investments are sold.

ASC 320 reflects pre-tax changes in market value as OCI. ASC 740-20-45-11(b) requires that the tax effects of pre-tax changes to OCI occurring during the year be recorded net against the pre-tax changes in OCI.

Example TX 12-11 illustrates considerations related to appreciation in AFS debt securities when there is a valuation allowance.

EXAMPLE TX 12-11

Appreciation in AFS debt securities when there is a valuation allowance

Assume the following facts for USA Corp:

- Tax rate of 25%
- At year-end 20X1, there is a full valuation allowance on USA Corp's net DTA as shown:

DTA for NOLs carryforwards	\$2,000
DTA for unrealized loss on AFS debt securities	1,000
DTA before valuation allowance	3,000
Less: valuation allowance	(3,000)
Net DTA	\$—

- During 20X2, financial results for pre-tax continuing operations were breakeven and \$4,000 of pre-tax gains from unrealized appreciation on AFS debt securities was included in OCI.
- At December 31, 20X2, management concluded that a full valuation allowance continued to be required.

How much tax should be allocated to the AFS component of OCI?

Analysis

When there is a valuation allowance applicable to beginning-of-year DTAs and there is a change in circumstances during the year that causes the assessment of the likelihood of realization in future years to change, the effect would be reflected in continuing operations. However, if the reversal of the valuation allowance is directly related to the appreciation of a reporting entity's AFS debt security during the current year (current-period income) and not to expectations of taxable income in future periods, the reversal of the valuation allowance would be recorded in OCI.

In this example, USA Corp would have a total tax expense of zero and a net DTA of \$2,000 (\$12,000 pre-tax deductible temporary difference and NOL carryforward at December 31, 20X1, less \$4,000 pre-tax OCI gain = \$8,000 net pre-tax at December 31, 20X2, times 25%) with a full valuation allowance. As pre-tax income related to continuing operations is zero, no tax provision or benefit would be allocated to it. Due solely to the income from AFS debt securities of \$4,000, \$1,000 of the prior-year valuation allowance would be released. As a result, the entire valuation allowance release of \$1,000 would offset the tax attributable to the \$4,000 pre-tax gain from OCI of \$1,000 (\$4,000 times 25%), resulting in no tax allocated to the AFS component of OCI.

Example TX 12-12 illustrates intraperiod allocation related to reclassifications from AOCI.

EXAMPLE TX 12-12**Intraperiod allocation related to reclassifications from AOCI**

In Year 1, USA Corp purchased debt securities for \$210 accounted for as AFS. At the end of Year 1, the AFS debt securities had a fair value of \$150, resulting in an unrealized loss of \$60 recorded through OCI. In Year 2, USA Corp sold all of the AFS debt securities for \$150, which resulted in reclassification of the pre-tax loss of \$60 (from Year 1) from AOCI to earnings.

USA Corp reported pre-tax income from continuing operations of \$200 inclusive of the loss realized on the AFS debt securities and a reclassification gain of \$60 in OCI (thus, the effect on comprehensive pre-tax income from the disposition of the AFS debt securities is zero). USA Corp's tax rate is 25%.

Does the reclassification adjustment of \$60 from AOCI to earnings impact the intraperiod tax allocation given that the net effect on comprehensive net income is zero?

Analysis

Yes. Reclassification adjustments, such as gains and losses on AFS debt securities reclassified from AOCI to earnings, form part of the current period income (loss) from continuing operations and current period income (loss) in OCI. Therefore, their income tax effect should be evaluated in the same manner as any other item of income or loss reported in the current period. They should be considered in ASC 740's three-step intraperiod allocation approach.

	Step 1:	Step 2:	Step 3:
	Total tax expense or benefit	Tax attributable to continuing operations	Allocate remaining tax to OCI
Pre-tax income (loss)	\$260	\$200	\$60
Tax rate	25%	25%	25%
Tax (expense) benefit	\$(65)	\$(50)	\$(15)

In this example, total tax for the period is \$65. Without the disposition of AFS debt securities, the total tax would also be \$65 (income from continuing operations would be \$260 and there would be no gain in OCI). However, while the net tax effect of the reclassification adjustment in step 1 of the intraperiod allocation model is zero, there is a tax effect to allocate to continuing operations and a consequent tax offset to OCI. In this example, the reclassification adjustment resulted in splitting the total tax effect for the period of (\$65) between continuing operations and OCI.

Disproportionate tax effects lodged in OCI

The tax effects reflected directly in OCI are determined pursuant to ASC 740's intraperiod allocation rules. Under this incremental approach, subsequent adjustments to deferred taxes originally charged or credited to OCI are not necessarily reflected in OCI. Specific circumstances in which subsequent adjustments are not reflected in OCI, but instead are reflected in continuing operations, include:

- A change in enacted tax rates (because ASC 740-10-45-15 requires that the effect of a tax law change on DTAs and DTLs is reflected in continuing operations).
- A change in the valuation allowance for beginning-of-year DTAs that results from a change in circumstances that causes a change in judgment about the realizability of DTAs in future years (because ASC 740-10-45-20 requires that this change in valuation allowance be reflected entirely in continuing operations).
- In certain circumstances, the application of the exception to the “with-and-without approach” described in ASC 740-20-45-7 may also result in a disproportionate tax effect in OCI. See TX 12.4 for a discussion of the ASC 740-20-45-7 exception and the impact of ASU 2019-12 (which removes the exception).

As a result of these requirements, the tax effect lodged in OCI will not necessarily equal the net DTA or DTL that is recognized in the balance sheet for the temporary differences related to the pre-tax items recorded in OCI. Question TX 12-2 addresses considerations related to “reconciling items” that remain in OCI as a result of the effects of a change in valuation allowance or change in tax rate having been charged or credited to continuing operations.

Question TX 12-2

What, if anything, should be done about the “reconciling items” that remain in OCI as a result of the change in valuation allowance or change in tax rate effects having been charged or credited to continuing operations?

PwC response

ASC 740 is silent as to the disposition of a disproportionate tax effect lodged in OCI. We believe that the OCI balance, including any related tax effects, must be eliminated when the circumstances upon which it is premised cease to exist. Presumably, the pre-tax items in OCI ultimately will be cleared to income (perhaps in an indefinite, distant future period). For example, sale of a foreign operation or actions that result in a complete liquidation requires that the related CTA account balance be recognized in income. Any disproportionate tax effect related to such an item that was lodged in OCI should also be cleared to income. Because the disproportionate tax effect at one time was reflected in income (either in continuing operations or in the cumulative effect of initial application of ASC 740), its clearing ordinarily will be to income from continuing operations.

Question TX 12-3 addresses whether the clearing of disproportionate tax effects related to AFS debt securities (ASC 320) should be determined on an item-by-item or an aggregate portfolio basis.

Question TX 12-3

When clearing disproportionate tax effects relating to AFS debt securities (ASC 320), should this be determined on an item-by-item (individual investment) or an aggregate portfolio basis?

PwC response

We believe there are two acceptable approaches for clearing the disproportionate tax effects of AFS debt securities.

Item-by-item approach:

Under the item-by-item approach, a portion of the disproportionate tax effect is assigned to each individual investment in an unrealized gain or loss position at the time of the event causing the disproportionate tax effect. When one of those individual investments is sold, the assigned portion of the reconciling item is removed from the AFS component of OCI and charged or credited to income from continuing operations.

Aggregate portfolio approach:

Under the aggregate portfolio approach, the disproportionate tax effect remains intact as long as the investment portfolio remains. Thus, if an entity with unrealized gains and losses on debt securities elects the aggregate approach, there presumably will be no need to completely clear the disproportionate tax effect from AOCI as long as the entity holds an AFS portfolio.

In applying the aggregate portfolio approach, we believe that the disproportionate tax effect should be cleared if at any point during the year the portfolio is liquidated, even if a portfolio is re-established during the same interim period. This view is based on the fact that, at the time the portfolio was completely liquidated, the circumstance upon which the original disproportionate effect was premised ceased to exist.

Example TX 12-13 illustrates disproportionate effects lodged in OCI resulting from a change in valuation allowance.

EXAMPLE TX 12-13

Disproportionate effect lodged in OCI related to a change in valuation allowance

USA Corp's investment in debt securities, which originally cost \$1,000, had a market value of \$900 at the end of 20X1. The company accounts for this investment as an AFS debt security under ASC 320, resulting in an unrealized loss of \$100 charged to OCI during 20X1. USA Corp recorded a DTA of \$21, but it also provided a \$21 valuation allowance; thus, no tax benefit was recognized in OCI on the \$100 pre-tax OCI loss.

In 20X2, the market value of the securities did not change. However, as a result of a change in circumstances, USA Corp changed its estimate of future taxable income and eliminated the valuation allowance. The tax benefit of \$21 was reflected in continuing operations pursuant to ASC 740-10-45-20. Because the initial DTA had a valuation allowance established through OCI, and the valuation allowance was released through continuing operations, a disproportionate tax effect was created within OCI that will be triggered upon the sale of the AFS debt securities.

At the end of 20X2, USA Corp had the following balance sheet accounts for the investment:

	Debit	Credit
Investment	\$900	
DTA	\$21	
Shareholders' equity		
Retained earnings		\$21
Unrealized loss on AFS debt securities (AOCI)	\$100	

In early 20X3, USA Corp sold the securities for \$900.

How does the sale impact the disproportionate tax effects lodged in OCI?

Analysis

USA Corp recognized in continuing operations a \$100 loss on the sale; the \$100 loss previously recognized in OCI was reclassified to income pursuant to ASC 220. The reclass from OCI to continuing operations results in no cumulative pre-tax gain or loss in accumulated comprehensive income. USA Corp was able to reduce its taxes currently payable by \$21, and it reflected this tax benefit in its current tax expense. However, deferred tax expense would reflect the reversal of the \$21 DTA related to the previously unrealized loss. Accordingly, the overall net tax effect recognized in comprehensive income (the “with” calculation) on the sale would be zero.

In continuing operations (the “without” calculation), the reclassification would reduce pre-tax income by \$100, resulting in a \$21 tax benefit. In the intraperiod allocation for 20X3, therefore, the \$21 difference between these two calculations is allocated to OCI. This results in a net reclassification adjustment of \$79 (compared with the \$100 AOCI balance at the beginning of 20X3) and \$21 of tax expense “lodged” in OCI, as demonstrated below.

	Debit	Credit
Realized loss – continuing operations	\$100	
AOCI		\$100
Income taxes payable or DTA	\$21	
Current income tax benefit – continuing operations		\$21
OCI – intraperiod tax allocation	\$21	
DTA		\$21

USA Corp must clear out the disproportionate tax effect since there is no longer any basis for an OCI balance. As a result, USA Corp clears the \$21 debit to deferred tax expense in continuing operations.

	Debit	Credit
Deferred tax expense – continuing operations	\$21	
OCI – disproportionate tax effect		\$21

In this scenario, USA Corp recognized in continuing operations a \$100 pre-tax loss on the investment in 20X3, but since the \$21 tax benefit was recognized in continuing operations in 20X2 when the valuation allowance was released, no net tax benefit was recorded in continuing operations (the \$21 tax benefit on the current-year loss was offset by the clearing of the \$21 amount that had been lodged in OCI). Because there is a \$100 pre-tax loss recognized within continuing operations, with no net income tax benefit, the effective tax rate for USA Corp will be higher as a result.

Question TX 12-4 addresses when it would be appropriate to clear the disproportionate tax effect lodged in AOCI relating to pension and OPEB plans accounted for under ASC 715.

Question TX 12-4

When there is a disproportionate tax effect relating to pension and OPEB plans accounted for under ASC 715, when would it be appropriate to clear the disproportionate tax effect lodged in AOCI?

PwC response

We believe that a disproportionate tax effect lodged in AOCI should be eliminated when the circumstances upon which it is premised cease to exist. As it relates to pension and OPEB plans, because the plan is what gives rise to the DTA, we believe that the disproportionate effect should not be cleared until the plan has been terminated. Because the unit of account is the pension or OPEB plan itself, we do not believe that a pro-rata approach to clearing the disproportionate effects related to an individual plan would be an appropriate alternative. For example, it would not be appropriate to clear the disproportionate effects as gains/losses and prior service costs/credits are amortized out of AOCI and into income.

Allocation of items of OCI in an outside basis temporary difference

As with other temporary differences, the allocation of deferred taxes between continuing operations and other items, such as OCI, must be considered with respect to deferred taxes provided by a parent or investor for the outside basis temporary difference.

Example TX 12-14 illustrates the measurement of an outside basis temporary difference in a partnership when the partnership has OCI.

EXAMPLE TX 12-14

Measurement of an outside basis temporary difference in a partnership when the partnership has OCI

USA Corp consolidates a partnership in which it owns a 70% interest. The remaining 30% partnership interest is owned by an unrelated party. In the current year, the partnership generates \$100,000 of book income from continuing operations and \$50,000 of OCI. The partnership's taxable income for the current year is \$80,000. In previous years, USA Corp has recorded a DTL for an excess book-over-tax basis in the partnership (outside basis difference). USA Corp's applicable tax rate is 25%.

Does the outside book basis include USA Corp's share of the partnership's OCI? If so, what is the intraperiod allocation of any deferred tax expense related to USA Corp's share of the partnership's OCI?

Analysis

Yes. The investor's financial reporting book basis of an investment in a partnership or a corporation encompasses the investor's share of comprehensive income. This would occur whether the investor consolidates or applies the equity method of accounting. Therefore, USA Corp's share of the partnership's OCI is a part of the overall outside basis difference between book and tax, similar to any difference between its share of partnership book income and taxable income.

In this circumstance, USA Corp's outside book basis would increase by 70% of consolidated partnership comprehensive income or \$105,000 (\$150,000 x 70%, the remaining partnership comprehensive income of \$45,000 is attributable to the noncontrolling shareholder). Its outside tax basis would increase by 70% of partnership taxable income or \$56,000. Accordingly, USA Corp has an additional outside basis taxable temporary difference of \$49,000 (i.e., the excess of its share of comprehensive income over taxable income) and an additional DTL of \$12,250. Consistent with ASC 740-20-45-11(b), USA Corp would recognize \$8,750 of the deferred tax expense in OCI (i.e., its share of the partnership's OCI or \$35,000 times 25%).

12.4 *Intraperiod allocation—exception to the basic model*

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. This guidance removes certain exceptions to the general principles of ASC 740 and simplifies several other areas. ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. If an entity chooses to early adopt, it must adopt all changes as a result of the ASU. The transition provisions vary by amendment.

One of the amendments within ASU 2019-12 removes the exception to the basic intraperiod model described in ASC 740-20-45-7. This amendment should be applied on a prospective basis.

12.4.1A Intraperiod allocation—exception to the basic model (before adoption of ASU 2019-12)

ASC 740-20-45-7 provides an exception to the “with-and-without” approach to intraperiod tax allocation. This exception applies to a situation in which (1) an entity has a loss from continuing operations and combined pre-tax income related to all other items, such as OCI or discontinued operations, and (2) the entity would not have otherwise recognized a tax benefit for the loss from continuing operations under the approach described in ASC 740-20-45 (e.g., because the entity has a valuation allowance against its net DTAs).

ASC 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.

ASC 740-20-45-7 states that all items should be considered for purposes of determining the amount of tax benefit that results from a loss from continuing operations and that should be allocated to continuing operations. We believe that “all items” means all items “below the line” (i.e., other than continuing operations), including discontinued operations, all elements of OCI, as well as taxable amounts recognized in shareholders’ equity. In this regard, we believe the amortization of an unrecognized loss out of AOCI (loss in net income, gain in other comprehensive income) would constitute a source of income. These “reclassification” sources of income within OCI would be aggregated with all other “below-the-line” gains and losses for purposes of determining whether there is an overall net gain from sources other than continuing operations.

Often, the intraperiod allocation computed when applying the ASC 740-20-45-7 exception results in components showing tax benefits or expense that may be counterintuitive. For example, when applying the exception, a tax benefit may be allocated to a loss in continuing operations, despite a full valuation allowance, due to combined pre-tax income from other components, such as OCI. This application of the ASC 740-20-45-7 exception may result in the “gross-up” of various individual components. See Example TX 12-15A for one such scenario.

EXAMPLE TX 12-15A

Application of ASC 740-20-45-7 to one financial statement component other than continuing operations when a valuation allowance exists

USA Corp, a calendar-year-end reporting entity, is taxable in only one jurisdiction. In its year-end 20X1 financial statements, USA Corp considers the following information when allocating its total tax expense to financial statement components:

- USA Corp incurred a \$3,000 pre-tax loss from continuing operations and \$800 of pre-tax gain from discontinued operations during 20X1.
- USA Corp anticipates that any net DTA at the end of the year will require a full valuation allowance.
- The applicable tax rate is 25%.

What is the allocation of income tax expense/benefit if there is only one item other than income from continuing operations?

Analysis

USA Corp's total tax expense/benefit for the year ended December 31, 20X1 is zero ("with" basis). The total pre-tax loss of \$2,200 (\$3,000 pre-tax loss from continuing operations less \$800 pre-tax gain recorded in discontinued operations) results in the creation of an additional DTA of \$550 ($\$2,200 \times 25\%$), offset by a corresponding increase in the valuation allowance.

On a "without" basis, no benefit would be allocated to continuing operations because the pre-tax loss of \$3,000 would result in an operating loss carryforward of \$750, accompanied by a full valuation allowance. However, the exception in ASC 740-20-45-7, requires that the \$800 gain recorded in discontinued operations be considered when determining the amount of benefit allocable to continuing operations. Accordingly, USA Corp should allocate a tax benefit of \$200 to continuing operations (the actual benefit realized by the discontinued operations gain) and a tax expense of \$200 to discontinued operations ($\$800 \times 25\%$).

If USA Corp instead had recognized only \$700 of loss from continuing operations (assume all other factors were the same), the amount of tax benefit allocated to the loss from continuing operations would have been \$175 ($\$700 \times 25\%$). In other words, the amount of tax benefit allocated to continuing operations is limited to the lesser of (1) the tax effect of the loss from continuing operations or (2) the tax avoided on the overall net pre-tax income from all components other than continuing operations that provide a source of realization of the continuing operations loss.

To the extent that income in another component represents a source of income that enables realization of the tax benefit of the current-year loss in continuing operations, the tax rate used to determine the amount of benefit in continuing operations should be based on the rate that is applicable to that other component. See ASC 740-20-55-10 for an example that illustrates this concept. In that example, ASC 740's intraperiod rules allocate a tax benefit to the loss from continuing operations at the capital gain tax rate.

To the extent that there is more than one financial statement component other than continuing operations, the tax expense required to be reflected as a result of the application of ASC 740-20-45-7 should be allocated to these components consistent with the guidance in ASC 740-20-45-14. Application of the guidance in ASC 740-20-45-14 generally will result in the allocation of tax expense to current-year gain items on a pro rata basis.

Example TX 12-16A illustrates the application of ASC 740-20-45-7 to more than one financial statement component other than continuing operations.

EXAMPLE TX 12-16A

Application of ASC 740-20-45-7 to more than one financial statement component other than continuing operations

USA Corp has a \$2,000 loss carryforward at the beginning and end of 20X1. The related DTA has a full valuation allowance at both dates. During the year, USA Corp incurs a \$1,000 loss from continuing operations, \$2,000 of income from discontinued operations, and an unrealized loss from AFS debt securities in OCI of \$1,000. The applicable tax rate is 25%.

What is the allocation of income tax expense/benefit when a valuation allowance exists with multiple financial statement components?

Analysis

ASC 740-20-45-7 requires recognition of a \$250 tax benefit in continuing operations because a benefit was realized from the loss in continuing operations. Looking to income from financial statement components other than continuing operations, \$1,000 of net income existed to realize the tax benefit generated by the loss from continuing operations in the current year. In other words, absent the net income from these other sources, the loss carryforward would have grown larger (and required a valuation allowance).

Since the total tax expense is zero, a tax charge of \$250 must be allocated to discontinued operations and OCI in accordance with ASC 740-20-45-14. Following the ASC 740-20-45-14 methodology, losses are considered first. As the current-year loss in OCI from AFS debt securities provides no incremental tax benefit (the total tax expense for the year is no different with or without the current-year loss from AFS debt securities), no benefit is allocated to the current-year loss in OCI from AFS debt securities. As a result, with discontinued operations the only remaining component, the entire tax expense of \$250 would be allocated to discontinued operations.

Example TX 12-17A illustrates disproportionate tax effects lodged in OCI as a result of the application of the exception to the “with-and-without” approach.

EXAMPLE TX 12-17A

Disproportionate tax effects lodged in OCI as a result of the application of the exception to the “with-and-without” approach

USA Corp owns AFS debt securities accounted for under ASC 320. In 20X1, USA Corp reported a pre-tax loss from continuing operations of \$100 and a pre-tax unrealized gain in OCI of \$100

generated by AFS debt securities. USA Corp maintains a full valuation allowance. USA Corp's tax rate is 25%.

There is no tax benefit to record for the loss in continuing operations (step 2) under the "with-and-without" tax allocation approach because of the full valuation allowance. However, ASC 740-20-45-7 provides an exception to the "with-and-without" approach to intraperiod tax allocation by requiring that all items (e.g., OCI items discontinued operations, and so forth) be considered for purposes of determining the amount of tax benefit that results from a loss from continuing operations.

Accordingly, USA Corp recorded a deferred tax benefit in continuing operations and a deferred tax expense in OCI. This effectively grossed up the components of comprehensive income with no net effect on the balance sheet since the DTA was offset by a DTL. The resulting loss from continuing operations was \$75 (\$100 pre-tax loss less the \$25 income tax benefit), and the income reported in OCI was \$75 (\$100 OCI gain less \$25 of tax expense recorded in OCI).

In 20X2, USA Corp incurred more losses from continuing operations and due to market conditions, the value of its AFS debt securities declined by \$100. The \$100 pre-tax loss in OCI effectively reversed the prior year's unrealized gain in AOCI.

What should be the intraperiod tax allocation in 20X2 assuming there are no other items of income or loss? When should the tax effect (i.e., a deferred tax expense) recorded in 20X1 be cleared out of AOCI?

Analysis

Under the "with-and-without" three-step intraperiod allocation approach, the "with" (step 1) and continuing operations (step 2) tax effects are zero in 20X2 given the full valuation allowance. Therefore, there is no tax effect allocable to OCI (step 3). The recognition of loss in OCI without a corresponding tax effect creates what is referred to as a disproportionate effect.

USA Corp would clear the disproportionate tax effects lodged in OCI in accordance with their accounting policy. Under the aggregate portfolio approach, the disproportionate tax effect would only be cleared at the future point when the portfolio is entirely liquidated. Under an item-by-item approach, a portion of the disproportionate tax effect is cleared upon each future sale of the portfolio, as of the effective date of each sale. This clearing would be based on the proportion of the portfolio sold compared to the total portfolio.

Applicability of intraperiod exception (ASC 740-20-45-7) to equity accounts

ASC 740-20-45-7 states that "all items" should be considered in determining how much of the tax benefit from a loss from continuing operations should be allocated to continuing operations. However, a question arises as it relates to benefits in equity accounts, as illustrated in Example TX 12-18A.

EXAMPLE TX 12-18A

Application of ASC 740-20-45-7 with debt issuance

Company ABC has \$600 in NOLs subject to a full valuation allowance at the beginning of 20X1. During 20X1, Company ABC has additional losses of \$200. Company ABC's tax rate is 25%. The NOL DTA at the end of the year (\$800 gross or net DTA of \$200) would have required a full valuation allowance; however, on the last day of the year, Company ABC issues convertible debt that results in a DTL in accordance with ASC 740-20-45-11(c) of \$50. This DTL results in a source of income, and, therefore, the valuation allowance is reduced to \$150.

Does the intraperiod exception of ASC 740-20-45-7 apply when recording the reduction to the valuation allowance?

Analysis

We believe the exception applies because of the inclusion of the terms “all items” and “and so forth” within ASC 740-20-45-7, which seem to require all items to be considered in the application of the exception. As a result, Company ABC would record a tax benefit to continuing operations of \$50 with an offsetting tax expense in APIC.

We are aware of an alternative view under which the exception is not applied based on the definition of “comprehensive income” in the ASC master glossary, which excludes items resulting from investments by owners and distributions to owners.

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. One of the amendments within ASU 2019-12 removes the exception to the basic intraperiod model described in ASC 740-20-45-7. See TX 12.4 for additional information on ASU 2019-12, including effective dates and transition requirements.

12.5 Intraperiod allocation—other areas for consideration

Other transactions and activities that may require special consideration in the intraperiod allocation process include shareholders equity transactions, discontinued operations, unrecognized tax benefits, common control transactions and sales of a subsidiary.

12.5.1 Intraperiod allocation for dividends

ASC 740-20-45-8(d) requires that the benefit of tax-deductible dividends be reflected in continuing operations. This general rule includes the tax effects of tax-deductible dividends on unallocated ESOP shares that are accounted for under ASC 718, as such dividends are not charged to retained earnings (per ASC 718-740-45-7). In addition, ASC 718-740-45-8 through ASC 718-740-45-12 concludes that, when an income tax benefit is realized from dividends or dividend equivalents that are paid to employees on equity-classified nonvested equity shares, nonvested equity share units, or outstanding equity share options, even when those dividends are charged to

retained earnings, the tax benefit should be recognized within income tax expense or benefit in the income statement.

12.5.2 *Intraperiod allocation related to discontinued operations*

US GAAP requires presentation of discontinued operations in financial statements in certain circumstances. The objective of the requirement is to provide users with information about the portion of a reporting entity's operations that will not continue and to provide historical financial results comparable with a company's continuing operations. A reporting entity with a component that meets the conditions for discontinued operations should report the results of operations of the component, less applicable income taxes (benefit), as a separate component of income. This requires that companies consider the intraperiod allocation rules for all periods presented in the financial statements.

12.5.2.1 *Intraperiod allocation for restating discontinued operations*

In the period when operations that meet the criteria in ASC 205-20 for discontinued operations are disposed of or classified as held-for-sale, prior years' results are segregated retrospectively between continuing and discontinued operations in accordance with ASC 205-20-45-3 through ASC 205-20-45-5. When this occurs, a new allocation of tax expense or benefit to continuing operations must be determined for the prior years.

ASC 740-270-45-8 specifies that the amount of tax to be allocated to discontinued operations should be the difference between the tax originally allocated to continuing operations and the tax allocated to the restated amount of continuing operations. Amounts of tax allocated to components of income (loss) other than continuing operations recognized in prior years should not be adjusted in recasting the financial statements for the discontinued operation. This prescribed "with-and-without" allocation approach will often result in a different amount than would result from a complete reapplication of the intraperiod allocation rules.

The reallocation between continuing and discontinued operations of the tax expense originally allocated to continuing operations should be based entirely on estimates that were made in preparing the prior years' financial statements and should not reflect any hindsight. While ASC 740-270-45-8 specifically applies to interim financial reporting, we believe its provisions apply to restating prior annual periods as well. See Example FSP 16-1 for the accounting when a change in tax law occurred in the prior period being restated for discontinued operations.

When the prior years include changes in the valuation allowance for beginning-of-year DTAs, however, a question arises as to whether any of the change should be attributed to the discontinued operations. To the extent the discontinued operations were included in a consolidated tax return along with the remaining continuing operations, the change in valuation allowance resulting from the change in judgment about the realizability of DTAs in future years should be recorded entirely in continuing operations consistent with the "general rule" set forth in ASC 740-10-45-20. This would be the case even if the change in judgment (at the time) related to beginning-of-year DTAs that arose in operations that are now classified as discontinued or as a result of income that was expected from those now discontinued operations. As provided in TX 12.3.2.4, if the benefit of a loss is not recognized in the year in which the loss is incurred, it will not, when recognized in a subsequent year, be classified on the basis of the source of the loss. Thus, the fact that a loss carryforward or deductible difference arose from operations in a prior

year that subsequently were classified as discontinued would not be relevant in classifying the tax benefit initially recognized in the current year.

There is one situation, however, where departure from the general rule may be appropriate. If the discontinued operations filed a separate tax return, it may be appropriate to record in discontinued operations the change in assessment of the realizability of DTAs in future years. However, in situations where a valuation allowance is required in a spin-off transaction, the recognition of a valuation allowance may be required to be reflected through continuing operations. Refer to TX 14.8.1.

A question also could arise when the disposal results in a different realization, or estimate of future realization, of DTAs from that reflected in the beginning-of-year valuation allowance. DTAs (or DTLs) that relate to a subsidiary's inside basis temporary differences may simply disappear, perhaps indirectly realized in the pre-tax gain or loss on sale of the subsidiary's stock. These tax effects should be reflected as the tax effects of the gain or loss on disposal, even though implicitly they may reflect a change in the valuation allowance related to beginning-of-year DTAs.

In the event that there is a change to the reporting entity's estimated tax rate (e.g., change in blended state tax rate) within a particular jurisdiction as a direct result of the sale of discontinued operations, a question may arise as to whether the adjustment should be reflected in continuing operations or discontinued operations. Although the need to adjust the estimated tax rate arose because of discontinued operations, the remaining temporary differences are part of continuing operations. Therefore, the impact of revaluing the reporting entity's DTAs and DTLs should be reflected in continuing operations.

With respect to discontinued operations, we believe the net effect of the change in estimated tax rate generally should be reflected in the period in which the subsidiary is classified as held for sale.

12.5.2.2 *Intraperiod allocation for unrecognized deferred taxes*

A question arises as to the intraperiod allocation of a deferred tax expense/benefit when an entity's discontinued operation is in a subsidiary with an outside basis difference and has not previously recorded a DTL or DTA for the outside basis difference, for one of three possible reasons:

- An excess outside book-over-tax basis difference related to an investment in a foreign subsidiary was not recorded as a DTL because of the "indefinite reversal" criteria of ASC 740-30-25-17.
- An excess outside book-over-tax basis difference related to an investment in a domestic subsidiary was not considered a taxable temporary difference because the entity expected that the difference would reverse without tax effect (ASC 740-30-25-7).
- A DTA was not recognized for a deductible temporary difference because it was not apparent that the excess outside tax basis would reverse in the foreseeable future (ASC 740-30-25-9).

In this circumstance, consistent with ASC 740-30-25-10, the entity should record a DTA or DTL for the outside basis difference when its expectation has changed and, in any event, no later than the date on which the component of the entity is classified as held-for-sale. There are precedents

in practice that support intraperiod allocation of the related tax benefit or expense to either discontinued operations or continuing operations. Support for discontinued operations would be that the temporary difference was generated from the operations (e.g., operating losses) of the subsidiary and that the disposition triggers the recognition of the outside basis difference. Support for continuing operations would be that the temporary difference is related to the tax consequences of the investor's interest in the entity. We would not object to allocation to either component, provided that appropriate disclosures were made.

12.5.3 Unrecognized tax benefits

See TX 15.7 for a discussion on intraperiod allocation of the tax provision impacts of liabilities for unrecognized tax benefits.

12.5.4 Tax effect of changes in accounting principle

The cumulative effect adjustment from an accounting change generally will be included as an adjustment to beginning retained earnings. ASC 740-20-45-11(a) requires that the tax effect of the cumulative effect adjustment should also be recorded as an adjustment to beginning retained earnings, but the tax effects to be recorded are the effects that would have been recorded if the newly adopted accounting method had been used in prior years. Presumably, hindsight would not be used in this determination.

We believe that the tax effect of a cumulative effect of a change in accounting principle that is reported as an adjustment to beginning retained earnings is an adjustment of cumulative income tax expense from prior periods and not an allocation of the current period's tax expense. For example, assume that an entity has a change in accounting principle that results in a cumulative increase in prior-year financial reporting income that is to be reported as a cumulative effect adjustment to beginning retained earnings. Such an increase also would have resulted in an increase in taxable temporary differences as of that date. The resulting DTL should be established by taking into account the deferred tax balances at the beginning of the year and the enacted tax rates expected to be in effect when those temporary differences reverse (as determined under ASC 740-10-30-8). Accordingly, if the taxable temporary differences would have allowed for a lesser valuation allowance at the beginning of the year on previously recorded DTAs, the valuation allowance release also would be included in the cumulative effect. Although a change in accounting principle also may yield a revised estimate of future pre-tax book income, generally there will be no impact on taxable income.

If the cumulative effect is required to be reported as a component of net income, it would be subject to the intraperiod allocation rules. In calculating such cumulative effect, the intraperiod allocation rules would be applied to each prior period.

This guidance applies to the general manner in which changes in accounting principle are reported. However, any new accounting standard may specify different methods not specifically addressed here. For example, a standard could be adopted during an interim period or at the end of the year. It also might require a change in accounting to be reported in net income, as opposed to retained earnings, or other components of equity or net assets. Thus, it is important to consider the specific manner in which a change in accounting will be reported in order to determine the appropriate reporting of the related tax effects.

12.5.5 Intraperiod allocation for convertible debt issuance

See TX 9.4 for a discussion of the income tax impacts from issuing convertible debt instruments, including situations which may require a pre-tax component of the issuance to be recorded through APIC.

12.5.6 Taxable exchange between entities under common control

See TX 10.10 for a discussion of the income tax impacts of changes in tax basis resulting from a taxable exchange between entities under common control.

12.5.7 Tax effects of the sale of stock of a subsidiary

If the sale of a subsidiary is structured as an asset sale (e.g., an asset acquisition or a share acquisition treated as an asset acquisition), the seller will reflect a gain or loss on the sale of the assets in pre-tax income and will recognize any current taxes, as well as the reversal of any deferred taxes related to the business, in the tax provision.

If the transaction is structured as a stock sale (e.g., a third party purchases 100% of the parent's stock in the subsidiary), the tax effects of the parent include the realization of any basis difference that exists on the parent's investment in subsidiaries being sold. In addition, the historical tax bases of the subsidiary's individual assets and liabilities generally transfer to the buyer (and do not impact the seller's tax on the transaction) resulting in the need to eliminate the subsidiary's inside basis differences on parent's consolidated financial statements. We believe that calculating the pre-tax book gain or loss based on the parent's carrying value of the subsidiary, including the DTAs and DTLs of the entity being sold, is an acceptable method of accounting for the elimination of deferred taxes on the inside basis differences of the subsidiary sold. This view reflects the fact that the acquirer, by agreeing to buy the stock of the entity (and receiving the tax carryover basis), also is buying the future deductions or future taxable income inherent in the entity.

Example TX 12-19 illustrates this method for calculating the pre-tax gain or loss of a subsidiary which is inclusive of deferred taxes.

EXAMPLE TX 12-19**Calculation of pre-tax gain or loss of a subsidiary inclusive of deferred taxes**

- A subsidiary holds one asset, with a carrying amount of \$1,000 for book purposes and a tax basis of zero.
- The tax rate for both the parent and subsidiary is 25%.
- The subsidiary has recorded a \$250 DTL related to that temporary difference.
- The parent has a GAAP basis investment in the subsidiary of \$750 (\$1,000 pre-tax, less the \$250 DTL recorded by the subsidiary) and a tax basis in the shares of the subsidiary of zero. The parent has not previously recorded a DTL on this book-over-tax outside basis difference. It is assumed that there was no held-for-sale accounting in an earlier period and, therefore, the guidance in TX 11.5 (which requires recognition of an outside-basis deferred tax no later than the held-for-sale date) does not apply.

- The parent sells 100% of the stock of the subsidiary for \$1,200.

How is the pre-tax gain or loss computed of a subsidiary “inclusive of deferred taxes”?

Analysis

The pre-tax gain would be calculated as follows:

Pre-tax GAAP gain	\$450	(\$1,200 proceeds – \$750 carrying amount of investment)
Current tax provision	300	(\$1,200 proceeds – zero tax basis × 25%)
Net income	\$150	(\$450 pre-tax gain less \$300 tax provision)

There may be other acceptable methods depending on the facts and circumstances. We would expect that an entity would consider how it treated deferred taxes in its disposal group previously classified as held for sale (see TX 12.5.7.1) and whether there have been any changes to the facts.

12.5.7.1 *Deferred income taxes in a disposal group (held for sale)*

A reporting entity should determine whether deferred taxes need to be included in the carrying amount of a disposal group classified as held for sale. According to ASC 360-10-15-4, a disposal group represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. A determination of whether deferred tax assets and liabilities should be included in the disposal group depends on whether the buyer will acquire any of the tax attributes and succeed to the tax basis of assets and liabilities. If the buyer will be acquiring tax benefits or assuming tax liabilities (otherwise known as “inside” basis difference), deferred taxes should be included in the disposal group. While the determination ultimately depends on the terms of the sale and the provisions of the relevant tax law in the applicable jurisdiction, in general sales of asset groups in the form of the sale of the shares of a corporation would result in the tax bases of assets and liabilities and tax attributes carrying over to the buyer. Conversely, a sale of an asset group that is structured as the sale of assets and liabilities will result in the buyer establishing a new tax basis in those assets and liabilities.

If the sale is structured as a sale of stock, deferred taxes associated with any book-tax basis differences in the assets and liabilities of the disposal group will usually be assumed by the buyer. Therefore, these deferred taxes should be included in the carrying amount of the disposal group because the deferred taxes meet the definition of assets to be disposed of or liabilities to be transferred (included in the definition of a disposal group in ASC 360-10-15-4).

A decision to sell the shares of a subsidiary could require the recognition of additional deferred taxes associated with the difference between the seller’s carrying amount of the subsidiary’s net assets in the financial statements and its basis in the shares of the subsidiary (otherwise known as “outside” basis difference). Because those deferred taxes will remain with, and be settled by the seller, they should not be included in the disposal group. Refer to ASC 740-30-25-10 and TX 11.1 for further guidance regarding the recognition of any temporary difference related to the outside basis difference.

If the sale is structured as an asset sale, the seller will usually retain and settle or re cover the deferred tax assets and liabilities (i.e., any inside basis differences will reverse in the period of sale and become currently deductible by or taxable to the seller). Therefore, in an asset sale, deferred taxes should usually not be included in the carrying amount of the assets and liabilities that are held for sale because they will not be transferred to the buyer (i.e., they are not part of the disposal group as defined in ASC 360-10-15-4).

Chapter 13:
Income tax accounting for
foreign currency effects

13.1 Chapter overview—tax accounting for foreign currency effects

When a reporting entity conducts transactions in more than one currency, preparing financial statements in a single currency requires that changes in the relationship between different units of currency be recognized and measured. ASC 830, *Foreign Currency Matters*, uses the following two distinct processes to express all of a reporting entity's transactions in a single reporting currency.

- Foreign currency measurement—This is the process by which an entity expresses, in its functional currency, transactions whose terms are denominated in a foreign currency. Changes in functional currency amounts that result from the measurement process are called transaction gains or losses and are included in net income.
- Foreign currency translation—This is the process of expressing a foreign entity's functional currency financial statements in the reporting currency. Changes in reporting currency amounts that result from the translation process are called translation adjustments and are included in the cumulative translation adjustment account, which is a component of other comprehensive income.

This chapter addresses the income tax accounting issues associated with foreign currency matters and the hedging of investments in foreign subsidiaries. See PwC's *Foreign currency* guide for detailed discussion of foreign currency matters.

13.1.1 General translation/remeasurement process

The reporting currency is the currency in which a reporting entity prepares its financial statements. The functional currency is the currency of the primary economic environment in which the entity operates. Accordingly, foreign entities that maintain their financial statements in a functional currency that is different than the reporting currency need to translate their financial statements each reporting period into the enterprise's reporting currency. This is accomplished through the following:

- All transactions in, or denominated in, a currency other than the functional currency are remeasured into the functional currency of the foreign entity using the current exchange rate for monetary accounts (e.g., cash, accounts receivable, accounts payable and long-term debt) and historical rates for nonmonetary accounts (e.g., fixed assets, inventory), assuming the foreign entity maintains its books in a currency other than the functional currency. Accordingly, for monetary accounts, changes in the exchange rate between the initial recording and the remeasurement date will give rise to foreign currency gain or loss.
- The functional currency financial statements are translated into the reporting currency using the "current rate method." The effect of changes in the exchange rate between the foreign entity's functional currency and the reporting currency is recognized in the reporting entity's CTA. Under the "current rate method" of translation:
 - Assets and liabilities are translated using the current exchange rate at the balance sheet date
 - Capital accounts (e.g., common and preferred shares) are translated at the historical exchange rates (i.e., the exchange rates in effect when the transactions occurred)

- Income statement accounts are translated at the exchange rate on the date the income or expense was recognized (use of the weighted average exchange rate during the period is generally appropriate)

13.1.2 *Deferred taxes related to the translation/remeasurement process*

ASC 740 generally requires deferred taxes to be provided on temporary differences between the book carrying values and the tax bases of assets and liabilities. That general principle is considered in determining the appropriate tax accounting for temporary differences relating to foreign currency translation and transactions. The process for determining deferred taxes related to foreign operations differs depending on whether the functional currency is the local currency or something other than the local currency (e.g., when the US dollar is the functional currency). When the local currency is different from the functional currency, the guidance for recognizing deferred taxes depends on the nature of the individual foreign assets and liabilities as either monetary or nonmonetary as further discussed in TX 13.5. When the local currency is the functional currency, deferred tax assets and liabilities are measured under ASC 740 for the temporary differences between the functional currency financial statement carrying amounts of assets and liabilities and their related functional currency tax bases in the foreign jurisdiction. The functional currency deferred tax assets and liabilities are then translated into the reporting currency using current exchange rates at the balance sheet date.

13.2 *Translation of foreign deferred taxes.*

When the local currency is the functional currency, the local currency-denominated income tax assets and liabilities, including foreign deferred taxes and liabilities for uncertain tax positions, are translated at current rates under ASC 830. The translation results are generally reported in CTA.

Additionally, so-called “top-side” and consolidating accounting entries should be evaluated to determine whether such entries should be considered as part of the foreign entity’s books. If they are part of the foreign entity’s books, those accounts must be remeasured in the functional currency and then translated to the reporting currency using the current rate method of translation. Such accounting entries may include acquisition accounting adjustments or unrecognized tax benefits relating to uncertain tax positions of the foreign operation.

13.2.1 *Translation adjustments in outside basis difference*

Translation adjustments typically represent a portion of the outside basis difference related to a parent’s investment in a foreign subsidiary. These adjustments, in general, reflect the gains and losses associated with the translation of a foreign subsidiary’s financial statements from its functional currency into the reporting currency. ASC 830-30-45-21 states that deferred taxes shall not be provided on translation adjustments when deferred taxes are not provided on unremitted earnings under the indefinite reversal exception discussed in ASC 740-30-25-17. However, if deferred taxes are not provided on unremitted earnings because it is expected that their repatriation will result in no additional US tax because of foreign tax credits, it may still be necessary to provide for deferred tax on translation adjustments.

When determining whether to record income taxes for translation adjustments, as well as how the tax would be estimated, the following points should be considered:

1. The evaluation should first be made on a foreign operation by foreign operation basis. Then, circumstances may indicate that operations will be aggregated by tax jurisdiction for tax planning and measurement purposes.
2. Even though all local currency assets and liabilities affect the translation adjustment, the measurement of the tax should be directly related to the portion of equity that is expected to be remitted. If a return of both capital and retained earnings is contemplated, it may be appropriate to consider whether the capital portion is likely to be taxed as a capital gain and will not trigger any foreign tax credits as no local taxes would typically have been paid with respect to the currency effects.
3. Companies should also consider whether the translation adjustments will result in ordinary or capital gain or loss. Different tax rates may apply, and the assessment of whether realization of deferred tax assets is more likely than not may be affected. Further, potential utilization of foreign tax credits and applicable foreign tax withholdings need to be considered in determining the measurement of deferred taxes.

13.3 Taxes on foreign currency transaction gains and losses

For transactions denominated in a currency other than the functional currency, changes in exchange rates will generally result in gains or losses recognized in the income statement.

Gains and losses from foreign currency transactions will generally be taxable (or deductible) in the US or in a foreign country based on the applicable tax law. If these gains and losses are included in taxable income in a period that differs from the one in which they are included for financial reporting purposes, ASC 830-20-05-3 requires deferred tax accounting in accordance with ASC 740.

13.3.1 Foreign withholding tax and outside basis differences

Foreign withholding taxes related to the reversal of outside basis differences are technically a liability of the parent and therefore the parent's foreign currency transactions. As a result, to the extent foreign withholding taxes are being provided on the outside basis difference in a foreign subsidiary, the related transaction gains and losses caused by changes in the exchange rate should be recognized in the income statement in accordance with ASC 830-20-35-1. These transaction gains and losses can be recognized in either pre-tax income or as part of the income tax provision consistent with ASC 830-740-45-1. Once made, this classification decision should be consistently applied to all foreign withholding tax transaction gain and losses.

13.4 Deferred taxes related to branch CTA

While deferred taxes must be recorded for branch earnings, another area that must be considered when looking at the accounting for branches is the accounting for any CTA related to the operations of the branch. In circumstances when the temporary differences associated with the CTA of the foreign branch will not be taxed in the US until there is a remittance of cash or property, a question arises as to whether or not a company can apply an indefinite reversal assertion to the CTA of the foreign branch.

We believe the answer depends on which of two acceptable views is applied in an entity's interpretation of the accounting literature. View 1 is that an indefinite reversal assertion is not available for a branch. View 2 allows for the application of an indefinite reversal assertion (when facts and circumstances permit). The views are summarized as follows:

View 1 (Inside basis approach)—ASC 740-30-25-17, which is an exception to the comprehensive recognition of deferred taxes, only applies to outside basis taxable temporary differences related to investments in foreign subsidiaries and certain foreign corporate joint ventures. Because branch income is directly taxable to the owner or parent, there is technically no outside basis in the branch and therefore the exception in ASC 740-30-25-17 is not applicable. Furthermore, ASC 740-30-15-4 prohibits applying the indefinite reversal criterion to analogous types of temporary differences.

View 2 (Outside basis approach)—In deliberating ASC 740, the FASB indicated that the underlying rationale for the exception in ASC 740-30-25-17 is based on the inherent complexity and hypothetical nature of the calculation. Application of the exception depends on a company's ability and intent to control the timing of the events that cause temporary differences to reverse and result in taxable amounts in future years. In particular, the exception focuses on the expectation of owner or parent taxation in the home jurisdiction. Taxation of CTA varies by jurisdiction and can be complex. There may be some circumstances when taxation of CTA occurs only upon a remittance of cash from the branch. In these limited circumstances, the timing of taxation can be controlled by the owner or parent. On that basis, an indefinite reversal assertion could potentially be applied to the CTA of a foreign branch (even though the assertion could not apply to the periodic earnings of the branch since they pass through to the parent). This is not an "analogous" temporary difference which would be prohibited by ASC 740-30-15-4; rather, it is in the scope of ASC 740-30-25-17. That is because such amount relates to a foreign operation and carries with it the same measurement complexities as any other foreign outside basis difference.

Although either view is acceptable, the election is an accounting policy that should be applied consistently. If View 2 is adopted, indefinite reversal could be asserted for any branch for which the criteria are supportable by specific plans relating to the unremitted branch earnings. As a result, under View 2, an indefinite reversal assertion could be made and supported for one branch while not being made for another.

For a company applying View 2, other points to note are as follows:

- View 2 is analogous to the conclusion reached in TX 11.10.2.2 with respect to previously taxed income of a foreign subsidiary. As noted in TX 11.10.2.2, the fact that earnings have already been taxed can make an indefinite reversal assertion difficult when there is a possibility of repatriation from foreign operations.
- When an overall translation loss exists in the CTA, it is necessary to demonstrate that the temporary difference will reverse in the foreseeable future before recognizing a deferred tax asset under ASC 740-30-25-9.
- In the event that an indefinite reversal assertion changes, the deferred taxes attributable to current year CTA movement are recorded to other comprehensive income in accordance with ASC 740-20-45-11(b). However, because the beginning-of-year CTA balance did not arise during the year, but rather in prior years, ASC 740-20-45-11(b) does not apply and the tax effects associated with these prior-year cumulative balances should be recorded to continuing operations.

13.5 *Deferred taxes with US dollar functional currency*

The guidance for recognizing deferred taxes related to assets and liabilities of a foreign entity whose functional currency is the US dollar (rather than the local currency) depends on the nature of the individual foreign assets and liabilities as either monetary or nonmonetary. The guidance in TX 13.5.1 and TX 13.5.2 assumes that the functional currency of the foreign entity and its parent (as well as its parent's reporting currency) is the US dollar. However, the same principles would apply in any circumstance in which a "foreign" subsidiary's functional currency is the same as the ultimate parent's functional and reporting currency.

13.5.1 *Deferred taxes on foreign nonmonetary assets and liabilities*

Deferred taxes are recognized under ASC 740 based on the assumption that assets will be recovered and liabilities will be settled at their carrying amounts. When a foreign operation has a US dollar functional currency, the carrying amounts of nonmonetary assets and liabilities (e.g., fixed assets, inventory) should be based on US dollar amounts that are derived using historical exchange rates (assuming the foreign entity maintains its books in a currency other than the functional currency).

The foreign tax basis of the asset would have been initially established when the asset was acquired and would have equaled the amount of foreign currency paid to acquire the asset. To be recorded in the US dollar functional currency, the amount would have been remeasured at the exchange rate in effect when the asset was acquired (i.e., the historical rate). The foreign tax basis, especially in hyperinflationary countries, may also be subject to indexing under the foreign tax law. As a result, for any nonmonetary asset, the temporary difference for financial statement purposes includes the following three components:

1. The difference between the foreign tax basis, before any adjustment for indexing, and the US GAAP carrying amount on the local currency books (before remeasurement into US dollars)
2. The difference created by changes in tax basis, if any, resulting from indexing provisions of the foreign tax law
3. The difference arising in remeasurement (i.e., the difference between nonmonetary assets remeasured at the historical rate for financial statement purposes and the tax basis at the current rate)

Under ASC 740-10-25-3(f), an exception to the general recognition of deferred taxes precludes recognition of deferred taxes for the second and third components.

Excerpt from ASC 740-10-25-3(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

Thus, for fixed assets, when the US dollar is the functional currency, deferred taxes should be computed in the local currency by comparing the historical book and tax bases in the local currency after the respective depreciation, but before any indexing for book or tax purposes. The local currency

deferred tax is then remeasured into US dollars using the current exchange rate with the resulting remeasurement impact recorded to the income statement. Any additional tax depreciation on the current period return that results from indexing will reduce the current tax provision and the foreign effective tax rate as there is no corresponding amount in pre-tax book income.

In many instances, net operating loss carryforwards in these jurisdictions are also indexed for inflation. The impact of indexing the NOLs should be recognized in the financial statements and the tax loss reported on the tax return should be used to calculate the NOL upon which a deferred tax asset is reported. Because ASC 830-10-45-18 does not regard deferred tax assets and liabilities as items that must be remeasured using historical exchange rates, we believe the prohibition in ASC 740-10-25-3(f) does not apply. In jurisdictions employing indexation for tax purposes, a foreign entity's tax return will use indexed tax bases for nonmonetary assets to calculate tax deductions that may increase the NOL upon which a deferred tax asset is reported. We do not believe that it is practicable to determine the portion of prior tax losses that are attributable to indexing nonmonetary assets. Thus, the entire amount of the indexed foreign currency NOLs should be recognized as a deferred tax asset and remeasured using current exchange rates. Such deferred tax assets should then be evaluated for realization as required by ASC 740.

Example TX 13-1 illustrates the deferred tax accounting for nonmonetary assets.

EXAMPLE TX 13-1

Foreign subsidiary with US dollar functional currency

A foreign subsidiary with a US dollar functional currency purchased manufacturing equipment for 5,000 euro at the start of 20X1, when the euro-US dollar exchange rate was 5 to 1. The asset is depreciated on a straight-line basis over ten years for financial reporting purposes and over five years for tax purposes. The applicable foreign tax law does not include indexing. The exchange rate increases to 7 to 1 in 20X3.

What portion of the temporary difference gives rise to deferred taxes?

Analysis

Deferred taxes should only be provided on the difference between the euro tax basis and the euro equivalent of the US dollar book basis, both remeasured at the current exchange rate. Consistent with ASC 740-10-25-3(f), deferred taxes should not be provided on the remaining difference that is attributable to changes in the exchange rate since the time of the asset's acquisition (i.e., the difference between the current exchange rate and the historical exchange rate at the date of the asset's acquisition). The temporary differences and the portion of the temporary difference that gives rise to deferred taxes are calculated as follows:

	Foreign currency		US dollar book basis	US dollar book basis in local currency (at current rate)
	Tax basis	Book basis before remeasurement		
Year 2				
Exchange rate: €5 = \$1 (no change in 20X1 or 20X2)				
Cost	€5,000	€5,000	\$1,000	
Accumulated depreciation	<u>(2,000)</u>	<u>(1,000)</u>	<u>(200)</u>	
Tax/book basis	€ <u>3,000</u>	€ <u>4,000</u>	\$ <u>800</u>	€ <u>4,000</u>
Temporary difference	€1,000			
Recognized under ASC 740	€1,000			
Year 3				
Exchange rate: €7 = \$1				
Cost	€5,000	€5,000	\$1,000	
Accumulated depreciation	<u>(3,000)</u>	<u>(1,500)</u>	<u>(300)</u>	
Tax/book basis	€ <u>2,000</u>	€ <u>3,500</u>	\$ <u>700</u>	€ <u>4,000</u>
Temporary difference	€2,900			
Recognized under ASC 740	€1,500			

The temporary differences recognized under ASC 740 would be measured at the applicable foreign tax rate and remeasured into the functional currency (US dollar) at the current exchange rate.

In 20X3, there is a total temporary difference of €2,900. This is the difference between the tax basis of the asset and the future foreign currency revenues at the current exchange rate needed to recover the functional currency book basis. The temporary difference of €2,900 has arisen from two sources:

- The difference between US GAAP book depreciation in the foreign currency before remeasurement and tax depreciation. This element, which is a temporary difference of €1,500, is recognized under ASC 740. After applying the foreign tax rate to this temporary difference, the local currency deferred tax liability would be remeasured at the current exchange rate into US dollars for inclusion in the functional currency financial statements.
- The change in the exchange rate that changes the foreign currency equivalent of the functional currency book basis, using the current exchange rate. In this example, it increases the temporary difference by €1,400, (€4,900 vs. €3,500). This element is not recognized in the financial statements under the exception of ASC 740-10-25-3(f).

13.5.2 *Deferred taxes on foreign monetary assets and liabilities*

An entity located and taxed in a foreign jurisdiction that has the US dollar as its functional currency may have monetary assets and liabilities denominated in the local currency. When there is a difference between the local currency tax basis and the local currency US GAAP book basis, a temporary difference would be recognized in the financial statements. The local currency is typically the currency used to prepare the income tax return in the foreign jurisdiction. When the monetary item is

denominated in local currency, changes in exchange rates do not have tax consequences in the foreign jurisdiction and do not create basis differences between the local currency financial statement carrying amounts and the local currency tax basis provided that for local tax purposes, local currency is the functional currency. While the effects of changes in the exchange rate would give rise to transaction gains or losses in the functional currency financial statements, the resulting change in the functional currency financial statement carrying amounts generally will not result in the recognition of either current or deferred taxes in the foreign jurisdiction.

However, such an entity may have monetary assets and liabilities that are denominated in currencies other than the local currency, such as US dollar denominated items. Gains or losses from such foreign currency transactions may be taxable either in the local country or in a foreign country based on the applicable tax law. If these gains and losses are included in taxable income in a period that differs from the period in which they are included in income for financial reporting purposes, a deferred tax liability or asset would need to be recorded.

A common example is a foreign subsidiary's intercompany payables denominated in US dollars. If the entity will be taxed on the difference between the original foreign currency asset or liability and the amount at which it is ultimately settled, there would be a temporary difference for the monetary asset or liability. That difference would be computed by comparing the book basis in the local currency (i.e., the carrying amount in US dollars in the remeasured financial statements translated into the local currency at the current exchange rate) with the tax basis in the local currency. After application of the applicable tax rate to the temporary difference, the deferred tax would be remeasured at the current exchange rate into US dollars for inclusion in the functional currency financial statements.

This process will cause a deferred tax asset or liability to be recognized as the exchange rate (between the foreign currency and local currency) changes. Accordingly, changes in the exchange rate between the US dollar and the local currency can give rise to a deferred tax, even though there is no pretax exchange rate gain or loss in the functional currency financial statements. In some jurisdictions, changes in the exchange rate would have current tax consequences, as illustrated in Example TX 13-2.

EXAMPLE TX 13-2

Foreign subsidiary with US dollar functional currency and unrealized foreign exchange gains/losses on intercompany loans

Company P is a multinational company domiciled in the US with a wholly-owned subsidiary ("Sub") in Country B where the local currency is the euro. Company P prepares US GAAP consolidated financial statements in US dollars. Sub has concluded that its functional currency is also the US dollar, and, therefore, has decided to maintain its books and records in US dollars. Thus, Sub has no need to remeasure its assets, liabilities, revenues, and expenses from local currency to some other functional currency for financial reporting purposes. However, under the provisions of the tax law in Country B, Sub must file its tax return in local currency, the euro. Sub has a US dollar-denominated intercompany payable to Company P in the amount of \$30 million.

The tax law of Country B recognizes gains and losses from foreign currency-denominated receivables and payables only upon settlement (i.e., unrealized gains and losses are not included in taxable income until the period in which the asset or liability settles and the gain or loss becomes realized). Since the intercompany loan is denominated in US dollars, there is no pre-tax accounting under ASC 830 for unrealized transaction gains/losses at each reporting date. However, for purposes of Sub's tax filing in

local currency, foreign exchange gains/losses will be reported on the tax return when the liability is settled.

Do the unrealized foreign exchange gains/losses result in a temporary difference under ASC 740?

Analysis

Yes. The unrealized foreign exchange gains/losses that are not currently taxable will be taxable when the liability is settled. Therefore, unrealized foreign exchange gains/losses that arise upon remeasurement of the intercompany loan to local currency for tax reporting purposes should be treated as a temporary difference.

An understanding of the applicable tax law in the relevant jurisdiction is important in determining the accounting for the income tax effects of such unrealized gains/losses. In this particular fact pattern, the tax law of Country B requires that such gains/losses be included in taxable income in the period in which the liability is settled. In some jurisdictions, however, the law instead would require taxation when the exchange gains/losses arise. In those circumstances, because the tax effects would be incurred and recognized as part of each period's current tax provision, a temporary difference would not exist and a deferred tax asset/liability would not be required.

13.6 Tax accounting—change in functional currency

The US federal income tax law concept of functional currency is rooted in the financial accounting concept. IRC Section 985 allows functional currency for US tax purposes to be determined in accordance with financial accounting in certain circumstances. Nonetheless, the timing of the recognition of the effects of a change can differ for book and tax purposes. For US federal tax purposes, a change in functional currency is a change in accounting method. The resulting adjustments generally are computed as of the last day of the taxable year prior to the year of change. However, there are certain circumstances where a change in functional currency occurs during the taxable year and the resulting adjustments are made the day before the effective day of the change. Depending on the circumstances, tax adjustments may include recognition of exchange gains or losses and the effects on the tax basis of assets and liabilities. Such adjustments may have direct tax consequences (e.g., branch operations) or the effects may only arise through E&P adjustments (e.g., foreign subsidiaries).

Refer to FX 3.3 for guidance on the financial statement accounting for a change in functional currency.

13.6.1 Tax accounting—highly inflationary economies

A currency in a highly inflationary economy is not considered stable enough to serve as a functional currency. As a result, ASC 830 requires that a foreign entity in a highly inflationary economy change its functional currency to the reporting currency. Generally, we believe the reporting currency is the functional currency of the entity's immediate parent (see FX 6.3). This may have the effect of discontinuing the recording of CTA and instead recording gains and losses on monetary assets and liabilities in earnings. Translation adjustments from prior periods are not removed from equity and the translated amount for nonmonetary assets at the end of the prior period become the accounting bases of those assets upon transition.

When the functional currency is the reporting currency, ASC 740-10-25-3(f) prohibits recognition of deferred tax effects that result from indexing, for tax purposes, assets and liabilities that are

remeasured into the reporting currency using historical exchange rates. Deferred tax effects that were recognized for indexing before the change in functional currency to the reporting currency are eliminated when the related indexed amounts are realized as deductions for tax purposes.

Prospectively, deferred tax assets should not be recorded for future indexation consistent with the prohibition in ASC 740-10-25-3(f). Thus, tax effects attributable to any such indexing that occurs after the change in functional currency to the reporting currency are recognized when realized on the tax return.

13.6.2 Tax accounting—economy no longer highly inflationary

When an economy is no longer highly inflationary and, as a result, the local currency is reinstated as the functional currency, existing balances in the reporting currency are translated at the current exchange rate at the date of change. The translated amounts become the new functional currency bases going forward. The effects of future exchange rate movements are reflected through the overall consolidation process.

When the reporting currency is the functional currency, ASC 740 does not permit the recording of deferred taxes for the portions of the temporary differences that result from the remeasurement of nonmonetary items and from tax indexing. However, once ASC 830-10-45-15 has been applied, these portions become part of the temporary differences between the new functional currency bookbases of nonmonetary items and their tax bases adjusted for any indexing. The temporary differences for nonmonetary items are not changed, but the ASC 740 exception for portions of the differences no longer applies. As such, there is likely to be an effect on deferred taxes even though there is no effect of the change in functional currency on the consolidated carrying amount of nonmonetary items. ASC 830-740-45-2 requires that deferred taxes associated with the temporary differences that arise from a change in functional currency when an economy ceases to be considered highly inflationary are reflected in CTA.

13.7 Tax effects of hedging an investment in a foreign subsidiary

A parent company may designate either a derivative instrument or a non-derivative instrument (e.g., a foreign currency denominated loan) as a hedge of its net investment in a foreign subsidiary. Any gains or losses associated with this designated hedge are recognized in CTA under ASC 815-35-35-1. Refer to FX 4.4.3 for further information regarding foreign currency transaction gains and losses not recognized in the income statement.

Consistent with the treatment of gains and losses associated with the designated hedge, the tax effects of temporary differences created by this designated hedge generally are credited or charged to CTA under ASC 830-30-45-21 and ASC 740-20-45-11(b). Unlike indefinitely reinvested earnings of a foreign subsidiary, the instrument serving as the hedging instrument may be owned by the group parent and thus subject to tax in the parent's US return. Thus, the parent should provide for the tax effects of any temporary differences resulting from the designated hedge because the instrument used to hedge will have tax consequences upon its settlement (or at the end of the taxable year if the hedge is subject a mark-to-market method of accounting).

In such situations, a deferred tax asset or liability would be recognized on any unrealized gains or losses associated with the hedging instrument, with corresponding entries for CTA. A resulting deferred tax asset would be assessed for realizability, particularly giving consideration to whether the

hedging instrument would give rise to a capital loss. The net tax effects of the hedging instrument would remain in CTA until the investment in the foreign entity was sold or completely or substantially liquidated. At that time, the remaining net tax effects of the hedging instrument within CTA would be reversed and a corresponding tax expense or benefit would be recorded in continuing operations.

13.8 *Tax accounting—intercompany loan with foreign subsidiary*

Often, parent entities have intercompany loans with their foreign subsidiaries that are of a long-term investment nature (that is, settlement is not planned or anticipated in the foreseeable future, as discussed in ASC 830-20-35-3(b)). Typically, these loans are either denominated in the functional currency of the parent or the functional currency of the subsidiary. Because of the difference between the functional currencies and the denomination of the loan, foreign currency translation adjustments arise. In general, currency gains and losses relating to intercompany loans are included in consolidated earnings. However, gains and losses on the remeasurement of loans that are designated as long-term are reclassified to CTA in consolidation. Consideration must be given to whether deferred taxes should be recorded on the gains and losses included in translation adjustments, particularly in light of any assertion of indefinite reversal under ASC 740-30-25-17. Consider Example TX 13-3.

EXAMPLE TX 13-3

Deferred taxes on the foreign currency gains and losses reported in CTA

Company X is a US multinational corporation and has several outstanding intercompany loans with one of its wholly-owned foreign subsidiaries, Subsidiary Y. The functional currency of Subsidiary Y is the local currency. Company X has asserted that the loans are of a long-term investment nature. Therefore, foreign currency gains and losses related to the loans are reported in CTA in the consolidated financial statements under ASC 830-20-35-3(b).

The intercompany loans can be divided into the following two categories:

- Loans denominated in the functional currency of the parent for which Subsidiary Y bears the currency risk.
- Loans denominated in the functional currency of Subsidiary Y for which the parent bears the currency risk.

Company X asserts and meets the indefinite reversal criteria under ASC 740-30-25-17 for its investment in Subsidiary Y.

Should deferred taxes be provided on the foreign currency gains and losses related to the loans and reported in CTA?

Analysis

ASC 830-30-45-21 states that translation adjustments should be accounted for in the same way that temporary differences are accounted for under the provisions of ASC 740, except for translation adjustments related to foreign subsidiaries when deferred taxes are not provided on unremitted earnings under the indefinite reversal exception in ASC 740-30-25-17.

Loans denominated in the functional currency of Subsidiary Y

The intercompany loans and the related gains and losses on the loans denominated in the functional currency of Subsidiary Y (the local currency) should be viewed as a part of Company X's net investment in Subsidiary Y (i.e., outside basis). The tax effects should be evaluated under the governing principles of the indefinite reversal criteria in ASC 740-30-25-17. Accordingly, if Company X is able to meet the indefinite reversal criteria under ASC 740-30-25-17, a deferred tax liability would not be recorded for a book-over-tax outside basis difference.

Loans denominated in the functional currency of the parent

The gains and losses on intercompany loans denominated in the functional currency of Company X create a difference between the book basis and tax basis of the intercompany payable on Subsidiary Y's books (i.e., inside basis difference). Deferred taxes should generally be provided on these types of temporary differences, and the tax benefit or expense should generally be recorded in CTA, subject to the intraperiod allocation rules of ASC 740-20. However, as the parent is asserting indefinite reversal of its outside basis difference in Subsidiary Y under ASC 740-30-25-17, it may be appropriate in limited circumstances not to record deferred taxes on the temporary differences related to the cumulative translation adjustments pursuant to ASC 830-30-45-21. This approach would be acceptable if the ultimate taxation of the foreign currency effects of the loan only occur upon repayment and if settlement is not planned or anticipated in the foreseeable future. Importantly, if any actions other than a cash remittance or repatriation could cause the foreign currency effects of the loan to become taxable, Company X would need to consider whether the taxable event can, in fact, be deferred indefinitely. Such actions might include modifying the terms of the loan or recapitalizing a portion of it.

In addition, any temporary difference resulting from an excess of tax-over-book outside basis difference would need to be evaluated under ASC 740-30-25-9. Under that guidance, a deferred tax asset is recorded only if it is apparent that the temporary difference will reverse in the foreseeable future.

Management's stated intentions used to determine the appropriate accounting for US GAAP purposes should be consistent with those used to determine the appropriate tax treatment. If for accounting purposes management asserts that the debt is renewed at maturity and, therefore, is of a long-term investment nature, that assertion must be considered in assessing the relevant tax law treatment of the transaction.

13.9 Intraperiod tax allocation to CTA

Some transaction gains and losses (ASC 830-20-35-3) and all translation adjustments are recorded directly in CTA. ASC 830-30-45-21 requires the tax effects of these items to be allocated to CTA.

With respect to deferred taxes provided by a parent or investor for the outside basis temporary difference, the method of allocating deferred taxes between continuing operations and other items must be considered. As indicated in ASC 740-20-45-14, the allocation of tax effects to two or more items other than continuing operations must follow certain procedures.

Although several alternatives exist, one logical method of allocation is set forth below. For simplicity of discussion, it should be assumed that (1) the only sources of change in the outside basis difference

during the year are continuing operations and translation adjustments for the year, and (2) no remittance or other recovery of the parent's investment has occurred during the year. It is also assumed that there is no current or deferred taxes in the local jurisdiction.

1. Compute the total deferred tax provision for the year. This would be the difference between (a) the required year-end deferred tax liability at enacted tax rates and current exchange rates, utilizing available credits, and (b) the beginning-of-year deferred tax liability.
2. Compute the charge to continuing operations. This consists of the following components:
 - a. The deferred taxes related to the current year's continuing operations at average exchange rates for the year (i.e., the rate used in translating the income statement).
 - b. The change in the deferred tax asset/liability resulting from changes in tax laws or rates and the portion of a change in the valuation allowance that results from a change in judgment about the realizability of the related deferred tax asset in future years.
3. The differential (1 less 2 above) represents (in the absence of any other items except continuing operations) the charge (or credit) to CTA. This computation will require appropriate consideration of foreign withholding taxes and limitations on utilization of foreign tax credits.

TX 12 offers a comprehensive discussion of intraperiod allocations.

***Chapter 14:
Separate financial statements
of a subsidiary***

14.1 Chapter overview—separate financial statements of subsidiary

Intercorporate (or intra-entity) tax allocation (i.e., allocating income taxes to entities within a consolidated tax group) involves related parties and typically results from an expressed or implied agreement among the parties concerning the allocation of taxes currently payable. It is not uncommon for intercorporate tax-allocation agreements to be inconsistent with arrangements that might have been derived on an arm's-length basis. ASC 850, *Related Party Disclosures*, recognizes that a subsidiary does not independently control its own actions and that most related-party transactions, including intercorporate tax allocations, might have been structured differently if the subsidiary had not been a controlled entity.

14.2 Allocation of consolidated income tax expense

ASC 740-10-30-27 requires that the consolidated amount of current and deferred tax expense for a group that files a consolidated tax return be allocated among the group members when those members issue separate financial statements. See TX 14.5 for a discussion of additional considerations for allocating income tax expense to single-member and multiple-member LLCs. Further, the method adopted must be systematic, rational, and consistent with the broad principles of ASC 740. Typically, the same method should be used to allocate tax expense to each member of the consolidated tax group. However, depending on the individual facts and circumstances, it may be acceptable to use more than one allocation method for different subsidiaries in a consolidated group.

While ASC 740-10-30-27 does not require the use of any single allocation method, it does indicate that the following methods are inconsistent with the broad principles of ASC 740:

- A method that allocates only current taxes payable to a member of the group that has taxable temporary differences
- A method that allocates deferred taxes to a member of the group using a method fundamentally different from its asset and liability method
- 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

14.2.1 Separate return method

Under ASC 740-10-30-27, it is acceptable to use a method that allocates current and deferred taxes to members of the group by applying ASC 740 to each member as if it were a separate taxpayer. In SEC Staff Accounting Bulletin (SAB) Topic 1 question 3, which discusses financial statements included in registrations of initial public offerings, the SEC staff states its belief that the separate return basis is the preferred method for computing the income tax expense of a subsidiary, division, or lesser business component of another entity included in consolidated tax returns. According to SAB Topic 1B, when the historical income statements do not reflect the separate return basis, pro forma income statements reflecting a tax provision calculated on the separate return basis is required.

Under the separate return method, the subsidiary is assumed to file a separate return with the taxing authority, thereby reporting its taxable income or loss and paying the applicable tax to or receiving the appropriate refund from the parent. Thus, it is possible that the subsidiary could recognize a loss or

credit carryforward, even though there is no carryforward on a consolidated basis (i.e., they were used by the parent). Additionally, when the tax law in the jurisdiction provides for the carryback of losses, the subsidiary could reflect the carry back of a current-year loss against prior taxable income even though the consolidated group had losses.

When the separate return method is used to allocate the current and deferred tax expense or benefit for a group that files a consolidated return, the subsidiary's current provision would be the amount of tax payable or refundable based on the subsidiary's hypothetical, current-year separate return. After computing its current tax payable or refund, the subsidiary should provide deferred taxes on its temporary differences and on any carryforwards that it could claim on its hypothetical return. The subsidiary should also assess the need for a valuation allowance on the basis of its projected separate return results. The assessment should include tax-planning strategies that are prudent and feasible.

ASC 740-10-30-27 acknowledges that if the separate return method is used, the sum of the amounts reported by individual members of the group may not equal the consolidated amount. For example, one member might generate deferred tax assets for which a valuation allowance would be required if that member were a separate taxpayer. However, a valuation allowance may not be needed when the assessment is made from the standpoint of the consolidated group. Similarly, the sum of amounts determined for individual members may not equal the consolidated amount as a result of intercompany transactions.

14.2.2 Benefits-for-loss

Entities may modify the separate return approach for the assessment of deferred tax asset realizability. A "benefits-for-loss" approach modifies the separate return method so that current or deferred tax assets are characterized as realized (or realizable) by the subsidiary when those tax assets are realized (or realizable) by the consolidated group, even if the subsidiary would not otherwise have realized them on a stand-alone basis. Thus, when the benefit of the current or deferred tax asset is recognized in the consolidated financial statements, the subsidiary would generally reflect a benefit in its financial statements. We believe the benefits-for-loss approach complies with the criteria in ASC 740-10-30-27.

Application of this policy may be complicated when the consolidated group requires a valuation allowance on its deferred tax assets. To comply with the criteria in ASC 740, the policy should not be applied in a manner that results in either current or deferred tax benefits being reported in the separate subsidiary financial statements that would not be considered realizable on a consolidated basis unless such benefits are realizable on a stand-alone basis.

While not a pre-requisite, oftentimes the benefits-for-loss policy mirrors the tax-sharing agreement between the parent and the subsidiary. To the extent that the consolidated return group settles cash differently than the amount reported as realized under the benefits-for-loss accounting policy, the difference should be accounted for as either a capital contribution or as a distribution (see TX 14.3). Example TX 14-1 addresses considerations when the current or deferred taxes utilized by the parent differs from those at the separate company level.

EXAMPLE TX 14-1

Determining the separate company tax provision when the benefits-for-loss approach is used

Company A has two subsidiaries, Company X and Z, that comprise all the operations of the consolidated company. Company X and Company Z are part of Company A's consolidated tax return.

Both subsidiaries have previously generated NOL carryforwards of \$1,000 each that have not yet been used by the parent. Company Z issues its own financial statements and uses the separate return method modified for the “benefits-for-loss” approach. In the current year, Company X generated losses of \$100 and Company Z generated income of \$250. On a consolidated basis, the company will have net taxable income of \$150 and will utilize NOL carryforwards to offset the taxable income. The parent will pay each subsidiary for the NOLs utilized at the consolidated level by applying a formula outlined in the tax sharing agreement. In accordance with that agreement, Company X received \$100 and Company Z received \$50 for their NOLs, respectively.

In determining the current and deferred tax provision for Company Z in its separate company financial statements, how much of the NOL should be recognized by Company Z?

Analysis

Company Z should recognize current taxes of zero and a decrease to its NOL DTA of \$250. Even though on a consolidated basis the carryforward being utilized related to Company Z is only \$50 based on the tax sharing agreement, Company Z on a stand-alone basis has sufficient taxable income to realize \$250 of NOLs. Although the tax sharing agreement provides a lower cash settlement, it would not be consistent with ASC 740 to reflect an income tax expense at the subsidiary level when sufficient NOL carryforwards exist to offset the subsidiary’s taxable income. Therefore, any difference between the NOL realized by the subsidiary and the NOL utilized in consolidation and settled by the parent is accounted for in equity.

14.3 Tax allocation versus tax-sharing arrangements

If a tax-sharing agreement differs from the method of allocation under ASC 740-10-30-27, the difference between the amount paid or received under the tax-sharing agreement and the expected settlement amount based on the method of allocation is treated as a dividend (i.e., when less cash was received or more cash was paid by the subsidiary than would have been expected under the method of tax allocation) or a capital contribution (i.e., when more cash was received or less cash was paid by the subsidiary than would have been expected under the method of tax allocation). For example, a single-member limited liability company (LLC) that presents a tax provision on the separate return basis, but is not required to remit cash to the parent for any amounts payable, should characterize the amounts payable as a capital contribution (because less cash was paid than would have been expected under the allocation method). A single-member LLC should also characterize the amounts payable or receivable as a capital contribution or dividend if the parent decides not to collect tax from or reimburse a subsidiary under a tax-sharing arrangement that would otherwise require settlement. Example TX 14-2 illustrates the accounting for differences between the tax-allocation method and tax-sharing arrangement.

EXAMPLE TX 14-2

Differences between amounts expected under a tax-allocation method and amounts settled under the tax-sharing arrangement

A subsidiary that prepares separate company financial statements is included in the consolidated tax return of the parent. The subsidiary uses the separate return method to determine income taxes in its stand-alone financial statements. Under the tax-sharing arrangement, the subsidiary pays taxes to or receives tax refunds from the parent based on the separate return method. When the subsidiary

generates operating losses that are carried back to offset tax liabilities on the consolidated tax return, the parent establishes an intercompany account to the subsidiary in lieu of remitting cash.

In 20X1, the subsidiary generated operating losses that resulted in a \$100 million receivable from the parent because the subsidiary reported that, under the separate return method, the operating losses were being carried back to taxable income from prior years. The parent decided that it will not cash-settle the intercompany account with the subsidiary.

How should this decision be recorded in the subsidiary's separate company financial statements?

Analysis

The decision by the parent not to cash-settle the subsidiary's intercompany receivable should be recorded as a dividend in the separate financial statements of the subsidiary. In essence, the parent has amended the tax-sharing arrangement with the subsidiary. The excess of the expected settlement amount based on the method of allocation (\$100 million) over the actual settlement amount under the amended tax-sharing arrangement (\$0) should be recorded in equity.

14.3.1 Tax sharing agreement—settlement of temporary differences

A tax-sharing agreement may call for settlement of a separate reporting entity's deferred tax assets and liabilities. This type of agreement may lead to a question about whether it is appropriate for the separate reporting entity to derecognize the deferred tax assets and liabilities that are settled under the tax-sharing agreement.

Derecognition of deferred tax assets and liabilities related to temporary differences is inconsistent with the broad principles of ASC 740. This is because a basis difference continues to exist at the separate reporting entity even after the separate reporting entity is paid by, or makes a payment to, its parent to settle the deferred tax assets and liabilities. However, if the tax-sharing agreement requires the parent to pay the separate reporting entity for the tax benefits of net operating losses or other tax attributes unrelated to temporary differences of the separate reporting entity's assets and liabilities, we believe it is acceptable for the separate reporting entity to derecognize those settled attributes in its separate financial statements.

14.4 Change in tax allocation policy

Because ASC 740 prescribes criteria that an intra-entity tax-allocation policy must meet to be considered acceptable under US GAAP, a change in tax-allocation policy is considered a change in accounting principle. Therefore, the change must be preferable. Companies need to follow the guidance in ASC 250, *Accounting Changes and Error Corrections*, which requires a retrospective application of changes in accounting policies. Question TX 14-1 addresses whether a change in a company's tax-sharing agreement requires a change in its tax-allocation policy.

Question TX 14-1

Is a company required to change its tax-allocation policy to the extent there is a change to its tax-sharing arrangement?

PwC response

No. The tax-sharing arrangement is a legal agreement among the members of the consolidated return group. While this agreement typically reflects how cash is to be settled among the parties, it does not necessarily impact the amount of tax expense or benefit that would be reported in a subsidiary's separate company financial statements. Allocating taxes in separate company financial statements is an accounting policy. While there may be a relationship between the tax allocation method selected and the tax-sharing agreement, the two are independent of one another. Therefore, a company can change its tax-sharing arrangement without requiring a change to its tax-allocation policy.

14.5 *Single-member and multiple-member LLCs****New guidance***

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. This guidance removes certain exceptions to the general principles of ASC 740 and simplifies several other areas. ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. If an entity chooses to early adopt, it must adopt all changes as a result of the ASU. The transition provisions vary by amendment.

One of the amendments within ASU 2019-12 specifies that an entity is not required to allocate income tax provision to a legal entity that is both not subject to tax and disregarded by the taxing authority, but an entity may elect to do so. This accounting policy election can be applied on an entity-by-entity basis even if the separate entities are included in the same consolidated income tax return. This amendment should be applied on a retrospective basis for all periods presented. See TX 14.5.1A for applicable guidance before adoption of ASU 2019-12.

14.5.1 *Single-member and multiple-member LLCs (after adoption of ASU 2019-12)*

Questions often arise regarding how single-member and multiple-member LLCs should account for income taxes in their separate financial statements. ASC 272, *Limited Liability Entities*, provides some guidance for accounting for LLCs. ASC 272-10-05-4 indicates that LLCs are similar to partnerships in that members of an LLC are taxed on their respective shares of the LLC's earnings (rather than the entity itself). Therefore, multiple-member LLCs generally do not reflect income taxes if they are taxed as partnerships (i.e., a partnership tax return is filed and the investors each receive a K-1) and are not otherwise subject to state or local income taxes. However, if a multiple-member LLC is subject to state or local income taxes (certain states impose income taxes on LLCs) the entity would be required to provide for such taxes in accordance with ASC 740. This approach would apply irrespective of whether the members are part of the same consolidated group or not.

Single-member LLCs may be accounted for differently. The US federal tax law provides an election for single-member LLCs to be taxed as either associations (i.e., corporations) or “disregarded entities.” If the election is made to be taxed as an association, there is no difference between classification as a single-member LLC and a wholly owned C corporation for US federal income taxes. If a single-member LLC does not specifically “check the box” and elect to be taxed as an association, it is automatically treated as a disregarded entity. This means that for US federal income tax purposes, single-member LLCs are accounted for as divisions of the member and do not file separate tax returns.

ASC 740-10-30-27A provides an accounting policy election for allocating consolidated income tax provision to entities that are both not subject to tax and disregarded by the taxing authority (e.g., single-member LLCs that did not “check the box” to elect to be taxed as an association).

ASC 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.

The separate financials of a single-member LLC should disclose if it elects to record a tax provision. The accounting policy should be applied consistently from period to period. In addition, single-member LLCs that present a tax provision should also include disclosures consistent with those required by ASC 740-10-50-17 (discussed in FSP 16.7.3).

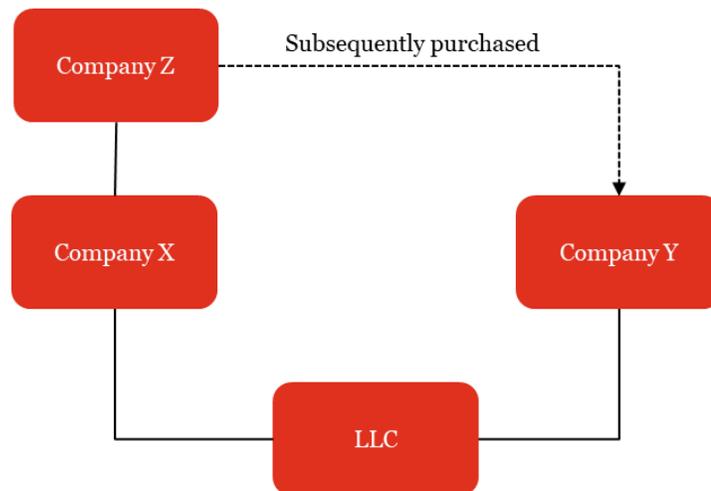
Example TX 14-3 illustrates the assessment of whether a wholly-owned multi-member LLC is an in-substance single-member LLC.

EXAMPLE TX 14-3

Determining whether a wholly-owned, multi-member LLC is an in-substance single-member LLC

An LLC is 50% owned by two parties, Company X and Company Y (both C corporations). Company X is owned by another C corporation, Company Z. The LLC’s separate company financial statements appropriately do not provide for income taxes because it is a multi-member LLC and thus a flow-through entity for tax purposes. In a subsequent purchase transaction, Company Y was acquired by Company Z. After the acquisition of Company Y by Company Z, the LLC is ultimately wholly-owned by Company Z.

The following depicts the organizational structure.



After the purchase is completed, should the LLC reassess its determination as to whether to provide taxes in its separate company financial statements?

Analysis

No. We believe that the determination of whether taxes should be provided in the LLC's separate financial statements should focus on whether the tax law considers the entity to be a flow-through entity. In this case, Company X and Company Y continue to retain their respective interests in the LLC. Therefore, the LLC is still considered a partnership for US federal income tax purposes, and the separate financial statements of the LLC should not include any provision for income taxes.

14.5.1A Single-member and multiple-member LLCs (before adoption of ASU 2019-12)

Questions often arise regarding how single-member and multiple-member LLCs should account for income taxes in their separate financial statements. ASC 272, *Limited Liability Entities*, provides some guidance for accounting for LLCs. ASC 272-10-05-4 indicates that LLCs are similar to partnerships in that members of an LLC are taxed on their respective shares of the LLC's earnings (rather than the entity itself). Therefore, multiple-member LLCs generally do not reflect income taxes if they are taxed as partnerships (i.e., a partnership tax return is filed and the investors each receive a K-1) and are not otherwise subject to state or local income taxes. However, if a multiple-member LLC is subject to state or local income taxes (certain states impose income taxes on LLCs) the entity would be required to provide for such taxes in accordance with ASC 740. This approach would apply irrespective of whether the members are part of the same consolidated group.

Single-member LLCs may be accounted for differently. The US federal tax law provides an election for single-member LLCs to be taxed as either associations (i.e., corporations) or "disregarded entities." If the election is made to be taxed as an association, there is no difference between classification as a single-member LLC and a wholly-owned C corporation for US federal income taxes. If a single-member LLC does not specifically "check the box" and elect to be taxed as an association, it is automatically treated as a disregarded entity. This means that for US federal income tax purposes, single-member LLCs are accounted for as divisions of the member and do not file separate tax returns.

How single-member LLCs account for income taxes in their separate financial statements depends in part on the character of the single member. For example, if the member was a C corporation, the earnings and losses of the LLC would automatically roll up into the member's corporate tax return, where they would be subject to tax at the corporate rate. From a US federal income tax perspective, there is no substantive difference between a single-member LLC that is treated as a disregarded entity and a division that is included in the consolidated tax return. In these situations, we believe that presenting a tax provision in the separate financial statements of a single-member LLC is the preferred accounting policy election.

Conversely, if the single member was a partnership, the earnings and losses of the LLC would automatically roll up into the member's partnership return and be passed through to the individual partners. In these cases, we believe that the single-member LLC should not provide income taxes in its separate financial statements. In instances when the LLC is owned by a second single-member LLC, we believe the character of the member of the second LLC (for example, a C corporation or a partnership) should determine the presentation of income taxes in the separate financial statements of the lower-tier LLC.

The separate financials of all single-member LLCs should disclose the entity's accounting policy with regard to income taxes (i.e., whether a tax provision is recorded). The accounting policy should be applied consistently from period to period.

In addition, single members that present a tax provision should also include disclosures consistent with those required by ASC 740-10-50-17 (discussed in FSP 16.7.3). Single members that do not present a tax provision should consider including the following disclosures in their financial statements:

- The reasons why they chose an accounting policy not to record a tax provision (e.g., the single-member LLC is a disregarded entity for US federal and state tax purposes)
- Affirmation that no formal tax-sharing arrangement exists with the member
- A description of any commitments the single-member LLC has to fund any tax liability of the member with earnings of the LLC

The single-member LLC may also want to consider providing pro forma information reflecting the impact on its financial statements had it recorded a tax provision.

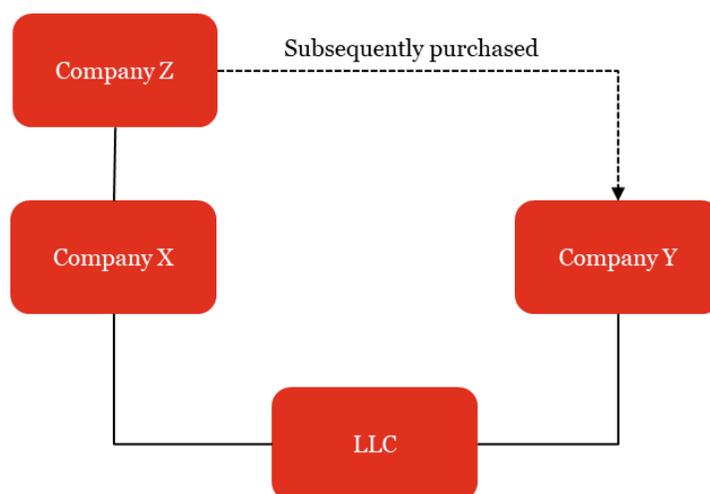
Example TX 14-3A illustrates the assessment of whether a wholly-owned multi-member LLC is an in-substance single-member LLC.

EXAMPLE TX 14-3A

Determining whether a wholly-owned, multi-member LLC is an in-substance single-member LLC

An LLC is 50% owned by two parties, Company X and Company Y (both C corporations). Company X is owned by another C corporation, Company Z. The LLC's separate company financial statements appropriately do not provide for income taxes because it is a multi-member LLC and thus a flow-through entity for tax purposes. In a subsequent purchase transaction, Company Y was acquired by Company Z. After the acquisition of Company Y by Company Z, the LLC is ultimately wholly-owned by Company Z.

The following depicts the organizational structure.



After the purchase is completed, should the LLC reassess its determination as to whether to provide taxes in its separate company financial statements?

Analysis

No. We believe that the determination of whether taxes should be provided in the LLC's separate financial statements should focus on whether the tax law considers the entity to be a flow-through entity. In this case, Company X and Company Y continue to retain their respective interests in the LLC. Therefore, the LLC is still considered a partnership for US federal income tax purposes, and the separate financial statements of the LLC should not include any provision for income taxes

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. This guidance specifies that an entity is not required to allocate income tax provision to a legal entity that is both not subject to tax and disregarded by the taxing authority, but an entity may elect to do so. See TX 14.5 and TX 14.5.1 for additional information on ASU 2019-12, including effective dates, transition requirements, and post-adoption guidance.

14.6 Parent-subsidiary basis differences

ASC 740-20-45-11(g) addresses the way an entity should account for the income tax effects of transactions among or with its shareholders. It provides that the tax effects of all changes in tax bases of assets and liabilities caused by transactions among or with shareholders should be included in equity. In addition, if a valuation allowance was initially required for deferred tax assets as a result of a transaction among or with shareholders, the effect of recording such a valuation allowance should also be recognized in equity. However, changes in the valuation allowance that occur in subsequent periods should be included in the income statement. Refer to TX 12 for further discussion of intraperiod tax allocation.

For example, ASC 740-20-45-11(g) would apply in the separate financial statements of an acquired entity that does not apply pushdown accounting to a transaction in which an investor entity acquires 100% of its stock (i.e., a nontaxable transaction). See TX 10 and BCG 10.1 for further discussion on pushdown accounting. If, for tax purposes, this transaction is accounted for as a purchase of assets (e.g., under IRC Section 338(h)(10)), there would be a change in the tax bases of the assets and liabilities. However, because the purchase accounting impacts are not pushed-down to the separate financial statements of the acquired entity for book purposes, there would be no change in the carrying value of the acquired entity's assets and liabilities. In this situation, both the impacts of the change in tax basis and any changes in the valuation allowance that result from the transaction with shareholders would be recognized in equity. However, changes in the valuation allowance that occur in subsequent periods should be included in the income statement.

Example TX 14-4, Example TX 14-5, Example TX 14-6, Example TX 14-7, and Example TX 14-8 illustrate the accounting for the tax impacts of various transactions among or with shareholders on separate historical financial statements.

EXAMPLE TX 14-4

Interaction of pushdown accounting and deferred taxes on a subsidiary's separate financial statements

Company A purchased Company B's stock in a transaction accounted for as a taxable business combination (i.e., an asset purchase for tax purposes) as a result of an election under IRC Section 338(h)(10). The value of the assets acquired for book and tax are equal. Company B is required to issue separate company financial statements. Company B uses the separate return method to record taxes in its separate financial statements.

Company B has the choice of whether or not to apply pushdown accounting in accordance with ASC 805-50-25-4. Regardless of whether or not pushdown accounting is applied, the tax basis in goodwill would be stepped up as a result of the asset purchase. Thus, Company B will enjoy the benefit of the amortization of the tax basis in goodwill.

Should Company B record deferred taxes related to goodwill (which is equal for book and tax purposes on a consolidated basis at the time of the business combination) in its separate financial statements if Company B (1) applies pushdown accounting, or (2) does not apply pushdown accounting?

Analysis

Scenario 1—Pushdown accounting

No. Deferred taxes related to goodwill would not be recognized at the date of acquisition. Company B would reflect book goodwill at the amount that is pushed down. In this example, the book pushdown amount would equal tax goodwill and, thus all goodwill would be classified as component 1 goodwill (as described in ASC 805-740-25-8 through ASC 805-740-25-9). Assuming no goodwill impairment is recognized for book purposes, goodwill would be amortized and deducted for tax purposes creating a book over tax difference on the component 1 goodwill over time, for which a deferred tax liability would be recorded.

Scenario 2—No pushdown accounting

Yes. Deferred taxes related to goodwill should be recognized at the date of acquisition. Company B would not record book goodwill in its separate financial statements. However, the tax basis created on the tax-deductible goodwill as a result of the election to treat the business combination as an asset purchase would be attributable to Company B and should be reflected in Company B's separate financial statements.

ASC 740-20-45-11(g) indicates that the effects of "all changes in the tax bases of assets and liabilities caused by transactions among or with shareholders shall be included within equity." Accordingly, Company B would report an increase to contributed capital by the amount of the DTA initially recorded relating to the excess of tax over book basis in goodwill. In subsequent periods, changes to the DTA resulting from amortization of the goodwill for tax purposes would be reported as a component of deferred tax expense in the income statement, which would offset the current tax benefit attributable to the amortization of goodwill, resulting in no impact on the effective tax rate.

EXAMPLE TX 14-5

Accounting for the income tax effect of a taxable distribution by a subsidiary to its parent on the subsidiary's separate financial statements

Company A owns 100% of Company B. Company B makes a taxable distribution of appreciated property to Company A. In Company B's separate financial statements, the distribution is recorded for GAAP purposes at book value and reflected as a distribution to Company A; as such, no gain is recognized for book purposes. However, Company B is taxed in its jurisdiction on the excess of the distributed property's fair value over its tax basis.

How should the tax effect of this transaction be reflected in the separate financial statements of Company B?

Analysis

ASC 740-20-45-11(c) states that the tax effects of an increase or decrease in contributed capital should be charged or credited to shareholders' equity. Accordingly, in the example above, Company B should reflect the tax effects of the transaction as a reduction of paid-in capital. The application of ASC 740-20-45-11 should be made from the perspective of the reporting entity (Company B).

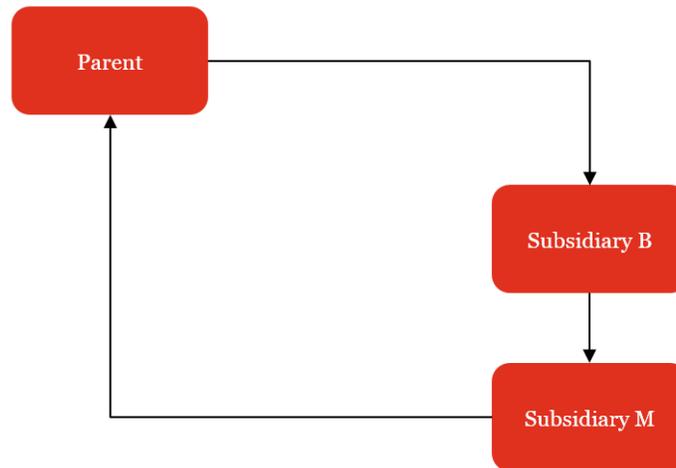
EXAMPLE TX 14-6

Accounting in separate company financial statements for the tax consequences of a transfer of shares that results in a gain for tax purposes

Parent owns 100% of the stock of Subsidiary B, which in turn owns 100% of Subsidiary M. Parent and subsidiaries B and M fall within the same tax jurisdiction (US). Subsidiary B prepares separate company financial statements using the separate return method. Parent files a US consolidated tax return that includes subsidiaries B and M.

Subsidiary B distributes the stock of Subsidiary M to Parent through a nonreciprocal transfer at book value. The book basis that Subsidiary B has in Subsidiary M's stock exceeds the tax basis of its investment, but is less than the fair value of the shares. The transfer of Subsidiary M by Subsidiary B triggers an IRC Section 311(b) tax gain, which is deferred for tax return purposes because the transfer

occurred within the consolidated tax group. On a consolidated basis, the gain will be recognized when Subsidiary B is no longer considered part of the consolidated group or upon the sale of Subsidiary M to a third party. A diagram of the organization and transfer follows:



Should Subsidiary B record the tax effects of this transaction in its separate company financial statements, even though the Section 311(b) gain is a deferred intercompany transaction on a consolidated tax basis?

Analysis

Yes. Under the separate return method, Subsidiary B must calculate the income tax effects of this transaction in accordance with ASC 740-10-30-27 as if it were a stand-alone entity. The transfer of Subsidiary M to Parent should be characterized as a transfer that would trigger recognition of the 311(b) gain on a separate return basis. However, because the transaction involves a shareholder, ASC 740-20-45-11 must also be considered.

The income tax consequence would be comprised of two components and would be accounted for as follows:

1. Difference between Subsidiary B's book and tax basis in Subsidiary M (i.e., the outside basis difference)

In many cases, Subsidiary B would have historically asserted that Subsidiary M would be divested in a tax-free manner. This is because Subsidiary M is a domestic subsidiary, and therefore a deferred tax liability would not have been previously recorded for the outside basis difference when the tax law provides a means in which the investment can be recovered tax-free and the entity expects that it will ultimately use that means (ASC 740-30-25-7). Because Subsidiary M was divested in a manner that was not tax-free, Subsidiary B must record the tax effects of any previously unrecognized outside basis difference through the income statement, with a corresponding liability recorded in the balance sheet. The effect of this change should be recognized in the income statement in the period during which Subsidiary B is no longer expected to recover the outside basis difference in a tax-free manner.

If a deferred tax liability had been previously recorded for the difference between the book basis and the tax basis related to Subsidiary B's investment in Subsidiary M, and if that deferred tax liability represented the actual tax consequence for the outside basis difference, no incremental tax consequence would need to be recognized in the income statement of Subsidiary B. Any differences between the deferred tax liability previously recorded on the outside basis difference and the actual tax rate applied to the outside basis difference would need to be recognized through the income statement in the period during which the expectation changed.

2. Difference between the fair value and book basis of the stock

To the extent that a tax liability is generated from Subsidiary B's transfer of Subsidiary M's shares to Parent, the portion of the tax liability related to the excess of fair value over book value should be accounted for as a direct charge to equity by analogy to ASC 740-20-45-11(g), which provides that "the tax effects of all changes in the tax bases of assets and liabilities caused by transactions among or with shareholders should be included in equity." This portion of the tax liability is not related to a previously unrecognized outside basis difference, but rather is considered an incremental tax effect of an equity restructuring between the company (Subsidiary B) and its shareholder (Parent).

The cash settlement of this liability depends on the terms of the intercompany tax-sharing agreement. If Subsidiary B will not be responsible for the tax due either currently or at some future date, the extinguishment of that liability is considered a capital contribution by Parent to Subsidiary B and should be recorded as a credit to equity.

EXAMPLE TX 14-7

Alternatives for recording a valuation allowance in purchase accounting in separate company financial statements

Company A acquired 95% of Company B's outstanding shares in a transaction in which the tax bases of Company B's assets and liabilities are not affected (i.e., carryover basis). Company B elected to apply pushdown accounting. Subsequent to the acquisition, Company B will be included in Company A's consolidated US federal income tax return. However, because Company B will continue to issue separate financial statements, Company B will need to elect an accounting policy for the allocation of current and deferred income tax expense in accordance with ASC 740-10-30-27. Company B elects the separate return method.

As part of acquisition accounting, Company A evaluated the need for a valuation allowance against the acquired US federal deferred tax assets related to Company B and has determined that, on a consolidated basis, the company will generate sufficient future taxable income to realize its DTAs and that no valuation allowance is necessary.

Company B has generated losses in the past and anticipates generating future losses. Accordingly, Company B has determined that, as a standalone taxpayer, it would require a full valuation allowance against its DTAs.

How should Company B account for the establishment of the valuation allowance against its DTAs in its separate financial statements?

Analysis

We believe that there are two acceptable alternatives that are consistent with a separate return method.

Alternative 1 – no adjustment to goodwill

Company B would record the valuation allowance as part of applying pushdown accounting (after considering, to the extent appropriate, any newly created deferred tax liabilities resulting from the acquisition), record the same amount of goodwill as the consolidated entity (with respect to the acquisition of Company B), and reflect the difference (essentially the effect of establishing the valuation allowance) in net equity. This methodology would result in an allocation of income taxes consistent with a separate return method and would also keep goodwill consistent between the entities. Supporters of this alternative believe that because pushdown accounting is generally considered a "top-down" concept, the purchase price allocation (including the resulting goodwill) should be the same for the subsidiary as it is for the consolidated entity.

Alternative 2 – adjustment to goodwill

Company B would record the valuation allowance as part of applying pushdown accounting with an offsetting increase in goodwill. This methodology would result in an allocation of income taxes consistent with a separate return method, but goodwill at Company B would be different than the goodwill related to Company B carried in the consolidated accounts. Proponents of this alternative believe that because the separate return method is intended to reflect the current and deferred tax consequences of the subsidiary's activities as if it was a separate taxpayer, the tax effects arising from the pushdown of the new book bases of assets and liabilities (including the resulting implications on the determination of recorded goodwill) should reflect the implications to the entity as a separate taxpayer. Supporters of this view also note that goodwill impairment testing should be done on a separate company basis as described in ASC 350-20-35-48, which, in some circumstances, could result in an impairment of goodwill at the subsidiary level, but not in consolidation or vice versa.

A similar question may arise when determining the appropriate tax rate for establishing deferred taxes in the separate financial statements of an acquired subsidiary. For example, when considering state deferred tax assets and liabilities in a separate company financial statement, there may be differences from the consolidated financial statement as a result of different state apportionment factors that would apply on a combined versus separate tax return basis. We believe the alternatives expressed above (adjustment to goodwill or no adjustment to goodwill) could also be applied to such a situation.

EXAMPLE TX 14-8**Deferred income tax effects of the acquisition of the noncontrolling interest in the consolidated and separate company financial statements of a pass-through entity**

Company A consolidates a multi-member LLC in which Company A owns a 70% equity interest. The LLC holds public debt and is therefore required to file separate financial statements with the SEC. In prior periods, income taxes have not been reflected in the LLC's financial statements because the LLC was a partnership for US federal tax purposes. In the current year, Company A acquires the 30% noncontrolling interest (NCI) for fair value. As a result, the LLC ceases to be a partnership, becomes a single-member LLC, and effectively converts to a taxable division of Company A for US federal income

tax purposes. The acquisition of the NCI is accounted for in equity with no change in the carrying amount of the assets and liabilities of the LLC.

For US federal income tax purposes, Company A is deemed to purchase the partnership assets proportionate to the acquired LLC interest (i.e., Company A is deemed to have acquired 30% of the partnership assets at fair value). Further, Company A is deemed to receive a distribution of partnership assets equal to its pre-existing equity interest (i.e., 70%). This creates a bifurcation of the partnership assets for tax purposes. The portion acquired through the purchase of the NCI is considered newly acquired, with tax basis equal to the price paid for the NCI. The assets deemed distributed would have carryover tax basis and lives.

- a) How should Company A account for the additional tax basis in the consolidated financial statements?
- b) How should the LLC account for the termination of its partnership tax status in the separate company financial statements?

Analysis

- a) There can be direct and indirect tax effects stemming from transactions with noncontrolling shareholders (see TX 10.9). All direct tax effects, net of valuation allowance, should be accounted for in equity in accordance with ASC 740-20-45-11(c), which is applicable when total equity is increased or decreased. Any indirect tax effects, such as a change in indefinite reinvestment assertion or valuation allowance assessment, would be recorded in continuing operations in the current period. In this fact pattern, the benefit from the tax basis step-up was achieved through application of the relevant tax law resulting from a transaction recorded in equity. Therefore, it is a direct tax effect that should be recorded in equity.
- b) The LLC was effectively converted from a pass-through entity to a single member LLC. Therefore, as discussed in TX 14.5, we believe the LLC should present current and deferred income taxes in the separate company financial statements beginning in the period in which the tax status changed (ASC 740-10-25-32). If the company has adopted ASU 2019-12, as noted in TX 14.5, the company should follow its policy election for allocating consolidated income tax expense to single-member LLCs. The separate company financial statements should disclose the policy election and apply it consistently from period to period. All tax effects from the conversion, including the initial recognition of deferred taxes, would be recognized in continuing operations (i.e., income tax benefit or expense for the period) in accordance with ASC 740-10-45-19.

14.7 *Uncertain tax positions in separate financial statements*

The accounting for uncertain tax positions in the separate financial statements of a member of a consolidated tax group is the same as the accounting applicable to the consolidated group. We believe the assumptions used for determining the unrecognized tax benefits in the separate financial statements of the group member should be consistent with those used in the consolidated financial statements. This is because the assumptions made by management of the consolidated group form the basis for the consolidated tax provision that is being allocated.

In addition, the separate financial statements of a member of a consolidated group should generally include disclosures related to the uncertain tax provisions. The level of disclosures, however, may vary depending on the tax allocation method.

Example TX 14-9 illustrates the accounting for uncertain tax positions in the separate financial statements of a carve-out entity.

EXAMPLE TX 14-9

Uncertain tax positions in the separate financial statements of a carve-out entity

Company A intends to sell a portion of its business to Company B in a transaction structured as an asset sale. The business to be sold (the “Carve-out”) does not comprise a separate legal entity. Financial statements for the Carve-out have not previously been prepared, but Company A will do so for the first time in conjunction with the transaction. The stand-alone financial statements will cover the three-year period ended December 31, 20X1.

In 20X1, Company A recorded a liability for unrecognized tax benefits related to certain deductions claimed on its income tax return but for which no benefit was recognized in the consolidated financial statements. The deductions in question arose from expenses incurred by the Carve-out and reflected in the Carve-out's stand-alone statement of operations. The liability for unrecognized tax benefits will remain with Company A subsequent to the sale of the Carve-Out to Company B. The Carve-out's tax accrual and provision will be prepared using the separate return method.

Should the Carve-out record any income tax benefit for the position taken on the consolidated tax return? If not, should the liability for unrecognized tax benefits be included in the Carve-out's separate financial statements?

Analysis

Because the tax position relates to the activities of the Carve-out, on a separate return basis the Carve-out would reach the same conclusion as Company A in the consolidated accounts. This is because the assumptions made by management at the consolidated level form the basis for the consolidated tax provision being allocated. No income tax benefit would be recognized for those expenses for which no benefit was recognized in consolidation.

With respect to the resulting liability for unrecognized tax benefits, we believe two alternatives are acceptable in the separate financial statements of Carve -out:

1. Present a liability for unrecognized tax benefits in its separate financial statements. Reflecting the contingent liability in the Carve-out financial statements reflects the fact that on a stand-alone basis, Carve-out has an incremental liability for unpaid taxes for the deduction claimed that did not meet the recognition and measurement criteria under ASC 740.
2. Reflect a capital contribution for Company A's assumption of the liability for unrecognized tax benefits. Reflecting the contingent liability as a contribution of capital in the Carve-out financial statements reflects the fact that the contingent liability would remain with Company A subsequent to disposition.

14.8 Carve-out financial statements

Carve-out financial statements refer to financial statements prepared by an entity for a division or other part of its business that is not necessarily a separate legal entity, but is part of the larger consolidated financial reporting group. The preparation of carve-out financial statements can be complex and is often highly judgmental. Preparing the tax provision for carve-out financial statements can likewise be challenging, particularly if separate financial statements (including a tax provision) have not historically been prepared. However, as required by ASC 740-10-30-27 related to separate financial statements, taxable entities must include a tax provision in carve-out financial statements.

The methods for intercorporate tax allocation for a carve-out are the same as the methods described previously for the separate financial statements of a subsidiary that is part of a consolidated tax group. However, preparing a tax provision for carve-out financial statements can present a specific set of reporting considerations. These include the following:

- **Understanding the purpose of the carve-out financial statements and the corresponding pre-tax accounting:** Carve-out financial statements are often guided by the legal or strategic form of a business transaction that involves capital formation, or the acquisition or disposal of a portion of a larger entity. Alternatively, the statements may be guided by regulatory requirements for certain industry-specific filings.

Those responsible for preparing a tax provision should coordinate closely with those responsible for the pre-tax aspects of the carve-out financial statements. The tax provision should be based on the financial statement accounts that are included in the carve-out entity. Accordingly, reflecting the appropriate tax effect requires a full understanding of the pre-tax accounts that will be included in the carve-out statements, as well as the impacts of any adjustments to such accounts.

The tax provision can be affected by methodologies being used for revenue or cost allocations that differ from historical practices. Carve-out financial statements should reflect all of the costs of doing business. That typically requires an allocation of corporate overhead expenses (and the related tax effects) to the carve-out entity—even if allocations were not previously made. Similarly, it may be necessary to allocate other expenses, such as stock-based compensation, to the carve-out entity.

Stand-alone financials may also reflect “pushdown” accounting adjustments, which can often relate to debt obligations of the parent or other members of the reporting group. The tax provision would be prepared based upon such pre-tax accounts. Accordingly, the stand-alone entity would be assumed to have tax basis in such debt for purposes of applying ASC 740 and, as a consequence, no temporary difference or deferred tax consequence would arise from the pushdown.

- **Intercompany transactions:** Intercompany transactions that were formerly eliminated in the consolidated financial statements (e.g., transactions between the carve-out entity and other entities in the consolidated financial statements) generally would not be eliminated in the carve-out financial statements. For example, sales of inventory to a sister company that are eliminated in the consolidated financial statements would remain in the carve-out statements. Accordingly, the income tax accounting for those transactions would also change. Specifically, ASC 740-10-25-3(e), which prescribes the accounting for the income tax effects of intercompany inventory transactions, would not apply to such transactions in the carve-out financial statements.

In addition, it may be appropriate for carve-out statements to reflect intercompany transaction gains (or losses) that were previously deferred in a consolidated return. It would also be necessary to assess whether the income tax accounting effects of certain intercompany transactions are recognized in equity, as described in ASC 740-20-45-11(c) or (g).

- **Intercompany cash settlement arrangements:** When a company is preparing carve-out financial statements, the underlying cash flows related to taxes during the historical period may have no relationship to the actual tax liabilities of the carved-out entity. As such, there could be a series of equity transactions (capital contributions and dividends) that account for the differences between actual cash flow and the taxes that are allocated under the accounting policy chosen for intercorporate tax allocation.
- **Hindsight:** ASC 740-10-30-17 refers to the consideration of “all available evidence” and historical information supplemented by “all currently available information about future years” when assessing the need for a valuation allowance. Notwithstanding this guidance, we generally believe that hindsight should not be used to apply ASC 740 when preparing carve-out financial statements for prior years. For example, consider a deferred tax asset that was supportable in Year 1 based on the fact that the entity had been profitable and had no negative evidence. As a result of significant subsequent losses, a valuation allowance was required in Year 2. When preparing carve-out financial statements, we believe that it would continue to be appropriate to reflect the deferred tax asset without a valuation allowance in Year 1 and then to record a valuation allowance in Year 2 based on the subsequent developments.
- **Historical assertions made by management of the consolidated group:** At times, management may indicate in a carve-out situation that it would have made different assertions or tax elections if the entity had been a stand-alone entity. However, it is generally not appropriate to revisit historical assertions or elections made by management of the consolidated group because the tax provision for the carve-out entity is an “allocation” of the group tax provision. Similarly, it would generally be inappropriate to reassess the historical recognition and measurement of uncertain tax positions when preparing carve-out financial statements. The preparation of carve-out financial statements, in and of itself, does not constitute new information that would justify recording a change with respect to uncertain tax positions.

For example, some have questioned whether it would be appropriate to revisit the indefinite reinvestment assertion (ASC 740-30-25-17) that the parent reflected in its consolidated financial statements. We do not believe that this would be appropriate. However, if the carve-out entity expects its assertions may change in the near future (e.g., after it has been separated from the consolidated group), it may be appropriate to disclose such expectations and the estimated financial reporting impact of such a change. See additional discussion in TX 14.8.1.

14.8.1 Spin-off transactions—*indefinite reversal assertion*

In the event of a spin-off transaction, the parent (or spinor) entity will need to evaluate whether the decision to spin-off the business into a separate entity results in a change to management’s ability and intent to indefinitely prevent the outside basis difference of a foreign subsidiary from reversing with a tax consequence. To the extent the decision to spin-off the business results in a change to the indefinite reinvestment assertion, the consolidated financial statements of the parent should reflect a charge to continuing operations at either the time of the decision to consummate the spin-off (i.e., prior to the spin), or at the time of the spin-off, even though such a charge would not have been required if the spin-off had not occurred.

If a charge is recognized in the consolidated financial statements prior to the spin-off, this charge should also be reflected in the standalone financial statements of the subsidiary (to the extent not already reflected in earlier periods if the subsidiary was accounting for deferred taxes in accordance with the separate return method described in TX 14.2.1).

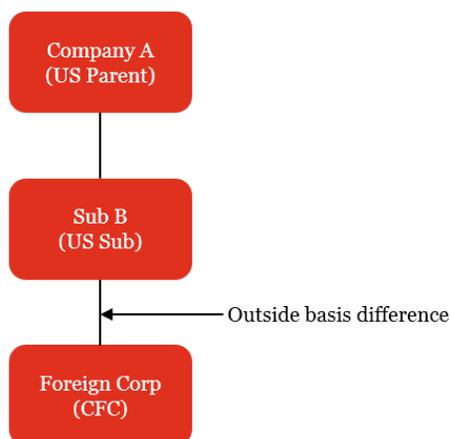
Example TX 14-10 discusses the alternatives related to the timing of recording the charge in the consolidated financial statements.

EXAMPLE TX 14-10

Accounting for a change in the indefinite reinvestment assertion as a result of a nontaxable spin-off transaction

In 20X1, Company A decided to spin-off Subsidiary B and its controlled foreign corporation (CFC) in a nontaxable transaction. Company A's management will prepare carve-out financial statements for Subsidiary B in connection with the anticipated transaction.

Historically, Company A asserted indefinite reinvestment under ASC 740-30-25-17 regarding Subsidiary B's outside basis difference in its investment in CFC (i.e., no deferred tax liability was recorded on the outside book-over-tax basis difference). After the spin-off, Subsidiary B will no longer be able to assert indefinite reinvestment. This is because after the spin-off, Subsidiary B will no longer receive funding from Company A and therefore will need to repatriate CFC's cash in order to fund its US operations and repay separate company borrowings. Absent the spin-off transaction, Company A would expect to continue to assert indefinite reinvestment (i.e., no other factors exist that would cause Company A to change its indefinite reinvestment assertion).



At what point in time, and on whose books (i.e., spinor's or spinnee's), should the tax effect of a change in the indefinite reinvestment assertion (i.e., the recording of a DTL for the outside basis difference) as a result of the nontaxable spin-off be recorded?

Analysis

We believe that there are two acceptable accounting alternatives.

Alternative 1

Record the DTL on both the spinnor's and spinnee's books when the decision to consummate the spin-off transaction is made (i.e., prior to the spin).

This view is supported by ASC 740-30-25-19, which provides that “[i]f 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 company, it should accrue as an expense of the current period income taxes attributable to that remittance.” In addition, this view is consistent with ASC 740-30-25-10, which indicates that a company should record a DTL for the outside basis difference when it is apparent that the temporary difference will reverse in the foreseeable future (i.e., no later than when the subsidiary qualifies to be reported as discontinued operations).

Proponents of this alternative point to the fact that the temporary difference related to Subsidiary B's outside basis difference in its investment in the CFC existed prior to the change in assertion, but, by virtue of the indefinite reinvestment exception, Company A was not required to accrue income taxes on the undistributed earnings of the CFC. Consequently, the moment it becomes apparent that some or all of the undistributed earnings of the subsidiary will be remitted in the foreseeable future, Company A should record the DTL on the outside basis difference.

Alternative 2

Record the DTL on both the spinnor's and spinnee's books at the time of the spin-off transaction.

Proponents of this alternative point to the fact that absent the spin-off transaction, Company A would continue to assert indefinite reinvestment under ASC 740-30-25-17. Therefore, Company A's expectations regarding the indefinite reversal of the temporary difference will not change until the consummation of the spin-off.

Refer to TX 12.5.2.2 for discussion of intraperiod allocation of the related tax expense when recording the deferred tax liability.

Example TX 14-11 illustrates the recording of the tax effects of a taxable spin-off.

EXAMPLE TX 14-11**Measurement of the tax effects of a taxable spin-off of a majority-owned investment**

Company A agrees to acquire Company B in a business combination. As a condition precedent to the purchase transaction stemming from its need for regulatory approval, Company A requires Company B to spin-off one of Company B's majority-owned subsidiaries ("Spinnee"). This transaction will be treated as a taxable transaction under the Internal Revenue Code. Prior to this transaction, Company B asserted that its outside basis difference in Spinnee (due to undistributed earnings) was indefinitely reinvested and therefore deferred taxes were not historically provided. At the date of the spin-off,

Company B's investment in Spinnee was \$500 and its tax basis was \$400. As of the date of the spin-off, Spinnee's fair value was \$800.

How should Company B account for the tax consequences of the taxable spin-off?

Analysis

The tax effects of this transaction can be separated into two distinct parts:

Part 1: The book/tax difference for which no deferred tax liability has previously been provided ($\$500 - \$400 = \$100$)

Part 2: The additional taxable income resulting from the fair value of Spinnee over its current book basis ($\$800 - \$500 = \$300$)

A tax liability should be provided on each, but the intraperiod allocation of the tax expense is different.

Consistent with the accounting for a change in assertion for Part 1, a deferred tax liability should be recognized for the outside basis difference of \$100 multiplied by the applicable tax rate with a corresponding charge to tax expense in the income statement no later than the time of the spin-off.

ASC 740-20-45-11 states that "the tax effects of all changes in the tax bases of assets and liabilities caused by transactions among or with shareholders should be included within equity." Thus, for Part 2, the tax consequence of the \$300 increase in the fair value of Spinnee would be a change in the tax basis caused by a transaction with shareholders (the spin-off). Therefore, upon spin-off, the tax expense arising from the increase in the value of Spinnee that will be borne by Company B should be charged to equity.

14.8.2 *Recording a valuation allowance upon spin-off*

In certain cases, deferred tax assets exist related to the subsidiary that are supportable in consolidation, but will, upon spin-off, require a valuation allowance. An issue arises as to whether this impairment should be recognized in the consolidated financial statements prior to the spin-off. In such cases, the consolidated financial statements of the parent should reflect a charge to continuing operations at the time of the spin-off. The rationale for that treatment is that the parent is not transferring the deferred tax assets at the value at which those assets were recorded in consolidation. Rather, the deferred tax assets have been impaired by the decision to spin off the business into a separate entity that will be unable, at least at a more-likely-than-not confidence level, to realize the value of those deferred tax assets.

The recognition of the valuation allowance would also be reflected in the standalone financial statements of the subsidiary if it had not already been reflected in earlier periods under the separate return method described in TX 14.2.1. In limited situations, specifically when the discontinued operations have filed a separate tax return, it may be appropriate to present the charge for the recognition of the valuation allowance as part of discontinued operations. Refer to TX 12.5.2.1 for further discussion.

Chapter 15:
Accounting for uncertainty in
income taxes

15.1 Chapter overview—accounting for uncertainty in income taxes

ASC 740 prescribes a comprehensive two-step model for recognizing, measuring, and disclosing uncertain tax positions. A tax benefit from an uncertain position may be recognized in the financial statements only if it is more-likely-than-not that the position is sustainable, based solely on its technical merits and consideration of the relevant taxing authority's widely understood administrative practices and precedents (see TX 15.3). If the recognition threshold for the tax position is met, only the portion of the tax benefit that is greater than 50% likely to be realized upon settlement with a taxing authority should be recorded (see TX 15.4).

This chapter details the two-step model and addresses the accounting for changes in judgment (see TX 15.5) and for interest and penalties (see TX 15.6). The qualitative and quantitative disclosure requirements related to uncertain tax positions are discussed in FSP 16.6.3.

15.2 Uncertain tax positions—scope and unit of account

ASC 740 provides guidance for recognizing and measuring tax positions taken or expected to be taken in a tax return. The guidance in ASC 740 applies to taxes (and thus uncertain tax positions) that are “based on income.” It should *not* be applied by analogy to non-income-based taxes, such as sales taxes, value-added taxes, or property taxes. Entities have historically applied ASC 450, *Contingencies*, to the recognition of non-income-based tax exposures. We believe that uncertainties associated with non-income-based tax exposures should continue to be accounted for as contingencies pursuant to ASC 450.

15.2.1 Uncertain tax position—entities within scope

The guidance related to the recognition and measurement of uncertain tax positions within ASC 740 is applicable to business entities, not-for-profit organizations, pass-through entities, and entities whose tax liability is subject to 100% credit for dividends paid (such as investment trusts and registered investment companies). It applies to all jurisdictions and all tax positions accounted for under ASC 740, regardless of the nature of the entity or taxing jurisdiction. Therefore, the requirements of ASC 740 are applicable to tax positions taken by a not-for-profit or governmental entity, including those that would affect the amount of unrelated business income taxes. The requirements of ASC 740 may also be applicable to certain S corporations that have converted from C corporation status and have recorded deferred taxes related to built-in gains.

Additionally, a non-US parent entity may file US GAAP consolidated financial statements that include both non-US and US subsidiaries. The parent entity must calculate the impact of applying ASC 740's guidance for recognition and measurement of unrecognized tax benefits for the group as a whole (i.e., for all income tax jurisdictions) because the guidance is applicable to all positions accounted for under ASC 740, regardless of the taxing jurisdiction.

Finally, foreign registrants and non-issuer foreign businesses that follow their local GAAP and present a footnote reconciling their local GAAP to US GAAP for US regulatory filing purposes are required to apply the recognition and measurement criteria in ASC 740 to determine net income and shareholders' equity in accordance with US GAAP.

15.2.1.1 *Uncertain tax positions in a business combination*

In a taxable business combination, positions may be taken in allocating the acquisition price and in filing subsequent tax returns that are expected to be challenged by the taxing authority. Similarly, in nontaxable business combinations, there may be uncertainties about the tax basis of individual assets or related to the pre-acquisition tax returns of the acquired business.

Entities should record income tax-related uncertainties acquired in a business combination in accordance with the recognition and measurement criteria of ASC 805-740.

Adjustments to uncertain tax positions made subsequent to the acquisition date are recognized in earnings, unless they qualify as measurement period adjustments. Measurement period adjustments are recorded first as an adjustment to goodwill, then as a bargain purchase. A measurement period adjustment is an adjustment within the measurement period that relates to facts and circumstances that existed at the acquisition date.

See TX 10.7 for further discussion on the treatment of income tax uncertainties in a business combination.

15.2.1.2 *Uncertain tax positions in separate financial statements*

ASC 740-10-30-27 addresses the preparation of separate financial statements of a subsidiary and requires that entities adopt a method for allocating taxes to the subsidiary that is “systematic, rational, and consistent with the broad principles established by this Subtopic.” Accordingly, we believe that entities should include uncertain tax positions when preparing separate financial statements. See TX 14 for guidance on accounting for separate entity financial statements.

15.2.2 *Identifying uncertain tax positions*

ASC 740 defines the term “tax position.”

Excerpt from FASB 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.

The average corporate tax return will include numerous positions taken in the ordinary course of business that are subject to significant and varied interpretation. Due to the complexities of many tax systems and today's business environment, we believe that almost all entities will have some uncertain tax positions in open tax years. Uncertain positions do not just relate to positions that have an ultimate effect on income tax expense. They may include issues that impact other line items, such as the allocation of purchase price to assets and liabilities acquired in business combinations and issues related to share-based payments. They may also relate to positions that have no current year impact on the income statement, such as a fully reserved net operating loss (NOL) carryforward.

Entities will need to identify and assess all significant uncertain positions in all tax years that are still subject to assessment or challenge under relevant tax statutes.

15.2.2.1 *Decision not to file a tax return*

An entity's decision not to file a tax return in a jurisdiction where it might have nexus in a particular US state or a permanent establishment in a foreign tax jurisdiction is considered a tax position.

If the entity is unable to support the technical sustainability of its position at the prescribed recognition threshold, it must recognize a liability for the amount of the benefit that it realized from its unfiled tax return (i.e., by not filing and consequently not paying tax, the entity essentially realizes the benefit of taking this position). The entity must also recognize interest and any penalties, even though it has not been audited by the taxing authority. If the entity is able to support the technical sustainability of its position, it will need to measure the benefit as the largest amount that is cumulatively greater than 50% likely to be sustained upon settlement. If the amount measured is less than the full benefit of not filing returns, the difference is reflected as a liability.

In jurisdictions where failing to file a tax return prevents the statute of limitations from commencing, it is possible that the liability may never reverse, enabling interest and penalties to accrue in perpetuity. This would not eliminate the need to recognize a liability under ASC 740. If, when assessing nexus, the jurisdiction in question has a widely understood practice of pursuing back-taxes for a limited number of years, the entities subject to that jurisdiction should apply the "administrative practices" accommodation described in ASC 740-10-25-7(b) by accruing taxes, interest, and penalties (if applicable) for those years. TX 15.3.1.4 discusses the application of administrative practice and precedent to the recognition of a liability for an unrecognized tax benefit, while TX 15.6.2 discusses the application of administrative practice and precedent to interest and penalties.

15.2.2.2 *UTPs related to equity method investments*

When assessing whether uncertain tax positions exist, the analysis may extend beyond the entities included in the consolidated financial statements. For example, a corporation that owns an interest in an entity that, for tax purposes, is classified as a partnership may use equity method accounting to account for its partnership interest. However, the corporation should analyze significant uncertain tax positions that exist within the partnership since positions taken by the partnership affect both the current and deferred tax provision of the corporate partner. That is, a corporate partner's distributive share of partnership income or loss should be the share of partnership income or loss that can be recognized by the partner pursuant to ASC 740. US partnerships typically issue Schedule K-1s to its partners and report the partners' distributive share of partnership income or loss. The difference between amounts reported on Schedule K-1 and amounts that should be reported pursuant to ASC 740 would represent unrecognized tax benefits.

Additionally, a reporting entity may have investments in other entities that are taxable as corporations and are accounted for under the equity method of accounting. While the entity is not required to separately report the uncertain tax positions of its equity method investees, it should consider analyzing any significant uncertain tax positions that may affect its investment in the equity method investee. Disclosures of significant uncertainties that may affect the corporate investor's accounting for its equity investments may be appropriate.

15.2.3 Unit of account for uncertain tax positions

The unit of account defines the level at which a tax position should be analyzed. A tax exposure could have multiple elements or parts that are interrelated with varying implications on the expected tax benefits. Therefore, the selection of a unit of account (i.e., the appropriate level of disaggregation) can affect the amount of tax benefit that may be recognized in the financial statements. The unit of account is addressed in ASC 740-10-25-13.

ASC 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.

For many tax exposures, the selection of the appropriate unit of account is intuitive (e.g., company-wide cost of meals and entertainment in a taxing jurisdiction). However, for some tax exposures, determining a unit of account can be a complex exercise that involves a number of different factors (e.g., different jurisdictions, activities, characteristics of the benefits).

To determine the appropriate unit of account, management should consider the facts and circumstances specific to each entity and position, including the tax return computation of a deduction, credit, or income generated by the position. An entity should also consider the audit approach that a taxing authority might take when examining the position and the entity's audit experience related to the same or similar positions.

The significance of the exposure in relation to the overall tax return may impact the assessment of unit of account. A position that results in a tax return benefit that is significant within the context of the entity's operations or key measures might suggest that a more disaggregated analysis should be performed.

ASC 740-10-55-83 through ASC 740-10-55-86 provides an example of how to apply the guidance on unit of account.

15.2.3.1 Consistency in a tax position's unit of account

Once a unit of account for a given tax position has been determined, it should be applied consistently to that position from period to period, unless changes in circumstances suggest that a change in the analysis is warranted. Factors that might prompt management to change its assessment of the

appropriate unit of account include, but are not limited to, changes in organizational structure and level of activity, changes in product line or service offering, changes in the regulatory environment, and experience with the taxing authority. These types of changes would be characterized as a change in estimate. See ASC 740-10-55-88 through ASC 740-10-55-89 for an example of when a change in the unit of account may be warranted.

15.2.3.2 *Unit of account for UTPs for multiple similar transactions*

An entity may have multiple transactions or positions that are similar and likely to be evaluated in aggregate by the relevant taxing authority. In certain cases, management's assessment might support one unit of account for all of the transactions combined (e.g., the unit of account is 50 similar transactions analyzed as one). Management may be able to support a single unit of account if it concludes that the transactions are substantially the same in terms of (1) the expected tax benefits, (2) the relevant technical issues and uncertainties, and (3) the approach that a taxing authority will take during an examination (i.e., if a portfolio approach would be used). If using a portfolio approach, a taxing authority may reject certain individual positions that a filer takes as a means of settlement because they are precluded from negotiating a settlement on an individual position. Still, as long as the related positions are substantially the same, management may be able to support a single unit of account even though the taxing authority may choose to settle the components individually.

15.2.3.3 *Unit of account for UTPs for multiple dissimilar transactions*

An entity may take positions on multiple transactions that require a separate unit of account for each transaction. If all of the positions meet the requirements for recognition, but the taxing authority is expected to settle them in aggregate (i.e., a portfolio approach), entities may be inclined to use a single unit of account for measurement even though separate units of account were used for the recognition assessment. However, we believe that the unit of account should be the same for recognition and measurement of a tax position. When the appropriate unit of account is determined to be the individual transaction, the recognition and measurement steps should be applied to that discrete position.

A taxing authority's portfolio approach to settlement can be viewed as another possible outcome in a range of possible outcomes used in the measurement analysis. For example, assume that a research credit has five individual tax positions that all meet the recognition threshold and are expected to be settled using a portfolio approach. The taxpayer expects to receive 80 cents on the dollar for those five positions in aggregate. Under this approach, 80% of each individual position would be separately recognized (i.e., you would assume each position will be settled at 80%). This is acceptable if there is evidence to suggest that the relevant taxing authority has accepted such a settlement approach in the past.

15.3 *Recognition of benefits from uncertain tax positions*

Once entities have identified their uncertain tax positions, they need to determine when, if ever, the tax return benefit (or expected tax return benefit) should be recognized for financial reporting purposes. The following principles should be employed when assessing the recognition of benefits from an uncertain tax position.

ASC 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.

ASC 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 must be evaluated without consideration of the possibility of offset or aggregation with other positions.

15.3.1 More-likely-than-not recognition threshold

For a position to qualify for benefit recognition, the position must have at least a more-likely-than-not chance of being sustained based on its technical merits if challenged by the relevant taxing authorities and taken by management to the court of last resort.

In deciding whether a tax position meets the recognition threshold, an entity must assume that the taxing authority has full knowledge of the position and all relevant facts available as of the reporting date. That is, an entity must be able to conclude that the tax law, regulations, case law, and other objective information regarding the position's technical merits sufficiently support the sustainability of the position's benefits with a likelihood that is greater than 50% (detection or examination risk should not be considered).

If an entity decides that a particular position meets the more-likely-than-not recognition threshold, the entity essentially asserts its belief that it is entitled to the economic benefits associated with a tax position. If management cannot reach this conclusion, none of the tax benefit provided by the position can be currently reflected in the financial statements.

Question TX 15-1 addresses considerations for determining whether a position meets the more-likely-than-not recognition threshold when a tax law requires more than one criterion be met to sustain a tax position.

Question TX 15-1

Assume tax law on a particular tax position includes three criteria a company needs to meet in order for the position to be sustained. A company asserts it has a 95% chance of meeting the first two criteria, but only a 40% chance of meeting the third criterion. In determining whether the position meets the more-likely-than-not recognition threshold, should the company evaluate the position by (1) averaging the three probabilities, (2) aggregating the three probabilities, or (3) evaluating each criterion individually?

PwC response

The company should evaluate each of the criteria individually when determining if the position meets the recognition threshold for uncertain tax benefits. None of the tax benefit provided by the position can be currently reflected in the financial statements unless all three criteria meet the more-likely-than-not requirement of ASC 740. In effect, recognition of a benefit for the position is based upon the weakest link in the chain. In this instance, since the third criterion does not meet this standard, the company should not recognize a tax benefit for this uncertain tax position.

Management should consider a wide range of possible factors when asserting that the more-likely-than-not recognition threshold has been met. The entity's processes should ensure that all relevant tax law, case law, and regulations, as well as other publicly available experience with the taxing authorities, have been considered.

A tax position that is supported by little authoritative guidance or case law may still have a more-likely-than-not chance of being sustained based on the facts, circumstances, and information available at the reporting date. The absence of specific authoritative guidance or case law does not automatically preclude a more-likely-than-not determination. Rather, other sources of authoritative tax law, although they do not specifically address the tax position, could be relevant in concluding whether a position meets the more-likely-than-not recognition threshold.

Example TX 15-1 illustrates the meaning of the term "court of last resort" in determining whether a position has at least a more-likely-than-not chance of being sustained based on the technical merits if challenged by the relevant taxing authorities and taken by management to the court of last resort.

EXAMPLE TX 15-1

The meaning of the term "court of last resort"

State A has enacted a tax law that utilizes a nexus model that subjects Company B to income taxes in State A. In determining whether the recognition criteria are met and whether Company B is subject to tax in State A, Company B considers whether its tax benefit would be sustained in a court of last resort, as per the guidance in ASC 740-10-55-3. Company B believes that the court of last resort would be the US Supreme Court, as this is the highest court that could potentially hear its case. Company B believes that it is more-likely-than-not that the tax law enacted by State A would be overturned by the US Supreme Court based on the constitutional grounds of state tax law and an economic nexus model.

Company B's view is supported by a competent legal analysis although Company B is aware that the US Supreme Court refused to hear a similar case.

Does Company B meet the more-likely-than-not recognition threshold?

Analysis

Yes. As part of determining whether the uncertain tax position meets the recognition threshold, Company B would include an assessment based on the technical merits of whether the issue is in conflict with laws governing interstate commerce. As a result, the technical analysis of whether State A's tax law would be overturned should be considered. A denial of a request for a hearing by the court of last resort is considered company-specific and does not impact Company B's assessment. Company B should not take into account the court of last resort's decision not to hear another company's similar case. Company B also does not need to consider the likelihood of its case ultimately being heard by the court of last resort. However, Company B needs to consider whether it would be willing to take the case to the court of last resort.

Note that both the likelihood of a settlement with the state taxing authority and the likelihood that the US Supreme Court will hear the case may factor into the measurement of an unrecognized tax benefit. See TX 15.4 for a discussion of the measurement requirements.

Determining whether the recognition threshold has been met is often fact-dependent and requires considerable reliance on professional judgment. Two entities with similar positions might reasonably arrive at different conclusions, depending on which factors management believes are relevant and how those factors are weighted. Management should ensure that its judgments and estimates are reasonable.

15.3.1.1 Sources of authoritative tax laws

Sources of tax authority that should be considered in determining whether an uncertain tax position meets the recognition threshold vary depending on the jurisdiction (federal, state, or foreign) within which a tax position arises. In general, relevant sources include statutes (including the underlying legislative intent), regulations, certain taxing authority rulings, case law, and treaties. For US federal income tax purposes, those authorities include, but are not limited to:

- Internal Revenue Code (IRC) and other statutory provisions
- Regulations interpreting such statutes
- Revenue Rulings, Revenue Procedures, Notices, and Announcements
- Tax treaties and regulations thereunder and Treasury Department and other official explanations of such treaties
- Court cases
- 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")
- Internal Revenue Service information or press releases

- Pronouncements published in Internal Revenue Bulletins
- Private Letter Rulings, Technical Advice Memoranda, Chief Counsel Advice, Field Service Advice, and similar documents

When determining whether recognition has been satisfied, entities should consider the weight of the particular authorities cited in relation to the weight of authorities supporting contrary treatment, and the authorities' relevance, persuasiveness, and the types of document providing the authority. Also, an authority does not continue to be an authority to the extent that it is overruled or modified by a body with the power to overrule or modify the authority.

In the US, when a tax position arises in a state or local jurisdiction, Public Law 86-272 (which governs state nexus requirements in interstate commerce) and any similar federal laws governing interstate commerce are considered authoritative, in addition to the particular state's tax statutes and regulations. When a tax position arises in a foreign jurisdiction, continental business and tax legislation may also be considered authoritative, depending on the jurisdiction.

In addition, certain rulings and agreements issued to the taxpayer by the taxing authority would typically form the basis for meeting the recognition threshold, provided the facts and representations that form the basis of the ruling are complete and accurate. These authorities include, for example:

- Private Letter Rulings or a Technical Advice Memorandum
- Advance Pricing Agreements, which are entity-specific transfer pricing agreements with the taxing authority
- Competent Authority (CA) resolution, which is a formal agreement between the taxing authorities of two countries interpreting provisions in a bilateral income tax treaty for the elimination of double taxation applicable to entity-specific facts and circumstances
- Pre-filing agreements

As it relates to taxpayers who were not a party to the ruling or agreement, such rulings/agreements are generally not binding on the taxing authority and are of more limited authority.

CA resolutions are applicable to entity-specific facts and circumstances. Entities can invoke the CA process when they believe that the actions of the taxing authorities cause a tax situation that was not intended by a treaty between two countries or when they need specific treaty provisions to be clarified or interpreted. The fact that the CA has agreed with an entity's position would presumably provide sufficient evidence to meet the recognition threshold and may influence measurement. However, this might still be subject to further approvals in certain tax jurisdictions (e.g., the approval of the Joint Committee on Taxation for US federal tax refunds over a defined amount).

Question TX 15-2 addresses whether proposed regulation should be considered when assessing a company's tax positions for financial reporting purposes.

Question TX 15-2

Do proposed regulations need to be considered when assessing a company's tax positions for financial reporting purposes?

PwC response

Yes. Companies should assess the information made available through the issuance of a proposed regulation by the US Treasury in the period in which the proposed regulation is issued. Although they are not “enacted,” proposed regulations represent the tax authority’s latest interpretation of existing law. Therefore, they constitute new information that a company should assess for purposes of the recognition and measurement of tax positions. As part of this assessment, companies should also consider whether they can rely on the proposed regulations for their filing positions prior to the regulations being finalized. Absent new information, we would not expect a company’s tax position to change after the release of the proposed regulations.

15.3.1.2 *Tax opinions and external evidence*

ASC 740-10-25-6 acknowledges that 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.” The standard contains no explicit requirement to obtain an opinion from tax counsel. Whether management decides to obtain a tax opinion to affirm the sustainability of a position based on its technical merits depends, among other things, on the significance (e.g., its nature and complexity) of a tax position taken or expected to be taken on a tax return. A large number of tax positions will have clear support in the tax law and will not require substantial documentation to satisfy the recognition assessment. For example, the tax law may clearly allow a deduction for a noncash expense but there is uncertainty about the amount of benefit. However, there will also be a number of positions that require management to expend a significant amount of time and energy gathering evidence in support of its more-likely-than-not assertion.

Management should document its conclusion, including the information and factors considered, how those factors were weighted, and which factors might be particularly susceptible to change. Those factors most susceptible to change should be monitored.

15.3.1.3 *Examination by taxing authority (detection risk)*

ASC 740-10-25-7 and ASC 740-10-30-7 require an entity to assume that an uncertain tax position will be discovered by a taxing authority and that the taxing authority will examine the position with access to all relevant facts and information using resources that have sufficient experience and expertise in the area of tax law creating the uncertainty. ASC 740’s recognition guidance requires entities to presume that a taxing authority has full knowledge of a position, even if the entity has no history of being examined by taxing authorities or the chance of the taxing authority actually identifying the issue (if it were to conduct an audit) is remote.

15.3.1.4 *Administrative practices and precedents*

According to ASC 740-10-25-7(b), the assessment of whether an entity can sustain a position should be based on the technical merits of the position, including consideration of “administrative practices and precedents.” Administrative practices and precedents represent situations in which a tax position could be considered a technical violation of tax law, but it is widely known, well understood, and a consistent practice of the taxing authority (with full knowledge of the position being taken) to nonetheless accept the position. When asserting that a particular administrative practice or precedent is applicable to a particular tax position, an entity should presume that the taxing authority will examine the position using the same information that is available to the entity.

While administrative practices and precedents do not need to be sanctioned by taxing authorities in formal regulation or letter ruling, it should be clear (through the taxing authorities' well-known past actions or declarations) that a tax position is more-likely-than-not to be sustained (if examined), despite its apparent conflict with the enacted tax law. Unless it becomes known that the taxing authority will no longer accept a particular administrative practice, preparers should consider these practices in forming their conclusions as to whether a position has satisfied the recognition threshold.

The following ASC paragraphs describe an administrative practice related to asset capitalization.

ASC 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.

ASC 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.

Use of the administrative practices and precedents accommodation should be limited and considered only if a tax position might be deemed a technical violation of the tax law or if there is compelling evidence that the taxing authority has and is expected to accept the tax position as an administrative accommodation.

A particular agent or examiner within a taxing authority may historically have accepted a position that is generally not accepted by other agents auditing other taxpayers in similar businesses. Regardless of how a particular agent has treated an item in the past, the recognition step requires that tax positions be evaluated on the technical merits of the position. The historical action of one agent or examiner would not represent a consistent administrative practice that is "widely understood" and hence would not generally be relevant in determining whether the recognition threshold has been met.

Administrative practices and precedents available to entities that self-report

Many jurisdictions offer amnesty programs or limit the tax they assess in past periods for taxpayers that voluntarily come forward and admit noncompliance in previous years. However, the administrative practice or precedent that may be available to self-reporting entities for nexus-related issues may not be available to those entities that fail to come forward and are subsequently identified by the taxing authority. Accordingly, it would not be appropriate for an entity that has no intention of

coming forward to consider an administrative practice made available to those that do come forward, unless there is substantial evidence that they will be treated the same way as those that self-report.

Nexus-related administrative practices and precedents

In general, an entity may have some form or combination of legal, structural, or commercial ties to a jurisdiction (e.g., employees, inventory, fixed assets, commissionaire arrangements, contract manufacturing arrangements). An entity with such ties could potentially have nexus, and would therefore be required to file a tax return under the tax laws of the relevant jurisdiction. Absent an applicable administrative practice, a nexus position (i.e., a decision not to file a tax return in a particular jurisdiction if nexus potentially exists) that does not meet the recognition threshold would require the accrual of tax, interest, and penalties for the entire period in which nexus could be asserted by the taxing authority.

However, as a matter of administrative convenience, some jurisdictions have limited the number of years for which an entity would be required to file back tax returns. Under ASC 740-10-25-7, that practice should be considered in management's decision to record tax, interest, and/or penalties.

ASC 740-10-55-94 through ASC 740-10-55-95 provide the following example about the use of administrative practices and precedents within the context of nexus.

ASC 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.

ASC 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.

15.3.1.5 Existence of potentially offsetting positions

ASC 740-10-25-7 requires that each tax position be evaluated on its own information, facts, and technical merits. The possibility of offset in the same or another jurisdiction or the possibility that the position might be part of a larger settlement should not affect the determination of the unit of account. For instance, a corporation must separately assess for recognition each known, significant uncertain tax position, even if the corporation expects that it will prevail on one position because it expects to settle another related tax position.

15.3.1.6 Existence of potential indirect benefits

A liability recorded for one position may cause a tax benefit to be recognized on another position. A deferred tax asset (or potentially a current tax receivable depending on the facts and circumstances) should be recorded for the indirect tax benefit. However, the resulting indirect benefit should not affect the need to separately assess the recognition of a liability on the first tax position. For example, an uncertain tax position taken in a foreign jurisdiction must be separately assessed for recognition of a liability, even though the resulting liability could give rise to a foreign tax credit benefit in the parent jurisdiction.

15.3.1.7 Uncertainties regarding valuation

For tax positions for which the uncertainty is based solely on a transaction's value (e.g., transfer pricing, value of goods donated), we believe that the recognition threshold has been met if it can be concluded that some level of tax benefit in the year in which the transaction occurred meets the more-likely-not recognition threshold. If the recognition threshold is met, the uncertainty associated with the transaction's valuation should be addressed as part of measurement. For example, an entity may donate shares in a privately held company to a charity and claim a tax deduction. If the entity's deduction is certain (based on the position's technical merits), the tax benefits can be recognized. However, the deduction amount may be uncertain because of complexities surrounding the appropriate fair market value of the donated shares. The entity should consider this valuation uncertainty in determining the measurement of the uncertain tax position (discussed in TX 15.4).

15.3.1.8 Uncertainties related to timing of tax payment

ASC 740 defines a temporary difference as the difference between the tax basis of an asset or liability and its reported amount in the financial statements. ASC 740's recognition and measurement criteria are applicable to temporary differences between book and tax bases, even if the only uncertainty is the timing of the position taken for tax purposes. For example, assume that an entity deducts for tax purposes the entire balance of an intangible asset in the year of an acquisition. For book purposes, the entity amortizes the intangible asset over five years (leading to a deferred tax liability). While the ultimate deduction of the asset is certain under the relevant tax law, the timing related to whether the deduction can be taken in full in the year of the acquisition is uncertain. Uncertain tax positions relating to temporary differences do not generally affect the aggregate amount of taxes payable over time. However, they can generate an economic benefit by delaying the payment of tax to future periods. Thus, an uncertain tax position associated with the timing of the tax payment can result in an exposure for interest and penalties.

Uncertain tax positions that relate only to timing (i.e., when, not whether, an item of income or expense is included in a tax return) are automatically deemed to meet the more-likely-than-not recognition threshold under ASC 740-10-25-6. See examples 9 and 10 in ASC 740-10-55-110 through ASC 740-10-55-116 for an illustration of the application of the guidance to timing-related uncertainties.

Example TX 15-2 illustrates the recognition of uncertain tax positions that relate only to timing.

EXAMPLE TX 15-2**Recognition of timing-related uncertain tax positions**

Company A incurs \$100 in repairs and maintenance expenses. For financial statement purposes, Company A expenses the costs as incurred and plans to take the entire \$100 as a deduction on its current-year tax return. However, Company A believes that the taxing authority would require straight-line amortization of the \$100 expenditure over four years. Therefore, if the as-filed tax position (i.e., the full deduction claimed in the current-year tax return) is not sustained, Company A would be entitled to only a \$25 deduction in the current year with the remaining \$75 of deductions taken over the next three years. Company A is a profitable taxpayer in the current year, and has a 20% tax rate in this jurisdiction. For purposes of this example, interest is ignored.

How should Company A compute its liability for unrecognized tax benefits and calculate its deferred taxes?

Analysis

Company A has no book basis because it fully expensed the associated costs when incurred. The tax basis would be \$75 (the cost of \$100 less the current-year permitted deduction of \$25). At the reporting date, Company A has a \$75 deductible temporary difference and would record the resulting deferred tax asset of \$15 ($\$75 \times 20\%$).

Company A would record the following journal entry:

Dr. Income taxes payable	\$20	
Dr. Deferred tax asset	\$15	
Cr. Current income tax benefit		\$5
Cr. Liability for unrecognized tax benefit		\$15
Cr. Deferred income tax benefit		\$15

The journal entry above records (1) the reduction of \$20 in income taxes payable for the \$100 maintenance deduction ($\$100 \times 20\%$ tax rate), (2) a current tax benefit for the tax effect of the deduction taken on the tax return that meets the recognition and measurement criteria of ASC 740 ($\$25 \times 20\%$ tax rate), (3) a deferred tax asset (and related deferred tax benefit) for the expected future deductible amount associated with the repairs and maintenance costs ($\$75 \times 20\%$ tax rate) determined pursuant to ASC 740's recognition and measurement criteria (i.e., straight-line amortization over four years, with three years remaining as of the end of the current year), and (4) a liability for the tax effect of the amount deducted on the tax return that did not meet the recognition and measurement criteria of ASC 740 ($\$75$ at a 20% tax rate).

15.3.1.9 Amended returns and refund claims

Although an uncertain tax position is most commonly associated with a tax liability or the decrease of a tax asset, it can also be associated with cases that result in an increase of a tax asset (e.g., a tax receivable recorded as a result of the filing, or the intent to file, an amended return).

ASC 740 is applicable to all tax positions that were included on previously filed returns and are expected to be included on returns that have not yet been filed. This includes amended returns or refund claims that have not yet been filed as of the end of an accounting period. Generally, filing an amended return results in a tax receivable. When the filed (or expected-to-be-filed) amended return includes an uncertain tax position, the recognition, derecognition, and remeasurement of the receivable should be assessed under ASC 740's recognition and measurement criteria. We believe that the threshold for the recognition of the associated tax benefit should be the same, regardless of whether the accounting entry results in a tax receivable, a decrease in a liability for an unrecognized tax benefit, or a current tax payable. However, obtaining the tax benefit might involve additional procedural steps (e.g., in the US federal tax jurisdiction, approval by additional government authorities, such as the Joint Committee on Taxation that serves under the US Congress), which might affect the risk that an advantageous lower-level decision could be reversed.

When a refund claim or an amended return fails the requirement for recognition, the expected tax benefit (i.e., refund receivable) cannot be recognized in the financial statements. Similarly, a refund receivable recognized in a prior period would be derecognized if it fails the recognition threshold in the current period (i.e., the tax receivable asset would be reversed). However, the amount of the refund claim would still be included as an unrecognized tax benefit in the disclosures required under ASC 740-10-50-15. There may be instances in which an entity's expectations and intentions regarding an amended return or refund claim are unclear. Such situations may require the use of professional judgment to determine whether, or to what extent, the amended return or refund claim can be considered when assessing recognition and measurement criteria.

Courts in some jurisdictions require that taxes in question be paid as a prerequisite to petition the court. If the taxpayer's position meets the recognition threshold (and no reserve is required in the measurement step), the taxpayer should record an asset for the prepaid tax and accrue interest income (if applicable). Example TX 15-3 illustrates this situation in further detail. Additionally, refer to TX 15.6.1 for further discussion of interest accruals associated with uncertain tax positions.

EXAMPLE TX 15-3

Payment for uncertain tax positions prior to final resolution

Company X has taken a position in its tax return that it believes is more-likely-than-not to be sustained. This position has no corresponding impact on deferred tax balances (i.e., it is a permanent item). By taking this position, Company X reduced its taxes payable by \$100. After assessing several possible outcomes, Company X has determined the need for a \$25 liability for its unrecognized tax benefits.

The taxing authority challenges the position and delivers a \$100 assessment to Company X. Company X intends to appeal the assessment. However, the taxing authority requires the assessment to be paid before an appeal can be filed.

Does this payment change the assessment of the uncertain tax position under the ASC 740 model?

Analysis

No. The payment of the assessment does not directly impact the recognition and measurement of the uncertain tax position. The uncertain tax position should continue to be assessed at the balance sheet

date as if the payment had not been made. The payment of the tax would be recorded against the UTP. If the payment exceeds the amount of the UTP, any excess would be recorded as a tax receivable.

In the US, during an IRS examination, taxpayers may present claims for additional tax benefits that were not reported on the original tax return under examination. Such claims arise from new information that was not available when the original return was filed. The IRS policy allows for claims to be submitted during the examination without requiring the filing of an amended return. However, documentation supporting the basis for the claim and the resulting impact on the tax liability must be presented to the IRS during the examination process.

Such claims constitute tax positions subject to ASC 740's recognition and measurement principles. If the application of ASC 740 would result in no or a partial benefit being reported for the claims, an uncertain tax benefit must be included in the required tabular reconciliation of uncertain tax positions until the tax benefits can be recognized or the statute closes. The disclosure requirement begins when a taxpayer decides to present claims for additional tax benefits (refer to FSP 16.6 for additional discussion of the disclosure requirements for uncertain tax benefits).

Question TX 15-3 addresses when a public entity should include claims for additional tax benefits in its tabular rollforward during an IRS audit.

Question TX 15-3

During an IRS audit of a prior year tax return, a public entity presents claims for additional tax benefits that were not reported as part of that prior year return and represent new information that was not available at the time the original return was filed. The timing and presentation of the claims complied with IRS policy that allows claims to be directly submitted without requiring the filing of an amended return. Assuming the public entity determines that the claims represent an unrecognized tax benefit under ASC 740, when should the claims be included in the tabular reconciliation footnote?

PwC response

For purposes of the tabular reconciliation footnote, the public entity is assumed to have "taken" the position for additional tax benefits when it decided to present the claims to the IRS. Accordingly, it should disclose any related unrecognized tax benefits in the period in which the claims were presented to the IRS. These unrecognized tax benefits should be included as an increase in the unrecognized tax benefits recorded for positions taken during the current year.

15.3.1.10 Uncertain tax positions and valuation allowances

The recognition of an additional tax liability as a result of an uncertain tax position must be distinguished from the assessment of the need for a valuation allowance. The recognition of a liability for an unrecognized tax benefit stems from uncertainty about the sustainability of a tax position taken or expected to be taken on a tax return. The recognition of a valuation allowance stems from uncertainties related to whether taxable income will prove sufficient to realize sustainable tax positions. That is, uncertainties about sustaining tax positions relate to whether a tax liability or deferred tax asset exists. Uncertainties about sufficient taxable income relate to the realization of recorded deferred tax assets. Therefore, valuation allowances may not be used to replace a liability for unrecognized tax benefits.

15.4 *Measuring the tax benefit to be recorded*

After concluding that a particular filing position can be recognized (i.e., has a more-likely-than-not chance of being sustained), ASC 740-10-30-7 requires that the amount of benefit recognized be measured using a methodology based on the concept of cumulative probability. Under this methodology, the amount of benefit recorded represents the largest amount of tax benefit that is greater than 50% likely to be realized upon settlement with a taxing authority that has full knowledge of all relevant information.

The analysis that needs to be performed and the level of documentation that needs to be created will vary based on the significance and complexity of the issue, as well as the degree of perceived uncertainty in the tax law. In some cases, this may require entities to develop a cumulative probability table. In other cases, this may not be necessary.

15.4.1 *The cumulative probability approach*

ASC 740 does not define “cumulative probability.” However, the term is included in the measurement examples provided in ASC 740-10-55-102 through ASC 740-10-55-107. When more than two outcomes may alternatively resolve an uncertain tax position (i.e., resolution may occur other than on an “all-or-nothing” basis), the measurement step requires that each potential outcome be assigned a probability to determine the greatest amount of tax benefit whose probability of being realized is greater than 50%.

The outcome that provides the greatest tax benefit should be assessed first. If that outcome’s individual probability is greater than 50%, the individual probabilities of the remaining outcomes need not be considered. The measurement step is concluded because the greatest amount of benefit was obtained from the most favorable outcome. Alternatively, if the individual probability of the greatest tax benefit is less than 50%, the next most beneficial outcome should be assessed. If that outcome’s individual probability, coupled with the individual probability of the greatest tax benefit, is greater than 50%, the second most beneficial outcome should be selected for measurement. If the cumulative probability of the second most beneficial outcome is not greater than 50%, the entity should continue the process until the probability of the selected outcome (added to the more beneficial outcomes previously assessed) is greater than 50% on a cumulative basis.

The concept of cumulative probability is best understood through an example. Assume that a tax return includes a position that results in an as-filed benefit of \$100. It is more-likely-than-not that the position will be sustained based on its technical merits and thus meets the requirement for recognition.

Amount of the “as filed” tax benefit that can be sustained	Probability of each outcome	Cumulative probability
\$100	40%	40%
\$75	20%	60%
\$50	15%	75%
\$25	15%	90%

\$0	10%	100%
	—————	
	100%	

In this case, \$75 is the amount of tax benefit that would be recognized in the financial statements because it represents the largest amount of benefit that is more than 50% likely to be sustained upon settlement, based on cumulative probability.

Although ASC 740-10-30-7 requires the consideration of a range of possible outcomes, as well as their individual and cumulative probabilities (when appropriate), it does not mandate the use of cumulative probability tables. Some tax positions that meet the requirement for recognition may have one expected outcome that is clearly more than 50% likely to be sustained if challenged by the relevant taxing authority. ASC 740-10-55-109 provides an example of this situation:

ASC 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.

It is important to note that a virtually identical tax position could be measured differently by different preparers based solely on management's appetite for risk and willingness to compromise. For example, an entity might determine that if it is challenged, it would continue to litigate the tax position to the court of last resort and the probability of sustaining the full amount of the benefit is greater than 50%. In this fact pattern, the entity would record the full amount of the benefit. However, another entity might believe that upon challenge, it would be willing to settle for 80% of the tax benefit. Assuming the expectation of settlement at this level is greater than 50%, that entity would record 80% of the benefit.

15.4.1.1 Individual probability and possible outcomes

Determining the individual probability of each possible outcome will require management to exercise judgment. Probabilities can be based on factors such as (1) the perceived weight of the tax law in the taxpayer's favor, (2) the extent of precedent of the tax law being applied to the particular position or transaction, (3) expectations regarding how aggressively the taxing authority might pursue a particular position or, alternatively, its willingness to reach a negotiated compromise, and (4) the entity's willingness to defend the position in tax court (as opposed to conceding to a negotiated compromise to avoid extended litigation). Comparable and resolved exposures that the entity or similar entities have experienced will often inform the development of measurement estimates and the assignment of individual probability. A history of negotiating and settling the same or similar tax positions would provide strong evidence in support of individual probabilities.

Furthermore, while all potential outcomes (e.g., litigation, negotiated compromise) should be considered to determine possible measurement outcomes and their individual probabilities, detection risk cannot be considered. That is, measurement must be performed under the assumption that the taxing authority has full knowledge of the uncertain tax position.

15.4.1.2 Consideration of past income tax audit experience

A taxpayer's past audit results can be considered in measuring the most likely amount of tax benefit that can be recorded for an uncertain tax position. For measurement purposes, recent settlements can be considered a reliable indication of the expected tax benefit that will be sustained on an audit of the same or a similar tax position, as long as no new information has arisen to suggest that the previously negotiated outcome would no longer be acceptable (ASC 740-10-55-109). That said, a taxpayer's history of settlement with a taxing authority on the same or similar tax positions is only one source from which expected outcomes may be derived.

A taxpayer's lack of or limited audit history should not impact its ability to estimate the expected outcome for measurement of a recognized tax benefit. As discussed previously, when determining expected outcomes, a taxpayer must assume that the taxing authority has full knowledge of the uncertainty. When a taxpayer has limited or no audit experience, other taxpayers' experience with negotiating and settling the same or similar positions can be used as a source of expected outcomes. Relevant law (e.g., statute, regulations, rulings, case laws) that provides an indication as to the expected amount of tax benefit that may be sustained can also be used to inform the estimate of expected outcomes.

15.4.1.3 Highly certain tax positions

The tax treatment of certain tax positions is based on clear and unambiguous tax law. For these positions, the amount of benefit that is expected to be sustained is near certain. The measurement of highly certain tax positions often represents 100% of the benefit expected to be or actually claimed in the tax return. The following reference demonstrates the measurement of a highly certain tax position.

ASC 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.

ASC 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.

15.4.1.4 Binary tax positions

A taxing authority may not always be willing (or in certain cases legally permitted) to accept a compromise on a position. Additionally, there may be positions taken by an entity that are so significant (e.g., status of the entity) that the entity cannot negotiate with the taxing authority. This subset of uncertain tax positions are considered binary. This means there are two possible outcomes:

1. The position is sustained and the entire as-filed tax return amount (i.e., 100% of the benefit) will be accepted.
2. The position is lost upon challenge and none of the as-filed tax return amount (i.e., zero benefit) will be accepted.

When a binary tax position qualifies for recognition, the measurement should be based on the largest amount of tax benefit that is more likely than not to be realized upon settlement. This would generally cause 100% of the expected benefit (i.e., the as-filed amount) to be recorded.

15.4.2 Interplay of measurement and recognition of tax positions

Generally, the individual and cumulative probabilities that are considered relevant to the measurement step would not have a direct impact on the recognition step. Once a tax position has satisfied the more-likely-than-not requirement for recognition, the position should be evaluated to determine the measurement of the largest amount of tax benefit that can be recorded in the financial statements. However, if only an insignificant amount of the tax benefit can be realized (i.e., the uncertain tax position liability is large in comparison to the amount of benefit recognized) the entity may want to reevaluate the more-likely-than-not conclusion reached in the recognition step.

15.4.3 The implications of “should” level tax opinions

The recognition and measurement of a tax position are two separate steps in the ASC 740 accounting model. A tax opinion issued by outside counsel or tax service provider can constitute external evidence supporting management’s assertions in relation to the recognition of a tax position. A tax opinion that concludes that a tax position “should” be sustained may indicate that the recognition threshold has been met. It may not, however, be sufficient to justify recording 100% of the expected tax benefit, especially if the opinion addresses the sustainability of the position without identifying the amount that can be sustained. For example, if an entity knows (or has reason to believe) that the relevant taxing authority expects some concession and the entity does not intend to litigate, the largest amount of benefit that has a cumulative probability greater than 50% may be less than 100%, notwithstanding the existence of a should opinion.

15.4.4 Measurement and transfer pricing

Transfer pricing generally refers to the method of determining the price of goods, intangibles, and services in transactions between commonly controlled companies. The pricing calculation is often multifaceted, taking into account economics, finance, industry practice, and functional analyses. As a result, one company’s transfer pricing position often sits at a particular point along a wide continuum of possible pricing outcomes. Absent a reasonable number of comparable and resolved exposures that the entity or similar entities have experienced, there might not be sufficient information to develop a probability assessment of every possible outcome. Despite this, the entity must develop and support a

conclusion as to which possible outcome represents the one that provides for the greatest benefit that has a greater than 50% cumulative probability of being sustained.

The assignment of probabilities to a particular outcome is not an exact science. This exercise depends heavily on the facts and circumstances that are specific to the particular transaction in question, management's experience and knowledge of the tax authority's position on particular transactions, and the experience and knowledge of industry peers with respect to settlements and strategies. Advanced pricing agreements with the relevant tax authorities can be helpful in determining how to measure any uncertain tax positions related to transfer pricing.

An uncertain tax position taken in one jurisdiction related to transfer pricing may give rise to a corresponding tax position reducing taxable income in another jurisdiction where an affiliate resides. Any corresponding tax payable (or receivable) from the potentially offsetting transactions should be recorded on a gross basis on the balance sheet. As mentioned in TX 15.3.1.5, entities measuring the amount of an uncertain tax position should evaluate any potentially offsetting transactions separately.

Contemporaneous documentation typically helps determine whether an entity appears to have met the standards of reasonableness with respect to transfer pricing penalties. It may not, however, determine the likelihood that a position will be sustained, whether a particular position has a greater than 50% cumulative probability of being sustained, or whether there are particular alternative outcomes that might be asserted by the respective taxing authorities. Accordingly, entities may need to consider alternative transfer pricing methods or profit-level indicators in their analysis of alternative settlement positions. The best method for transfer pricing documentation is not necessarily the only method that should be considered. The best method analysis contained in transfer pricing documentation may describe only why an entity did not choose other methods (and should be protected from penalty exposure). Entities may need to review other methods and their respective results more closely when considering ASC 740.

15.4.5 Tax rates and uncertain tax positions

The income tax rate to be applied to an uncertain tax position may be dependent on the nature of the tax uncertainty as well as the period to which the uncertainty relates. Liabilities should generally be recorded at the enacted income tax rate associated with the period of the uncertainty. For example, assume a company records a liability for an uncertain tax position that meets the recognition threshold related to a position taken in its Year 1 tax return. In Year 2 there is a change in tax rate. The company should maintain its liability at the enacted tax rate for Year 1 as this is the rate the company would be charged if the company's Year 1 tax position was not sustained. However, if the liability for an uncertain tax position taken in Year 1 is expected to reverse in a future year by affecting income taxes payable (e.g., through utilization of an NOL generated in Year 1), the uncertain tax position liability should be measured using the Year 2 tax rate.

15.5 Changes in recognition or measurement of tax positions

The assessment of an uncertain tax position is a continuous process, which does not end with the initial determination of a position's sustainability. As of each balance sheet date, unresolved uncertain positions must be reassessed for both recognition and measurement. Management must determine whether the factors underlying the sustainability assertion have changed and whether the amount of the recognized tax benefit is still appropriate.

With regard to reassessing recognition, ASC 740-10-25-8 provides guidance on the timing and types of changes that could cause an entity to recognize a tax benefit due to a change in the sustainability of the tax position.

ASC 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 subsequent to the reporting date but prior to the issuance of the financial statements shall be recognized in the period in which the change in facts occurs.

In addition, an uncertain tax position does not need to be legally extinguished and its resolution does not need to be certain to be recognized, derecognized or measured. Changes in the expected outcome of an uncertain tax position must be based on new information, and not on a mere re-evaluation of existing information. New information can relate to developments in case law, changes in tax law, new regulations issued by taxing authorities, interactions with the taxing authorities, or some other development. Such developments could potentially change the estimate of the amount that is expected to be sustained or to cause a position to cross over the recognition threshold (i.e., either the position's sustainability becomes more-likely-than-not or the position ceases to meet the recognition threshold).

New information would exist if management's previous evaluation was fully informed and based on all relevant facts and if, in the intervening period, legislative developments or developments in case law gave rise to the different interpretation. New information requires a new judgment on whether the recognition threshold has been met.

Example TX 15-4 illustrates consideration of whether a proposed settlement with the taxing authority provides new information.

EXAMPLE TX 15-4

Consideration of a tentative "global" settlement with a taxing authority in measuring uncertain tax positions

Company A has multiple uncertain tax positions, all of which have been assessed under ASC 740. Some tax positions met the recognition threshold of ASC 740, while other positions did not. The individual tax positions are not similar and are not interdependent. Positions that did not meet the recognition threshold were fully reserved (i.e., no benefit has been recognized). The taxing authority is conducting an audit of three years in which the positions were taken.

Company A has been in negotiations with the taxing authority and, as of the end of the current reporting period, the parties have reached a tentative "global" settlement agreement. The agreement

would settle all positions within the three tax years under examination and close out the audit for those years. While the Company believes they have reached an agreement with the taxing authority's examination team, the agreement is subject to another level of governmental review before it becomes final and binding.

Company A determined that the additional level of review is substantive and could result in the agreement being changed or withdrawn (by either party). As a result, Company A determined that the uncertain tax positions that have not met the recognition threshold are not considered "effectively settled" as described in ASC 740-10-25-10. In addition, no new information came to light during the examination process that would cause Company A to change its assessment of the technical merits of any of the individual uncertain tax positions. Therefore, no adjustment will be made to the tax positions that have not met the recognition threshold.

For positions that have met the recognition threshold, should Company A adjust its measurement of the related benefit of those positions based upon the tentative global settlement agreement?

Analysis

It depends. The proposed global settlement is new information. However, Company A must determine whether the proposed global settlement changes their assessment of the expected outcome for each tax position that has met the recognition threshold. In making this determination, Company A should consider its expected course of action, and related expected outcome, if the global settlement proposal is withdrawn or changed in the review process.

In this example, negotiations were conducted on a global basis (i.e., considering all positions in the aggregate). Consequently, Company A would likely conclude that there was no new information with respect to any of the individual tax positions that caused management to change their previous assessment. As a result, no adjustment would be made to the measurement of the related benefit.

15.5.1 *Impact of a jurisdiction's dispute-resolution process*

In addition to monitoring developments in the technical merits of a position, entities must monitor the progress of the dispute-resolution process as part of their reassessment of the recognition threshold to determine whether a tax position is effectively settled through examination, negotiation, or litigation.

There may be phases in the taxing authority's examination process that provide new information, which would result in recognition or remeasurement of a tax position or, in some cases, de-recognition of a previously recognized tax position. Entities must also consider if recognition of tax benefits or remeasurement of previously recognized tax benefits is appropriate when a tax examination is closed if the relevant statute of limitation for assessing taxes is still open. This determination is critical because, in many cases, a taxing authority completes its examination of a tax year before the statute of limitations expires.

15.5.2 *Impact of effective settlement on recognition*

Tax positions can be effectively settled upon examination by a taxing authority, which may impact an entity's reassessment of whether the tax position should be recognized or not. Settlement is assessed on a position-by-position basis. To be considered "effectively settled," the conditions in ASC 740-10-25-10 must be met.

ASC 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.

In analyzing whether a tax position meets the three conditions of ASC 740-10-25-10 and can therefore be considered effectively settled, certain key considerations should be noted.

Tax position is not specifically examined

As stated in ASC 740-10-25-11, a tax position does not need to be specifically reviewed or examined by the taxing authority during the examination of a tax year in order for it to be considered effectively settled through examination.

In cases in which the position has not been specifically reviewed or examined by the taxing authority, additional judgment may be necessary to conclude whether the likelihood that the taxing authority would subsequently examine the position is remote. It is also important to remember that this conclusion must be reached under the presumption that the taxing authority has full knowledge of all relevant information.

Completion of examination and other procedures

If a position is challenged, the resolution process in many jurisdictions can potentially involve several stages and various government departments, each of which might be empowered to overturn or modify another department's ruling. A previously unrecognized tax benefit can be recognized when an entity is able to conclude that a tax position is "effectively settled." Under the US federal income tax system, Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*, is used upon completion of an IRS examination to indicate the taxpayer's agreement with the revenue agent's proposed adjustments and agreement to pay any deficiency. The Revenue Agent's Report (RAR) accompanies the Form 870. By signing the Form 870, the taxpayer waives the right to a notice of deficiency and thus permits the IRS to assess the tax immediately. In effect, this represents the closing of the IRS examination upon acceptance by the IRS. Generally, the IRS will only re-open a closed case if (1) there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact, (2) the closed case involves a clearly

defined, substantial error based on an established service position existing at the time of the examination, or (3) other circumstances exist that indicate that re-opening of the case is supported for effective tax administration.

We generally expect the closing of an IRS examination via the Form 870 to constitute effective settlement of a position taken in the examined year when not being appealed, other than cases involving continued governmental review (e.g., Joint Committee) or years in which there was no tax payable (e.g., NOL years).

When evaluating whether the taxing authority has “completed its examination procedures” (as discussed in ASC 740-10-25-10(a)), NOLs and tax credit carryforwards need to be evaluated differently. To illustrate, assume that a US entity generated an NOL carryforward of \$500 on its tax return for a particular year, but only \$400 of that amount was recognizable in the financial statements because of an uncertain tax position that totaled \$100. The uncertain position is not examined by the IRS in the subsequent examination, and the examination is later closed.

In this case, it is unlikely that the entity would be in a position to conclude that the unrecognized benefit of \$100 was effectively settled upon closure of the examination for the year in which the NOL first arose. This is because the IRS has the ability to examine the positions that led to the generation of the NOL and tax credit carryforwards if the issues were not previously examined when the carryforwards are utilized on a future year’s tax return. The IRS can perform the examination of the loss even if the statute of limitations for the year of generation has since expired as it affects a later open tax year. Other jurisdictions may have the same or a similar ability based in tax law, regulations, or judicial doctrine.

Assessing whether an appeal is effectively settled

Entities that file an appeal similarly need to assess when the appeal is effectively settled. At the conclusion of an appeal, the IRS appeals division typically issues a Form 870-AD, *Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment*. Form 870-AD is used almost exclusively by the appeals division and differs from Form 870. Specifically, Form 870-AD states that the case will not be reopened by the IRS unless, among other things, there was “fraud, malfeasance, concealment or misrepresentation of a material fact,” “an important mistake in mathematical calculation,” or “excessive tentative allowance of a carryback.”

We generally believe sign-off on Form 870-AD constitutes effective settlement. Even if the tax position had not been examined, the likelihood that the IRS would challenge a position after receiving a Form 870-AD would generally be remote. The instructions for Form 870-AD indicate that by signing, the taxpayer is agreeing not to re-open the referenced tax years and the IRS will only re-open the tax years in very limited circumstances. Although the Form 870-AD is not a formal closing agreement, it is generally viewed as final by the IRS.

Ongoing reassessment

ASC 740-10-40-3 requires the continuous re-evaluation of tax positions that were previously determined to be “effectively settled.” An entity should re-evaluate a tax position that was effectively settled if it believes that a taxing authority may examine or re-examine the tax position, or if the entity intends to appeal or litigate any aspect of the tax position. Under these circumstances, the criteria in ASC 740-10-25-10 would no longer be met and the tax position would no longer be considered effectively settled.

ASC 740-10-25-12 acknowledges that an entity may obtain information during an examination that would enable it to change its assessment of the technical merits of a tax position or of similar tax positions taken in other periods. However, the fact that a position has been effectively settled for a given year should not be used as a basis for concluding that similar tax positions taken in future years can be recognized. The fact that a position was effectively settled for a particular year does not in and of itself constitute “new information” that would allow the entity to recognize the benefit from similar positions taken in subsequent years. See TX 15.5.2.1 for additional information.

15.5.2.1 *Relevance of resolution experience to future periods*

The resolution of an uncertain position in a given audit cycle should also be assessed for its relevance to future periods. For example, the resolution of an uncertain tax position might involve new or additional interpretation (or clarification) by the taxing authority of the relevant authoritative tax guidance and its applicability to the uncertain tax position. This new or additional information might provide evidence supporting the technical merits of a similar position in subsequent periods and therefore may allow recognition of a similar position pursuant to ASC 740-10-25-8(a). However, ASC 740-10-25-12 cautions that an uncertain tax position that is effectively settled pursuant to ASC 740-10-25-10 may not provide any basis for management to change its assessment of the technical merits of the same or a similar position taken in other periods. That is because the taxing authority may not have examined the uncertain tax position (and thus settlement may not provide any technical insight).

The resolution might also fail to provide any technical insight if it is the result of a negotiated settlement that involves many issues and so-called “horse-trading” unrelated to the technical merits of the resolved position. Management will need to assess whether new information came to light as a result of the resolution that could change their prior recognition conclusions. In making this determination, management should consider the level at which a resolution was reached, the substance of communication and discussion during the resolution process, and the materiality and importance of the position relative to the tax return.

15.5.2.2 *Entities not subject to audit by a taxing authority*

Because recognition and measurement cannot consider detection risk, an entity that is not subject to a taxing authority’s audit will not be able to recognize a tax benefit that did not meet the recognition and measurement criteria of ASC 740 until the statute of limitations expires or until subsequent changes in the technical merits of the tax position permit a change in judgment about the position’s sustainability.

15.5.3 *Subsequent derecognition of uncertain tax positions*

ASC 740-10-40-2 states that a previously recognized tax position should be derecognized in the first period in which the position no longer meets the more-likely-than-not recognition threshold. New information resulting in derecognition must be considered and accounted for even if that

derecognition results in a deferred tax asset that would require a valuation allowance to be recorded against it.

15.5.4 Subsequent events related to uncertain tax positions

ASC 855-10-15-5(a) makes it clear that reporting entities should apply ASC 740 to subsequent events which impact recognition, derecognition, or changes in measurement of a tax position taken in a prior period. Under ASC 740-10-35-3, developments that occur after the balance sheet date but before issuance of financial statements (including the discovery of information that was not available as of the balance sheet date) should be recognized in the period in which they occur (i.e., the period subsequent to the period covered by the unissued financial statements). Only an explanatory disclosure of the event (if it is significant) would be appropriate in the prior period's financial statements.

ASC 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. Subsequent to the reporting date, but prior to the issuance of the financial statements, 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.

ASC 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.

Management will need to carefully assess whether events that impact the recognition or measurement conclusions are the result of new information or information that was available as of the balance sheet date. The requirement to regularly review the sustainability of all material positions and the measurement of associated tax benefits will require coordination between an entity's tax and financial reporting personnel.

15.5.5 Interim changes in uncertain tax positions

When new information causes a change in judgment about the recognition or measurement of an uncertain tax position (including any related interest and penalties) in a prior year, the effect should be recorded as a discrete item in the period in which the change occurs.

Changes in judgment related to uncertain tax positions taken in a prior interim period, but within the same fiscal year, are an integral part of an annual period, and should be accounted for in accordance with the principles of ASC 740-270-35. TX 16.3.4 includes a discussion about which tax effects are included as part of the consolidated annual effective tax rate and which ones are recorded based on year-to-date activity.

15.6 Interest and penalties

Generally, taxing authorities assess interest on any underpayment of tax, but only assess penalties if a disallowed position fails to meet certain minimum thresholds of support.

15.6.1 Interest

If a benefit claimed on a tax return does not qualify for financial reporting recognition, the benefit essentially constitutes a loan from the government and therefore results in an interest charge. Consequently, the basis for an interest accrual should be the difference between the tax position recognized in the financial statements and the amount claimed (or expected to be claimed) in the tax return. The commencement of an interest accrual should be in accordance with the relevant tax law. For example, in the US federal tax system, a calendar-year corporation generally starts accruing interest two and one-half months after the end of the tax year for which the position was taken on a tax return. Interest should be accrued each period prior to ultimate resolution of the uncertainty.

15.6.1.1 Interest income on uncertain tax positions

While ASC 740 does not reference interest *income* specifically, we believe that interest income related to uncertain tax positions should be accounted for in the same manner as interest expense. That is, interest income should be recognized over the time period in which it accrues under the applicable tax law. Example TX 15-5 and Example TX 15-6 demonstrate concepts associated with recording interest income related to uncertain tax positions.

EXAMPLE TX 15-5

Recording interest income on a transfer pricing tax position

Company X has taken a position related to transfer pricing. In Jurisdiction A, Company X has recorded a liability for an unrecognized tax benefit for \$100 and will record interest expense at a rate of 5% per year. However, under competent authority between Jurisdiction A and Jurisdiction B, Company X believes that it is more-likely-than-not that it will be able to amend its tax return for Jurisdiction B to reduce its taxable income for the related tax position that was not sustained in Jurisdiction A. In addition, Company X would be entitled to interest income on the overpayment of tax for the amended return in Jurisdiction B at a statutory interest rate of 6%.

What interest should Company X record?

Analysis

We believe that Company X should record interest expense on the liability of \$5 ($\$100 \times 5\%$) in Jurisdiction A and also record interest income of \$6 ($\$100 \times 6\%$) in Jurisdiction B.

EXAMPLE TX 15-6**Recording interest income on overpayments of tax**

Company A has determined that a tax position resulting in a \$1,000 tax benefit qualifies for recognition and should be measured. After considering all relevant information, management believes that there is a greater than 50% chance that all of the benefit will be realized. To stop interest charges from accumulating in the event that it loses the issue, Company A makes a payment to the taxing authority for the \$1,000. Under the laws of the jurisdiction in which this uncertainty exists, Company A will receive interest income from the taxing authority if the position is ultimately sustained.

Should Company A record any interest income on the \$1,000 payment?

Analysis

Yes. Because \$1,000 is the largest amount of benefit that is greater than 50% likely to be realized upon settlement, the \$1,000 payment would be considered a pre-payment to the taxing authority and recorded as an asset. Given that the settlement of the amount recorded in the financial statements would entitle Company A to interest income on the \$1,000 pre-payment, this interest income should be accrued by Company A.

15.6.2 Penalties

Certain situations trigger the potential imposition of penalties. Although it is the filing of a return that creates a legal obligation, the penalty should be recorded in the period in which the tax position is taken. Example TX 15-7 illustrates the impact past practice may have on the decision to accrue a penalty.

EXAMPLE TX 15-7**Considering a taxing authority's past practices to determine whether a tax penalty should be accrued**

Company X has filed tax returns in Jurisdiction Y and has determined that after the application of ASC 740's recognition and measurement criteria, \$100 of a tax benefit claimed on its tax return in Jurisdiction Y cannot be recognized for financial reporting purposes.

The relevant tax law in Jurisdiction Y provides for a 50% penalty assessment on any unpaid balance that exists after the original due date of the tax return (this amount is in addition to the requirement for interest to be paid on the unpaid balance). It is widely known that in Jurisdiction Y, the taxing authority routinely charges interest for underpayments, but historically has only assessed the 50% penalty if fraud is suspected or if the expectation that the tax position will be sustained based upon its technical merits is remote.

Company X has concluded that the tax position at issue did not constitute fraud and that the position has more than a remote chance of being sustained based on its technical merits.

How should Company X account for the penalty under the relevant tax law in Jurisdiction Y?

Analysis

In this instance, the taxing authority appears to have established a de facto minimum statutory threshold for assessment through its historical administrative practice of only assessing the 50% penalty under specified conditions.

Consistent with ASC 740-10-25-7, which provides for the consideration of past administrative practices and precedents that are widely understood, we believe that the administrative practice in regard to penalties should be considered. As a result, Company X should not accrue the 50% penalty.

15.6.3 Classification of interest and penalties

In accordance with ASC 740-10-45-25, the classification of interest on the liability for unrecognized tax benefits as either a component of income tax expense or interest expense is an accounting policy election that is required to be disclosed. Penalties are also allowed to be classified as a component of income tax expense or another expense classification (e.g., selling, general & administrative expense) depending on the reporting entity's accounting policy. See FSP 16.4.2 for additional information.

ASC 740 does not address the classification of interest income. We believe that it would be consistent to classify both interest income and interest expense as either a component of tax or of pretax income.

15.7 Intraproduct allocation for uncertain tax positions

The initial recognition of a liability for unrecognized tax benefits is a component of the tax expense for the current period subject to the ordinary intraperiod allocation process (see TX 12). As such, the tax expense associated with recording a liability for an unrecognized tax benefit may have initially been recorded in any of the components of income (e.g., continuing operations, discontinued operations, other comprehensive income) or equity. If the liability for unrecognized tax benefits is remeasured in a subsequent year, an entity should record the remeasurement in continuing operations. This conclusion is based on the principle in ASC 740-10-45-20 under which the tax effects of any changes to the beginning of the year valuation allowance (as a result of a change in judgment) is generally recorded in continuing operations. By analogy, the tax effects of a change in the opening balance of unrecognized tax benefits should be recorded in current-period income/loss from continuing operations. However, pursuant to ASC 740-20-45-3, we believe "backwards tracing" for the tax effects of the equity items listed in ASC 740-20-45-11(c) and (f) also includes both favorable and unfavorable adjustments resulting from changes in the assessment of uncertain tax positions. Refer to TX 12.3.3.3 for intraperiod allocation for OCI items, including changes in uncertain tax positions recorded through OCI.

We believe that the principle in ASC 740-10-45-20 also applies by analogy to unrecognized tax benefits related to prior period discontinued operations. As such, if a liability for unrecognized tax benefits that was allocated to discontinued operations in the year of its origination is remeasured in a subsequent year, the change in measurement would be recorded to continuing operations. However, we also believe that an alternative accounting treatment for this fact pattern could be supported by analogy to ASC 205. For example, consider remeasurements of a liability for unrecognized tax benefits when the original liability's tax expense was recorded in discontinued operations. ASC 205-20-45-4 requires that subsequent adjustments to contingencies recorded as part of prior-year discontinued operations be classified as discontinued operations in the period in which the subsequent adjustment is made. Although tax uncertainties are subject to ASC 740 and not ASC 450, we believe it is reasonable to

interpret tax uncertainties as contingencies under ASC 205-20-45-4. Therefore, subsequent resolution would be reflected in that year's financial statements as discontinued operations even in the absence of current-period pretax income or loss from discontinued operations (i.e., the income statement line item "income or loss from discontinued operations" would show a tax benefit, but no pretax income or loss).

We believe both alternatives are acceptable. The alternative selected, however, is an accounting policy and should therefore be applied consistently.

15.8 Indemnification arrangements

Income tax indemnifications are contractual arrangements established between two parties whereby one party will reimburse the other for income taxes paid to a taxing authority related to tax positions that arose (typically) prior to a transaction. Income tax indemnifications can arise from a number of circumstances, including business combinations, spin-offs and IPOs. Common scenarios, including the general direction of indemnification arrangements, are summarized below:

Scenario	Indemnifying Party		Indemnified Party
Sale of a subsidiary that previously filed a separate tax return	Seller	⇒	Buyer
Sale of a subsidiary that previously filed as part of a consolidated tax return	Seller	⇒	Buyer
Spin-off, IPO or carve-out of an entity that previously filed a separate tax return	Previous owner	⇒	New entity or shareholders
Spin-off, IPO or carve-out of an entity that previously filed as part of a consolidated tax return	Previous owner	⇔	New entity or shareholders

The accounting for indemnification arrangements described in the next sections differs from the accounting that would result if the entity purchased insurance coverage from a third party to mitigate its exposure. In that situation, the entity should consider the guidance in ASC 720-20, *Insurance Costs*. Indemnification arrangements may also arise in a number of commercial or financing transactions such as leases; however, the accounting for such arrangements is not addressed in this section.

15.8.1 Accounting for tax indemnification by indemnifying party

When determining how to account for an indemnification, entities should consider the relationship with the taxing authority and the relationship between the parties to the arrangement.

The indemnifying party must determine whether it is a primary obligor to the taxing authority. In situations in which an entity that previously filed a separate tax return is sold to a third party or spun-

off to shareholders, the determination may be clear. For example, when a US company sells its interest in a foreign subsidiary, the consolidated entity generally has no legal obligation to pay back taxes in the foreign jurisdiction subsequent to the sale. Therefore, even if the US company indemnified the buyer, it would likely not be the primary obligor.

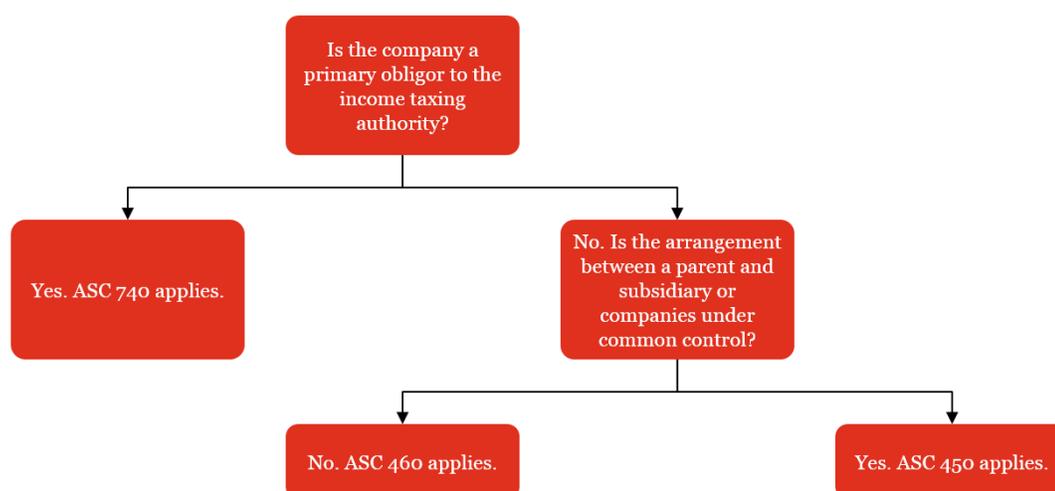
In situations in which the transferred entity was previously included as part of a consolidated return, the determination may be less clear and more than one party may be considered a primary obligor. If a company is a primary obligor to the taxing authority, it should account for any tax exposure pursuant to the uncertain tax provision guidance of ASC 740. If the tax is determined to be a non-income based tax, a similar analysis will need to be performed; however, the guidance in ASC 740 should not be followed. Rather, accounting guidance such as ASC 450 may need to be applied.

If an indemnifying party is not a primary obligor to the taxing authority, it should account for the tax risk pursuant to ASC 460, *Guarantees* (ASC 460), which requires the use of fair value based upon the guidance in ASC 820, *Fair Value Measurements and Disclosures* (ASC 820). The scope of ASC 460 does not apply to an indemnification issued between a parent and its subsidiary or between companies under common control. However, if a parent indemnifies a subsidiary prior to a spin-off or sale, a decision to retain the guarantee post transaction is the same as issuing a new guarantee at the date of the transaction. As a result, ASC 460 would apply subsequent to the transaction.

If the ASC 460 parent-subsidiary scope exception applies, a company should account for the indemnification pursuant to ASC 450, *Contingencies*. ASC 450 requires a company to accrue a liability when it is probable that the liability has been incurred and the amount of loss can be reasonably estimated.

Figure TX 15-1 illustrates considerations related to determining the applicable guidance for an indemnification.

Figure TX 15-1
Determining applicable guidance for an indemnification



A change in circumstances causing a change in the applicable principle may result in adjusting or recognizing (and possibly reclassifying) a liability. For example, a company that was previously a

primary obligor may have recorded a liability for unrecognized tax benefits pursuant to ASC 740. Following a disposition, the company is no longer a primary obligor to the taxing authority but may agree to indemnify the buyer. The company would need to adjust its liability to reflect an ASC 460 approach.

15.8.1.1 *Entities previously filed as part of consolidated return*

When a wholly-owned subsidiary that was previously included as a member of a consolidated federal income tax return is spun off from its parent, the subsidiary may agree to indemnify the parent for any income taxes that the parent may be assessed related to the resolution of the subsidiary's pre-spin uncertain tax positions. Further, because the entities were previously included as part of a consolidated return, both the parent and the spun-off entity may be considered a primary obligor under current US tax law.

In general, when considering the former subsidiary's indemnification of the parent, we do not believe it would be appropriate for the subsidiary to record a liability for the income taxes related to the parent's operations. Although the subsidiary may be legally liable for the parent's taxes (because the taxing authority may consider all entities in the original consolidated filing as jointly liable for the taxes of the entire pre-spin consolidated group), the convention under US GAAP is that each entity should recognize income taxes related to its own operations. However, if the parent becomes insolvent (and, therefore, the taxing authority's only recourse is to seek recovery from the subsidiary), it may be appropriate for the subsidiary to account for the potential liability related to the parent's tax uncertainties as a contingent liability in accordance with ASC 450.

15.8.2 *Accounting for tax indemnification by indemnified party*

The indemnified party must also determine if they are a primary obligor to the taxing authority and, if so, recognize and measure a liability in accordance with ASC 740. If the indemnifying and indemnified parties are both liable for the exposure, both parties should apply the guidance in ASC 740. The indemnified party must then determine the amount to recognize for the indemnification receivable.

The relevant accounting guidance for the indemnified party may differ depending on whether the transaction is accounted for as a business combination (see TX 10.7 for discussion of indemnification uncertainties in a business combination). Regardless of the recognition and measurement model followed for the indemnified asset, the indemnified party should not offset the indemnification receivable against the tax liability because those amounts are receivable from and payable to two different parties and so do not qualify for off-set.

The guidance in ASC 805 is limited to business combinations and, therefore, does not apply to transactions such as spin-offs or asset acquisitions. Accordingly, the question arises whether "mirror image" accounting should be applied to transactions other than business combinations. In "mirror image" accounting, the indemnified party recognizes an indemnification asset (as it relates to the uncertain tax position) at the same time that it recognizes the indemnified item and measures the asset on the same basis as the indemnified item.

Question TX 15-4 addresses the tax accounting related to indemnification receivables.

Question TX 15-4

Company B used to be the parent of **Company A**. However, the two companies are no longer related. **Company B** has indemnified **Company A** for any uncertain tax position liabilities ultimately payable by **Company A** related to periods when **Company B** was **Company A**'s parent. Therefore, **Company B** has recorded an indemnification receivable equivalent to its uncertain tax position liabilities from that time period. **Should deferred income taxes be recorded related to the indemnification receivable?**

PwC response

No. From a US tax perspective, there are typically no consequences from indemnification payments. The amount paid to the taxing authority and the amount collected from the seller would generally offset, with no net impact on taxable earnings. As a result, in most cases the indemnification receivable recorded would not be expected to have a deferred tax effect.

Question TX 15-5 addresses intraperiod considerations related to tax consequences of an indemnification.

Question TX 15-5

Company A spins off **Company B** but retains a partial interest. The spinnor (**Company A**) may indemnify the spinnee (**Company B**) for a legal claim. When the legal claim is settled, any necessary indemnification payments from the spinnor to the spinnee would constitute taxable income to the spinnee. How should the tax consequences of the indemnification payment be recorded?

PwC response

In this case, the tax consequences of the indemnification payment should generally be recorded in the same manner as the indemnification payment. For example, if the indemnification payment is recorded as a capital contribution due to an ownership relationship between the two parties, the tax consequences should also be recorded in accumulated paid-in-capital.

In certain situations, in an effort to neutralize the impact of a tax exposure to a fund's net asset value (NAV), a fund manager is willing to indemnify the fund for its tax exposure. In connection with the implementation of ASC 740's guidance related to uncertain tax positions, certain investment funds approached the SEC staff for guidance on how to measure an indemnification receivable. In a letter to the funds, the SEC staff noted 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." The SEC's letter provides support for recognizing the indemnification receivable at the same amount as the recorded liability absent any collectability or contractual limitations on the indemnified amount.

A more common indemnification scenario, outside of a business combination, is when a parent spins off a subsidiary. Following the spin-off, the parent may indemnify the new entity for income tax exposures related to the spun-off entity's prior operations. Assuming that the indemnification fully covers the exposure, we believe that it would be reasonable for the spun-off entity to record an indemnification receivable at the same amount as the tax liability. This view is consistent with the SEC's letter to the funds.

When a parent retains a controlling interest after a transaction like an IPO or spin-off, the parent-subsidiary relationship survives the transaction. If the parent indemnifies the subsidiary, consideration should be given to whether the indemnification asset and subsequent changes should be recorded in equity.

15.8.3 *Presentation and disclosure—indemnified arrangements*

An indemnification asset should not be netted against the related liability. Adjustments to the indemnification asset should be recorded in pre-tax income, not as part of income tax expense. The income tax line item is reserved for only those amounts expected to be paid to (or received from) the taxing authorities. Therefore, although dollar-for-dollar changes in an income tax liability and a related indemnification asset will offset on an after-tax basis, pre-tax income measures and a company's effective tax rate will be impacted.

Companies should ensure that liabilities for unrecognized tax benefits, regardless of whether covered by an indemnification agreement, are included in the company's annual disclosures. That is, the disclosures required by ASC 740-10-50-15 would reflect the unrecognized tax benefits with no offset or netting for an indemnification. For example, the company would need to include the tax position in its disclosure of gross amounts of increases and decreases in unrecognized tax benefits and amounts that, if recognized, would affect the effective tax rate. However, it may often be necessary to provide additional disclosure in regard to the terms of any indemnification arrangements so that financial statement readers can appropriately assess the net economic exposure to the entity.

Chapter 16:
Accounting for income taxes
in interim periods

16.1 Overview — accounting for income taxes in interim periods

ASC 740-270, *Interim Reporting*, prescribes the use of an estimated annual effective tax rate (ETR) for calculating a tax provision for interim periods. This guidance focuses primarily on how to compute interim period tax provisions, though it does not provide guidance on the presentation of deferred tax assets and liabilities and other tax-related balance sheet tax accounts in interim periods. This chapter walks through some of the key considerations and complexities in accounting for income taxes during interim periods.

16.2 Basic method of computing an interim tax provision

At each interim period, a company is required to estimate its forecasted full-year effective tax rate. That rate is applied to year-to-date ordinary income or loss in order to compute the year-to-date income tax provision. In order to compute the annual ETR, a company needs to estimate its full year ordinary income and its total tax provision, including both current and deferred taxes. When a company is subject to tax in multiple jurisdictions, one overall (i.e., worldwide) estimated annual ETR is developed and applied to consolidated ordinary income/(loss) for the year-to-date period, with certain exceptions and limitations as discussed later in this chapter.

If management is unable to estimate a portion of its ordinary income, but is otherwise able to reliably estimate the remainder, ASC 740-270-25-3 provides that the tax applicable to that item be reported in the interim period in which the item occurs. Examples of such items may include, but are not limited to, foreign exchange gains or losses and changes in the fair value of certain equity method investments that are required to be recognized in the income statement in accordance with ASC 321, *Investments – Equity Securities*.

ASC 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.

ASC 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.

ASC 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.

Since the tax effects of current-year ordinary income receive different interim accounting treatment than the tax effects of other types of income during the same period, the definition of ordinary income is important. The glossary in ASC 740-270-20 defines these terms.

Definitions from ASC 740-270-20

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 definition of the terms unusual nature and infrequency of occurrence.

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 paragraph 225-20-60-3).

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 paragraph 225-20-60-3). The language in ASC 740-270-25-2 makes it clear that the estimated annual ETR only applies to the tax effect of ordinary income. Other events and/or transactions may occur that relate to continuing operations, but do not represent “ordinary income” or tax effects thereon. The tax effects of such events are accounted for discretely in the interim period in which they occur and should not be included in the derivation of the company’s estimated annual ETR. However, the pre-tax income and tax effects of some “non-operating” items, for example gains or losses from the disposal of fixed assets or the tax benefit of dividends-received deductions, as long as they are not considered unusual or infrequent, should be incorporated into the calculation of the estimated annual ETR.

16.3 *Interim provision—items excluded from ordinary income*

Although most items fall within the definition of ordinary income, there are also items which should be excluded from the definition of ordinary income. In some cases, the standard is clear regarding items that should be excluded from the definition of ordinary income, and other times, judgment will be necessary.

16.3.1 *Interim provision—significant unusual or infrequent items*

ASC 740-270-30-12 provides guidance related to specific items that should be excluded from the annual effective tax rate calculation. In addition, ASC 270-10-45-11A states that “gains or losses from disposal of a component of a reporting entity, and unusual or infrequently occurring items shall not be prorated over the balance of the fiscal year.”

ASC 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.

The definition of “ordinary income (or loss)” referred to in ASC 740-270-20 differentiates ordinary income from items that are unusual in nature or that occur infrequently.

An item does not need to be both unusual and infrequent to be excluded from the estimated annual effective tax rate calculation. Deciding whether an item is unusual or infrequent is an area of significant judgment, and a company’s business model may be relevant to that evaluation. For example, catastrophe losses (e.g., losses resulting from natural disasters, such as hurricanes) are not unusual or infrequent for property and casualty insurance companies because those companies are in the business of insuring customers against those risks. However, the losses from a hurricane may well be unusual or infrequent for a manufacturing company with only one of its plants in a hurricane zone.

Example TX 16-1 illustrates the impact of goodwill impairment on an interim period tax provision.

EXAMPLE TX 16-1**Impact of goodwill impairment on interim period tax provisions**

Company ABC recorded a financial statement impairment of goodwill during the second quarter.

Would the impairment of goodwill be considered an unusual or infrequent item that requires discrete treatment, or should it be considered a component of the estimated annual ETR?

Analysis

While judgment is necessary to determine whether a goodwill impairment should be classified as an unusual or infrequent item, in circumstances in which there has been no history of goodwill impairments and there is presently no reasonable expectation of significant goodwill impairments in the future, the tax effect of the impairment would typically qualify for discrete treatment in the period in which the impairment is recorded.

Example TX 16-2 compares the quarterly (and year-to-date) tax consequences of a restructuring charge that is classified as a discrete item to an item that is part of ordinary income.

EXAMPLE TX 16-2**The impact of including or excluding an item in the annual ETR**

Company ABC projected \$165 of pre-tax book income and \$190 of pre-tax book income adjusted for permanent items and an annual ETR of 28.8%. In the second quarter, Company ABC recorded a \$50 restructuring charge. The restructuring had not been anticipated at the end of the first quarter. As a result, Company ABC now projects \$115 of pre-tax book income and \$140 of pre-tax book income adjusted for permanent items. The statutory tax rate for the jurisdiction is 25%.

What is the impact of the restructuring charge if it is classified as discrete item versus an item that is part of ordinary income?

Analysis

The following table illustrates the tax impact between the annual ETR including and excluding the restructuring charge:

		Estimated Annual ETR (excluding restruck- turing charge)	Estimated Annual ETR (including restruck- turing charge)
Pre-tax book income (before restructuring)		\$165.0	\$165.0
Less: Restructuring expense			(50.0)
Projected pre-tax book income (after restructuring)		\$165.0	\$115.0
Add back: Nondeductible meals & entertainment		25.0	25.0
Projected pre-tax income adjusted for permanent items		\$190.0	\$140.0
Statutory rate		25%	25%
Projected tax expense on pre-tax income plus permanent items		\$47.5	\$35.0
Estimated Annual ETR		28.8%	30.4%
Tax benefit from restructuring (\$50.0 x 25%)		(12.5)	
Projected tax expense for the year		\$35.0	\$35.0
	Q1	Q2	Q3
Pre-tax book income (before restructuring)	\$50.0	\$30.0	\$60.0
Less: Restructuring expense in Q2		(50.0)	
Pre-tax book income	\$50.0	\$(20.0)	\$60.0
Quarterly YTD tax expense if restructuring impairment is considered unusual or infrequent and the tax effects are reported entirely in Q2 ¹	\$14.4 ¹	\$(3.9) ²	\$17.3 ¹
			\$7.2 ¹

			Estimated Annual ETR (excluding restruck- turing charge)	Estimated Annual ETR (including restruck- turing charge)
Reported quarterly YTD ETR (discrete) ⁴	28.8%	19.5%	28.8%	28.8%
Reported year-to-date ETR (discrete) ⁴	28.8%	35.0%	30.1%	30.4%
Quarterly YTD tax expense if restructuring impairment is considered ordinary and the forecasted ETR is used for the remainder of the year) ¹	\$14.4 ¹	\$(5.3) ³	\$18.3 ¹	\$7.6 ¹
Reported quarterly YTD effective rate (spread) ⁴	28.8%	26.4%	30.4%	30.4%
Reported year-to-date ETR (spread) ⁴	28.8%	30.4%	30.4%	30.4%

¹ Calculated as pre-tax income x annual ETR (Quarterly pre-tax book income x 28.8%)

² Calculated as pre-tax income x annual ETR plus discrete adjustment (\$30 x 28.8%) + ((\$50) x 25%)

³ Calculated as pre-tax income x annual ETR plus catch up from Q1 change in AETR (\$50 x (28.8% - 30.4%)) + ((\$20) x 30.4%)

⁴ Reported ETR is the rate derived from taking the reported total tax provision divided by pre-tax book income (i.e., the rate implied from the reported financial statements).

Example TX 16-3 illustrates the impact of a capital gain on an interim period tax provision.

EXAMPLE TX 16-3

Impact of capital gains on interim period tax provisions

Company ABC is a manufacturing company that invests excess funds in a portfolio of debt securities, classified as available-for-sale securities under ASC 320, *Investments - Debt and Equity Securities*. The interest income generated from the portfolio has been consistent with management estimates since inception and is included in the development of Company ABC's annual ETR. The portfolio, by design, contains low-risk investments, and the company has typically held the debt securities to maturity and therefore experienced minimal capital gains or losses.

During the third quarter, there is significant appreciation in one of the debt securities and Company ABC realizes a capital gain when the security is unexpectedly redeemed by the issuer prior to maturity. This gain will allow utilization of historical capital loss carryforwards for which Company ABC had previously recorded a full valuation allowance.

Company ABC determined that the redemption and resulting capital gain were unusual and/or infrequent, given their history of holding debt securities to maturity and presented the item as a separate component of income from continuing operations.

Should the related tax effect be included or excluded from the estimated annual ETR calculation?

How should the benefit from the release of the valuation allowance on the historical capital loss carryforwards be reported?

Analysis

Because the redemption was deemed to be unusual and separately reported, Company ABC would not include the tax effect in the estimate of the ETR. Since the gain (which is treated discretely) is triggering the release of the valuation allowance, that impact should also be recognized discretely in the period of the redemption.

Even if Company ABC determined that the redemption did not need to be separately reported, and was not significant or unusual, it would still need to consider whether an estimate could be made of capital gains for purposes of determining the ETR. In situations when capital gains and losses cannot be estimated, discrete treatment might be appropriate (see TX 16.5). However, in situations when an entity's business model and operations inherently include the generation of capital gains and losses, those expectations should be considered in determining the estimated annual ETR.

Example TX 16-4 illustrates the interim period accounting when a parent company plans to purchase the noncontrolling interest in a partnership.

EXAMPLE TX 16-4

Interim period accounting when a parent company plans to purchase the noncontrolling interest in a partnership

Company ABC consolidates a 60%-owned partnership (a flow-through entity for tax purposes) and is preparing its first quarter tax provision. Company ABC expects to purchase the 40% noncontrolling interest (NCI) in the third quarter of the current year. The timing and terms of the expected acquisition are established, and pursuant to Company ABC's rights under the partnership agreement, Company ABC concludes that the transaction is primarily within its control. The purchase of the NCI will increase Company ABC's estimated annual ETR because Company ABC currently consolidates the partnership (i.e., includes 100% of the partnership's results in pre-tax income), but only recognizes the tax expense associated with 60% of the partnership's income. The tax on the remaining 40% is the tax obligation of the noncontrolling interest holder and is not recognized in Company ABC's consolidated financial statements.

Should the anticipated third-quarter purchase of the NCI have an impact on Company ABC's ETR in the first quarter?

Analysis

The first hurdle is whether the anticipated acquisition of an ownership interest should ever be considered in the annual estimated ETR prior to consummation. In the case of most business acquisitions or dispositions between unrelated third parties, we believe those transactions should not be considered in the ETR until they occur. However, in light of the fact that the anticipated purchase of the noncontrolling interest in this fact pattern is primarily within Company ABC's control, we believe it may be appropriate to consider including the transaction in the ETR. The second hurdle is whether Company ABC views the transaction as ordinary or not. If it is considered unusual/infrequent, it should be treated as discrete when the purchase of the NCI occurs. The nature of Company ABC's business, their reasons for holding the partnership investment, and their relationship with the

noncontrolling interest holder are all factors that Company ABC would consider in making that assessment.

16.3.2 *Interim provision—discontinued operations*

See ASC 205-20-45-1 for a discussion of what constitutes a discontinued operation. Under that guidance, the results of operations and the gain or loss from disposal of discontinued operations are presented net of tax and outside of continuing operations in the income statement. Pursuant to the guidance in ASC 740-270-30-12, items reported net of their related tax effect (e.g., discontinued operations) are excluded from the ETR calculation. The tax effect of the discontinued operation should be recognized when it occurs under ASC 740-270-25-2.

16.3.3 *Interim provision—change in accounting principle*

The cumulative effect of a change in accounting principle is presented net of its related tax effects outside of continuing operations. Therefore, pursuant to the guidance in ASC 740-270-30-12, these changes and their related tax effects are excluded from the ETR calculation and should be recognized when they occur under ASC 740-270-25-2.

16.3.4 *Interim provision—limited exceptions for other items*

In general, ordinary income is defined broadly under ASC 740-270 such that most items will be considered part of the ETR calculation. However, there are a number of specific exceptions.

16.3.4.1 *Interim provision—tax-exempt interest*

Tax-exempt securities often form a portion of ordinary income of an entity that routinely invests in such securities and the related interest may be appropriately considered in the annual ETR calculation. However, it is also acceptable to exclude tax-exempt interest from the annual ETR calculation based on a specific discussion in the basis for conclusions in FASB Interpretation No. 18, *Accounting for income taxes in interim periods*, paragraph 80. The FASB acknowledged the then-common practice of excluding tax-exempt interest from the estimated annual ETR calculation and explicitly acknowledged their decision not to provide specific guidance on this issue.

Whichever approach is selected should be applied consistently.

16.3.4.2 *Interim provision—investment tax credits*

ASC 740-270-30-14 and ASC 740-270-30-15 provide guidance for the impact of investment tax credits (ITCs) on the estimated annual ETR. Whether investment tax credits are included or excluded in the ETR calculation depends, in part, on the accounting treatment selected for the credits—the flow-through method or the deferral method. As described in ASC 740-270-30-14, if the deferral method is elected, amortization of the deferred ITCs does not need to be considered in estimating the ETR. See TX 3 for additional guidance for the accounting for investment tax credits.

ASC 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 ASC 740-10-25-46 and 740-10-45-28).

16.3.4.3 Interim provision—income from equity method investments

It is typically appropriate to record an investor's equity in the net income of a 50% (or-less) owned investee on an after-tax basis (i.e., the investee would provide taxes in its financial statements based on its own estimated annual ETR calculation). It may be appropriate to exclude any incremental tax incurred at the investor level (e.g., the deferred tax liability for unremitted earnings) from the calculation of the investor's overall ETR calculation. Instead, this incremental tax would be calculated based on a separate ETR calculation related to the investee (i.e., the amount of incremental tax expected to be incurred in the annual period divided by the estimated annual amount of equity method income). We are aware of diversity in practice in this area and, to the extent material, recommend disclosure of the selected method.

16.3.4.4 Interim provision—changes in uncertain tax positions

Pursuant to ASC 740-10-25-14 through ASC 740-10-25-15, the existence of new information that results in a change in judgment that causes subsequent recognition, derecognition, or a change in measurement of a tax position taken in a prior annual period is to be recognized as a discrete item (including interest and penalties) in the period in which the change occurs. For example, if an event during an interim period (e.g., a court case or tax ruling related to another taxpayer with a similar exposure) prompts a change in the assessment of the sustainability of a tax position taken in a prior year, the effect of the change should be recorded discretely in the period in which the assessment changes.

However, pursuant to ASC 740-270-35-6, if the event results in a change in the assessment with respect to a current-year tax position that is considered part of ordinary income, the new assessment should generally be incorporated into the revised ETR that will be applied to the year-to-date ordinary income. If the tax uncertainty relates to a pre-tax item that is accounted for discretely, such as discontinued operations, then the change in assessment would simply be part of the calculation of the tax effect of that item.

16.3.4.5 Interim provision—interest and penalties

ASC 740-10-25-56 requires accrual of interest on the liability for unrecognized tax benefits from the first period in which the interest would begin accruing according to the provisions of the relevant tax law. Therefore, interest expense should be accrued as incurred and should be excluded from the estimated annual ETR calculation. ASC 740-10-25-57 indicates that a penalty should be recorded when a tax position giving rise to a penalty is taken or anticipated to be taken on the tax return, or when the entity's judgment about whether the position gives rise to a penalty changes. Therefore, penalties should also be accrued as incurred and should be excluded from the estimated annual ETR

calculation. Interest and penalties should be accounted for discretely as they occur under ASC 740-270-25-2 since they are not related to ordinary income.

16.3.4.6 *Interim provision—change in tax law or rate*

ASC 740-270-25-5 through ASC 740-270-25-6 discuss when to recognize the effect of changes in tax laws.

ASC 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.

ASC 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.

In accordance with ASC 740-270-25-5 through ASC 740-270-25-6, adjustments to deferred tax assets and liabilities as a result of a change in tax law or rates should be accounted for discretely in continuing operations at the date of enactment. Similarly, the effects of a retroactive change in tax rates should be accounted for discretely in continuing operations in the interim period in which the law is enacted. However, the prospective effects of a change in tax law or rates on tax expense for the year of enactment should be reflected in the estimated annual ETR calculation. See TX 7.4 (including Example TX 7-2) for more information on the accounting for changes in tax law.

16.3.4.7 *Interim provision—change in tax status*

As specified in ASC 740-10-25-32 through ASC 740-10-25-34, the effect of a voluntary change in tax status should be recognized discretely on (1) the date that approval is granted by the taxing authority or (2) the filing date, if approval is unnecessary. The entire effect of a change in tax status should be recorded in continuing operations in accordance with ASC 740-10-45-19. TX 8 offers more information on the accounting for changes in tax status.

16.3.4.8 *Interim provision—change in valuation allowance*

The need for a valuation allowance must be reassessed at each interim reporting date. Under the guidance in ASC 740-270-25-4 and depending on the circumstances that lead to a change in valuation allowance, the change may be reflected in the estimated annual ETR or recognized discretely in the interim period during which the change in judgment occurred, or both.

ASC 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.

ASC 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.

As prescribed by ASC 740-270-25-7, the interim accounting for the effect of a change in the beginning-of-the-year balance of a valuation allowance will depend on whether the change is being driven by income in *future* years or the *current-year*.

ASC 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.

Under ASC 740, companies should include the changes in valuation allowance in determining the ETR for the year when the change relates to deductible temporary differences and carryforwards expected to originate during the current year as well as decreases to the valuation allowance associated with current year income (refer to Example TX 16-5 for further details). If there is a reduction in the valuation allowance for beginning-of-year deferred tax assets that results from income other than ordinary income (e.g., discontinued operations), the benefit should be reflected discretely in year-to-date results (presuming, of course, that current-year continuing operations and projections of future income could not have supported the realization).

Example TX 16-5 illustrates a change in the assessment of the realizability of beginning-of-year deferred tax assets as a result of changes in projections of future income.

EXAMPLE TX 16-5**Change in assessment of the realizability of beginning-of-year deferred tax assets as a result of changes in projections of future income**

At the end of the second quarter, a company determines that future taxable income for the current year and for future years will be higher than estimated at the end of the previous year due to an increase in sales orders. This will permit a decrease in the valuation allowance against deferred tax assets related to NOL carryforwards that existed at the beginning of the year.

The company had \$3,000,000 of NOL carryforwards available at the beginning of the year. At that time, the enacted tax rate was 33.5%. Management maintained a valuation allowance of \$1,005,000 for the full amount of the deferred tax asset related to the NOL carryforward at the end of the prior year. Although the company broke even for the first three months of the current year, a second quarter increase in net income and sales orders has prompted the company to (1) revise its estimate of current-year income from zero to \$200,000 and (2) change the expectation regarding income in future years to be sufficient to allow recognition of the entire deferred tax asset. This will permit a full reversal of the valuation allowance for NOL carryforwards that existed at the beginning of the year.

Should this change in judgment be recorded as a discrete event that is accounted for in the second quarter, or should the change be allocated to subsequent interim periods as part of the estimated annual ETR calculation?

Analysis

The decrease in the valuation allowance is the result of a change in judgment about income in both the current and future periods. Thus, the release of the valuation allowance has two components: (1) the portion related to a change in estimate regarding current-year income and (2) the portion related to a change in estimate about future years' income.

The first component is recognized in income by adjusting the estimated annual ETR for the current year (i.e., the reduction in the valuation allowance is spread over the current year-to-date results and subsequent quarters through the revised ETR). The second component is recognized entirely in the second quarter as a discrete item.

As a result of revising the estimate of future profitability at the end of the second quarter, the company calculates current-year income taxes as follows:

Estimated full-year pre-tax income	\$200,000
Tax expense:	
Tax on current-year income at 33.5%	67,000
Reversal of valuation allowance related to current year income	(67,000)
Total current tax	<u>\$—</u>
Estimated ETR at end of second quarter [$\$0 / \$200,000$]	<u>0.0%</u>

Reversal of valuation allowance based on future years' income (\$1,005,000 less \$67,000 current year portion)	(938,000)
Total tax provision (benefit)	(938,000)
Net income	\$1,138,000

The \$938,000 valuation allowance release attributable to future year's income would be accounted for as a discrete event in the second quarter.

The tax benefit associated with the income from the current year would be incorporated into the annual ETR calculation and would offset the current tax expense on the income generated during the current year resulting in a 0.0% ETR for the six-month period. At the end of the year, assuming no other temporary differences arising during the year, the deferred tax asset account would have a balance of \$938,000, and there would be no valuation allowance. The following is a summary of activity by quarter, which demonstrates the release of the valuation allowance.

Reporting period	Quarterly income/ (loss)	Year-to-date income/ (loss)	Est. annual effective tax rate	Tax (or benefit)			
				Year-to-date ETR	Discrete	Less previous-ly provided	Reporting period amount
First quarter	\$ —	\$ —	0.0%	\$ —	\$ —	\$ —	\$ —
Second quarter	50,000	50,000	0.0%	—	\$(938,000)	—	(938,000)
Third quarter	50,000	100,000	0.0%	—	(938,000)	(938,000)	—
Fourth quarter	100,000	200,000	0.0%	—	(938,000)	(938,000)	—
Fiscal year		\$200,000					\$(938,000)

The 0.0% ETR consists of the current tax provision of \$67,000 on the current year income of \$200,000, fully offset by the deferred tax benefit of the corresponding release of the valuation allowance.

If, in the third quarter, Company A revises its forecast of current year ordinary income to \$500,000, the annual ETR remains zero (because there is sufficient NOL to shelter current year ordinary income). Company A would record a discrete period adjustment in the third quarter to reflect the effect of the change to the amount expected to reverse in *future years*. This would effectively reverse a portion of the discrete period benefit recognized in an earlier interim period because more of the valuation allowance reversal is being attributed to current year earnings.

16.3.4.9 Interim provision—indefinite reinvestment assertion

A company may change its intentions or the facts and circumstances may change, which may impact whether it will indefinitely reinvest undistributed earnings of foreign subsidiaries, or of corporate joint ventures that are essentially permanent in duration, and thus whether deferred taxes need to be recognized. In these situations, the tax effect of the change in judgment for the establishment (or reversal) of the deferred tax liability related to an outside basis difference that had accumulated *as of the beginning of the year* should be excluded from the annual ETR calculation and recognized in the interim period during which the intention or assertion changes.

The tax effect of a change in intention or assertion related to earnings (ordinary income) generated during the *current* year should be included in the company's estimated annual ETR calculation.

16.3.4.10 Change in estimate related to prior-year tax provision

As discussed in TX 16.2, the language in ASC 740-270-25-2 provides that the estimated annual ETR approach should only be used to record the tax effect of ordinary income for the period. A change in estimate in the current year that is related to a prior-year tax provision does not constitute a tax effect of current-year income. Therefore, the effects of this type of change should be recorded discretely in the interim period during which the change in estimate occurs. TX 6.3 presents guidance for determining whether a change in the prior-year tax provision is an error or a change in estimate.

16.4 Computing the estimated annual ETR

The estimated annual effective tax rate should represent the best estimate of the composite tax provision in relation to the best estimate of worldwide pre-tax book ordinary income. The composite tax provision should include federal, foreign, and state income taxes, including (but not limited to) the effects of credits, special deductions, capital gains taxed at different rates, effects of uncertain tax positions related to the current year, and valuation allowances for current-year changes in temporary differences and losses or income arising during the year. The estimated annual ETR is then applied to year-to-date ordinary income to compute the year-to-date interim tax provision on ordinary income. The tax effect of discrete items is then added to compute the total year-to-date interim tax provision.

The difference between the current quarter's year-to-date interim tax provision and the year-to-date interim tax provision as of the preceding interim period constitutes the tax provision for that quarter. Because of this, the ETR for any particular quarter may not have a predictable relationship to pre-tax income for the quarter or the current estimated annual ETR.

There are certain circumstances when the basic ETR approach cannot be applied or must be modified. See TX 16.4.2 for discussion of when the tax benefit of interim losses may be limited, and TX 16.5 for exceptions to the ETR approach.

ASC 740-270-55 contains numerous examples that illustrate the application of the estimated annual ETR approach to a variety of fact patterns. Examples address:

- Income fluctuates from quarter to quarter
- Valuation allowance considerations
- Losses projected for the year or incurred on a year-to-date basis

- Multiple jurisdictions
- Tax law changes
- Discontinued operations
- Significant unusual or infrequent items

Use of the ETR approach, as required by ASC 740-270, could yield results that are materially different from a discrete calculation of the year-to-date provision. The two approaches are applicable in specific situations and are not interchangeable and not subject to a policy choice.

16.4.1 Best current estimate of the annual ETR

ASC 740-270 requires companies to make their best estimate of the annual ETR for ordinary income. At the end of each period, companies should make the best estimate for the full fiscal year; however, there may be instances when the year-to-date actual ETR during the period represents the best estimate of the annual ETR.

ASC 740-270-30-18

Estimates of the annual ETR 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 ETR for the year to date may be the best estimate of the annual ETR.

16.4.1.1 Treatment of nonrecognized subsequent events on the ETR

At times, a significant pre-tax nonrecognized subsequent event may occur after the interim balance sheet date but before financial statement issuance. If the subsequent event is not of a nature that would inherently be treated as a discrete item for interim tax accounting purposes, a question arises about whether the company's estimate of annual pre-tax ordinary income should be updated. For example, subsequent to the interim balance sheet date, a significant new customer contract could be signed or severe hurricane losses may be suffered by an insurance company. In both instances, the subsequent event significantly changes the company's current estimate of its annual pre-tax ordinary income and thereby its estimated annual ETR.

ASC 740-270-35-3 requires that the estimated annual ETR be revised, if necessary, at the end of each interim period during the fiscal year to reflect the company's best estimate. Relying on this guidance, it is reasonable to conclude that the company's best current estimated annual ETR should be based on information available prior to the date of issuance, even though some of that information did not exist at the interim balance sheet date.

Conversely, ASC 855-10-25-3 indicates that nonrecognized subsequent events should not be reflected in the financial statements. If an entity were to incorporate a significant nonrecognized subsequent event into the development of an updated ETR, some of the subsequent event's indirect effects would be recorded in the balance sheet date that precedes the nonrecognized event. Following that guidance, it would be reasonable to conclude that the effects of a nonrecognized subsequent event should be excluded from the interim calculation of the ETR.

Given that either approach can be supported by a reasonable interpretation of existing guidance, we believe that both are acceptable.

Regardless of the approach chosen, it is important to distinguish those items whose tax effects are required to be recognized discretely in the period that they occur, such as: (1) changes in tax laws or rates, (2) new information received after the reporting date related to the assessment of uncertain tax positions (as discussed in ASC 740-10-35-2, TX 15.5.4 and TX 16.3.4.4), and (3) discontinued operations, and other significant unusual or infrequent items (as discussed in TX 16.3.1).

When there is a significant time lag from the interim date to the date of the issuance of the financial statements (as may be the case with a company reporting on a prior interim period for the first time in connection with an initial public offering), it may become increasingly difficult to assert that an event in the extended period should affect the estimated annual ETR applied to the interim period. We generally believe that the delayed issuance of the financial statements should not result in a different assessment of the estimated annual ETR than would have been the case had the financial statements been issued on a timely basis.

16.4.2 *Limitation on benefits of losses in interim periods*

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. The guidance removes certain exceptions to the general principles of ASC 740 and simplifies several other areas. ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. If an entity chooses to early adopt, it must adopt all changes as a result of the ASU. The transition provisions vary by amendment.

One of the amendments within ASU 2019-12 eliminates a limitation on the amount of income tax benefit that can be recognized in an interim period when a year-to-date loss exceeds the anticipated loss for the year. This amendment should be applied on a prospective basis. See TX 16.4.2.1A for applicable guidance before adoption of ASU 2019-12.

16.4.2.1 *Limitation on benefits of losses in interim periods (after adoption of ASU 2019-12)*

The income tax provision/benefit reflected in interim financial statements is generally based on the company's estimated annual ETR. However, ASC 740-270-30-30 through ASC 740-270-30-34 modifies the ETR approach in certain instances when a company incurs losses in interim periods and the tax benefit of those losses may be limited.

Generally, the amount of income tax benefit recognized should not exceed the tax benefit the company expects to (a) realize during the year (e.g., when losses incurred earlier in the fiscal year are expected to be offset by income during the remaining periods of the fiscal year), or (b) recognize as a deferred tax asset or a tax receivable (if the company expects to carryback the loss to offset income taxes paid previously) at the end of the fiscal year. In applying this guidance in interim periods, companies need to assess the realizability of forecasted end-of-year deferred tax assets. A company should consider if it

expects a valuation allowance to be necessary at year end, including any expected change in the valuation allowance during the balance of the year.

16.4.2.1A Limitation on benefits of losses in interim periods (before adoption of ASU 2019-12)

The income tax provision/benefit reflected in interim financial statements is generally based on the company's estimated annual ETR. However, ASC 740-270-30-30 through ASC 740-270-30-34 modifies the ETR approach in certain instances when a company incurs losses in interim periods, and the tax benefit of those losses may be limited.

Generally, the amount of income tax benefit recognized should not exceed the tax benefit the company expects to (a) realize during the year (e.g., losses incurred earlier in the fiscal year are expected to be offset by income during the remaining periods of the fiscal year), or (b) recognize as a deferred tax asset or a tax receivable (if the company expects to carryback the loss to offset income taxes paid previously) at the end of the fiscal year. In applying the loss limitation guidance in interim periods, companies need to assess the realizability of forecasted end-of-year deferred tax assets. A company should consider if it expects a valuation allowance to be necessary at year end, including any expected change in the valuation allowance during the balance of the year.

Another limitation in ASC 740-270-30-28 applies when the year-to-date pre-tax loss exceeds the amount of the anticipated full-year pre-tax loss. In these cases, the year-to-date tax benefit is limited to the amount that would be recognized if the year-to-date loss were the anticipated full-year loss. Essentially, the year-to-date period is deemed to be the full year for purposes of computing the tax benefit to be recognized.

This limitation should be applied in determining both separate jurisdiction and worldwide estimated annual ETRs. We believe that this limitation also applies to foreign rate differentials that would potentially increase the tax benefit to be recognized in the ETR during loss periods.

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. One of the amendments within ASU 2019-12 eliminates a limitation on the amount of income tax benefit that can be recognized in an interim period when a year-to-date loss exceeds the anticipated loss for the year. See TX 16.4.2 and TX 16.4.2.1 for additional information on ASU 2019-12, including effective dates, transition requirements, and post-adoption guidance.

16.5 Exceptions to the use of the worldwide estimated annual ETR

ASC 740-270 requires the use of an estimated annual effective tax rate to compute the tax provision for ordinary income in all jurisdictions during an interim period (refer to TX 16.4 for computing the estimated annual ETR). As discussed in TX 16.2, whether a reliable estimate of ordinary income or loss or the related tax can be made is a matter of judgment. ASC 740-270-25-3 provides that the tax applicable to items that cannot be estimated be reported in the interim period in which the item occurs. The tax effect of these items is therefore excluded from the annual ETR and recognized discretely.

There are, however, two situations in which ASC 740 provides an exception to the use of a worldwide ETR.

ASC 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 ([ASC] 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.

State and municipal income tax jurisdictions are subject to the same exceptions with respect to what can be included in the consolidated worldwide ETR.

The estimated annual ETR approach can yield unconventional results (such as a negative ETR or an ETR exceeding 100%). Nevertheless, apart from ASC 740-270-30-18 discussed in TX 16.2 and the specific exceptions noted in ASC 740-270-30-36, ASC 740-270 provides no flexibility in the requirement to apply the ETR approach.

16.5.1 Loss jurisdictions for which no benefit can be recognized

When a company operates in a jurisdiction that has generated ordinary losses on a year-to-date basis, or anticipates an ordinary loss for the full fiscal year, and no benefit can be recognized on those losses, ASC 740-270-30-36(a) requires the company to exclude that jurisdiction's income (or loss) from the overall estimate of ETR. A separate ETR should be computed and applied to ordinary income (or loss) in that jurisdiction. In effect, any jurisdictions with losses for which no benefit can be recognized are removed from the base calculation of the ETR. If the reason that no benefit can be recognized is

because the resulting net operating loss deferred tax asset is subject to a full valuation allowance, the separate ETR for that jurisdiction will often be zero.

We also believe that the use of the term *no tax benefit* is an absolute standard. If a company can record *any* benefit (e.g., carryback of current-year losses to offset income in prior years), the ETR approach should be used unless another exception applies.

Example TX 16-6 illustrates the treatment of withholding tax in an interim period income tax calculation for a reporting entity with operations in multiple jurisdictions.

EXAMPLE TX 16-6

Treatment of withholding tax in an interim period income tax calculation for a reporting entity with operations in multiple jurisdictions

Company ABC (“Parent”) has operations in Jurisdiction A. Company ABC has a wholly owned subsidiary, Subsidiary B, with operations in Jurisdiction B. A distribution from Subsidiary B is subject to withholding tax in Jurisdiction B, for which Company ABC is the legal obligor. Company ABC does not consider the earnings of Subsidiary B to be indefinitely reinvested, and, therefore, records a deferred tax liability on the outside basis difference (e.g., the withholding tax) in its investment in Subsidiary B. For purposes of this example, ignore currency rate movements.

At the end of Q2, Subsidiary B has year-to-date ordinary income and anticipates ordinary income for the fiscal year. Company ABC’s operations in the US have a year-to-date ordinary loss and an anticipated ordinary loss for the fiscal year. Company ABC has a full valuation allowance on its net deferred tax assets and therefore will not be included in the overall worldwide estimated ETR.

Should Company ABC’s tax obligation to Jurisdiction B related to Subsidiary B’s earnings be included in the worldwide ETR calculation?

Analysis

We believe there are two acceptable alternatives, as long as the method chosen is consistently applied.

Alternative A: Include Company ABC’s obligation to Jurisdiction B in the worldwide ETR (i.e., look to the tax obligations by jurisdiction). Under this view, the withholding tax is considered separately from Company ABC’s tax to Jurisdiction A on the earnings of Subsidiary B.

Each tax obligation component would be analyzed as follows:

Jurisdiction A (Parent)—The operations in Jurisdiction A are excluded from the worldwide ETR calculation due to there being a year-to-date ordinary loss for which no benefit may be recognized (i.e., a full valuation allowance is needed).

Jurisdiction B (Parent)—Company ABC is recording withholding tax related to Subsidiary B’s earnings. Subsidiary B has year-to-date ordinary income and anticipates ordinary income for the fiscal year. This jurisdictional component is not in a year-to-date loss situation and should therefore be included in the worldwide ETR calculation.

Jurisdiction B (Subsidiary B)—Subsidiary B has year-to-date ordinary income and anticipates ordinary income for the fiscal year. Therefore, Subsidiary B should be included in the worldwide ETR calculation.

This alternative is supported by the jurisdictional discussion in ASC 740-270-30-36, which includes the following language: “an enterprise that is subject to tax in multiple jurisdictions pays taxes based on identified income in one or more individual jurisdictions...” This view is also supported by the general requirements of ASC 740-10-45-6 for financial statements to include the presentation of income taxes by tax-paying component within a particular tax jurisdiction. In this example, with regard to Company ABC’s tax obligation to Jurisdiction B, the identified income is on the earnings of Subsidiary B (on which the tax is levied), and the tax-paying component is Parent, the legal obligor.

Alternative B: Include Company ABC’s withholding tax to Jurisdiction B in Company ABC’s separate income tax calculation and therefore exclude it from the worldwide ETR. Under this view, the withholding tax is considered a component of the measurement of Company ABC’s tax expense on its investment in Subsidiary B.

Each component would be analyzed as follows:

Jurisdiction A and Jurisdiction B (Parent)—Jurisdiction A would be excluded from the worldwide ETR calculation due to there being a year-to-date ordinary loss for which no benefit may be recognized. Company ABC’s obligation to Jurisdiction B would also be excluded from the worldwide ETR estimate.

Jurisdiction B (Subsidiary B)—Subsidiary B has year-to-date ordinary income and anticipates ordinary income for the fiscal year. Therefore, Subsidiary B would be included in the worldwide calculation.

Consistent with the discussion in ASC 740-10-55-24, Alternative B is supported by the fact that the withholding tax due to Jurisdiction B’s taxing authority is considered a component of the Parent’s measurement of taxes on its investment in Subsidiary. ASC 740-10-55-24 provides that measurement should be based on expectations regarding tax consequences (e.g., capital gains or ordinary income). The computation of a deferred tax liability for undistributed earnings based on dividends should reflect any related dividends received deductions or foreign tax credits, and taxes that would be withheld from the dividend.

This analysis is further supported by ASC 740-270-30-36(b), which states that “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, etc.”

16.5.1.1 ***Zero-rate jurisdictions & nontaxable entities***

ASC 740-270 does not specifically address whether a jurisdiction that has a zero tax rate should be included in the ETR calculation. We believe there is conceptual support to either include or exclude zero-rate jurisdictions and are aware of diversity in practice in this area. We have identified three acceptable approaches:

Approach 1: Always exclude pre-tax ordinary income or loss from a zero-rate jurisdiction from the ETR calculation. This view is premised on the theory that the income in a zero-rate jurisdiction is effectively tax-exempt. The exclusion of pre-tax income from a zero-rate jurisdiction is analogous to the optional treatment of tax-exempt income discussed in TX 16.3.4.1.

Approach 2: Exclude pre-tax ordinary income or loss from a zero-rate jurisdiction from the ETR calculation if there is a year-to-date loss and/or if a loss is anticipated for the full fiscal year in that jurisdiction. The rationale for this view is based on the notion that a loss ultimately will not provide a tax benefit. Support for this view can be found in ASC 740-270-30-36(a), which requires the exclusion of jurisdictions with year-to-date losses if no tax benefit can be recognized for the year-to-date loss or for an anticipated full-year loss.

Approach 3: Always include pre-tax ordinary income or loss from a zero-rate jurisdiction in the ETR calculation because the underlying principle in ASC 740-270 is that, absent a specific requirement or exception, all current-year ordinary income or loss should be included in the ETR calculation. This view only applies the exception in ASC 740-270-30-36(a) which requires the exclusion of jurisdictions with losses if no tax benefit can be recognized to taxable jurisdictions for which a valuation allowance may be necessary. This view is premised on the notion that the ETR approach is known to yield, at times, unconventional results in particular periods, yet there are only two specific exceptions to the full inclusion of all jurisdictions in the worldwide ETR computation.

The approach used should be applied consistently to all zero-rate jurisdictions of the reporting entity.

A question can also arise on how to treat ordinary income of a non-taxable entity. Practice in certain industries has been to exclude the non-taxable entity's ordinary income from the estimated annual ETR. For example, real estate investment trusts (REITs) are generally designed and function in a manner similar to non-taxable entities to the extent they distribute all of their income. However, REITs often own subsidiaries that are subject to income tax (known as a taxable REIT subsidiary, or TRS). Most REITs determine their ETR by reference (solely) to the TRS income or loss and thereby effectively report the income of the REIT on a discrete basis.

16.5.2 Jurisdictions for which a reliable estimate cannot be made

ASC 740-270-30-36(b) provides the following two situations in which a company should exclude a jurisdiction from the overall computations of the estimated annual ETR:

- If a company operates in a foreign jurisdiction for which a “reliable estimate” of the annual ETR in terms of the parent entity’s functional currency cannot be made.
- If a reliable estimate of ordinary income or the related tax expense/benefit for a particular jurisdiction cannot be made.

The first situation would arise when the exchange rate between the parent company’s functional currency and the foreign currency is highly volatile, which is relatively uncommon.

With respect to the second situation, determining whether an estimate is reliable requires the use of professional judgment. While there is a general presumption that entities will be able to make a reliable estimate, exceptional circumstances can exist in which a genuine inability to make a reliable estimate justifies exclusion of a jurisdiction from the worldwide ETR. This might be the case for a

company that is anticipating only marginal pre-tax book profitability for the year, but has significant permanent differences that could result in wide variability in the tax expense (benefit) and, in turn, the ETR. In such cases, an estimate of the ETR might not be reliable. A company's assertion that it cannot develop a reliable estimate should be consistent with its other disclosures and communications to its investors, creditors, and other financial statement users.

Example TX 16-7 illustrates an interim period calculation of the ETR involving a jurisdiction that anticipates an ordinary loss for the fiscal year.

EXAMPLE TX 16-7

Interim calculation of the ETR when a jurisdiction anticipates an ordinary loss for the fiscal year

Company ABC operates in and is subject to tax in two different jurisdictions. For the current fiscal year, management projects ordinary income in Jurisdiction A and ordinary loss in Jurisdiction B. Because Company ABC is a seasonal business, operating results are expected to vary from quarter to quarter. Company ABC expects to realize the full benefit of the losses in Jurisdiction B such that any resulting DTAs will not require a valuation allowance. Company ABC is able to make reliable estimates of ordinary income and loss for Jurisdictions A and B.

Based on the forecast, Company ABC determines that the estimated annual ETR is negative 5% and as such, management believes that application of the global estimated annual ETR produces counterintuitive results on a quarterly basis and proposes using a separate estimated annual ETR for each individual jurisdiction.

Is the alternative approach proposed by Company ABC's management acceptable?

Analysis

No. If a company is subject to tax in multiple jurisdictions, ASC 740-270 requires that the interim period tax related to consolidated ordinary income be computed using one overall estimated annual ETR, unless one of the exceptions in ASC 740-270-30-36 applies. As neither is applicable in this fact pattern, Company ABC must apply the single ETR.

16.5.3 Effect of naked credits on the estimated annual ETR

“Naked credits” (see TX 5.5.1) occur when an indefinite-lived intangible asset has a book basis in excess of its tax basis as a result of tax amortization. Since the asset is not amortized for book purposes, the taxable temporary difference is not scheduled to reverse and can generally not be considered a source of income supporting realization of deferred tax assets in jurisdictions with expiring attributes. When a company is incurring losses and has a full valuation allowance, the increase of a deferred tax liability related to such basis difference will trigger a deferred tax expense for the current year. The impact of this “naked credit” should be included in a company's ETR calculation whether the jurisdiction is included in an entity's worldwide ETR calculation or excluded from the worldwide ETR calculation and treated as a separate jurisdiction with a standalone estimated annual ETR under ASC 740-270-30-36(a).

However, discrete treatment of this deferred tax expense is appropriate when the annual estimate of the tax rate is not considered a reliable estimate under ASC 740-270-30-36(b).

16.6 *Intraperiod allocation in interim periods*

ASC 740-270-45 indicates that the intraperiod allocation rules (see TX 12) should be used to allocate the interim tax provision to the various components of income in the interim financial statements. Although the “with-and-without” model is basically the same for interim and annual periods, as discussed in ASC 740-270-45-2, the allocation of tax expense or benefit for interim periods should be performed using the estimated fiscal year ordinary income and tax for ordinary income (or loss) and the year-to-date income and tax for (1) an infrequent or unusual item, (2) the gain or loss on disposal of a discontinued operation, or (3) another component of the financial statements (e.g., other comprehensive income). If more than one of the above items is present, the computation should reflect the order of precedence that will be assumed in the annual financial statements. Thus, unusual or infrequent items that are included in continuing operations will generally be considered before any items that are excluded from continuing operations.

If more than one item is excluded from continuing operations, the process outlined in ASC 740-20-45-14 should be used to apportion the remaining provision after the tax expense or benefit allocated to continuing operations is considered. This allocation process should be consistent with the process used in the annual calculation, as discussed in TX 12.

16.6.1 *Subsequent revisions of intraperiod allocation*

Tax attributed to financial statement components that are reported in an early quarter can be subsequently revised to reflect a change in the estimate of tax related to annual ordinary income or changes in year-to-date income or loss in other components. ASC 740-270 requires the computation of the interim provision to be performed on a year-to-date basis. As a result, the tax provision for a given quarter equals the difference between the year-to-date provision calculated via the estimated annual ETR approach (plus the impact of discrete items) less the cumulative provision recorded as of the end of the prior interim period. Changes in circumstances from quarter to quarter might make it necessary to record the tax effects in a financial statement category that differs from the one in which the company recorded the tax effects during a previous quarter. The goal of the ASC 740-270 model is to treat the interim periods as integral components of the current annual period consistent with the broad principles of ASC 270. As a result, the intraperiod allocation, like the estimated annual ETR, must be updated and recomputed each quarter.

16.6.2 *Restatement of interim periods for discontinued operations*

Once operations are classified as discontinued, all prior periods are restated in the income statement. ASC 740-270-45-6 through ASC 740-270-45-8 provides detailed rules for taking the tax previously assigned to ordinary income and allocating it between the recomputed ordinary income and the discontinued operations in the periods prior to the date the operations are considered discontinued. In addition, ASC 740-270-55-29 provides an illustration of accounting for income taxes applicable to income or (loss) from discontinued operations at an interim date. See TX 12.5.2 for a more detailed discussion about intraperiod allocation issues related to discontinued operations.

16.6.3 **Exception to the intraperiod model in interim periods**

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. The guidance removes certain exceptions to the general principles of ASC 740 and simplifies several other areas. ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. If an entity chooses to early adopt, it must adopt all changes as a result of the ASU. The transition provisions vary by amendment.

One of the amendments within ASU 2019-12 removes the exception to the basic intraperiod model described in ASC 740-20-45-7. This amendment should be applied on a prospective basis.

16.6.3.1A **Exception to the intraperiod model in interim periods (before adoption of ASU 2019-12)**

ASC 740-20-45-7, which describes the exception to the basic “with-and-without” approach to intraperiod allocation, must also be considered in interim periods. If a company has a valuation allowance and expects (1) pre-tax losses from continuing operations and (2) income in other components of the financial statements, application of ASC 740-20-45-7 may result in the reporting of a tax benefit (which would be incorporated in the estimated annual ETR) in continuing operations, even though no such benefit would be computed using the basic “with-and-without” approach.

New guidance

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. One of the amendments within ASU 2019-12 removes the exception to the basic intraperiod model described in ASC 740-20-45-7. See TX 16.6.3 for additional information on ASU 2019-12, including effective dates and transition guidance.

16.7 **Interim tax consideration for business combinations**

The acquisition of a business can significantly impact the acquiring company’s estimated annual expected tax rate. Because a business combination is a transaction that is not typically accounted for in periods prior to the acquisition date, no effect should be given to a business combination in the estimated annual ETR before the interim period in which the business combination is consummated.

Beginning with the interim period in which the purchase is consummated, the estimated annual ETR for the year would be calculated to reflect the expected results, including the results of the acquired company. That rate would be applied to the consolidated year-to-date ordinary income/(loss) to compute the year-to-date tax provision/(benefit) on ordinary income/(loss).

When assessing changes to the valuation allowance as a result of a business combination in an interim period, the valuation allowance release would follow the general approach used when releasing a valuation allowance at an interim period (see Example TX 16-5).

16.8 Different financial reporting and tax year-end

A tax year-end date that is different from a corporation's financial reporting year-end date will impact the estimated annual effective tax rate calculation.

The fundamental question is whether the tax provision should be based on the tax year or the financial reporting year. Authoritative literature does not address how to account for the tax provision if a corporation's tax year and financial reporting year do not coincide. We believe that either approach is acceptable. In either case, the tax provision included in the annual financial statements needs to be for the full annual period covered by the financial statements.

16.8.1 Short-period financial statements and change in fiscal years

Complexities can arise when a reporting entity has to compute a tax provision considering the effects of short-period financial statements as a result of a change in fiscal year. We believe there are two alternatives, as illustrated in Example TX 16-8.

EXAMPLE TX 16-8

Calculation of an income tax provision for short-period financial statements due to a change in fiscal year

On July 15, Company ABC sold 100% of the stock of Subsidiary B to an unrelated third-party. In accounting for the acquisition, the acquirer will record Subsidiary B's net assets at fair value in accordance with ASC 805, *Business Combinations*. For tax purposes, the net assets will be recorded at carry-over basis.

Company ABC has a December 31 year-end for both financial reporting and income tax purposes. Historically, Subsidiary B was included in the consolidated income tax return of Company ABC. After the sale, Subsidiary B changed its year-end to June 30 for both financial reporting and income tax purposes to coincide with its new parent's year-end. Company ABC will be required to include the taxable income for Subsidiary B through July 15 in its tax return for the year-ended December 31.

In connection with the sale transaction, Subsidiary B is required to prepare stand-alone financial statements. Subsidiary B has historically calculated its income tax provision using the separate return method. Subsidiary B anticipates that it will file a registration statement in the near future and, therefore, is preparing its financial statements in accordance with SEC reporting requirements. Accordingly, Subsidiary B will be required to report audited results for the transition period from January 1 through June 30.

How should Subsidiary B calculate its income tax provisions for the six-month transition period ended June 30?

Analysis

We believe there are two acceptable approaches:

Approach A: Subsidiary B could treat the six-month period ended June 30 as an interim period and calculate its income tax provision using an estimated annual ETR in accordance with ASC 740-270. The basis for this approach is that as of June 30, there has been no change in the tax reporting period (that is, Subsidiary B's tax year-end is still December 31). Accordingly, the income tax provision would be based on the tax reporting period.

Approach B: Subsidiary B could treat the six-month period ended June 30 as a discrete period and calculate its income tax provision as if it would be filing a short-period return as of June 30. The basis for this approach is that for financial reporting purposes, the six-month period ended June 30 is being treated as a discrete period (i.e., a six-month annual period). Accordingly, the income tax provision would be based on the financial reporting period (in this case, the transition period).

Under either approach, Subsidiary B would need to prepare footnote disclosures as of June 30 for audited financial statements as required by ASC 740 and Regulation S-X, Rule 4-08. Accordingly, if Approach A is selected, Subsidiary B would need to estimate its individual temporary differences using an approach described in TX 10.5.2, which provides guidance for determining temporary differences in an interim period in a business combination.

We believe that the above alternatives could also apply in a similar set of facts when after the sale there is no change in financial reporting or tax year, but Subsidiary B is required to split its financial statements into two separate periods, such as when Subsidiary B elects to apply push-down accounting in separate company financial statements. Approach A would continue to seem acceptable. Approach B also seems acceptable because push down accounting could essentially be viewed as the termination of the old accounting reporting entity and the creation of a new one.

16.9 Balance sheet activity during interim periods

ASC 740-270 prescribes the approach to compute the income tax provision for interim periods. The guidance is silent on the measurement and presentation of deferred tax assets and liabilities and other balance sheet tax accounts (e.g., taxes payable) in interim periods other than a requirement to assess deferred tax assets for realizability at each interim date. Absent any specific authoritative guidance, tax-related balance sheet accounts should be adjusted on an interim basis using a systematic and rational approach that is consistently applied and considers significant changes in deferred tax balances by jurisdiction.

Chapter 17:
Income tax accounting for
stock-based compensation

17.1 Chapter overview—tax accounting for stock-based compensation

This chapter discusses the income tax accounting effects related to stock-based compensation and the reporting of those effects in an entity's financial statements.

Under US tax law, the ultimate tax deduction for nonqualified stock options, restricted stock, restricted stock units, and stock appreciation rights will almost always differ from the amounts recognized for financial reporting because they generally result in a tax deduction when the taxable event occurs (e.g., upon exercise). Statutory options, including ISOs and ESPP purchases, ordinarily do not result in a tax deduction. The tax effects from these awards are not recorded unless a disqualifying disposition occurs.

This chapter also covers other income tax accounting topics related to modifications of awards, repurchases and clawbacks of awards, awards exchanged in a business combination, valuation allowances, interim reporting, and multinational entities.

Refer to PwC's *Stock-based compensation* guide for further guidance on topics related to accounting for stock-based compensation under ASC 718, *Compensation—Stock Compensation*.

17.2 Basics of income tax accounting for stock-based compensation

ASC 718 provides specific guidance on income tax accounting and clarifies how ASC 740 should be applied to stock-based compensation. ASC 718 requires that entities recognize the fair value of employee stock-based compensation awards as compensation cost in the financial statements beginning on the grant date. Compensation cost is based on the fair value of the awards the entity expects to vest and is recognized over the vesting period.

The related tax deduction generally occurs later and is measured principally at the award's intrinsic value. For example, in the US, an entity's income tax deduction generally is determined on the exercise date for stock options and on the vesting date for restricted stock. As a result, for awards that are expected to result in a tax deduction, a deferred tax asset is created as the entity recognizes compensation cost for book purposes.

For equity-classified awards under ASC 718, book compensation cost is determined at the grant date and compensation cost is recognized over the service period. As compensation cost is recognized, a corresponding deferred tax asset may need to be recognized to the extent there is a difference in timing for the deduction for tax purposes.

At the date of settlement, if the tax deduction exceeds the cumulative book compensation cost for the award, the tax benefit associated with any excess deduction is recognized as an income tax benefit in the income statement. If the tax deduction is less than the cumulative book compensation cost, the resulting difference is recognized as income tax expense in the income statement.

The income tax accounting for liability-classified awards (e.g., cash-settled stock appreciation rights) is similar to the income tax accounting for equity-classified awards. The difference is that the liability for book purposes is remeasured each reporting period and thus the related deferred tax asset is also

remeasured to reflect the effects of remeasuring the book liability. Unlike an equity-classified award, a liability-classified award generally will not be expected to generate an excess tax benefit or tax deficiency upon settlement because the ultimate tax deduction will equal the cumulative book compensation cost as a result of the periodic remeasurements.

17.3 *Income tax accounting for nonqualified stock options*

An entity that grants a nonqualified stock option to an employee generally is entitled to a tax deduction equal to the intrinsic value of the option on the exercise date. Entities generally expense stock options for book purposes before a tax deduction arises, thus creating a temporary difference, and the initial recognition of a deferred tax asset under ASC 740.

The amount of the deferred tax asset will almost always differ from the amount of the entity's realized tax benefit. This is because the deferred tax asset is based on the compensation cost the entity recorded for book purposes, which is determined based on fair value on the grant date. The ultimate tax deduction is based on intrinsic value on the exercise date for a stock option and the vesting date for restricted stock.

Figure TX 17-1 summarizes the key accounting events (from the grant date to the settlement date) that relate to a typical equity-classified, nonqualified stock option that generates an employer's tax deduction upon the option's exercise.

Figure TX 17-1

Key income tax accounting events for an equity-classified, nonqualified stock-based compensation award

When	Step
On the option's grant date	Measure the option's fair value.
Over the option's requisite service period	Recognize compensation cost (adjusted for actual or estimated forfeitures) and the deferred tax asset. Adjust the deferred tax asset to reflect a change in an entity's applicable tax rate and employee relocations to jurisdictions with different tax rates; do not adjust deferred tax assets to reflect increases or decreases in the entity's stock price.
On the option's settlement date (e.g., exercise or post-vesting cancellation)	Compare the tax deduction (typically the intrinsic value of the option on the exercise date) with the cumulative book compensation cost. To the extent that the tax deduction exceeds the cumulative book compensation cost, the result is an excess tax benefit. Conversely, when the tax deduction is less than the cumulative book compensation cost, a tax deficiency occurs. Any excess tax benefit or tax deficiency is reflected in the income statement. The deferred tax asset is reversed upon settlement as a deferred tax expense.

17.3.1 *Accounting for options that are forfeited or expired*

For a variety of reasons, employees might never exercise their stock options (e.g., the stock option is underwater during its contractual term, or the employee might forfeit the option). When a stock-based compensation award is forfeited or expires unexercised, the accounting depends on whether the employee had completed the award's requisite service period at the time of settlement. If an award expires before the requisite service period has been completed, the related book compensation cost is reversed and the deferred tax asset is reversed to income tax expense.

If an award expires after the requisite service period has been completed, the related book compensation cost is not reversed. However, the employer will no longer receive a tax deduction for the option and, therefore, there is no longer a temporary difference. Because there is no longer a temporary difference, the related deferred tax asset should be reversed to income tax expense.

Completion of the requisite service period often, but not always, coincides with the "legal vesting date." An award is legally vested when an employee's right to receive or retain the award is no longer contingent on satisfying the vesting condition.

Entities can make a company-wide accounting policy election to either estimate forfeitures each period or to account for forfeitures as they occur. However, there are certain circumstances, such as at the time of a modification or issuance of a replacement award in a business combination, when it is necessary to estimate forfeitures.

An entity that has a number of awards and has elected to apply a forfeiture estimate would record compensation cost only for the number of awards it expects to vest. Accordingly, a deferred tax asset is only recorded for the awards the entity expects to vest. If actual forfeitures caused the entity to change its original forfeiture assumptions, then an adjustment to previously recognized compensation cost and the related deferred tax asset should be recorded.

Example TX 17-1 is an illustration of the income tax accounting for a grant of an equity-classified, nonqualified stock option.

EXAMPLE TX 17-1

Income tax accounting for nonqualified stock options

On both January 1, 20X1, and January 1, 20X4, USA Corp granted 10 million equity-classified, nonqualified stock options. Refer to the table below for grant-date details and terms. No additional awards are granted in 20X1, 20X2, and 20X3. The stock price is \$50 on January 1, 20X4, when all 8 million vested options are exercised from the January 1, 20X1 grants. Upon exercise, the intrinsic value of each option is \$20 (i.e., the shares have a quoted market price (\$50) that exceeds the options' exercise price (\$30) by \$20).

On January 1, 20X5, the stock price decreases to \$45, and the options from the January 1, 20X4 issuance remain underwater until they expire on December 31, 20X8.

Date	Grants	Exercise Price	Stock Price	Grant-date fair value	Terms / additional facts
January 1, 20X1	10 million equity classified, nonqualified stock options	\$30	\$30	\$15	-8 million options are expected to (and do) vest. -Award specifies three-year cliff vesting.
January 1, 20X4			\$50		All 8 million vested options are exercised from the January 1, 20X1 issuance.
January 1, 20X4	10 million equity-classified, nonqualified stock options	\$50	\$50	\$25	-8 million options are expected to (and do) vest. -Award specifies three-year cliff vesting
January, 20X5			\$45		

The applicable tax rate for all periods is 25%.

USA Corp recognizes compensation cost on a straight-line attribution basis.

All options have a contractual term of five years.

How should USA Corp compute the compensation cost, deferred tax asset, and tax benefits ultimately realized for options granted on January 1, 20X1 and 20X4?

Analysis

	20X1 Awards	20X4 Awards
Compensation cost	8 million options \times \$15 = \$120 million = \$40 million per year over three years	8 million options \times \$25 = \$200 million = \$66.6 million per year over three years
Deferred tax asset	\$40 million \times 25% = \$10 million deferred tax benefit each year, accumulating to a deferred tax asset of \$30 million.	\$66.6 million \times 25% = \$16.7 million deferred tax benefit each year, accumulating to a deferred tax asset of \$50 million.

	20X1 Awards	20X4 Awards
Tax benefit realized	<p>Total tax deduction of \$160 million (8 million options times intrinsic value of \$20 per option) yields realized tax benefit of \$40 million.</p> <p>Deferred tax asset of \$30 million existing on December 31, 20X3 is realized.</p> <p>Excess tax benefit of \$10 million (\$40 million total benefit less \$30 million deferred tax asset) would be credited to income tax expense.</p>	<p>No tax benefit would be realized as the employees never exercise the options.</p> <p>Deferred tax asset of \$50 million existing on December 31, 20X6 (end of vesting period) will remain until the options expire.</p> <p>When the options expire in 20X8 the entity will write off the \$50 million deferred tax asset.</p>

17.4 *Income tax accounting for incentive stock options*

Incentive stock options (ISOs) provide an employee with significant tax benefits by allowing the employee to exercise stock options, in limited amounts, without being taxed on the intrinsic value on the exercise date. To qualify as an ISO, an option must comply with certain Internal Revenue Code (IRC) requirements and restrictions. Refer to SC 10.6.4.3 for further guidance.

Although an entity treats nonqualified stock options and ISOs the same way when recognizing book compensation cost under ASC 718, the tax treatment for ISOs is different. Employers do not obtain a tax deduction for an ISO unless there is a disqualifying disposition by the employee (see TX 17.4.1). Therefore, a deferred tax asset is not recognized when an entity recognizes compensation cost for book purposes for such options.

17.4.1 *Disqualifying dispositions for incentive stock options*

A disqualifying disposition for an ISO occurs if the employee does not hold the shares for the minimum holding period required by the IRC. When there is a disqualifying disposition, the employee recognizes ordinary income for US tax purposes for the difference between the ISO's exercise price and the fair value of the shares at the time the option was exercised. The employer will receive a corresponding tax deduction for the amount of income recognized by the employee (refer to SC 10.7.2.4 for further information). The tax benefit for the deduction is credited to income tax expense. Employers should not anticipate a disqualifying disposition because they are outside of the employer's control. They should be recognized when they occur.

Excerpt from ASC 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.

17.5 Income tax accounting for restricted stock and RSUs

Restricted stock represents shares that an entity grants to an employee and are generally subject to vesting conditions. If the employee fails to vest in the shares, the employee forfeits the right to the shares.

A restricted stock unit (RSU) represents an arrangement whereby an entity promises to issue shares at a future date if certain vesting conditions are met. RSUs do not consist of legally issued shares and are not outstanding shares, and therefore do not give the holder voting rights. Not all RSUs are alike; some can be settled in cash or shares, and some have terms that include anti-dilutive features.

Generally, restricted stock and RSUs generate a tax deduction to the employer on the vesting date because the employee has a substantial risk of forfeiture as a result of the award's vesting condition until the vesting date.

Similar to the accounting for deferred taxes related to a nonqualified stock option discussed in TX 17.3, an entity recognizes a deferred tax asset based on the book compensation cost for restricted stock and RSUs over the requisite service period.

17.5.1 Measurement of tax deduction for restricted stock

The tax deduction for restricted stock generally is measured as the restrictions lapse (i.e., as the employee vests in the award). At that time, the entity will determine if there is any excess tax benefit or deficiency by reference to the current stock price in relation to the grant date fair value.

17.5.1.1 IRC Section 83(b) elections

Under IRC Section 83(b), employees may choose to have the taxable income for certain equity interests received measured on the grant date instead of the vesting date. An IRC Section 83(b) election enables an employee to pay tax on the fair market value of a restricted stock award on the date it is granted rather than on the vesting date, as required under the normal rule of IRC Section 83(a). An IRC Section 83(b) election has no impact on the vesting provisions of the award or the pre-tax recognition of compensation expense.

From the employee's perspective, the advantage of making an IRC Section 83(b) election is that any appreciation in the restricted stock after the grant date will be taxed as a capital gain instead of as ordinary income. If the stock appreciates in value after the grant, the capital gains treatment under this election can result in a significant reduction in the employee's taxes.

For the employer, the consequence of an 83(b) election is that the employer's tax deduction is fixed and claimable on the tax return at the grant date. If an employee makes an IRC Section 83(b) election, the entity would recognize a current tax benefit for the deduction and record a corresponding deferred tax liability reflecting the fact that the entity has received the tax deduction from the award before any compensation cost has been recognized for financial reporting purposes (the opposite of the nonqualified stock option scenario in which the book compensation cost is recognized in advance of the tax deduction). As the entity recognizes book compensation cost over the requisite service period,

the deferred tax liability will be reduced. If an IRC Section 83(b) election is made by an employee for an equity-classified award (i.e., an award that is not remeasured for book purposes), there will be no excess tax benefit or deficiency upon settlement because the tax deduction would equal the grant-date fair value.

Example TX 17-2 illustrates the computation of book compensation cost and the corresponding deferred tax accounting for a grant of an equity-classified restricted stock award both with and without an IRC Section 83(b) election.

EXAMPLE TX 17-2

Income tax accounting for restricted stock

On January 1, 20X1, USA Corp granted 10 million equity-classified restricted shares that have a grant-date fair value of \$15 per share and a three-year cliff-vesting requirement.

No forfeitures were assumed or occurred during the vesting period.

The stock price is \$25 on January 1, 20X4, when the requisite service period is complete.

The applicable tax rate is 25% during all periods.

The entity recognizes compensation cost on a straight-line basis.

How should USA Corp compute the compensation cost and the deferred tax asset for restricted stock granted on January 1, 20X1?

Analysis

Event / Date	IRC Section 83(b) election by employee?	
	No	Yes
Grant date	No entry	Record a \$37.5 million deferred tax liability, which offsets the current tax benefit (10 million shares × \$15 grant-date fair value × 25% tax rate)
Recognition of compensation cost over the requisite service period (three years)	Annual entry in 20X1, 20X2, and 20X3 to recognize a \$12.5 million deferred tax asset associated with compensation cost recognized in advance of the tax deduction (10 million shares × \$15 grant-date fair value ÷ 3 year service period × 25% tax rate) as book compensation cost is recognized	Annual entry in 20X1, 20X2, and 20X3 to reduce the deferred tax liability by \$12.5 million associated with compensation cost deducted for tax purposes in advance of recognition for book purposes (10 million shares × \$15 grant-date fair value ÷ 3 year service period × 25% tax rate)
December 31, 20X3 (conclusion of vesting)	Deferred tax asset is now \$37.5 million	No deferred tax asset or liability

IRC Section 83(b) election by employee?

Event / Date	No	Yes
Vesting date (January 1, 20X4)	<i>To record current tax benefit of \$62.5 million (\$25 fair value on vesting date × 10 million vested shares × 25% tax rate) and reversal of deferred tax asset. The excess tax benefit of \$25 million is reflected in the income statement</i>	No entry

Under either alternative, the entity will recognize \$150 million of book compensation cost over the three-year vesting period. However, the total tax benefit realized by the company will be capped at \$37.5 million when the employee makes a Section 83(b) election. Without the 83(b) election, the employer is entitled to the greater tax benefit of \$62.5.

17.6 *Income tax accounting for stock appreciation rights*

A stock appreciation right (SAR) gives an employee the contractual right to receive an amount of cash, stock, or a combination of both that equals the appreciation in an entity's stock from an award's grant date to the exercise date. SARs generally resemble stock options in that they may be exercised at the employee's discretion during the exercise period and do not give the employee an ownership right in the underlying stock. Unlike options, however, SARs generally do not involve payment of an exercise price. How the award is settled (in cash or in stock) also affects the classification of a SAR as either a liability or shareholders' equity, as discussed in SC 3.3.4.

Figure TX 17-2 compares the income tax accounting for cash-settled SARs and stock-settled SARs.

Figure TX 17-2
Income tax accounting comparison of cash-settled SARs and stock-settled SARs

	Cash-settled SAR	Stock-settled SAR
Grant date	Measure at fair value	Measure at fair value
As the award vests	Remeasure the fair value of the award at each reporting period and adjust cumulative compensation expense (and the corresponding compensation liability) based on the portion of the vested award; adjust the corresponding deferred tax asset based on the temporary difference arising from the book liability.	Recognize the book compensation cost over the service period based on the grant-date fair value; recognize a deferred tax asset for book compensation expense recognized in advance of the tax deduction.
After the award has vested but before it is settled	Remeasure the book compensation liability at fair value and adjust it each reporting period accordingly and adjust the corresponding deferred tax asset.	No accounting required.

At the time of settlement	The deferred tax asset at the time of settlement should equal the current tax benefit, resulting in no excess tax benefit or deficiency.	Reverse the existing deferred tax asset through income tax expense and recognize any excess tax benefit (or deficiency) in the income statement.
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17.6.1 *Income tax accounting for cash-settled SARs*

Under ASC 718, cash-settled SARs are classified as liability awards and therefore are remeasured at fair value each reporting period until the award is settled. The related deferred tax asset is adjusted when book compensation cost is recognized each reporting period as the cash-settled SAR is remeasured. When an employee exercises a SAR, the entity's tax deduction will generally equal the cash payment, which, at the point of settlement, is also the amount of the book compensation liability. If the SAR is cancelled prior to settlement, the liability is reversed, and the deferred tax asset is reversed through income tax expense. If the SAR expires worthless, there would be no accounting entries at the expiration date because, prior to expiration, the SAR and the corresponding deferred tax asset would have been remeasured each reporting period and at some point in time before expiration, the SAR would have no value and there would be no liability or associated deferred tax asset on the books.

17.6.2 *Income tax accounting for stock-settled SARs*

Stock-settled SARs generally are equity-classified awards under ASC 718. The income tax accounting is identical to that for an equity-classified, nonqualified stock option. In concept, a stock-settled SAR can be thought of as an option with a zero-exercise price. Accordingly, a deferred tax asset is recorded as book compensation cost is recognized. When an employee exercises a stock-settled SAR, the entity measures the amount of the tax deduction based on the award's intrinsic value at that time and any excess tax benefit or tax deficiency is recorded in the income statement.

17.7 *Income tax accounting for dividends on stock compensation*

Employees, as part of stock-based compensation awards, may receive dividends on their awards during their vesting periods or, in the case of options, during the period until the exercise of their options (so-called "dividend protection"). ASC 718-10-55-44 provides guidance on the accounting for these dividends and states that dividends paid on restricted stock and dividend-protected options that are expected to vest are factored into the fair value of the award. The fair value of dividend-paying stock already incorporates the expected payment of dividends and therefore the entity would make no adjustment to the fair value of restricted shares for the expected payment of dividends during the vesting period. However, the fair value of an option for stock that pays dividends should be adjusted to reflect the dividend protection. ASC 718-10-55-45 states that the payment of dividends on restricted stock or options should be accounted for in retained earnings if the shares are expected to vest. When the related award is not expected to vest, the payment of the dividends or dividend equivalents are recognized as additional compensation cost.

From a tax perspective, dividends paid to employees on restricted stock for which an employee has not made an IRC Section 83(b) election are not treated as dividends paid to a shareholder because the IRS

does not recognize the employee as having received the restricted stock until the restriction lapses (that is, until the shares vest). Therefore, the IRC treats the payment of these dividends as compensation, and the entity is entitled to receive a deduction on the dividends paid. Likewise, dividends paid as part of a dividend-protection plan for option grants are treated as compensation for US tax purposes. ASC 718-740-45-8 states that the tax benefit from dividends, or dividend equivalents, that are charged to retained earnings and paid to employees for equity-classified restricted stock, restricted stock units, and outstanding options should be recognized in income tax expense in the income statement.

17.8 Tax deduction limitations related to compensation

The tax deduction that an employer is eligible for related to compensation may be subject to certain limitations. One limitation is the “million-dollar” limitation, established by IRC Section 162(m), which provides that, for public companies, the annual compensation paid to individual covered employees in excess of \$1 million during the taxable year is not tax deductible. All individuals who hold the position of either chief executive officer or chief financial officer at any time during the taxable year are covered employees. Covered employees also include the company's three highest paid executive officers. The executive officers and the amount of compensation for the year are determined under the applicable SEC rules. Any individual who is deemed a covered employee will continue to be a covered employee for all subsequent taxable years (i.e., they remain a covered person indefinitely).

If annual compensation includes both cash compensation and stock-based-compensation, a company should first assess whether or not a covered employee's compensation will be subject to the Section 162(m) limitation. The anticipated effect of the Section 162(m) limitation should be considered using one of three methods (as discussed below) when recognizing deferred tax assets for awards that may be subject to the limitation. The selection of a method is an accounting policy that should be applied consistently.

We believe that any of the following approaches, if followed consistently, would be acceptable for determining whether a deferred tax asset should be recorded for stock-based compensation that is subject to the IRC Section 162(m) limitation:

- The impact of future cash compensation takes priority over stock-based-compensation awards. For example, if the anticipated cash compensation is equal to or greater than the total tax-deductible annual compensation amount for the covered employee, an entity would not record a deferred tax asset associated with any stock-based-compensation cost for that individual.
- The impact of the stock-based compensation takes priority over future cash compensation and a deferred tax asset would be recorded for the stock-based compensation up to the tax deductible amount.
- Prorate the anticipated benefit of the tax deduction between cash compensation and stock-based compensation and reflect the deferred tax asset for the stock-based-compensation award based on a blended tax rate that considers the anticipated future limitation in the year such temporary difference is expected to reverse.

Example TX 17-3 illustrates accounting for the tax effects of awards that may be subject to the IRC Section 162(m) limitation.

EXAMPLE TX 17-3

IRC section 162(m) limitations

Company USA enters into a three-year employment contract with its CEO, who is a “covered employee” as defined by IRC Section 162(m). The terms of the contract include \$1 million of cash compensation to be paid annually. Additionally, 100,000 shares of non-vested restricted stock are granted in year 1 and cliff vest in two years (i.e., the restricted stock will vest and become tax deductible on the first day of year 3). The fair value of the stock on the grant date is \$10 per share for a total fair value of \$1 million. Assume the fair value of the stock remains constant and the applicable tax rate is 25%.

How would Company USA account for the tax effects of awards that may be subject to the IRC Section 162(m) limitation?

Analysis

As the restricted stock does not vest until year 3, the CEO’s compensation in years 1 and 2 are not subject to the limitation (it does not exceed \$1 million). In year 3, the total compensation for tax purposes would be the \$1 million cash compensation and the \$1 million in restricted stock, which the CEO will be deemed to have received based on vesting. The deferred tax analysis under each of the three methods is as follows:

- (1) Cash compensation takes priority – Available tax deductions are first allocated to cash compensation. As the \$1 million in cash compensation would fully absorb the Section 162(m) limitation in year 3, the entire \$1 million of stock-based compensation would be considered non-deductible. As a result, the stock-based compensation would not give rise to a temporary difference, and no DTA should be recognized. The effective tax rate would be higher in years 1 and 2 under this approach as the book stock-based compensation charge would not result in a deferred tax benefit.
- (2) Stock-based compensation takes priority – Available tax deductions are first allocated to stock-based compensation. As the \$1 million in stock-based compensation would be fully deductible under the Section 162(m) limitation in year 3, the stock-based compensation recorded for book purposes in years 1 and 2 (\$500,000 per year) would give rise to a temporary difference, and a DTA should be recognized. The cash compensation in year 3 would be considered non-deductible. The effective tax rate impact from the Section 162(m) limitation is recognized entirely in year 3.
- (3) Pro rata allocation between cash and stock compensation – Available tax deductions would be allocated between cash compensation and stock-based compensation on a pro rata basis. As both cash compensation and stock-based compensation are expected to be \$1 million in Year 3 (total compensation of \$2 million), the available \$1 million of tax deductions would be allocated 50:50. Thus, while the stock-based compensation recognized for book purposes in Years 1 and 2 would give rise to a temporary difference, only 50% of the total compensation would be recognized as a deferred tax asset. Therefore, the deferred tax benefit in Years 1 and 2 ($\$500,000 \times 50\% \times 25\% = \$62,500$ in each year) result in a total DTA at the end of year 2 of \$125,000. The \$125,000 DTA would reverse in year 3 when the stock-based compensation is deducted on the tax return. Under the pro rata approach, the effective tax rate impact from the Section 162(m) limitation is spread over all three years.

17.9 *Income tax accounting for modification of an award*

A modification of an award under ASC 718 generally will be treated as an exchange of the original award for a new award. An entity should measure book compensation cost as the excess (if any) of the fair value of the new award over the fair value that the original award had immediately before its terms were modified. In addition, an entity also will assess the potential effect of the modification on the number of awards expected to vest, including a reassessment of the probability of vesting.

For an award that is otherwise tax deductible and for which an entity had previously recorded a deferred tax asset, if the entity records additional book compensation cost as a result of the modification, there will be a corresponding increase in the deferred tax asset.

As specified in ASC 718-20-35-3(b), to the extent an equity-classified award is modified to a liability-classified award, the total recognized compensation cost should at least equal the fair value of the award at the original grant date, unless any performance or service conditions of the original award are not expected to be satisfied. As part of the modification of these awards, incremental compensation cost may need to be recorded as part of the modification. To the extent additional compensation costs are recorded as part of the modification, the related deferred tax asset will also increase as there has not yet been a tax deduction. There is an exception to this rule in situations in which the possible tax deduction of a modified award is capped. For example, an entity may offer an election to convert each share into a fixed amount of cash. In these situations, it is appropriate to adjust the deferred tax asset based on the value of the corresponding liability, regardless of whether it is greater or less than the grant date fair value, as illustrated in ASC 718-20-55-144.

Certain modifications could result in an ISO losing its qualified status and in the modified award being considered a nonqualified stock option. Whereas prior to the modification no deferred taxes were recorded on compensation expense recognized related to the ISO because it does not ordinarily result in a tax deduction, if, as a result of the modification, the award would no longer be an ISO, the entity would have to begin recording the related deferred taxes on the nonqualified award. Accordingly, on the date of the modification, deferred taxes should be recognized on all compensation cost previously recognized for the award. After that, the tax effect would be accounted for in the same manner as any other nonqualified award.

17.10 *Determining the tax benefit from awards with graded vesting*

In some cases, an entity may grant awards with a graded vesting schedule (e.g., 25% of the award vests each year for four years), and, as a result, may separately estimate the fair value for each tranche (based on vesting date) of the award. As such, the deferred tax asset associated with each tranche of the awards will differ as they will have different grant date fair values. Because these awards will generally otherwise have the same grant date, exercise price, and expiration date, it may be difficult for the employer to determine, upon exercise, which tranche of the award was exercised and, in turn, which deferred tax asset should be deemed to have been recovered and/or whether there is an excess tax benefit or tax deficiency. If an entity is unable to determine which tranche of options was exercised, we believe it would be reasonable for the entity to assume that the first exercises were from the first tranche to vest and that subsequently exercised options were from any remaining options in the first tranche, followed by options in later tranches, in order of vesting (essentially a FIFO assumption).

17.11 *Income tax accounting for repurchase of an award*

SC 3.3.3 describes the pre-tax accounting for the repurchase of an award, which may result in the recognition of additional compensation expense, modification-like accounting, or the settlement of an award.

From a tax perspective, the amount of the cash settlement is generally deductible by the employer to the extent the entity has not previously taken a tax deduction for the award. For example, a deduction would not have previously been taken by the employer for a nonqualified stock option that has not been exercised by the employee. The amount that is deductible may also be subject to the IRC Section 162(m) limitation for covered employees (TX 17.8). Generally, the entity is not entitled to an additional deduction for the cash settlement if it has previously taken a deduction on the award (e.g., a restricted stock award in which the employee made an IRC Section 83(b) election; see TX 17.5.1.1 for further discussion of IRC Section 83(b) elections).

When there is a repurchase of an award for cash, any remaining deferred tax asset related to the awards (in excess of the tax benefit resulting from the repurchase, if any) would be written off through income tax expense.

17.12 *Income tax accounting for clawback of an award*

Entities may include a “clawback” provision in stock-based compensation awards.

Excerpt from ASC 718-10-55-8

A clawback feature can take various forms but often functions as a noncompete mechanism. For example, an employee that terminates the employment relationship and begins to work for a competitor is required to transfer to the issuing entity (former employer) equity shares granted and earned in a share-based transaction.

Clawback features may also require forfeiture of an award, or a portion of an award, if there is a termination for cause or as required by the Sarbanes-Oxley Act. In addition, the Dodd-Frank Act requires stock exchanges to put rules in place requiring entities listed on the exchange to adopt certain clawback provisions in their incentive compensation plans, including stock compensation, for certain current and former executive officers. The Dodd-Frank Act and financial statement accounting considerations relating to clawback provisions are discussed in more detail in SC 10.2.4.

The income tax accounting for the clawback of a stock-based compensation award depends on the status of the award at the time of the clawback and whether the entity has previously taken the tax benefit from the stock-based compensation award. If the clawback occurs prior to the exercise of a stock option (or the vesting of restricted stock for tax purposes) and no tax deduction has been taken for the clawed-back awards, the related deferred tax asset would be reversed through income tax expense. If an entity has taken deductions for a stock-based compensation award that is being clawed-back, the tax effect of the taxable income resulting from the clawback (i.e., reversal of the tax deduction for the forfeited compensation) would be included in the income tax provision for the period.

17.13 *Stock-based compensation exchanged in business combinations*

In accordance with ASC 805-740-25-10, for awards that ordinarily result in a tax deduction, a deferred tax asset should be recorded at the acquisition date related to the fair value of a replacement award granted by the acquirer. If the acquirer is obligated to grant the replacement award, the fair value of the award related to pre-combination services should be included in the consideration transferred to the acquiree and a deferred tax asset would be established in purchase accounting. This deferred tax asset represents a future tax benefit that the acquirer has obtained the right to receive as a result of the acquisition. If the acquirer is not obligated to grant the replacement award, the entire fair value of the award would be recognized as expense in the post-combination financial statements, and, as a result, the related deferred tax benefit for the establishment of the deferred tax asset should be recognized in the post-combination tax provision of the acquirer. For the fair value of a replacement award that is attributed to post-combination services, a deferred tax asset would be recorded in the post-combination financial statements as the service period is completed. When determining the deferred tax asset that should be recognized, the acquirer should also consider whether the IRC Section 162(m) limitation is expected to apply (TX 17.8).

17.13.1 *Equity-classified awards that result in a tax deduction*

As noted above, a deferred tax asset should be recorded at the acquisition date for replacement awards that ordinarily result in a tax deduction and are included in the consideration transferred for the acquiree. The resulting income tax effects of equity-classified awards (e.g., stock options or restricted shares) exchanged in a business combination should be accounted for in accordance with ASC 718-740. If the ultimate tax deduction received by the acquirer upon the exercise of stock options or vesting of restricted shares is different than the sum of the fair value of the award included in the purchase price plus the cumulative book compensation cost recorded by the acquirer post acquisition (if any), the difference should be recognized in income tax expense in the income statement. No adjustment to goodwill or purchase accounting is appropriate.

For example, if a partially vested replacement award is granted on the acquisition date, a deferred tax asset would only be recorded for the portion of the award's fair value that was attributed to pre-combination services. A deferred tax asset related to the portion of the awards' fair value attributed to post-combination services would be recorded in the post-combination financial statements as the service period is completed. In other words, for the portion of the awards' fair value attributed to post-combination services, there are no adjustments to goodwill for the deferred tax asset related to awards attributed to post-combination services.

Example TX 17-4 illustrates this guidance; however, it does not consider the par value of the common stock issued or cash received for the option's exercise price.

EXAMPLE TX 17-4

Income tax accounting for a partially vested equity-classified nonqualified option

Company A (the acquirer) exchanges replacement awards in its equity having a fair value of \$50 at the acquisition date for awards in Company B's (the acquiree) equity with a fair value of \$50. Company A was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company B's awards had a service period of four years. As of the acquisition date, three years of service required by the original terms of Company B's awards have been rendered. The replacement

awards have the same terms as the original awards. The awards are nonqualified options and, therefore, are expected to result in a tax deduction upon exercise of the awards. The exercise price of the awards is \$30. Company A's applicable tax rate is 25%. All of the awards are exercised two years after the acquisition date when the market price of Company A's shares is \$90.

What are the journal entries to record the replacement awards in acquisition accounting, the effects of post-combination services, and the income tax effects of the settlement upon exercise?

Analysis

As of the acquisition date, 75% (3 years pre-combination service / 4 years total service) of the fair value of the awards is attributable to pre-combination services. The replacement awards had no excess fair value over the acquiree awards; therefore, \$37.5 ($\$50 \times 75\%$) would be included in the consideration transferred for the acquiree:

Dr. Net assets acquired (e.g., goodwill)	\$37.5	
Cr. APIC		\$37.5

Company A would also record a deferred tax asset for the portion of the awards attributed to pre-combination services equal to \$9.4 ($\$37.5 \times 25\%$ tax rate) because the awards are expected to result in a tax deduction:

Dr. Deferred tax asset	\$9.4	
Cr. Net assets acquired (e.g., goodwill)		\$9.4

One year after the acquisition date, the remaining year of service is completed, resulting in the vesting of the replacement awards. Company A would record compensation cost of \$12.5 ($\$50 \times 25\%$) in the post-combination financial statements for the remaining 25% of the fair value of the awards. A deferred tax benefit of \$3.1 would also be recorded for the related increase in the deferred tax asset ($\$12.5 \times 25\%$ tax rate).

Upon exercise of the awards, Company A would be entitled to a tax deduction of \$60 ($\90 market price of Company A's shares – $\$30$ exercise price). The tax benefit of the tax deduction would be \$15 ($\$60 \times 25\%$). The excess tax benefit of \$2.50 (total tax benefit of \$15 – deferred tax asset of \$12.5) would reduce income tax expense in the income statement.

17.13.2 Liability-classified awards that result in a tax deduction

For liability-classified awards, the income tax accounting for awards exchanged in a business combination is similar to that for equity-classified awards. If the acquirer is obligated to grant the replacement award, the fair value of the award and the deferred tax asset related to pre-combination services should be included in the consideration transferred for the acquiree. Under the business combination guidance in ASC 805-30-55-13, all changes in the fair value of liability-classified awards after the acquisition date and the related income tax effects are recognized in the post-combination financial statements of the acquirer in the period in which the change occurs.

17.13.3 Awards that do not ordinarily result in a tax deduction

For awards that do not ordinarily result in a tax deduction (e.g., ISOs) for which the award's fair value was attributed to pre-combination services, the acquirer should not recognize a deferred tax asset at the acquisition date because the awards are not expected to result in a tax benefit. In some situations, the acquirer may receive a tax deduction due to events that occur after the acquisition date (e.g., the disqualifying disposition of an ISO). Under ASC 805-740-25-11, the tax effect of a disqualifying disposition should be recognized in the income statement when it occurs.

17.14 Interplay of stock compensation and valuation allowance

For most stock-based compensation awards, a reporting entity will recognize a related deferred tax asset. Just like any other deferred tax assets, a valuation allowance may be needed if, based on the weight of the available positive and negative evidence, it is more-likely-than-not that the deferred tax asset will not be realized. See TX 5 for guidance on assessing the need for a valuation allowance.

When an entity measures its deferred tax asset related to stock-based compensation awards or determines whether a valuation allowance is necessary, its current share price (and how far the award may be out of the money) is not a relevant datapoint. Rather, an entity should establish a valuation allowance only if it is more-likely-than-not that it will not have sufficient future taxable income to realize an economic benefit from the deferred tax asset. In particular, an entity should not consider whether a decline in the company's share price makes it likely an option would expire unexercised or if an exercise would not result in a tax deduction sufficient to recover the entire deferred tax asset. This is the case even where expiration of an unexercised award is imminent. For example, on December 31, 20X1, an entity would not record a valuation allowance on a deferred tax asset expected to reverse when an out-of-the-money award expires on January 15, 20X2. The entity should wait until the award's expiration date to adjust the related deferred tax asset. If an entity expects that pending deferred tax write-offs will be material, it should disclose this expectation. Refer to TX 5.7.3 for guidance on the interplay of anticipated future excess tax deductions (so-called "windfall tax benefits") when forecasting taxable income for purposes of assessing realizability of deferred tax assets. Additionally, refer to TX 16.3.1 for interim accounting considerations of excess tax deductions.

17.15 Income tax accounting for capitalized compensation cost

US GAAP requires that, in certain cases, compensation cost be capitalized in the balance sheet, such as when employees devote significant time to a particular project (e.g., manufacturing inventory or constructing fixed assets). If the related stock-based compensation award will give rise to a tax deduction (e.g., when exercised, or over time as the asset is depreciated), ASC 718-740-25-2 specifies that compensation cost that is capitalized as part of the cost of an asset should be considered part of the tax basis of that asset for financial reporting purposes. With respect to the determination of excess tax benefits and deficiencies and when those amounts should be recognized in the income statement, the same methodology (as when stock-based compensation is not capitalized) applies. That is, any adjustment for the excess benefit or deficiency is reflected in the same period the related tax deduction occurs.

Example TX 17-5 illustrates the journal entries that would be recorded to account for compensation expense related to a nonqualified option that is capitalized as part of an asset:

EXAMPLE TX 17-5

Capitalization of compensation cost related to an equity-classified nonqualified option

USA Corp grants nonqualified stock options to employees involved in the self-construction of a fixed asset, and \$1,000 of that compensation cost is capitalized as part of the fixed asset. The asset has a 10-year life and the awards are fully vested on the grant date. USA Corp will receive a tax deduction for the amount of the intrinsic value when the option is exercised.

USA Corp has a 25% tax rate.

At the completion of construction of the asset, the book and tax basis of the compensation cost included in the cost of the asset are equal. During the first year after the asset is placed in service, the entity records \$100 of depreciation expense for book purposes. Although the \$1,000 is deemed to be part of the tax basis, because the expense has not yet been incurred for tax purposes, no tax deduction can be taken. As a result, Company USA has a \$900 book basis in the portion of the carrying amount of the equipment that relates to the stock options compared to a \$1,000 tax basis.

At the end of the second year, the employees exercise the options when the intrinsic value is \$5,000 and an additional \$100 of incremental book depreciation expense has been recorded. The entity receives a tax deduction for the intrinsic value of the options when they are exercised. Thus, at the end of the second year, the entity's "tax basis" of \$1,000 has been fully consumed by the tax deduction (i.e., it is now zero) and the book basis of the asset related to compensation cost is \$800.

How should USA Corp account for this transaction and record the tax benefit?

Analysis

Grant date

Dr. Fixed assets	\$1,000	
		Cr. Additional paid-in capital
		\$1,000

To capitalize the portion of stock-based compensation cost associated with the self-constructed asset

Depreciation—Year 1

Dr. Depreciation expense	\$100	
		Cr. Accumulated depreciation
		\$100

To record annual depreciation expense for the portion of the cost of the self-constructed asset related to stock-based compensation

Dr. Deferred tax asset	\$25	
Cr. Deferred tax expense		\$25

To record the increase in the deferred tax asset associated with the annual depreciation expense for the portion of the cost of the self-constructed asset related to stock-based compensation ($\$100 \times 25\%$ tax rate).

Depreciation—Year 2

Dr. Depreciation expense	\$100	
Cr. Accumulated depreciation		\$100

To record annual depreciation expense for the portion of the cost of the self-constructed asset related to stock-based compensation

Dr. Deferred tax asset	\$25	
Cr. Deferred tax expense		\$25

To record the increase in the deferred tax asset associated with the annual depreciation expense for the portion of the cost of the self-constructed asset related to stock-based compensation ($\$100 \times 25\%$ tax rate). At end of year two, deemed tax basis is \$1,000 and book basis is \$800.

Exercise of options—end of Year 2

Dr. Income taxes payable	\$1,250	
Cr. Income tax benefit		\$1,250

To record the current tax benefit from the tax deduction as result of the employee's exercise of the option ($\$5,000$ tax deduction \times 25% tax rate).

Dr. Deferred tax expense	\$250	
Cr. Deferred tax asset		\$50
Cr. Deferred tax liability		\$200

To record the deferred tax effects of the employee's exercise of the option, which includes the recovery of the \$50 deferred tax asset established in years 1 and 2 and the recognition of the deferred tax liability for the excess of the book over tax basis of the asset at the end of year 2 ($\$800$ basis difference \times 25% tax rate).

The tax accounting related to the capitalization of compensation cost for an ISO is different because an ISO is not ordinarily expected to result in a tax deduction and therefore the tax effects are recorded only upon a disqualifying disposition. As an ISO is not expected to result in a tax benefit to the entity, no deferred tax benefit is established either at the outset or as the compensation cost is either capitalized or recognized in the income statement (through amortization or depreciation). Upon a

disqualifying disposition, however, an entity will receive a tax deduction or may receive additional tax basis in the asset. If the entity receives a tax deduction, assuming the related capitalized asset is not yet fully amortized or depreciated, upon the disqualifying disposition, a current tax benefit is reflected in the income statement while a deferred tax liability is recognized for the related temporary difference.

17.16 *Stock-based compensation—multinational entities*

US multinational entities face several income tax issues involving stock-based compensation for non-US-based employees. Income tax laws in each country are unique and may provide for tax deductions that differ from those permitted under US tax law. This may result in a different income tax accounting treatment than for a stock-based compensation award issued to a US employee.

A non-US subsidiary generally must bear the cost of a stock-based compensation award in order to be eligible for a local corporate income tax deduction. If the costs of a stock-based compensation award are recharged to the non-US subsidiary in return for cash, the recharge should be treated as the parent entity's issuance of capital stock in exchange for cash or property, and generally should not result in a taxable transaction in the US.

When a US multinational entity issues stock-based compensation to its employees in non-US subsidiaries and it expects to receive a tax deduction in the local jurisdiction, the non-US subsidiary should record a deferred tax asset, based on the local tax rate, as it recognizes book compensation cost over the requisite service period. At the time of settlement, the non-US subsidiary would determine its excess tax benefit or deficiency based on the local jurisdiction tax deduction and reflect that adjustment in income tax expense.

Stock-based compensation deductions incurred by non-US subsidiaries also may have an indirect effect on the ultimate US taxes paid by the US parent entity. For example, amounts that are charged back to the US parent under transfer pricing agreements that are determined on a "cost plus" basis might include a deduction for stock-based compensation, thereby providing the US parent with a greater tax deduction than would have been the case absent the award. Such indirect tax effects should not be considered for purposes of either (1) establishing the deferred tax asset over the requisite service period or (2) measuring the excess tax benefit or deficiency at settlement of the award.