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Simplifications to accounting for income taxes

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KPMG reports on ASU 2019-12[1], which removes certain exceptions for investments, intraperiod allocations and interim calculations, and adds guidance to reduce complexity in accounting for income taxes.

Applicability

All entities that pay income taxes under US GAAP.[2]

Key facts and impacts

The ASU adds new guidance to simplify accounting for income taxes, changes the accounting for certain income tax transactions and makes minor improvements to the codification.

The ASU introduces the following new guidance:

— provides a policy election to not allocate consolidated income taxes when a member of a consolidated tax return is not subject to income tax; and

— provides guidance to evaluate whether a step-up in tax basis of goodwill relates to a business combination in which book goodwill was recognized or a separate transaction.

The ASU changes the following current guidance:

— making an intraperiod allocation, if there is a loss in continuing operations and gains outside of continuing operations;

— determining when a deferred tax liability is recognized after an investor in a foreign entity transitions to or from the equity method of accounting;

— accounting for tax law changes and year-to-date losses in interim periods; and

— determining how to apply the income tax guidance to franchise taxes that are partially based on income.

The ASU is effective for calendar year-end public business entities on January 1, 2021 and other entities on January 1, 2022. Entities may early adopt the ASU in any interim period for which financial statements have not yet been issued (or made available for issuance).

[1] ASU 2019-12, Simplifying the Accounting for Income Taxes

[2] ASC 740, Income Taxes

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Separate financial statements of legal entities not subject to tax

The ASU specifies that an entity is not required to allocate any portion of the consolidated amount of current and deferred tax expense to a legal entity that is not subject to tax in its separate financial statements. However, an entity may elect to do so for an individual entity if the legal entity is not subject to tax and is disregarded by the taxing authority.

An entity may not allocate current and deferred tax expense to legal entities that are (a) partnerships or (b) other pass-through entities that are not wholly owned.

Current accounting guidance does not specify whether the requirement to allocate current and deferred income taxes to members that are included in a consolidated tax return applies to entities that are not subject to tax – e.g. single-member LLCs.[3] We understand that some entities are currently allocating current and deferred income taxes to legal entities that will meet the ASU's conditions to no longer require allocation. We believe an entity may change its current policy about allocation without establishing preferability because the ASU sufficiently supports making the change.[4]

Step-up in tax basis of goodwill

The ASU requires an entity to evaluate the step-up in tax basis of goodwill to determine if the step-up should be considered:

- part of the business combination, which results in a deferred tax asset only when it exceeds the remaining balance of book goodwill recognized in that business combination; or
- a separate transaction, which results in a deferred tax asset.

The ASU includes the following factors that may indicate that the step-up in tax basis should be considered a separate transaction.

- There is a significant lapse in time between the transactions.
- The tax basis in the newly created goodwill is not the direct result of settlement of liabilities recorded in connection with the acquisition.
- The step-up in tax basis is based on a valuation of the goodwill or the business that was performed after the business combination.
- The transaction resulting in the step-up in tax basis requires more than a simple tax election.
- The entity incurs a cash tax cost or sacrifices existing tax attributes to achieve the step-up in tax basis.
- The transaction resulting in the step-up in tax basis was not contemplated at the time of the business combination.

Under current US GAAP, if an entity enters into a transaction with the government that results in a step-up in tax basis of goodwill, it recognizes a deferred tax asset only if the tax deductible goodwill exceeds the remaining balance of book goodwill that was previously recognized in the business combination.[5] The guidance presumes that the tax basis in goodwill that results from the transaction with the government relates to the prior business combination. Therefore, the related deferred tax asset is recognized only if it would have been recognized in the acquisition accounting – i.e. if the total tax goodwill exceeds book goodwill.

Intraperiod tax allocation

Current US GAAP	ASU 2019-12
An entity generally allocates total income tax expense or benefit by first determining the amount attributable to continuing operations in isolation and then proportionally allocating the remaining tax expense or benefit to items other than continuing operations – e.g. discontinued operations.	

[3] ASC 740-10-30-27

[4] ASC 250-10-45-13

[5] ASC 740-10-25-54

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Current US GAAP	ASU 2019-12
However, there is an exception[6] that requires an entity with a loss from continuing operations to consider all components (including discontinued operations and items credited directly to equity) when determining the benefit from continuing operations.	The ASU removes the exception. Instead, an entity will follow the general intraperiod allocation of total tax expense regardless of whether there is a loss from continuing operations. An entity with a loss from continuing operations will determine the amount attributable to continuing operations in isolation.
This exception means that a loss-making entity with no total tax expense may report an income tax benefit from continuing operations and an offsetting income tax expense from the other components.	A loss-making entity with no total tax expense generally will report no income tax benefit from continuing operations and no offsetting income tax expense from the other components.

Ownership changes – Consolidation to equity method

Current US GAAP	ASU 2019-12
When an entity transitions from consolidation to the equity method of accounting for a foreign investment, it does not recognize a deferred tax liability related to the transition-date outside-basis difference if it had been asserting indefinite reversal to its investment in the former subsidiary.[7]	
This is an exception to the principle that an entity must recognize a deferred tax liability for a taxable outside-basis difference in the equity method investment.	The ASU removes the exception. Instead, an entity will follow the general principle in current US GAAP when transitioning from consolidation to the equity method. It will recognize a deferred tax liability for a taxable outside-basis difference in the equity method investment if it is no longer eligible to assert indefinite reversal.

Ownership changes – Equity method to consolidation

Current US GAAP	ASU 2019-12
When an entity transitions from the equity method to consolidation for a foreign investment, it retains the deferred tax liability previously recognized even if it asserts indefinite reversal when the investment becomes a subsidiary.[8]	
This is an exception to the principle that an entity that asserts indefinite reversal of a taxable outside basis difference in a foreign subsidiary investment does not recognize a deferred tax liability for the outside basis difference.	The ASU removes the exception. Instead, an entity will follow the general principle in current US GAAP when transitioning from the equity method to consolidation. Thus it will derecognize an existing deferred tax liability for a taxable outside basis difference in the equity method investment if it asserts indefinite reversal of the outside basis difference in the newly consolidated subsidiary.

[6] ASC 740-20-45-7

[7] ASC 740-30-25-15

[8] ASC 740-30-25-16

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Interim period tax accounting – Changes in tax law

Current US GAAP	ASU 2019-12
An entity generally recognizes the effects of a change in tax law in the period of enactment.[9]	
However, there is an exception for tax laws with delayed effective dates. An entity may not adjust its annual effective tax rate for a tax law change until the period in which the law is effective or administratively effective. As a result, if a tax law is enacted in the first quarter with an effective date in the third quarter, an entity recognizes the effect on existing deferred tax assets and liabilities in the first quarter but does not adjust its estimated annual effective tax rate until the third quarter.	The ASU removes the exception. An entity will follow the general principle and recognize all the effects of a change in tax law in the period that includes the enactment date, including adjusting its estimated annual effective tax rate.

Interim period tax accounting – Interim period loss exceeds expected annual loss

Current US GAAP	ASU 2019-12
An entity is required to make its best estimate of the annual effective tax rate for the full fiscal year at the end of each interim period and use that rate to calculate its income taxes on a year-to-date basis.	
However, there is an exception when the ordinary loss for an interim period exceeds the anticipated loss for the current year. In that situation, the year-to-date income tax benefit is limited to the amount that would be recognized if the year-to-date ordinary loss were the anticipated ordinary loss for the full fiscal year.[10]	The ASU removes the exception. An entity will follow the general principle and compute its income tax benefit at each interim period based on its estimated annual effective tax rate. It will no longer limit the computed benefit if it exceeds the amount of benefit that would be recognized if the year-to-date ordinary loss were the anticipated ordinary loss for the full fiscal year.

Franchise taxes that are partially based on income

Current US GAAP	ASU 2019-12
Current US GAAP income tax guidance does not apply to taxes that are based on a non-income-based measure (e.g. capital) when there is no additional tax based on income.	
However, taxes that require payment equal to the higher of the non-income-based tax and the income-based tax are in the scope of income tax guidance, but only for the portion in excess of the non-income-based tax.[11]	The ASU amends this guidance to require an entity to first account for these taxes as income taxes and then account for the non-income-based portion, if any, in pretax income.

[9] ASC 740-270-25-5, 55-49

[10] ASC 740-270-30-28, 55-16

[11] ASC 740-10-15-4

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Current US GAAP	ASU 2019-12
This guidance requires an entity to first account for the non-income-based portion of the tax in pretax income and then apply current US GAAP income tax guidance (including recognizing deferred taxes) to the incremental income-based portion, if any.	As a result, an entity will recognize deferred tax assets and liabilities assuming it will always pay under the income-based tax regime. It will not consider the effect of potentially paying a non-income-based tax in future years when evaluating the realizability of deferred tax assets. If an entity incurs incremental non-income-based tax, it will recognize that expense in pretax income.

Codification improvements

The ASU also makes the two minor codification improvements.

- **Income statement presentation of tax benefits of tax-deductible dividends.** The ASU amends the guidance on stock compensation[12] to require that the tax benefit of allocated and unallocated employee stock ownership plan shares be allocated to continuing operations. Current US GAAP requires an entity to recognize the benefit in the income statement.[13]
- **Impairment of affordable housing investments accounted for under the equity method.** The ASU corrects the illustration in the guidance for equity method investments by showing the investor recognizing other-than-temporary impairment in the first period in which projections of the total future tax benefits indicate that a net loss will be recognized over the remaining term of the investment.[14]

Effective dates and transition

	Public business entities	All other entities
Annual periods – Fiscal years beginning after	December 15, 2020	December 15, 2021
Interim periods – In fiscal years beginning after	December 15, 2020	December 15, 2022
Early adoption allowed?	Yes, in periods for which financial statements have not been issued (or made available for issuance). An entity that elects early adoption in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. An entity must adopt all amendments at the same time.	
Transition guidance		
Allocation of income taxes to entities not subject to tax	Retrospective for all periods presented.	
Changes in ownership of foreign equity method investments or foreign subsidiaries	Modified retrospective through cumulative-effect adjustment to retained earnings at the beginning of the period of adoption.	
Franchise tax partially based on income	Retrospective for all periods presented; **or** modified retrospective basis through a cumulative–effect adjustment to retained earnings as of the beginning of the period of adoption.	
All other topics in ASU 2019-12	Prospective.	

[12] ASC 718-740, Compensation—Stock Compensation—Income Taxes

[13] ASC 718-740-45-7

[14] ASC 323-740-55-8

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