



# Accounting for income taxes

**Handbook**

**US GAAP**

July 2024

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## Preface

We are pleased to provide you with our July 2024 edition of *Accounting for Income Taxes*. This book is designed to assist companies and others in understanding the application of ASC Topic 740, *Income Taxes*. In addition to an analysis of ASC Topic 740 and other pertinent sections of the FASB's ASC, this book provides interpretive guidance, including illustrative examples and questions and answers, and addresses specific implementation issues identified since these sections became effective.

We expect to update this Handbook as needed based on developments in practice. You will always be able to find the most up-to-date version of this and other KPMG publications on KPMG [Financial Reporting View](#).

In our July 2024 edition, we have added or clarified interpretive guidance as follows.

<i>Topic</i>	<i>Reference</i>
Removed guidance relevant prior to the adoption of ASU 2016-02	2.076d, <a href="#">2.085</a> , <a href="#">3.127</a> , <a href="#">4.133</a> , <a href="#">4.144a</a> , <a href="#">4.144b</a> , <a href="#">5.052</a> , <a href="#">6.111</a> , <a href="#">9.131</a> , A.050, <a href="#">A.052</a>
Removed guidance relevant prior to the adoption of ASU 2016-13	<a href="#">4.090</a> , 4.092a, <a href="#">A.005</a>
Removed guidance relevant prior to the adoption of ASU 2019-12	<a href="#">1.003</a> , <a href="#">1.018a</a> , <a href="#">2.053</a> , <a href="#">2.056 - 2.057a</a> , <a href="#">2.061 - 2.061a</a> , <a href="#">5.017b</a> , 5.017d - 5.017e, <a href="#">6.007 - 6.007b</a> , <a href="#">6.007e</a> , <a href="#">6.073 - 6.074a</a> , <a href="#">7.013</a> , <a href="#">7.055</a> , <a href="#">7.067</a> , <a href="#">9.026 - 9.029</a> , 9.049a, <a href="#">9.057b</a> , <a href="#">9.061</a> , <a href="#">9.066 - 9.066a</a> , 9.069a - 9.069b, <a href="#">9.074 - 9.074a</a> , <a href="#">9.135 - 9.139b</a> , <a href="#">10.008 - 10.008b</a> , 10.008e, <a href="#">10.012b - 10.013</a> , 10.014, <a href="#">10.043</a> , <a href="#">10.057 - 10.059b</a> , 10.064a, <a href="#">10.081a</a> , <a href="#">10.083 - 10.083a</a>
Removed guidance relevant prior to the adoption of ASU 2017-04	<a href="#">10.019a - 10.019b</a> , <a href="#">10.032 - 10.035</a> , 10.042b, Example 10.8a, Example 10.9a, Example 10.9d
Clarified guidance on the future reversal of taxable temporary difference supporting the realization of deferred tax assets	<a href="#">4.034</a>
New guidance related to income tax disclosures that will be effective upon the adoption of ASU 2023-09	<a href="#">1.018a</a> , <a href="#">9.078 - 9.079</a> , <a href="#">9.082</a> , <a href="#">9.085a</a> , <a href="#">9.090a - 9.090y</a>

<i>Topic</i>	<i>Reference</i>
Updated discussion of EITF 12-A which was issued as ASU 2023-02, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method	<a href="#">1.019</a> , <a href="#">2.032</a>
Removed guidance related to tax credits that is now addressed in <a href="#">KPMG Handbook, Tax credits</a>	<a href="#">1.030</a> , <a href="#">9.167 - 9.167cc</a> , Example 9.40a, Example 9.41, <a href="#">10.126 - 10.145</a> , Example 10.36b, Example 10.36c, Example 10.36d, Example 10.36e, Example 10.37, Example 10.37a, Example 10.37b, Example 10.37c, Example 10.37d, Example 10.37e, Example 10.38
Removed guidance relevant prior to the adoption of ASU 2017-11	<a href="#">2.108a</a>
New guidance and example related to the tax implications of recognizing credit losses on AFS debt securities	<a href="#">2.117 - 2.118a</a> , <a href="#">Example 2.13</a>
New guidance and example related to PCD Financial assets	<a href="#">2.119 - 2.119c</a> , <a href="#">Example 2.14</a>
Revised examples to reflect the adoption of ASU 2019-12	<a href="#">Example 5.8</a> , <a href="#">Example 6.1</a> , <a href="#">Example 6.2</a> , <a href="#">Example 6.3</a> , <a href="#">Example 9.6</a> , <a href="#">Example 9.7</a> , <a href="#">Example 9.8</a> , <a href="#">Example 9.8a</a> , <a href="#">Example 9.9</a> , <a href="#">Example 9.9a</a> , <a href="#">Example 9.9b</a> , <a href="#">Example 9.10</a> , <a href="#">Example 9.11</a> , <a href="#">Example 9.19</a> , <a href="#">Example 9.19a</a> , <a href="#">Example 9.22</a> , <a href="#">Example 10.29</a> , <a href="#">Example 10.29a</a> , <a href="#">Example 10.30a</a> , <a href="#">Example 10.31a</a> , <a href="#">Example 10.43</a>
Revised examples to reflect the adoption of ASU 2017-04	<a href="#">Example 10.7</a> , <a href="#">Example 10.8</a> , Example 10.9d
New guidance related to the settlement of target's share-based payment awards in a business combination	<a href="#">6.130</a>

<i>Topic</i>	<i>Reference</i>
New guidance related to obligations to ‘safeguard’ digital assets under SEC Staff Accounting Bulletin No. 121	<a href="#">9.082b</a>
Removed guidance relevant to the change in US tax rates in 2017	9.088a - 9.088b
New guidance related to the interaction of unrecognized tax benefits and an entity’s GILTI inclusion	<a href="#">9.125b</a>
Clarified guidance related to valuation allowances for acquired deferred tax assets	<a href="#">10.005a</a>
New guidance related to abbreviated financial statements under S-X Rule 3.05(e)	<a href="#">10.060a</a>
Revised guidance on failed sale and leaseback transactions under ASC Topic 842, Leases	<a href="#">A.053</a>
Clarified guidance related to future originating deductible temporary differences and carryforwards	<a href="#">4.048</a>
Clarified guidance related to initial recognition and measurement of tax receivable agreements	<a href="#">9.056c</a>
Clarified guidance related to transactions among shareholders	<a href="#">9.070</a>

This publication represents our current interpretation of ASC Topic 740, which is based partly on periodic, informal discussions with the FASB and SEC staff. Our interpretations may be affected by future guidance issued by the FASB or its staff, the SEC staff, and others involved in the standard-setting process.

We recommend that companies refer to the texts of the applicable literature and consult their accounting and tax advisers when considering the practical aspects of applying ASC Topic 740.

KPMG LLP

July 2024

## Abbreviations

The following abbreviations are used in this Handbook:

ASC	FASB's Accounting Standards Codification®
AMT	Alternative minimum tax
ARPA	American Rescue Plan Act
ASU	Accounting Standards Update
BEAT	Base erosion and anti-abuse tax
CAA	Consolidated Appropriations Act
CERT	Corporate equity reduction transaction
CFC	Controlled foreign corporation
CHIPS	Creating Helpful Incentives to Produce Semiconductors and Science Act of 2022
COD	Cancellation of debt
E&P	Earnings and profits
ESOP	Employee stock ownership plan
FDII	Foreign-derived intangible income
FIFO	First-in first-out
FTC	Foreign tax credit
GAAP	Generally accepted accounting principles
GILTI	Global intangible low-taxed income
IAS Standards	International Accounting Standards
IPR&D	In-process research and development
IRA	Inflation Reduction Act of 2022
IRC	Internal Revenue Code
ISO	Incentive stock option
LIFO	Last-in first-out
MD&A	Management discussion and analysis
NSO	Nonstatutory stock options
NOL	Net operating loss
OCI	Other comprehensive income
PBE	Public Business Entity
R&D	Research and development
R&E	Research and experimentation
REIT	Real estate investment trust
RIC	Registered investment company
VIE	Variable interest entity

# Section 1 - An Introduction to Accounting for Income Taxes

## Detailed Contents

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Example 1.2: Taxes Based on Net Revenue (Oklahoma Business Activity Tax)

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Endnotes

**1.000** ASC Topic 740, *Income Taxes*, the source governing accounting for income taxes, provides a methodology to recognize income tax expense for financial reporting (GAAP accounting) by focusing on the differences between the tax bases of assets and liabilities and the carrying amounts of assets and liabilities recognized for financial reporting. This introduction to accounting for income taxes discusses the objectives and basic principles of accounting for income taxes and the general concepts for accounting for the differences between tax accounting (taxes payable governed by U.S. federal, state, and foreign taxing authorities) and financial statement accounting for income taxes.

**1.001 Scope.** ASC Topic 740 applies to domestic and foreign entities in preparing financial statements in accordance with U.S. GAAP, including not-for-profit entities with activities that are subject to income taxes. These entities are required to recognize and disclose the income tax consequences of:

- Revenues, expenses, gains and losses that are included in taxable income of an earlier or later year than the year in which they are recognized for financial statement reporting.
- Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting.
- Operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years. ASC paragraph 740-10-05-1

All domestic federal income taxes and foreign, state and local (including franchise) taxes based on income must be included when accounting for income taxes. All of an entity's operations which are consolidated, combined, or accounted for under the equity method, both foreign and domestic, should apply the provisions of ASC Topic 740. ASC paragraphs 740-10-15-2 and 15-3

**1.002** State, foreign and local taxes and excise taxes may be based on various measures that raise questions about applying the provisions of ASC Topic 740. For example, state taxes may be based on adjusted operating results, revenues or gross receipts, or the greater of a capital tax or income tax, and excise taxes on not-for-profits may be based on foundation investment income. ASC paragraph 740-10-15-3 states that the Income Taxes Topic applies to “[d]omestic federal (national) income taxes (U.S. federal income taxes for U.S. entities) and foreign, state, and local (including franchise) taxes based on income,” and accordingly, those taxes that are assessed on an income-based measure generally are accounted for under ASC Topic 740. ASC Topic 740 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, inherent in ASC Topic 740 is the concept that taxes on income are determined after deducting allowable expenses and losses from gross revenues and gains. See the discussion beginning in Paragraph 9.134 for specific state tax application matters and Section 7, *Foreign Operations*, for specific foreign tax application matters.



### Example 1.1: Taxes Based on Tonnage

The American Jobs Creation Act of 2004 (the Act) permits qualifying corporations to elect to be taxed under a tonnage tax regime on their taxable income from certain shipping activities in lieu of the U.S. corporate income tax or, for foreign corporations, the gross transportation tax. The tonnage tax is calculated by multiplying the maximum corporate tax rate (35%) by the notional shipping income for the year. Notional shipping income is based on the weight (net tonnage) of each qualifying vessel and the number of days that the vessel was operated as a qualifying vessel during the year in U.S. foreign trade.

Accordingly, an electing entity's total tax for the year would be equal to the tonnage tax plus the income tax on nonqualifying activities. No deductions are allowed against the notional shipping income of an electing entity, and no credit is allowed against the tax imposed. Therefore, an entity in a loss position will still owe the tonnage tax. Qualifying entities may switch to this method of taxation by filing an election with the IRS. Under the tonnage tax regime an entity is required to include in determining its income taxes any gains associated with vessel dispositions unless replaced with a qualifying vessel within three years (any deferred gain for tax purposes reduces the tax basis in the replaced vessel). The tax basis of a vessel is based on the purchase price of the vessel reduced by depreciation as if the vessel was being depreciated for income tax purposes.

Because the tax calculation is based on the tonnage of an entity's qualifying vessels and is not directly tied to the income of the entity, the tonnage tax should be accounted for as a non-income-based tax. Therefore, the tonnage tax should not be classified as income taxes in the financial statements.

For purposes of measuring future tax consequences, ASC paragraph 740-10-25-20 makes an initial assumption that assets will be recovered and liabilities will be settled at their financial statement carrying amounts. Based on this assumption, expected future tax consequences are the tax effects of differences between the tax bases and financial statement carrying amounts of assets and liabilities. In this situation, if the vessels were sold at their book carrying amounts there would be taxable gain and a deferred tax liability should be established (the fact that the taxable gain can be deferred does not change this conclusion). The deferred taxes on the basis differences in the vessels and current taxes on vessel dispositions are related to *taxable income* as used in ASC Topic 740 and should be classified as income taxes in the financial statements. See the discussion beginning at Paragraph 2.002 for additional information on temporary differences.

### Example 1.2: Taxes Based on Net Revenue (Oklahoma Business Activity Tax)

The Oklahoma Business Activity Tax (BAT) was enacted beginning in tax year 2010 and was based on 1% of net revenues derived from business activity in Oklahoma. However, for tax years 2010-2012, although corporate entities were required to report what their tax liabilities would be based on net revenues, the amount required to be remitted was equal to \$25 plus the amount of Oklahoma franchise tax paid in 2010 for the 2009 tax year. BAT

*net revenues* were revenues reportable on an entity's federal tax return, excluding interest, dividends, and distributions received; less all ordinary trade or business expenses other than interest, income taxes, depreciation, and amortization. The BAT was scheduled to sunset beginning in tax year 2013, so absent further legislative action to extend the BAT past tax year 2012, taxpayers would never remit BAT based on net revenues.

While the BAT required taxpayers to report what their tax liabilities would be based on net revenues (which is an income-based measure, making the resulting tax subject to ASC Topic 740), because the enacted tax law would never, absent additional legislative action, require taxpayers to remit the BAT on that basis (i.e., the amount of BAT payable for tax years 2010-2012 was based on the Oklahoma franchise tax paid in 2010 and the Oklahoma franchise tax is not considered to be an income tax), the BAT regime was not considered to be an income tax subject to ASC Topic 740. The Oklahoma BAT sunset as scheduled for tax years beginning after December 31, 2012 and the Oklahoma franchise tax was reinstated.

### **Example 1.3: Taxes Based on Sales Volumes (French Contribution Economique Territorial)**

France's business tax regime, Contribution Economique Territorial (CET or local economic contribution), includes elements based on enterprise land value and enterprise value. The enterprise value component is based on a sliding tax rate of up to 1.5% (based on sales volumes) applied to an amount that is determined using defined elements of revenues and expenses. There are limitations on the total tax that may result in capping the total CET at 3% of the enterprise value component and additional transitional relief measures related to the CET.

As the enterprise value component is based on elements of revenues and expenses, it is considered to be an income tax under ASC Topic 740. The enterprise land value component is accounted for as a non-income tax included in operating results.

#### **1.003** ASC Topic 740 also specifically excludes:

- 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 ASC Topic 740. An entity that pays a franchise or similar tax that is partially based on income will account for the income-based portion of the tax as an income tax under ASC Topic 740 using the applicable statutory income tax rate and account for any incremental amount as incurred as a non-income-based tax (see Paragraph 9.135 for additional guidance on franchise taxes partially based on income);
- Withholding tax for the benefit of the recipients of a dividend. See Paragraph 7.025 for additional discussion of withholding taxes. ASC paragraph 740-10-15-4

**1.004 Objective and Basic Principles of Accounting for Income Taxes.** The objectives of accounting for income taxes are (1) to recognize the amount of taxes payable or refundable for current-year operations and (2) to recognize deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the financial statements or tax returns. These objectives are met through ASC Topic 740's basic principles:

- (a) Recognize a current tax liability or asset for the estimated taxes payable or refundable for the current year based on the provisions of the tax law.
- (b) Recognize deferred tax assets for the tax effects of tax carryforwards and deferred tax liabilities and assets for the estimated future tax effects of temporary differences between the financial statement carrying amount of assets and liabilities and their tax bases.
- (c) Measure current and deferred tax assets and liabilities based on the provisions of enacted tax law.
- (d) Recognize a valuation allowance for deferred tax assets that are not expected to be realized based on the *more likely than not* (a likelihood of more than 50%) criterion. ASC paragraphs 740-10-25-2, 30-2

The remainder of this section discusses the general principles of accounting for income taxes. The sequence is the same as the sequence of the other sections in this book, which is designed to present more fundamental concepts first and then build upon them.

**1.005 Temporary Differences.** *Temporary differences* are differences between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the amount reported in the financial statements is recovered or settled. Temporary differences are identified as *taxable temporary differences* (differences that will result in future taxable amounts) and *deductible temporary differences* (differences that will result in future deductible amounts). Identifying temporary differences generally requires developing a tax-basis balance sheet to compare to the financial statement carrying amounts of assets and liabilities. ASC paragraph 740-10-25-23

**1.006 Tax Calculation.** ASC Topic 740 requires the reporting entity to recognize (a) taxes payable or refundable for current year taxable income and (b) deferred tax assets and liabilities for the future tax consequences of events that have been recognized in the entity's financial statements or tax returns. Deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences and are calculated by multiplying temporary differences by the applicable enacted tax rate. Deferred tax assets also are recognized for the potential tax benefits of existing operating loss and tax credit carryforwards. ASC Topic 740 prohibits discounting deferred tax assets and liabilities. ASC paragraph 740-10-30-8

**1.007** *Current tax expense or benefit* is the amount of income taxes payable or receivable for the current year as determined by applying the provisions of the tax law to taxable income or loss for the year. *Deferred tax expense or benefit* generally is the change in the

sum of the deferred tax assets, net of any valuation allowance (see Section 4, *Valuation of Deferred Tax Assets*), and deferred tax liabilities during the year. Total tax expense is the sum of current tax expense or benefit plus deferred tax expense or benefit. *Total tax expense*, both current and deferred, generally must be calculated for each tax-paying component of the entity in each tax jurisdiction. ASC paragraph 740-10-10-1

Total tax expense = current tax expense (benefit) + deferred tax expense (benefit)

**1.008** The *applicable enacted tax rate* for current taxes is the tax rate dictated by the provisions of current tax law. The applicable enacted tax rate for deferred taxes is the enacted rate under current law that is applicable for the periods in which the temporary differences are expected to reverse. In many cases, the applicable tax rate will be a single flat rate. For example, under U.S. federal tax law after the reforms enacted in 2017, taxable income generally is taxed at a flat rate of 21%. However, there are some jurisdictions in which graduated rates are expected to apply in future years. In those jurisdictions, entities will measure deferred taxes based on the enacted tax rate expected to apply when those temporary differences reverse. Entities will also need to consider other provisions of enacted tax law in the tax calculation, such as the character of the income (e.g., different tax rates on ordinary income versus capital gains). ASC paragraphs 740-10-30-8 and 30-9

**1.009** As discussed, current and deferred tax expense or benefit is determined by applying the provisions of the tax law. While an entity may have a high degree of confidence that a tax position will be sustained for some positions, it may have a lower degree of confidence with respect to other positions where the tax law is subject to varied interpretation. An entity should include the current and deferred tax benefit of all its tax positions in the financial statements only when it is more likely than not that such positions will be sustained by the taxing authorities based on the technical merits of those positions. The current and deferred tax benefit is equal to the largest amount, considering possible settlement outcomes, that is greater than 50% likely of being realized upon settlement with the taxing authorities. ASC paragraphs 740-10-25-6, 30-7

**1.010 Valuation of Deferred Tax Assets.** A *valuation allowance* is required to be recognized to reduce the recorded deferred tax asset to the amount that will more likely than not (a likelihood of more than 50%) be realized. ASC subparagraph 740-10-30-5(e)

**1.011** Future realization of deferred tax assets (the tax benefits of deductible temporary differences and tax operating loss and credit carryforwards) depends on sufficient taxable income of the appropriate character (for example, ordinary income vs. capital gains) in the periods in which the deductible temporary differences are expected to be recovered (or within the *carryback* and *carryforward* periods, if any) under the tax law. Sources of taxable income include (1) taxable income in the current year or prior years that is available through carryback, if carryback is permitted (potential recovery of taxes paid for the current year or prior years), (2) future taxable income that will result from the reversal of existing temporary differences for which deferred tax liabilities are recognized, and (3) future taxable income that is generated by future operations. In addition, tax-planning strategies may be available to accelerate taxable income or

deductions, change the character of taxable income or deductions, or affect the amount of future taxable income that will be available to realize deferred tax assets. *All available evidence*, both positive and negative, should be considered when evaluating whether a valuation allowance is needed. ASC paragraphs 740-10-30-17 and 30-18

**1.012** The amount of the valuation allowance for deferred tax assets can range from zero to the total amount of the deferred tax assets, not just the net deferred tax asset (net of any deferred tax liability). When determining the valuation allowance, an entity should consider whether it is possible to offset deductible temporary differences against taxable temporary differences. However, offsetting deferred tax liabilities does not justify recognizing a deferred tax asset (not recognizing a valuation allowance) if the future taxable and deductible amounts cannot be offset under applicable tax law. Accordingly, an analysis of the expected timing of reversals of temporary differences may be necessary.

**1.013 Changes in Tax Laws, Rates, or Status.** Deferred tax assets and liabilities are adjusted to reflect the effects of enacted changes in tax rates, changes in other provisions of the tax law, and changes in tax status. Future changes in tax laws, rates, or status are not anticipated. The effects of enacted changes in tax laws or rates are charged or credited to income from continuing operations as part of tax expense or benefit in the period in which the changes are enacted. The tax effect of a change in tax status generally is recognized on the date the election is approved by the taxing authority or, if taxing authority approval is not required, the date the election is filed and also is included in income from continuing operations. ASC paragraphs 740-10-25-32 and 25-33, 35-4, 40-6, 45-15

**1.014 Business Combinations.** ASC Subtopic 805-740, *Business Combinations - Income Taxes*, requires that deferred tax assets and liabilities be recognized on differences between the recognized financial statement amounts and tax bases of assets acquired and liabilities assumed in business combinations, except for temporary differences related to the portion of financial statement goodwill for which amortization is not deductible for tax purposes, leveraged leases<sup>1</sup>, and certain specific acquired temporary differences identified in ASC subparagraph 740-10-25-3(a). Tax benefits are recognized at the date of acquisition for acquired deductible temporary differences and acquired carryforwards if realization is more likely than not. If a valuation allowance is recognized for acquired deductible temporary differences or acquired operating loss or tax credit carryforwards at the acquisition date, those tax benefits, when initially recognized, are recognized as a reduction to income tax expense. ASC paragraphs 805-740-25-3 and 25-4

**1.015 Foreign Operations.** The provisions of ASC Topic 740 apply to all foreign operations. In a foreign tax jurisdiction and for purposes of the consolidated financial statements, temporary differences may arise as a consequence of differences between the functional currency financial statement carrying amounts and the functional currency tax bases of a subsidiary's assets and liabilities. Deferred taxes should be recognized for the future tax consequences of the temporary differences in the foreign tax jurisdiction. However, ASC Topic 740 excludes some foreign temporary differences and retains the exception to recognizing deferred tax liabilities for investments in foreign subsidiaries if

that difference meets the indefinite reversal criterion of ASC Subtopic 740-30, *Income Taxes - Other Considerations or Special Areas* (APB Opinion No. 23, *Accounting for Income Taxes – Special Areas*). ASC paragraphs 740-10-15-2 and 15-3 and 25-3

**1.016 Financial Statement Presentation and Disclosures.** ASC Topic 740 provides guidance about classifying deferred tax assets and liabilities within an entity's balance sheet, allocating income tax expense to components of comprehensive income and shareholders' equity, and footnote disclosures.

- An entity with a classified balance sheet should present all deferred tax assets and liabilities as noncurrent.
- An entity's total tax expense generally is allocated to continuing operations, discontinued operations, other comprehensive income, and other items in shareholders' equity. Income tax expense is allocated to continuing operations generally assuming continuing operations is the only source of taxable income. However, certain tax effects are always included in income from continuing operations such as changes in judgment as to the realization of deferred tax assets in future years, changes in tax laws or rates, changes in tax status, and tax-deductible dividends paid to shareholders. The remaining tax expense or benefit is allocated among the other items in proportion to their individual effects on income tax expense or benefit for the year. ASC paragraphs 740-20-45-2 and 45-8
- Disclosures are required about current and deferred tax expense, differences between actual tax expense and *expected* tax expense based on statutory rates, temporary differences and carryforwards, taxable temporary differences for which deferred tax liabilities are not recognized based on the limited exceptions in ASC Topic 740, and information about tax uncertainties. Also see Paragraph 1.018. ASC paragraphs 740-10-50-2 and 50-3, and 50-6 through 50-15A

**1.017 Other Considerations.** Section 10, *Other Considerations*, of this publication provides guidance on accounting for income taxes in more specialized circumstances than those included in prior sections. The subjects covered are temporary differences acquired other than in a business combination, equity method investments, goodwill impairment calculations, intercorporate tax allocations, interim period tax calculations, pass-through subsidiaries, cooperatives, registered investment companies and real estate investment trusts, regulated entities, reorganizations and quasi-reorganizations, tax credits and government grants, and transactions among or with shareholders.

**1.018 Current Standard Setting Activity.** As part of its broader disclosure framework project, the FASB has been exploring, and twice proposed, a number of new disclosure requirements and modifications to (and removal of) certain existing disclosure requirements. In March 2022, the Board reevaluated the project and decided to narrow its scope to focus primarily on disclosures related to income taxes paid and the rate reconciliation. The final ASU was issued in the last quarter of 2023. See guidance on existing disclosure requirements beginning in Paragraph 9.077.

**1.018a** In December 2023, the FASB issued ASU 2023-09, [Improvements to Income Tax Disclosures](#), which makes the following changes to ASC Topic 740:

- Requires a tabular reconciliation for public business entities using both percentages and amounts, broken out into specific categories with certain reconciling items at or above 5% of the expected tax further broken out by nature and/or jurisdiction.
- Requires qualitative disclosures for other entities around the nature and effect of significant reconciling items by specific categories and individual jurisdiction.
- Requires disclosure of income taxes paid (net of refunds received), broken out between federal (national), state/local and foreign. Requires additional disclosure of income taxes paid (net of refunds received) to an individual jurisdiction when 5% or more of the total income taxes paid (net of refunds received).

ASU 2023-09 is effective for public business entities for annual periods beginning after December 15, 2024. For other entities, it is effective for annual periods beginning after December 15, 2025. Early adoption is permitted for annual financial statements not yet issued or made available for issuance.

**1.019** In March 2023, the FASB issued ASU 2023-02, *Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*, which expands the proportional amortization method (PAM) election to include qualifying investments made under any tax credit program (i.e., beyond investments in qualified affordable housing projects). ASU 2023-02 is effective for Public business entities for annual and interim periods in fiscal years beginning after December 15, 2023, and for all other entities, for annual and interim periods in fiscal years beginning after December 15, 2024. Early adoption is permitted in annual or interim financial statements as of the beginning of the related fiscal year. See chapter 7 of KPMG Handbook, *Tax credits*, for additional discussion on the PAM.

**1.020 – 1.021** Not used.

**1.022 COVID-19 Income Tax Relief.** On March 27, 2020, the President signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Among other provisions, the law provided relief to U.S. federal corporate taxpayers through temporary adjustments to net operating loss rules (see Paragraph 4.016aa), changes to limitations on interest expense deductibility (see Paragraph 4.016c), and the acceleration of available refunds for minimum tax credit carryforwards.

**1.023** The CARES Act also may have changed tax accounting methods. For example, taxpayers were required to change the depreciation methods of qualified improvement property placed in service after 2017 if it had been depreciated as 39-year building property. Taxpayers generally change the depreciation methods by filing an automatic

accounting method change, or an amended tax return if the property was depreciated in only one prior tax return.

**1.024** An entity generally demonstrates its commitment to making a change in a tax accounting method by preparing and submitting the Form 3115 before the period-end financial statements are issued (or available to be issued). However, all facts and circumstances should be considered. In addition, if the change is a non-automatic change, we would expect the change to be more likely than not to be sustained (see Paragraph 3.063).

**1.025** On December 27, 2020, the President signed the Consolidated Appropriations Act, 2021 (CAA). The CAA extended certain provisions of the CARES Act, provided additional funding for others and contains new relief provisions. Related to certain tax matters, the CAA:

- Clarified that gross taxable income does not include forgiven paycheck protection (PPP) loan amounts and allows borrowers to deduct otherwise allowable expenses paid with the proceeds, even if the loans are forgiven (see Paragraph 2.030a). These provisions were retroactively effective from the date of CARES Act enactment (March 27, 2020).
- Clarified that gross taxable income does not include other (non-PPP) loan forgiveness, emergency Economic Injury Disaster Loan (EIDL) grants or loan repayment assistance provided by the CARES Act and allowed taxpayers to deduct otherwise allowable expenses paid with the proceeds. These provisions were effective for tax years ending after the date of CARES Act enactment.
- Clarified that the provisions in the preceding bullet also applied to Targeted EIDL advances and Grants for Shuttered Venue Operators, effective for tax years ending after the date of CAA enactment (December 27, 2020).

**1.025a** In addition to COVID-19 related relief, the CAA extended (or made permanent) several temporary tax measures and introduced some new ones. Temporary provisions that were made permanent include the deduction for energy efficient commercial buildings and the railroad track maintenance credit. Those that were extended include:

- The look-thru rule for related controlled foreign corporations (which excludes from taxable income certain amounts accrued or received from such entities);
- The new markets tax credit;
- The employer tax credit for paid family and medical leave;
- Empowerment zone incentives; and
- The energy credit.

**1.025b** Among other things, the CAA also:

- Modified the low-income housing tax credit rate;



- Allowed for the use of 30-year ADS depreciation for certain residential real property placed in service before January 1, 2018;
- Expanded and extended the availability of the energy credit;
- Allowed a full deduction for business meal expenses incurred and paid from January 1, 2021 through December 31, 2022; and
- Provided tax relief, including employee retention credits and increases in low-income housing tax credit allocations, to states in the event of a disaster other than COVID-19.

### **1.026 – 1.026b** Not used.

**1.026c** On March 11, 2021, the American Rescue Plan Act of 2021 (ARPA) was signed into law. Before ARPA, section 162(m) of the Internal Revenue Code precluded public companies from taking a deduction for executive compensation in excess of \$1 million for the CEO, chief financial officer (CFO) and the next three highest compensated employees of the entity. ARPA expanded section 162(m) to also include the five highest compensated employees other than those already subject to the limitation. This amendment is effective for taxable years beginning after December 31, 2026. The change to section 162(m) did not immediately affect an entity's current income taxes in the period including the enactment date. However, it affects the measurement of deferred taxes on compensation related temporary differences to the extent the compensation is expected to become deductible in tax years beginning after December 31, 2026 (see Paragraph 8.035e).

**1.027 CHIPS and IRA Legislation.** On August 9, 2022, the CHIPS and Science Act of 2022 (CHIPS) was signed into law. CHIPS adds a one-time investment tax credit equal to 25% of a company's investment in facilities that manufacture semiconductors or semiconductor manufacturing equipment.

**1.028** On August 16, 2022, the President signed into law the Inflation Reduction Act of 2022 (IRA), which included significant law changes related to tax, climate change, energy and health care. The IRA introduces a new 15% corporate alternative minimum tax (AMT), a 1% excise tax on corporate stock repurchases and other revenue raisers and incentives. See additional discussion on Corporate AMT beginning at Paragraph 3.073.

**1.029** The excise tax on stock repurchases is determined on a non-income-based measure and is therefore not accounted for as an income tax. We believe companies will generally account for this excise tax as a direct cost of a repurchase. See section 5.8 of KPMG Handbook, *Debt and equity financing*, for further guidance on accounting for direct costs of a repurchase.

**1.030** See Chapter 2 of KPMG Handbook, *Tax credits*, for a detailed discussion of the new tax credit features introduced in these acts, and Chapters 3 and 5 for a detailed discussion of the accounting impact.

**1.031 Global Minimum Tax.** In an effort to reform the international tax system to address concerns about uneven profit distribution, the Organisation for Economic Cooperation and Development (OECD) published model rules that provide a template for the implementation of a top-up tax on excess profits, known as the ‘global anti-base erosion’ (GloBE) rules. Multinational enterprises with consolidated group revenue exceeding €750 million in at least two of the last four years would generally be required to pay a top-up tax on excess profits in any jurisdiction in which the GloBE effective tax rate for the jurisdiction is below a 15% minimum rate. Consistent with the FASB staff’s comments at the February 1, 2023 Board meeting, we believe the top-up tax is an alternative minimum tax within the scope of ASC Topic 740 (see additional discussion on alternative minimum taxes beginning at Paragraph 3.069). See KPMG Hot Topic, *Global Minimum Tax*, for additional discussion on the background and accounting implications of the top-up tax.

### ENDNOTES

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<sup>1</sup> In February 2016, the FASB issued ASU 2016-02, *Leases*. The new standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date. ASU 2016-02 is effective for all entities.

## Section 2 - Temporary Differences

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**2.000** One of the basic principles in accounting for income taxes is to recognize deferred taxes for the future tax consequences of events that have been recognized in the financial statements or tax returns. Such future tax consequences result from differences between the tax basis and the financial statement carrying amounts of assets and liabilities, or temporary differences. This section provides information to assist in identifying temporary differences and evaluating whether deferred taxes should be recognized for those temporary differences. Section 3, *Tax Calculation*, discusses the measurement of deferred taxes. ASC Topic 740, *Income Taxes*, defines a temporary difference as:

A difference between the tax basis of an asset or liability computed pursuant to 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...Some temporary differences cannot be identified with a particular asset or liability for financial reporting..., but those temporary differences do meet both of the following conditions:

- (a) Result from events that have been recognized in the financial statements; and
- (b) Will result in taxable or deductible amounts in future years based on provisions of the tax law.

Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences. ASC Section 740-10-20

**2.001** This temporary difference definition is fundamental when accounting for income taxes. Identifying temporary differences for which deferred taxes are recognized is one of the first steps in accounting for income taxes.

### **BASIC PRINCIPLES FOR IDENTIFYING TEMPORARY DIFFERENCES**

**2.002** Accounting for income taxes focuses on the balance sheet of an entity with the objective of recognizing deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the financial statements or in the tax returns. To measure those future tax consequences, ASC Topic 740 makes an initial assumption that assets will be recovered and liabilities will be settled at their financial statement carrying amounts. This assumption is a fundamental principle of ASC Topic 740 and is the basis for many aspects of accounting for income taxes. ASC paragraphs 740-10-10-1, 25-20

**2.003** Based on this assumption, expected future tax consequences are the tax effects of differences between the tax bases and financial statement carrying amounts of assets and liabilities. These differences are *basis differences* (the majority of which are also temporary differences) and arise because the recognition and measurement of assets and

liabilities under the tax law may differ from recognition and measurement under generally accepted accounting principles. The following is a summary of certain events identified in ASC Topic 740 that typically create basis differences because the results of the events are recognized or measured under generally accepted accounting principles differently than under income tax laws. ASC paragraph 740-10-25-20

- (1) **Revenues or Gains That Are Recognized for Financial Statement Purposes Before They Are Taxable.** Examples include undistributed earnings of investees accounted for under the equity method for financial statement purposes. These temporary differences can also arise when an entity uses one accounting method for revenue or gain recognition in its financial statements and another for income recognition on its tax return.
- (2) **Expenses or Losses That Are Recognized for Financial Statement Purposes Before They Are Deductible for Tax Purposes.** Examples include product warranty liabilities, deferred compensation, allowances for doubtful accounts, and inventory valuation reserves.
- (3) **Revenues or Gains That Are Taxable Before They Are Recognized for Financial Statement Purposes.** Examples include deferred gains on sale and leaseback transactions, advance payments and loan fees.
- (4) **Expenses or Losses That Are Deductible for Tax Purposes Before They Are Recognized for Financial Statement Purposes.** Examples include depreciable assets when accelerated methods of depreciation are used for tax purposes, certain computer software costs and sales commissions paid to employees that are capitalized as incremental costs to obtain a contract.
- (5) **A Reduction in the Tax Basis of Depreciable Assets Because of Tax Credits.** In certain jurisdictions that provide investment tax credits for acquisitions of depreciable assets, the tax basis of the depreciable asset may be reduced by the amount of the credit. This reduction would result in a difference between the financial statement carrying amount and the tax basis of the asset.
- (6) **Investment Tax Credits Accounted for By the Deferral Method.** Investment tax credits accounted for by the deferral method are viewed as reductions of the financial statement carrying amount of the related assets for determining basis differences even though the credits may be reported as deferred income for financial statement purposes. In these cases, the carrying amount of the asset for financial statement purposes would be less than the tax basis of the asset.
- (7) **An Increase in the Tax Basis of Assets Because of Indexing for the Effects of Inflation When the Local Currency Is the Functional Currency.** Tax laws in certain foreign tax jurisdictions might require or allow adjustment of the tax basis of assets for the effects of inflation. The index-adjusted tax basis of the asset is used to compute the taxable gain or loss on the sale of the asset. When the local currency in the foreign tax jurisdiction is the functional

currency for financial statement purposes, the indexing adjustment of the tax basis of the asset creates a basis difference.

- (8) **Business Combinations and Combinations Accounted for by Not-for-Profit Entities.** Differences often arise between the amounts assigned for financial statement purposes and the tax bases of assets acquired and liabilities assumed in business combinations. Differences also arise between the tax bases and the recognized values of assets acquired and liabilities assumed (or carried over to the new entity in the case of a new entity formed by a merger of not-for-profit entities) in an acquisition by a not-for-profit entity.
- (9) **Intra-entity Transfers of Assets Other Than Inventory.** Intra-entity transfers of assets other than inventory may result in a difference between the tax basis of the asset in the buyer's jurisdiction and the carrying amount in the consolidated financial statements. This difference results because the new tax basis in the buyer's jurisdiction generally is based on the selling price between the entities in the same consolidated group, while the carrying amount in the consolidated financial statements does not change.

**2.003a Differences in Revenue Guidance.** IRC section 451 addresses the interaction between financial reporting revenue or gain and taxable income. Section 451 generally requires accrual method taxpayers to recognize taxable income no later than the tax year in which the item is recognized as revenue in their financial statements (i.e., that the all events test is satisfied no later than the year in which the revenue is recognized for financial reporting purposes). This book conformity requirement has some exceptions.

**2.003b** Revenue and profit recognition for financial reporting purposes follows a five-step model to determine when to recognize revenue (or profit), and at what amount. The model specifies that revenue (or profit) is recognized when or as an entity transfers control of goods or services at the amount to which the entity expects to be entitled. Section 451 requires an entity to allocate the 'transaction price' to each 'performance obligation' the same way it does for financial reporting purposes and, as discussed previously, to recognize taxable income no later than when it recognizes revenue for financial reporting purposes (subject to the limited one-year deferral that was previously provided by Rev. Proc. 2004-34 (now codified in section 451(c)).

**2.004** The types of transactions and events noted above are specifically described in ASC Topic 740. Although not specifically identified by ASC Topic 740, other types of transactions or events also may create temporary differences. For example, the financial statement carrying amount of an acquired asset (that was not acquired in a business combination) may differ from its tax basis at acquisition due to provisions of the tax law. ASC paragraphs 740-10-25-50 through 25-52 provide detailed guidance on how to account for these transactions (see Paragraphs 2.095 and 10.001 for additional discussion). The difference between the tax basis of an asset or liability and its financial statement carrying amount that would result in taxable or deductible amounts when the financial statement carrying amount is recovered or settled represents a temporary difference under ASC Topic 740 without regard to how that difference arose.

**2.005** Basis differences generally result in either future taxable amounts or future deductible amounts when the related asset is recovered or liability is settled, depending on the relationship between the financial statement carrying amount and the tax basis of an asset or liability. Basis differences that have future tax consequences are either *taxable temporary differences* – differences that will result in future taxable amounts, or *deductible temporary differences* – differences that will result in future deductible amounts. Certain basis differences are not temporary differences because they do not result in a tax consequence when the asset is recovered or the liability settled (see Paragraph 2.022 for additional discussion). Furthermore, ASC Topic 740 includes certain exceptions to the recognition of the tax effects of certain temporary differences (see Paragraph 2.031 for additional discussion). However, those specific exceptions are limited and they cannot be applied by analogy to other basis differences. ASC paragraph 740-10-25-3, 25-20 through 25-26, 25-30

**2.006** Deferred taxes are recognized for the future tax consequences of temporary differences. *Deferred tax assets* are recognized for deductible temporary differences, tax operating losses and other *carryforwards*, and *deferred tax liabilities* are recognized for taxable temporary differences. The deferred tax asset for a deductible temporary difference or the deferred tax liability for a taxable temporary difference is determined based on the assumption that the related asset will be recovered at its financial statement carrying amount or the related liability will be settled at its financial statement carrying amount. The future tax consequences of recovering an asset or settling a liability at amounts different from the financial statement carrying amount are recognized in the future period in which the related financial statement gain or loss is recognized. ASC paragraph 740-10-25-20

### Example 2.1: Future Tax Consequence of Basis Differences

#### Taxable Temporary Difference

ABC Corp. has a depreciable asset with a financial statement carrying amount of \$100 and a tax basis of \$80. This \$20 basis difference results from the use of an accelerated depreciation method for tax purposes but a straight-line method for financial statement purposes. If the asset were sold for its financial statement carrying amount of \$100, ABC would report no financial statement income and \$20 of taxable income on its tax return (\$100 sales price less \$80 tax basis). Accordingly, a deferred tax liability is recognized for this future tax consequence of the existing taxable temporary difference.

The asset also could be recovered through its use in operations. In that case, it is assumed that ABC will recover the asset at its financial statement carrying amount by earning \$100, which will offset the financial statement depreciation of \$100 resulting in \$0 book income. However, for tax purposes, the \$100 of income will be offset by only \$80 of tax depreciation resulting in \$20 of taxable income.

### Deductible Temporary Difference

ABC establishes a \$50 financial statement liability for warranty costs. A tax deduction is not allowed until the obligation is paid. Settlement of the liability at its financial statement carrying amount of \$50 would result in a tax deduction of \$50. A deferred tax asset is recognized for the tax effect of the future tax deduction that would be obtained when the \$50 warranty liability is paid.

**2.007** The following chart describes the future tax consequences of differences between the financial statement carrying amount and the tax basis of assets and liabilities.

		Assets			Liabilities			
Taxable in the future (deferred tax liability)	Financial statement carrying amount exceeds tax basis				Tax basis exceeds financial statement carrying amount			
	<i>Example:</i> Fixed asset with financial statement carrying amount in excess of tax basis due to accelerated depreciation method used for tax purposes				<i>Example:</i> Convertible debt with a financial statement carrying amount less than its tax basis because it was issued with a beneficial conversion feature to which proceeds have been allocated through an adjustment to equity <sup>1</sup>			
		<b>Book</b>	<b>Tax</b>	<b>Taxable Temporary Difference</b>	<b>Book</b>	<b>Tax</b>	<b>Taxable Temporary Difference</b>	
	Fixed Asset	115	25	90	Convertible Debt	100	140	40
		Assets			Liabilities			
Deductible in the future (deferred tax asset)	Tax basis exceeds financial statement carrying amount				Financial statement carrying amount exceeds tax basis			
	<i>Example:</i> Organization costs capitalized and amortized for tax purposes but expensed when incurred for financial statement purposes				<i>Example:</i> Deferred compensation expensed for financial statement purposes but not deductible for tax purposes until paid			
		<b>Book</b>	<b>Tax</b>	<b>Deductible Temporary Difference</b>	<b>Book</b>	<b>Tax</b>	<b>Deductible Temporary Difference</b>	
	Organization Costs	—	75	75	Deferred Compensation	85	—	85



**2.008 Recovery of Assets and Settlement of Liabilities.** Many temporary differences may arise or continue to exist in periods in which no activity related to that item has been reported on the tax return. For example, deferred taxes should be recognized for the excess of the financial statement carrying amount of a depreciable asset over its tax basis even after the tax asset ceases to be reported on the tax return as a result of becoming fully depreciated for tax purposes. Those deferred taxes reflect the tax effects of the reversals of temporary differences resulting from recovery or settlement of the related asset or liability in a discrete transaction (such as the sale of an asset or payment of a liability) or through operations (using an asset until the asset becomes fully depreciated or incurring costs for providing future services to satisfy a liability). ASC paragraph 740-10-25-20

### Example 2.2: Recovery of Asset Through Use in Operations

ABC Corp. is a manufacturer of bicycles. As part of its manufacturing plant, ABC has a paint machine with a financial statement carrying amount of \$150 and a tax basis of \$110. Accordingly, ABC has recorded a deferred tax liability for the tax effect of the \$40 (\$150 - \$110) temporary difference. ABC plans on retaining and using the paint machine in operations. The paint machine is depreciated for both financial statement and tax purposes over its remaining useful life of five years. Accordingly, assuming straight-line depreciation is applied for both financial statement and tax purposes for the remaining life of the asset, the annual financial statement and tax depreciation would be \$30 ( $\$150 \div 5$  years) and \$22 ( $\$110 \div 5$  years), respectively.

The temporary difference of \$40 would reverse \$8 ( $\$30 - \$22$ ) per year for five years. In each of those years, the tax deduction would be \$8 less than book expense, which will result in additional taxable income in each of the next five years.

**2.009** A contract or deposit liability for financial statement purposes is another example of a temporary difference if the tax law requires that the gain be included in taxable income in the year of the sale. In those circumstances, the financial statement liability would give rise to a deductible temporary difference – a financial statement liability in excess of its tax basis. Similarly, a deductible temporary difference arises when an entity reduces its revenue for estimated volume discounts and product returns.

**2.009a** Although the amounts may be expected to result in financial statement income in the future, it is assumed under ASC Topic 740 that the liability for the deferred gain or unearned revenue will be settled at its financial statement carrying amount. As a result, those deferred gains and unearned revenue (or contract liability) represent deductible temporary differences. The model assumes that the entity will incur future costs to earn the related revenue that are equal in amount to the financial statement carrying amount of the liability. Those costs would result in future deductible amounts – a deductible temporary difference.

**2.010 Tax Uncertainties.** Due to uncertainties under the tax law, positions taken on tax returns may be challenged and ultimately disallowed by taxing authorities. Accordingly, it may not be appropriate to reflect a position taken on the tax return when the outcome of that tax position is uncertain. As discussed in more detail in Section 3, the tax effects of temporary differences arising from tax benefits of tax positions with uncertainty generally should not be recognized as deferred tax assets (or reductions of deferred tax liabilities) for financial statement purposes unless it is more likely than not that the position will be sustained with the taxing authority (see Paragraph 9.016 for discussion of application of this guidance to net operating loss carryforwards). If an entity takes a tax position with uncertainty on its tax return, the tax benefit should not necessarily be recognized for financial statement purposes just because the position is taken in the tax return. ASC Subtopic 740-10, *Income Taxes – Overall* (FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48))

**2.011** Assuming disallowance of a tax position (and thus not recognizing it for financial statement purposes) may involve several interrelated accounting consequences, such as recognition of a reserve to offset the current deduction taken on the tax return, adjustment or establishment of deferred taxes, accrual of interest and a related temporary difference (if interest is deductible for tax purposes when settled with the taxing authorities), and accrual of penalties (note that no deduction is available for federal tax penalties and therefore no temporary difference will arise from recognition of a liability for possible future penalties).

**2.012 Different Tax Jurisdictions.** ASC Topic 740 generally requires separate identification of temporary differences for each tax-paying component of an entity in each tax jurisdiction, including U.S. federal, state, local, and foreign tax jurisdictions. Accordingly, an entity should identify temporary differences for each tax jurisdiction in which the entity operates by considering applicable tax legislation in that jurisdiction. In some situations, a single entity may have basis differences that represent temporary differences in more than one tax jurisdiction. For example, a basis difference in the United States may be subject to U.S. federal taxes and state taxes. Similarly, a foreign branch of a U.S. entity or a foreign subsidiary that generates Subpart F income or global intangible low-taxed income (GILTI) may be subject to U.S. federal taxes and foreign local taxes. See Section 3 for additional discussion on performing tax calculations for multiple tax jurisdictions and Section 7, *Foreign Operations*, for additional discussion on foreign operations. ASC paragraph 740-10-30-5

**2.013** In certain situations, entities may be able to combine the deferred tax calculations for different tax jurisdictions, such as combining U.S. federal and state calculations when the temporary differences are the same for U.S. federal and state tax purposes, or combining deferred tax calculations for certain states when the temporary differences are the same in those state jurisdictions. Additionally, a single entity using an apportionment factor to allocate current taxable income to each state may apply a similar apportionment factor when calculating deferred taxes to the extent its expectations of future operations are consistent with such factors (see Paragraph 3.055). However, entities generally should separately identify all temporary differences for each tax jurisdiction to determine whether combined calculations would be appropriate. Although state income tax laws

generally follow U.S. federal income tax laws, some states differ significantly from U.S. federal tax law. The differences may result in different bases of assets and liabilities for state tax purposes resulting in different measurements of the temporary difference. Those differences must be identified and considered in determining whether combined U.S. federal and state deferred tax calculations are appropriate. ASC paragraph 740-10-55-25

**2.014** The financial statement carrying amount of a deferred state income tax asset or liability represents a temporary difference for the purposes of the U.S. federal deferred tax calculation because state taxes are deductible for U.S. federal tax. If a combined calculation of U.S. federal and state deferred taxes is performed, the effect of the deductibility of state taxes on U.S. federal taxes should be considered. See Paragraph 3.008 for additional discussion. ASC paragraph 740-10-55-20

**2.015** Because of differences in tax laws and different tax-paying components of the entity, separate deferred tax calculations for foreign tax jurisdictions generally will be required.

**2.016 Alternative Tax Systems; BEAT in the United States.** Deferred taxes in the U.S. federal tax jurisdiction are identified and measured based on the regular tax system. As a result, separate identification of temporary differences under the Base erosion and anti-abuse tax (BEAT) generally is not necessary. See Paragraph 3.069 for additional discussion. ASC paragraphs 740-10-30-10 through 11

**2.017** Other types of alternative tax systems may exist in foreign tax jurisdictions. It may be necessary to identify and consider temporary differences under both the regular tax and alternative tax systems in those situations. ASC paragraph 740-10-30-12

**2.017a** In certain situations, it may be appropriate to consider the effects of alternative minimum tax systems in the evaluation of the need for a valuation allowance on deferred tax assets. See Paragraph 4.109a for additional discussion.

## IDENTIFYING TEMPORARY DIFFERENCES

**2.018** The remainder of this section discusses (1) a process for identifying temporary differences, (2) basis differences that are not temporary differences, (3) exceptions to the recognition of deferred taxes for temporary differences, and (4) more complex matters that should be considered when identifying temporary differences.

**2.019** The first step in identifying temporary differences is to determine the tax bases of assets and liabilities for each tax-paying component of an entity in each tax jurisdiction. Then, the financial statement carrying amounts of the assets and liabilities are compared to their tax bases. The chart presented on the following pages provides an overview of typical temporary differences that may arise for U.S. federal income tax purposes. When identifying temporary differences, consideration should be given to assets and liabilities that may not exist for financial statement purposes and to assets and liabilities that have no tax basis. Consideration should also be given to whether the tax basis, as reflected in the tax return, is more likely than not of being sustained, as deferred taxes generally

should be calculated based on the difference between the carrying amounts of assets and liabilities for financial reporting purposes and the tax bases of those assets and liabilities as determined using the recognition and measurement guidance for uncertainty in income taxes. See Section 3 for additional discussion of accounting for uncertainty in income taxes. ASC Subtopic 740-10 (FIN 48)

**2.020** A tax-basis balance sheet generally should be constructed to identify temporary differences in each tax jurisdiction. A review of items reported on Schedule M of the U.S. federal income tax return, which identifies items that cause differences between income for financial statement purposes and taxable income reported for the year, may be helpful when constructing a tax basis balance sheet. Prior years' tax returns may need to be reviewed to ensure that all assets and liabilities for income tax purposes have been identified. In addition, a review of tax records (such as tax basis fixed asset subledgers), revenue agents' reports, and settlements reached with the taxing authorities may be necessary.

**2.021 Typical Temporary Differences.** The following list identifies many typical temporary differences.

Account	Potential Temporary Differences	Taxable or Deductible
Cash	Generally the same for financial statement and tax purposes	—
Securities	Securities recorded at fair value or the measurement alternative for financial statement purposes	Taxable or Deductible
Accounts receivable	Cash method used for tax purposes	Taxable
Allowance for doubtful accounts	Allowance not allowed for tax purposes	Deductible
	Allowance for tax purposes, if permitted, generally different from the financial statement allowance	Taxable or Deductible
Prepaid assets	Amounts expensed for financial statement purposes but recorded as prepaid assets for tax purposes	Deductible
	Amounts deductible when paid for tax purposes but recorded as prepaid assets for financial statement purposes	Taxable
Inventory	Valuation reserves for financial statement purposes	Deductible
	Basis differences from business combinations	Taxable or Deductible

<b>Account</b>	<b>Potential Temporary Differences</b>	<b>Taxable or Deductible</b>
	Additional costs capitalized for tax purposes under the uniform capitalization rules	Deductible
Notes receivable (net of discount/premium)	Discount or premium for financial statement purposes resulting from imputing interest, initial direct costs/fees, embedded derivatives, etc.	Taxable or Deductible
Cash surrender value of life insurance	Cash surrender value in excess of cumulative premiums paid (assuming amounts will be taxable on surrender of the policy) See Paragraph 2.023	Taxable
Property, plant, and equipment	Different depreciation lives or methods for financial statement and tax purposes	Taxable or Deductible
	Basis differences from business combinations	Taxable or Deductible
	Reduction in tax basis for investment tax credit, IRC section 179 expensing, or bonus depreciation	Taxable
	Costs capitalized for financial statement purposes but not for tax purposes	Taxable
	Differences in capitalized interest for financial statement and tax purposes	Taxable or Deductible
	Change to tax basis due to the introduction of new tax legislation	Taxable or Deductible
	Impairment write downs for financial statement purposes	Deductible
Intangible assets	Assets that exist for tax purposes but not for financial statement purposes	Deductible
	Assets that exist for financial statement purposes but not for tax purposes	Taxable
	Different amortization lives or methods for financial statement and tax purposes	Taxable or Deductible
	Assets that are not amortized for financial statement purposes	Taxable
	Basis differences from business combinations	Taxable or Deductible

<b>Account</b>	<b>Potential Temporary Differences</b>	<b>Taxable or Deductible</b>
	Impairment write-downs recognized for financial statement purposes	Deductible
Investments in other entities	Cost method used for tax purposes and equity method used for financial statement purposes	Taxable or Deductible
Investments in partnerships	Basis difference related to original acquisition of investment	Taxable or Deductible
	Basis difference in the underlying assets and liabilities of the partnership that result in a difference in the investment in the partnership	Taxable or Deductible
	Different methods used to account for investment for financial statement and tax purposes	Taxable or Deductible
Investments in stock of subsidiaries	Undistributed earnings recognized for financial statement purposes but not for tax purposes	Taxable
	Operating losses recognized for financial statement purposes but not tax purposes	Deductible
	Basis differences from business combinations	Taxable or Deductible
Accounts payable	Cash method used for tax purposes	Deductible
Accrued compensation	Accruals not permitted for tax purposes	Deductible
	Accrual for tax purposes, if permitted, different from financial statement accrual	Taxable or Deductible
Pension liability (or asset)	Tax basis generally will differ from financial statement carrying amounts	Taxable or Deductible
Postretirement benefit obligations	Generally not deductible until paid	Deductible
Other accruals	Tax rules generally prohibit accrual of expenses for items such as plant shutdowns, litigation, warranties, estimated volume discounts, and product returns	Deductible
State tax accruals, including deferred state income taxes	Liabilities recorded for state income taxes may differ for financial statement and tax purposes, creating temporary differences in U.S. federal jurisdiction	Taxable or Deductible

<b>Account</b>	<b>Potential Temporary Differences</b>	<b>Taxable or Deductible</b>
Self-insurance reserves	Self-insurance reserves generally not deductible for tax purposes	Deductible
Deferred income/Contract liability/Deposit liability	Income may be taxable but deferred for financial statement purposes  (See discussion of U.S. federal income tax and GAAP changes to income/revenue recognition beginning in Paragraph 2.003a.)	Deductible
	Gains on sales of assets recognized immediately for tax purposes but not for financial reporting purposes	Deductible
Debt obligations	Discount or premium for financial statement purposes resulting from imputing interest, initial direct costs/fees, separation of beneficial conversion features, embedded derivatives, etc.	Taxable or Deductible
	Excess interest deductions on certain convertible debt for tax purposes (deduction based on higher interest rate than for financial statement purposes)	Taxable
Deferred investment tax credits	Deferred method used for financial statement purposes	Deductible
Deferred cumulative catch-up adjustments for tax method changes (not recognized in financial statements)	Section 481 unamortized adjustment for change in tax accounting method	Taxable or deductible

## **BASIS DIFFERENCES THAT ARE NOT TEMPORARY DIFFERENCES BECAUSE THERE ARE NO FUTURE TAX CONSEQUENCES**

**2.022** Basis differences that will not result in future taxable or deductible amounts on recovery of the related asset or settlement of the related liability are not temporary differences because there are no future tax consequences. Accordingly, deferred taxes are not recognized on such differences. The following paragraphs discuss common basis differences that are not temporary differences because the differences will not result in taxable or deductible amounts. ASC paragraph 740-10-25-30

**2.023 Life Insurance Policies.** Under current U.S. tax law, proceeds received on a life insurance policy on the death of the insured are not taxable provided the insured party meets certain criteria as defined in the Pension Protection Act of 2006 (the Pension Act) or the policy has been grandfathered by the Pension Act. Accordingly, in those situations, the excess of the financial statement carrying amount (the amount that could be realized under the insurance contract under ASC Subtopic 325-30, *Investments—Other - Investments in Insurance Contracts*), over cumulative premiums paid (the tax basis) for a life insurance policy will not result in a taxable amount if the entity holds the policy until the death of the insured. Deferred taxes therefore would not be recognized on the excess financial statement carrying amount if the entity expects to recover the asset by holding the policy until the death of the insured (provided the insured party meets the criteria under the Pension Act to qualify for the tax benefit or the policy has been grandfathered). However, if the policy is surrendered before the death of the insured or if the policy is not eligible for the tax benefit under the Pension Act, that basis difference, when realized, would be subject to tax. Accordingly, in those circumstances, the excess of the financial statement carrying amount over the cumulative premiums paid does represent a temporary difference and a deferred tax liability should be recognized on that taxable temporary difference. ASC paragraph 740-10-25-30

**2.024** If deferred taxes previously had not been recognized on life insurance policies based on the expectation that the proceeds would not be taxable, a change in those expectations requires deferred taxes to be recognized for the excess financial statement carrying amount over the cumulative premiums paid. Those deferred taxes should be recognized when the entity changes its expectation with respect to the policies. It is not appropriate to delay recognition of the tax effects of the change in expectations until the policies are actually surrendered.

**2.024a** For example, an entity may collateralize a loan with the surrender value of life insurance policies to reduce its borrowing costs. Simply pledging the cash surrender value does not necessarily result in the recognition of a deferred tax liability for any excess financial statement carrying amount over the tax basis associated with the policy, assuming the entity does not expect to satisfy the loan with the proceeds. However, if the entity's expectation changes, it recognizes the deferred tax liability in the period in which the change in expectation occurs.

**2.025** In some situations, an employer will endorse all or a portion of the death benefit of a life insurance policy to the employee's beneficiary (commonly referred to as endorsement split-dollar life insurance arrangements). While the employer accrues an obligation over the service period of the employee under ASC Topic 715, *Compensation—Retirement Benefits* (ASC paragraphs 715-60-35-177 through 35-185), the settlement of the liability through payment of the benefit (either by the insurer or the employer) will not always result in a tax deduction for the employer. In those circumstances, the basis difference between the financial statement carrying amount of the liability and its tax basis (typically zero) is not a temporary difference and no related deferred tax asset would be recognized. Similar issues may arise in collateral assignment split-dollar life insurance arrangements. Entities should carefully consider the terms of these arrangements.



**2.026 Net Unrealized Built-in Gain.** After conversion from C Corporation status to S Corporation status under U.S. federal tax law, an entity may be subject to a corporate-level tax on the net unrealized built-in gain (excess of fair value over tax basis at the date of conversion) that is realized during the five-year period after the conversion. In accordance with the tax law, that unrealized built-in gain will result in future taxable amounts under the built-in gain system only if the related asset is sold, or otherwise disposed of, during the five-year period after conversion to S Corporation status. If the entity expects to dispose of the asset within the five-year period, deferred taxes would be recognized on the lesser of (i) the excess of the financial statement carrying amount at the date of the deferred tax calculation over its tax basis at the date of conversion, or (ii) the excess of the fair value of the asset at the date of conversion over the tax basis at the date of conversion. If it is expected that the related assets would not be sold during the five-year period, basis differences are not temporary differences for which deferred taxes are recognized under the built-in gain system. See Section 5, *Changes in Tax Laws, Rates, or Status*, for additional guidance on changes in tax status and specifically discussion on unrealized built-in gains beginning in Paragraph 5.030. ASC paragraphs 740-10-55-64 and 55-65, 55-168 and 55-169

**2.027 Accrued Tax-Exempt Interest.** In the U.S. federal tax jurisdiction, accrued interest receivable recognized in the financial statements on investments that generate tax-exempt income also may give rise to basis differences. However, because these basis differences do not result in future taxable amounts when received, they are not temporary differences and deferred taxes would not be recognized on those basis differences for U.S. federal tax purposes; however, if such basis differences do result in future taxable income in individual states or in foreign jurisdictions, deferred taxes should be recorded for those jurisdictions.

**2.028 Accrued Nondeductible Expenses.** Certain expenses (e.g., penalties, fines, entertainment expenses) accrued for financial statement purposes will not be deductible when paid. These basis differences are not temporary differences and thus deferred tax benefits would not be recognized because there would be no tax consequence on settlement of the liability.

**2.029 Investments in Domestic Subsidiaries.** Under U.S. tax law and the tax law in certain other jurisdictions, an investment in a domestic corporate subsidiary may be recovered tax-free in certain cases. As discussed in more detail beginning in Paragraph 2.038, an excess of the financial statement carrying amount over the tax basis of an investment in a majority-owned domestic subsidiary is not a temporary difference if the tax law provides a means by which the financial statement carrying amount of the investment can be recovered tax-free and the entity expects that it would ultimately use that means. However, that difference is a temporary difference and deferred taxes should be recognized on the difference if the entity expects the investment will not be recovered in a tax-free manner. ASC paragraph 740-30-25-7

**2.030** The situations when basis differences are not temporary differences because there are no future tax consequences are limited. To avoid recognition of deferred taxes on basis differences, the entity must (a) have the ability to recover the related asset (or settle

the related liability) in its current form in a tax-free manner under the tax law and (b) have the intent to recover the asset (or settle the liability) in that manner.

**2.030a Paycheck Protection Program (PPP).** The PPP is a loan program that was established as part of the CARES Act. PPP loans are 100% guaranteed by the Small Business Administration and were available only to entities that meet certain eligibility requirements. Loan recipients benefit from extended deferment on payments, a low interest rate, and waived personal guarantee and collateral requirements. The PPP also waives borrower fees and is eligible for forgiveness to the extent that the proceeds are used to make specified eligible payments – e.g., payroll, rent. The CAA amended the PPP and, among other things, permitted entities to obtain a second PPP loan – a “second draw.”

**2.030b** The CAA clarified that PPP loan proceeds (first or second draws) that are forgiven are not included in the borrower’s gross taxable income and do not reduce the tax bases or other attributes of the borrower’s assets. In addition, under the CAA, a borrower may deduct otherwise deductible expenses that are paid with the proceeds of a PPP loan, even if that loan is forgiven. This provision was retroactive to the CARES Act enactment date (March 27, 2020).

**2.030c Equity-linked Financial Instruments Characterized as Equity for Tax Purposes.** In some situations, an entity is required under U.S. GAAP to classify an equity-linked financial instrument as a liability or temporary equity, even if it is equity in legal form and for tax purposes. For example, this may occur when an entity issues warrants in connection with a share issuance (e.g. in initial public offering transactions for special purpose acquisition companies) if the warrants are classified as liabilities for GAAP (e.g. under ASC Topic 480, *Distinguishing Liabilities from Equity*, or ASC Topic 815, *Derivatives and Hedging*) but as equity for tax purposes (e.g. noncompensatory options or warrants). The same situation may arise when a redeemable share itself is classified as a liability under ASC Topic 480 or temporary equity under ASR 268 (for public companies) but as equity for tax purposes. As discussed in Paragraph 2.022, basis differences that will not result in future taxable or deductible amounts on recovery or settlement of the related asset or liability are not temporary differences because there are no future tax consequences. As a result, when an issuer of an equity-linked financial instrument remeasures the liability or temporary equity to fair value or maximum redemption amount, it recognizes a related deferred tax effect only if there would be a tax consequence on settlement at the financial statement carrying amount. If not, no deferred taxes are recognized for the basis difference and the remeasurement is recognized with no related tax effect.

## EXCEPTIONS TO RECOGNITION OF DEFERRED TAXES

**2.031** The previous section discussed basis differences that are not temporary differences because the differences will not result in future taxable or deductible amounts when the financial statement carrying amount of the related asset or liability is recovered or settled. This section discusses basis differences that ultimately will result in taxable or deductible amounts, and therefore are temporary differences, but deferred taxes will not be

recognized on such differences in specific situations due to the exceptions in ASC Topic 740. Generally, deferred taxes should be recognized for all temporary differences between the financial statement carrying amount and tax basis of assets and liabilities that result in future tax consequences. However, ASC Topic 740 includes certain limited exceptions to the recognition of deferred taxes for temporary differences. These exceptions are narrowly defined and ASC Topic 740 prohibits applying these exceptions to analogous temporary differences.

**2.032 Summary of Exceptions to Recognition of Deferred Taxes.** The following list, as identified in ASC paragraph 740-10-25-3, includes the exceptions to recognizing deferred taxes. The succeeding paragraphs discuss each of these exceptions in more detail. ASC paragraph 740-10-25-3

- (1) Certain differences between the financial statement carrying amount and tax basis of an investment in a foreign subsidiary or foreign corporate joint venture. See Paragraph 2.037.
- (2) Certain pre-December 15, 1992 undistributed earnings of a domestic subsidiary or a domestic corporate joint venture. See Paragraph 2.038.
- (3) Basis differences resulting from intra-entity transfers of inventory between tax jurisdictions. See Paragraph 2.063.
- (4) Differences related to goodwill when goodwill is not deductible for tax purposes. See Paragraph 2.081.
- (5) Basis differences related to foreign nonmonetary assets and liabilities that are remeasured from the local currency into the functional currency and that result from changes in exchange rates or indexing for tax purposes. See Paragraph 2.082.
- (6) Certain accounting requirements for leveraged leases. See Paragraph 2.084.
- (7) Transitional and other exceptions.
  - Certain pre-1988 bad debt reserves of qualified savings and loan institutions. See Paragraph 2.086.
  - Pre-December 15, 1992 policyholders' surplus of stock life insurance entities (no further detailed guidance provided in this book).

In addition:

- ASC paragraph 740-30-25-9 allows recognizing a deferred tax asset for an excess of the tax basis over the financial statement carrying amount for an investment in a subsidiary or a corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. See Paragraph 2.047.
- ASC paragraphs 740-30-25-7 and 25-8 state that the excess of the financial statement carrying amount over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is not a temporary difference if the tax

law provides a means by which the financial statement carrying amount can be recovered tax-free and the entity expects that it will use that means. See Paragraph 2.039.

- Deferred taxes are not recognized if an entity applies the proportional amortization method as prescribed in ASU 2023-02 for an investment in a tax equity structure. See chapter 7 of KPMG Handbook, [Tax credits](#), for further discussion on the accounting for the proportional amortization method.

### **EXCEPTIONS TO RECOGNITION OF DEFERRED TAXES – INVESTMENTS IN SUBSIDIARIES AND OTHER INVESTMENTS**

**2.033 Investments in Subsidiaries.** In consolidated financial statements, the assets and liabilities of the parent entity and its subsidiaries are presented as if the consolidated group were a single entity. Differences between the financial statement carrying amounts and tax bases of a subsidiary's assets and liabilities (*inside basis difference*) are temporary differences for which deferred taxes should be recognized. A difference between the financial statement carrying amount and the tax basis of the parent entity's investment in the stock of the subsidiary (*outside basis difference*) also may be a temporary difference even though that investment account is eliminated in the consolidated financial statements. The exceptions to recognition of deferred taxes for investments in subsidiaries apply only to outside basis differences. Deferred taxes are recognized on inside basis differences following other provisions of ASC Topic 740.

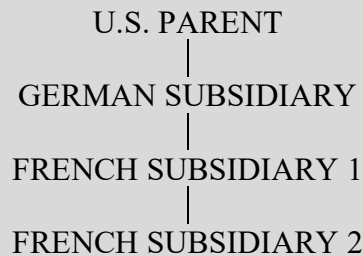
**2.034** Basis differences related to a parent entity's investment in the stock of a subsidiary may be created by undistributed earnings of the subsidiary, accumulated subsidiary losses, foreign currency translation gains and losses included in other comprehensive income (for foreign operations only), business combinations, or adjustments to equity on the issuance of stock by the subsidiary when the parent retains control. Those basis differences may result in future taxable or deductible amounts when (1) dividends are paid to the parent entity by the subsidiary; (2) the parent entity sells the stock of the subsidiary; (3) the subsidiary is liquidated; or (4) the subsidiary is merged into the parent entity. In some situations, the parent entity may be able to recover its investment in a subsidiary in a tax-free manner. ASC paragraphs 810-10-40-5 and 45-23

**2.035** There are certain exceptions to the recognition of deferred taxes for taxable outside basis differences related to investments in subsidiaries. The availability of these exceptions may depend on (1) whether the subsidiary is domestic or foreign, (2) the provisions of the applicable tax law, and (3) the parent entity's plans for reinvestment of undistributed earnings of the subsidiary. These exceptions generally are not available for investments in partnerships (or other pass-through entities) or 50%-or-less-owned investees (equity method investees). Furthermore, deferred tax assets are not recognized for deductible outside basis differences in investments in subsidiaries that will not be realized in the *foreseeable future*. The definition of the foreseeable future is discussed in Paragraphs 2.047 through 2.049 and generally is interpreted in practice to be within one year. ASC paragraphs 740-10-25-3, 740-30-25-9 through 25-13

**2.036 Determining Whether a Subsidiary Is Foreign or Domestic.** The determination as to whether a subsidiary is domestic or foreign generally should be based on the treatment in the parent entity's tax jurisdiction. For example, a subsidiary or corporate joint venture that is not incorporated in the United States generally is a foreign entity, from the perspective of a U.S.-based parent entity. Similarly, a U.S.-based subsidiary would be considered foreign from the perspective of a European-based parent entity. The assessment as to whether a subsidiary is domestic or foreign should be determined at each subsidiary level by reference to the subsidiary's immediate parent.

### Example 2.3: Tiered Subsidiaries

U.S. Parent owns German Subsidiary, German Subsidiary owns French Subsidiary 1 and French Subsidiary 1 owns French Subsidiary 2.



- German Subsidiary** - German Subsidiary is a foreign subsidiary to U.S. Parent. Accordingly, the provisions of ASC Topic 740 and ASC Subtopic 740-30, *Income Taxes - Other Considerations or Special Areas* (Accounting Principles Board Opinion No. 23, *Accounting for Income Taxes - Special Areas* (APB 23)) on investments in foreign subsidiaries (which are discussed below and in additional detail in Section 7) should be considered to determine whether deferred taxes in the United States should be recognized on the outside basis difference of U.S. Parent's investment in German Subsidiary.
- French Subsidiary 1** - French Subsidiary 1 is a foreign subsidiary to German Subsidiary and the provisions of ASC Topic 740 and ASC Subtopic 740-30 (APB 23) on investments in foreign subsidiaries also would be considered in determining whether deferred taxes should be recognized in Germany for the outside basis difference in German Subsidiary's investment in French Subsidiary 1.
- French Subsidiary 2** - French Subsidiary 2 is a domestic subsidiary of French Subsidiary 1 and thus the exceptions to the application of ASC Topic 740 included in ASC Subtopic 740-30 (APB 23) for investments in foreign subsidiaries cannot be applied. French Subsidiary 2 would be defined as a domestic subsidiary for purposes of the deferred tax calculation for the French jurisdiction as it is directly owned by French Subsidiary 1; therefore, the provisions of ASC Topic 740 related to investments in

domestic subsidiaries (not ASC Subtopic 740-30 (APB 23)) would apply to French Subsidiary 1's investment in French Subsidiary 2.

**2.037 Taxable Outside Basis Differences of Investments in Foreign Subsidiaries and Foreign Corporate Joint Ventures.** Deferred tax liabilities are not recognized for taxable temporary differences that result from the excess of the financial statement carrying amount over the tax basis of an investment in the stock of a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration if the taxable outside basis difference meets the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB Opinion No. 23, *Accounting for Income Taxes – Special Areas* (APB 23)). Deferred tax liabilities are recognized when they no longer meet the indefinite reversal criterion. See Paragraph 7.003 for additional guidance on the applicability of the ASC paragraph 740-30-25-17 (APB 23) exception.

**2.037a Outside Basis Differences and Subpart F.** As discussed in Paragraph 7.077, certain income of a foreign subsidiary described under the Subpart F rules is taxable to a U.S. parent when included in a controlled foreign corporation's earnings, regardless of whether the income is actually distributed. The indefinite reversal criterion generally would not apply to the portion of an outside basis difference in a foreign subsidiary operation attributable to inside basis differences that will later result in Subpart F income, if those basis differences are expected to reverse through normal operations. See Paragraph 7.077 for additional discussion.

**2.037b Global Intangible Low-Taxed Income.** A U.S. shareholder of a controlled foreign corporation (CFC) must include in taxable income its pro rata share of GILTI. GILTI is considered the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. Additionally, a U.S. shareholder generally can deduct a portion of its GILTI and apply a limited deemed paid credit for foreign taxes. A taxpayer's GILTI is based on its aggregate, net tested income from its CFCs. While the affected CFCs are ultimately allocated a pro rata amount of GILTI (and that amount increases the U.S. taxpayer's tax basis in the CFC stock), the initial computation is done at an aggregate level.

**2.037c** A FASB staff Q&A addresses the accounting for GILTI under ASC Topic 740. The Q&A states that the application of ASC Topic 740 to GILTI is unclear and therefore entities can make a policy election to either provide deferred taxes related to GILTI or account for taxes on GILTI as a period cost when incurred. While there is no guidance about how to identify and measure deferred taxes related to GILTI, we believe entities that elect to do so, like Subpart F, generally will recognize deferred taxes when basis differences exist that are expected to affect the amount of the GILTI inclusion on reversal. See Paragraph 7.087a for additional discussion of GILTI.

**2.037d** Because GILTI deferred taxes, if provided, would be recognized only when basis differences exist that are expected to affect the amount of the GILTI inclusion on reversal, we believe that an entity generally would not provide GILTI deferred taxes if it does not expect to have a GILTI inclusion for the foreseeable future. The FASB staff

believes that entities should disclose under ASC Topic 235 their accounting policies related to GILTI inclusions.

**2.038 Taxable Outside Basis Differences of Domestic Subsidiaries.** An excess of the financial statement carrying amount over the tax basis of an investment in a domestic subsidiary (taxable outside basis difference) may consist of several components including: (1) undistributed earnings that arose in fiscal years beginning on or before December 15, 1992 (pre-1993 undistributed earnings), (2) undistributed earnings that arose in fiscal years beginning after December 15, 1992 (post-1992 undistributed earnings), and (3) outside basis differences not caused by undistributed earnings. The indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) applies to domestic subsidiaries and domestic corporate joint ventures only to the extent that the excess of the financial statement carrying amount over the tax basis relates to pre-1993 undistributed earnings. The ASC paragraph 740-30-25-17 (APB 23) exception does not apply to the portion of the outside basis difference caused by post-1992 undistributed earnings or other sources (for example, business combinations). The determination of whether reversals of the outside basis difference relates to pre-1993 undistributed earnings should be based on a last-in, first-out pattern. That is, distributions are assumed to be made out of post-1992 earnings to the extent available before assuming pre-1993 earnings are distributed. ASC paragraphs 740-10-25-3, 740-30-25-18

**2.039** In addition to the potential exception to recognition of a deferred tax liability under ASC paragraph 740-30-25-17 (APB 23) for pre-1993 undistributed earnings of a domestic subsidiary or a domestic corporate joint venture, ASC Topic 740 also provides guidance on when it is appropriate to conclude the entire taxable basis difference related to an investment in a domestic subsidiary is not a temporary difference. Whether an excess of the financial statement carrying amount over the tax basis of an investment in a more-than-50%-owned domestic subsidiary is a taxable temporary difference depends on the provisions of the tax law and the intent of the entity. That excess is not a taxable temporary difference if the (a) tax law provides a means for the parent entity to recover the reported amount of that investment in a tax-free transaction and (b) the parent entity expects that it will ultimately use that means. A deferred tax liability for an excess of the financial statement carrying amount over the tax basis of the investment should be recognized when the parent no longer intends (or no longer is able) to recover the investment tax-free. That determination generally would be made no later than when the operations would be classified as *held for sale* under ASC paragraph 360-10-45-9. See Paragraph 2.049 for additional discussion. ASC paragraphs 740-30-25-7 and 25-8

**2.040** If the criteria in ASC paragraphs 740-30-25-7 and 25-8 have been met, the excess of the financial statement carrying amount over the tax basis of an investment in a more-than-50%-owned domestic subsidiary is not a taxable temporary difference and, therefore, a deferred tax liability is not recognized regardless of how that difference arose. For instance, current U.S. federal tax law allows a tax-free liquidation or statutory merger of a subsidiary into its parent entity if certain requirements under the tax law are met. If the parent entity expects to recover its investment in its subsidiary in a tax-free manner under current provisions of the tax law, the taxable outside basis difference is not a taxable temporary difference and a deferred tax liability should not be recognized.

Deferred taxes would however be recognized in accordance with ASC Topic 740 on basis differences related to the underlying assets and liabilities of the domestic subsidiary (inside basis differences). ASC paragraphs 740-30-25-7 and 25-8

**2.041** In some cases, only a portion of the investment in a domestic subsidiary may be recoverable in a tax-free manner based on the provisions of the applicable tax law. Accordingly, a deferred tax liability should be recognized on the portion of the excess of the financial statement carrying amount over the tax basis of the investment that cannot be recovered tax-free. The exception in ASC paragraphs 740-30-25-7 and 25-8 does not apply to equity method investments or domestic corporate joint ventures. See Paragraph 2.053 for additional discussion.

**2.042 Tax Law Related to Less-than-80%-Owned Domestic Subsidiaries.** Certain transactions to recover an investment in a domestic subsidiary tax-free are available only if the parent entity owns at least 80% of the domestic subsidiary. Under certain circumstances, parent entities that own more than 50% but less than the required percentage of the subsidiary's stock to recover the investment tax-free are permitted to anticipate that they will acquire sufficient additional interests in the domestic subsidiary. Under that provision of ASC Topic 740, a taxable outside basis difference in an investment in a more-than-50%-owned domestic subsidiary is not a temporary difference for which deferred taxes would be recognized if the parent entity expects to (a) acquire additional shares of the subsidiary's stock in the future to enable it to make the tax-free election and (b) the acquisition of such shares would not result in a significant cost (a significant amount in excess of the financial statement carrying amount of the noncontrolling interest). ASC paragraphs 740-30-25-7 and 25-8

**2.043** If the price per share to acquire the additional shares of the subsidiary's stock significantly exceeds the per share equivalent of the amount reported as noncontrolling interest in the consolidated financial statements, the parent entity may be able to assert that settlement of the noncontrolling interest would take place when settlement would not result in a significant cost to the parent entity. For example, the parent entity may be able to assert that the noncontrolling interest would be settled toward the end of the life of the subsidiary, after it has recovered most of its assets and settled most of its liabilities. At that point, the fair value of the noncontrolling interest may approximate the reported amount of the noncontrolling interest in the subsidiary's net assets (i.e., when those net assets consist primarily of cash). When evaluating whether a parent entity's strategy for acquiring noncontrolling interests is feasible, consideration should be given to any restrictions on the acquisition of those interests, such as regulatory approvals or agreements with other shareholders. If the entity later concludes that acquisition of the noncontrolling interest would result in significant cost, deferred taxes should be recognized. If a parent entity recorded a deferred tax liability on an investment in a more-than-50%-owned domestic subsidiary because it expected the acquisition of additional shares would involve a significant cost and subsequently the parent entity acquires the noncontrolling interest so that the parent entity owns 80% (or can otherwise execute a tax-free liquidation or statutory merger), the elimination of the deferred taxes should be recorded as a reduction of the cost of acquiring the noncontrolling interest. The difference between the parent's cost and the amount by which the noncontrolling interest needs to be



adjusted is recognized with an adjustment to equity under ASC Topic 810, *Consolidation*. ASC paragraphs 740-30-25-7 and 25-8

**2.044 Restrictions on the Exception for a Domestic Subsidiary.** The assessment as to whether a subsidiary can be liquidated tax-free should be based on the current form and structure of the entity and its subsidiaries and currently enacted tax laws. Management's intent to restructure a corporate subsidiary or change the tax status of a subsidiary to enable the domestic subsidiary to be liquidated tax-free generally would not be considered when determining whether deferred taxes should be recognized on the outside basis difference of a domestic subsidiary. ASC paragraphs 740-10-25-32 and 25-33, and 40-6

**2.045 Taxable Recovery of Investments in Domestic Subsidiaries.** As discussed beginning in Paragraph 2.038, certain provisions of the tax law and ASC Topic 740 may enable a parent entity to recover its investment in a domestic subsidiary tax-free and, as a result, deferred taxes would not be recognized on outside basis differences in those domestic subsidiaries. However, deferred taxes are required to be recognized for the basis differences if:

- The parent entity expects that it will recover its investment in the domestic subsidiary in a taxable transaction (e.g., by sale or distribution of earnings);
- The tax law in the parent entity's tax jurisdiction does not provide a means to recover an investment in a domestic subsidiary in a tax-free transaction; or
- The parent entity owns more than 50% but less than 80% of the stock and the acquisition of additional interests as described in ASC paragraph 740-30-25-7 is not applicable because the acquisition of the noncontrolling interest would involve significant cost or the parent entity expects that it will sell additional interests in the subsidiary.

**2.046** If the parent entity expects to recover all or a portion of the investment in a domestic subsidiary in a taxable manner, the deferred tax liability for that temporary difference is based on the tax treatment resulting from the expected means of recovery. For example, if all or a portion of the investment is expected to be recovered through distributions, the applicable dividends-received deduction, if any, is considered in the calculation of the deferred tax liability. If the investment is expected to be recovered through sale, the applicable provisions of the tax law (such as capital gains provisions, if any) are considered in the calculation of the deferred tax liability.

**2.047 Recognition of a Deductible Outside Basis Difference.** A deferred tax asset is recognized for a deductible temporary difference for the excess of the tax basis over the financial statement carrying amount of an investment in the stock of a subsidiary or corporate joint venture that is essentially permanent in duration (foreign or domestic) only if it is apparent that the temporary difference will reverse in the foreseeable future. Excess tax basis in an investment in a subsidiary generally is not presumed to meet this threshold because such differences normally will not reverse before the sale of the investment. ASC paragraph 740-30-25-9

**2.048** Although apparent reversal in the foreseeable future is the threshold for determining when a deferred tax asset should be recognized on a deductible outside basis differences, ASC Topic 740 does not define foreseeable future. Based on the guidance in ASC paragraph 740-30-25-10, which refers to the presentation of discontinued operations and, indirectly, to the criteria for classifying long-lived assets as held for sale (i.e., expected within one year) in ASC paragraph 360-10-45-9, foreseeable future generally has been considered in practice to be within one year for this purpose. Before recognizing a tax benefit for an excess of the tax basis over the financial statement carrying amount of an investment in the stock of a subsidiary, there should be a relatively high level of assurance that the tax benefit will be realized in the foreseeable future. ASC paragraphs 360-10-45-9, 740-30-25-10

**2.049** The criteria of ASC paragraph 360-10-45-9 to be classified as held for sale may be useful in determining whether the reversal of the temporary difference will occur within the foreseeable future. Those criteria include (a) an existing committed plan to execute the transaction, (b) an ability to immediately execute the transaction, (c) an active program marketing the subsidiary at a reasonable sale price to locate a buyer, (d) a conclusion that the transaction is probable and generally will be completed in one year, and (e) a conclusion that it is unlikely that significant changes to the plan (or withdrawal of the plan) will be made. Generally, it would not be appropriate to recognize such a deferred tax asset when the operations are held for sale if there are uncertainties concerning the form of the transaction or the ability to obtain a deduction for the excess tax basis under the tax law. If a deferred tax asset is recognized, that asset should be evaluated for recoverability based on the more-likely-than-not criterion to determine if a valuation allowance is necessary. See the discussion beginning in Paragraph 9.170 for additional information on the appropriate presentation of the deferred tax asset and the related benefit when the subsidiary qualifies for presentation as a discontinued operation. See the discussion in Paragraph 10.086b for additional information on the accounting when there has been a change in facts in the subsequent events window. ASC paragraphs 360-10-45-9, 740-30-25-9 through 25-10

**2.050 Effect of Exceptions to Recognition of Deferred Tax Liabilities on Evaluation of Deferred Tax Assets.** As discussed in Section 4, *Valuation of Deferred Tax Assets*, deferred tax assets should be evaluated for recoverability to determine whether a valuation allowance should be recognized based on the more-likely-than-not criterion. Future reversals of taxable temporary differences and future taxable income are sources of taxable income that may be considered in evaluating the need for a valuation allowance. However, as described in ASC paragraph 740-30-25-13, future reversals of taxable differences and future distributions of future earnings of a subsidiary should not be considered except to the extent that a deferred tax liability has been recognized for existing taxable temporary differences or earnings have been remitted in the past. Future taxable income that may arise from investments in subsidiaries should not be considered in the evaluation of the need for valuation allowances on deferred tax assets if the exceptions to recognition of deferred tax liabilities, such as ASC paragraph 740-30-25-17 (APB 23) exception, are being applied to those investments. ASC paragraph 740-30-25-13

**2.051 Investments in Variable Interest Entities.** Under ASC Subtopic 810-10, *Consolidation - Overall, Variable Interest Entities*, an entity consolidates a VIE if it has (a) the power to direct the activities that most significantly impact the VIE's economic performance and (b) the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. For that reason, an entity with less than 50% ownership in an investee that does not have a controlling voting interest could consolidate the VIE. In assessing whether outside basis differences on investments in variable interest entities (VIEs) meet the exceptions to recognition of deferred tax liabilities for domestic and foreign subsidiaries, consideration should be given to whether the primary beneficiary (parent entity) can control the decision of whether or not it can recover its investment in a tax-free manner. If the primary beneficiary (parent) can control how and when the outside basis difference will reverse and the ASC paragraph 740-30-25-17 (APB 23) indefinite reversal criterion is met, it may apply the exception to recognition of deferred taxes to investments in foreign VIEs. If the primary beneficiary (parent) of a domestic VIE subsidiary controls the means for liquidation or sale and meets the other ASC paragraphs 740-30-25-7 and 25-8 conditions (such as the ability to acquire noncontrolling interest), it may not be necessary to recognize a deferred tax liability on the basis difference related to an investment in a domestic VIE subsidiary. However, in some situations the primary beneficiary may not be able to control the conditions necessary to meet the ASC paragraph 740-30-25-17 (APB 23) indefinite reversal criterion or the ASC paragraph 740-30-25-7 and 25-8 conditions.

**2.052 Summary of Recognition of Deferred Taxes for Outside Basis Differences of Domestic Subsidiaries.** The requirements related to the recognition of deferred taxes for outside basis differences of domestic subsidiaries is summarized in the table below:

<b>Outside Basis Differences of Domestic Subsidiaries</b>	
<b>Future Deductible Amount</b>	Assess provisions of ASC paragraph 740-30-25-9. Recognition of deferred tax asset is prohibited <i>unless</i> it is apparent that the temporary difference will reverse in the foreseeable future. See Paragraphs 2.047-2.049.
<b>Future Taxable Amount</b>	Assess provisions of ASC paragraphs 740-30-25-7 and 25-8. Recognition of deferred tax liability is required <i>unless</i> the tax law provides a means to liquidate the investment in the subsidiary tax-free and the parent intends to use that means (see Paragraphs 2.038-2.044). In addition, a deferred tax liability is not recognized on undistributed earnings arising in fiscal years beginning on or before December 15, 1992 if the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) is met. (Note this exception also applies to domestic corporate joint ventures.)

**2.053 Equity Method Investments.** Investments in common stock accounted for under the equity method for financial reporting purposes in accordance with ASC Topic 323,

*Investments—Equity Method and Joint Ventures*, often give rise to temporary differences because such investments generally are accounted for under the cost method for tax purposes. Under the equity method, the investment is adjusted for the investor's share of the undistributed earnings or losses of an investee which may be affected by acquisition accounting adjustments made at the investor level (see Paragraph 10.009). Deferred taxes generally should be recognized on these differences between the investor's financial statement carrying amount and the tax basis of the equity method investment if recovery of the investment would be taxable. The exceptions to the recognition of deferred tax liabilities and deferred tax assets for basis differences in an investment in a subsidiary generally do not apply to equity method investments. The only specific exceptions to the recognition of deferred taxes for equity method investments are for (1) investments in certain foreign corporate joint ventures (see Paragraph 7.013), and (2) undistributed pre-1993 earnings of a domestic corporate joint venture.

**2.053a** In addition to these exceptions, if the investee is a partnership investment, we believe the investor may exclude portions of the outside basis difference (e.g., nondeductible goodwill, the outside basis difference of the partnership's investment in another entity) for which an ASC Topic 740 exception applies when recognizing deferred taxes for the outside basis difference. See Paragraph 2.102a for additional discussion.

**2.054** ASC paragraph 740-30-25-9 indicates that deferred tax assets should not be recognized for the excess of the tax basis over the financial statement carrying amount of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration (foreign or domestic) unless it is apparent that the temporary difference will reverse in the foreseeable future. That limitation on the recognition of deferred tax assets applies to subsidiaries and corporate joint ventures. However, it does not apply to other equity method investments. ASC paragraph 740-30-25-9

**2.055** The exceptions to the recognition of deferred taxes on differences related to unconsolidated corporate joint ventures apply only to corporate joint ventures (as defined in the ASC Master Glossary) that are essentially permanent in duration. The definition of a corporate joint venture refers to “a corporation owned and operated by a small group of businesses (the *joint venturers*) as a separate and specific business or project for the mutual benefit of the members of the group.” As discussed in ASC paragraph 740-30-05-7, these arrangements include the participation of investors in the management of the joint venture and the agreement of investors in the plans for long-term investment. Accordingly, the exception to recognition of deferred taxes for investments in corporate joint ventures applies only when investors participate in the management of the venture and there is a mutual agreement of the investors on the long-term investment plans. ASC paragraph 740-30-05-7

**2.056 Reduction to Below 50% Ownership in an Investee (Consolidated to Equity Method).** When an entity that has not recognized a deferred tax liability on an excess of the financial statement carrying amount over the tax basis of an investment in a more-than-50%-owned domestic subsidiary (based on the guidance in ASC paragraphs 740-30-25-7 and 25-8) sells a portion of its investment and the remaining investment will be accounted for under the equity-method of accounting, the investor generally should

recognize a deferred tax liability for the outside basis difference in the equity method investment if recovery of the investment would be taxable notwithstanding that a portion of the outside basis difference arose when the entity was a consolidated subsidiary (unless the equity method investee is a corporate joint venture that itself would be eligible for application of the indefinite reversal criterion).

**2.057** Not used.

**2.058** Subsequent to a partial sale of an investment in a domestic or foreign subsidiary that becomes an equity method investee, deferred tax liabilities, if any, must be recognized on subsequent undistributed earnings and other transactions that create taxable temporary differences because the exceptions in ASC Topic 740 no longer apply because the investment is not a subsidiary at the time those earnings are generated. Additionally, it would be unusual for a foreign subsidiary to convert into a foreign corporate joint venture (for which the ASC paragraph 740-30-25-17 (APB 23) exception would continue to apply) simply as a result of a change in ownership.

**2.059 Reduction to Below 50% Ownership in an Investee (Consolidated to Cost Method).** If a portion of the investment in a domestic or foreign subsidiary or corporate joint venture is sold and the remaining investment will be accounted for under ASC Subtopic 321-10, *Investments—Equity Securities - Overall*, a deferred tax liability must be recognized on the entire excess of the financial statement carrying amount of the retained investment over the tax basis of the investment if recovery of the investment would be taxable.

**2.060 Increase to Greater Than 50% Ownership in an Investee.** As discussed beginning in Paragraph 2.039, the excess of the financial statement carrying amount over the tax basis of an investment in a more-than-50%-owned *domestic* subsidiary is not a taxable temporary difference if the tax law provides a means to recover the investment tax-free and the parent entity expects to use that means. Accordingly, if a 50%-or-less-owned domestic investee for which a related deferred tax liability has been recognized becomes a more-than-50%-owned subsidiary and the excess of the financial statement carrying amount over the tax basis is not a taxable temporary difference based on the provisions of ASC paragraphs 740-30-25-7 and 25-8, the previously recognized deferred tax liability related to the investment should be eliminated. The elimination of that deferred tax liability would be recorded in income tax expense outside of the acquisition accounting (for additional discussion see Paragraph 6.070).

**2.061** Not used.

**2.061a** An entity that has recognized a deferred tax liability for a taxable outside basis difference in its foreign equity method investment will eliminate that deferred tax liability if the investee becomes a subsidiary and the investor intends to apply the indefinite reversal criterion to its taxable outside basis difference under ASC paragraph 740-30-25-17 (APB 23) or the investor expects to recover the investment in a tax-free manner.

**2.062** As discussed beginning in Paragraph 2.047, a deferred tax asset is recognized for a deductible temporary difference for the excess of the tax basis over the financial statement carrying amount of an investment in the stock of a subsidiary or corporate joint venture (foreign or domestic) only if it is apparent that the temporary difference will reverse in the foreseeable future. Accordingly, a deferred tax asset that has been recognized by an investor related to an investment in an equity method investee generally would be eliminated if the investee becomes a subsidiary. The elimination of that deferred tax asset would be recorded in income tax expense outside of the acquisition accounting (for additional discussion see Paragraph 6.071).

### **EXCEPTIONS TO RECOGNITION OF DEFERRED TAXES – INTRA-ENTITY TRANSACTIONS**

**2.063 Intra-entity Transactions.** An intra-entity sale or purchase of assets, such as the sale of inventory or depreciable assets between tax jurisdictions, generally is a taxable event for the seller and establishes a new tax basis for those assets in the buyer's tax jurisdiction. As a result, there generally will be a taxable gain in the seller's jurisdiction and a difference in the buyer's tax jurisdiction between the new tax basis and the carrying amount of those assets as reported in the consolidated financial statements.

**2.064** In accordance with ASC Topic 810, *Consolidation*, intra-entity balances, transactions, and intra-entity profit or loss on assets remaining within the group should be eliminated. Accordingly, no pretax gain or loss is recognized on transactions among entities within a consolidated group. However, both the seller and the buyer in an intra-entity asset transfer (excluding inventory transfers, see Paragraph 2.065) immediately recognize the current and deferred income tax consequences of the transaction. For transfers of assets other than inventory, the related income tax expense or benefit is recognized in net income in the consolidated financial statements that include both the buyer and the seller (see Paragraphs 9.052 and 10.148 for the separate financial statements of the buyer or seller). ASC paragraph 810-10-45-1

**2.065 Intra-entity Transfers of Inventory.** ASC paragraph 810-10-45-8 requires that for intra-entity transfers of inventory, income taxes paid on intra-entity profits in the seller's tax jurisdiction be deferred, and ASC subparagraph 740-10-25-3(e) prohibits recognition of a deferred tax asset for the tax effect of the difference between the tax basis of the inventory in the buyer's tax jurisdiction and its financial statement carrying amount (as reported in the consolidated financial statements). The Master Glossary defines inventory as tangible personal property items that are held for sale in the ordinary course of business, in process of production for such sale, or to be currently consumed in the production of goods or services to be available for sale. We believe that for the exception to apply, the transferred asset must be inventory for both the buyer and the seller. ASC subparagraph 740-10-25-3(e), and ASC paragraph 810-10-45-8

**2.066** The ASC Topic 740 exception for intra-entity transfers of inventory applies only to transactions that constitute a transfer of an asset for book or tax purposes, or both. An entity should consider the facts and circumstances of each transaction to determine

whether the underlying principles of ASC Topic 810 should be applied. If a transaction is not deemed to be an intra-entity transfer of inventory, for example when the transaction represents a right-to-use rather than the transfer of ownership of the inventory, then the tax effects, if any, of the transaction should be recognized, rather than deferred under the intra-entity rules, subject to the application of ASC Topic 740.

**2.067 Initial Recognition and Measurement of a Deferred Charge.** The net tax effect of an intra-entity transfer of inventory is deferred in consolidation. These deferred tax effects include the reversal of any existing deferred tax asset (and its related valuation allowance, if any), deferred tax liability, and unrecognized tax benefit liability (assuming the exposure has been eliminated). The deferred effect would also include recognition of unrecognized tax benefits that arise as a result of the intra-entity transaction, and taxes currently payable. Deferred effects generally are calculated by applying the with-and-without approach (i.e., the difference between the income tax expense of the seller with and without the intra-entity transfer).

**2.067a Presentation.** The deferred effect is not the result of a temporary difference; therefore, the related deferred charge or credit generally should not be classified as a component of the entity's deferred tax assets and liabilities. The deferred charge or credit generally is classified among other assets or liabilities. See also Paragraph 9.171 for additional information.

### Example 2.4: Intra-entity Transfer of Depreciable Asset

ABC Corp. transfers a depreciable asset with a fair value of \$120 and a financial statement carrying amount of \$80 to its wholly owned subsidiary DEF Corp. ABC and DEF operate in different tax jurisdictions and neither carry the asset as inventory. The asset has a tax basis of \$60. The transfer qualifies as a sale for income tax purposes and triggers a tax of \$13 on the tax gain (21% tax rate multiplied by the tax gain of \$60 (\$120 - \$60)).

ABC and DEF immediately recognize the current and deferred income tax consequences of the transfer of depreciable assets. ABC will recognize \$13 of current tax expense and \$4 of deferred tax benefit and DEF will recognize a deferred tax asset for the difference between the \$120 tax basis in its jurisdiction and the \$80 financial statement carrying amount.

### Example 2.5: Inventory Transfer between Consolidated Companies

ABC Corp. and DEF Corp. are wholly owned subsidiaries of Parent Z. Parent Z, ABC, and DEF file separate tax returns in different tax jurisdictions. ABC sells inventory to DEF for \$150. ABC's tax basis in the inventory is \$120 and the financial statement carrying amount is \$100.

The tax rate is 40% in ABC's tax jurisdiction and 35% in DEF's tax jurisdiction. Before the transfer, ABC recognized a deferred tax asset of \$8 related to the deductible temporary difference of \$20 (tax basis of \$120 less the financial statement carrying amount of \$100). No valuation allowance was recognized on that deferred tax asset. On transfer, ABC will incur taxes of \$12 (gain on sale for tax purposes of \$30 (\$150 - \$120) multiplied by the 40% tax rate) on the sale of inventory to DEF.

The elimination entries made to the consolidated financial statements of Parent Z that relate to the inventory transfer are:

	Seller	Buyer	Eliminations (including deferral of tax effects)	Consolidated
<b>Income Statement</b>				
				\$
Sales price	\$ 150	—	(150)	—
Cost of sale	(100)	—	100	—
Reported pretax gain	50	—		—
Tax expense:				
Current tax expense	12	—	(12)	—
Deferred tax expense	8	—	(8)	—
Total	<u>20</u>	—		<u>—</u>
Net income	\$ <u>30</u>	—		\$ <u>—</u>
	<b>Post-Transfer, Pre- Elimination Combined</b>		<b>Eliminations (including deferral of tax effects)</b>	<b>Post- Transfer, Post- Elimination Consolidated</b>
<b>Balance Sheet</b>				
Deferred tax asset	\$ —		\$ —	\$ —
Deferred charge	\$ —		\$ 20	\$ 20 <sup>1</sup>
Inventory	\$ 150		\$ (50)	\$ 100
Income tax liability	\$ (12)		\$ —	\$ (12)

<sup>1</sup> The deferred charge includes the taxes currently payable in ABC's tax jurisdiction of \$12 plus the reversal of ABC's deferred tax asset before the transfer of \$8.

**2.068 Scope.** The intra-entity inventory transfer provisions of ASC Topic 740 most often are applied to transfers between tax jurisdictions and generally are not applicable to carryover basis transfers between subsidiaries in the same tax jurisdiction that are part of a consolidated group for tax purposes. However, the provisions may be applicable to certain inventory transfers between subsidiaries within the same jurisdiction when the buying subsidiary and selling subsidiary file separate tax returns. If the transfer results in only transferring a deductible temporary difference and related deferred tax asset from one subsidiary to another subsidiary within the same tax jurisdiction, generally there



would be no need to apply the intra-entity inventory transfer provisions because there is no tax effect of the transfer. For example, assume a subsidiary transfers inventory with a tax basis of \$120 and a financial statement carrying amount of \$100 to another subsidiary within the same tax jurisdiction for \$120. In that case, the deferred tax asset of \$8 (temporary difference of \$20 multiplied by a 40% tax rate) would be retained in the consolidated financial statements because there has been no change in the temporary difference and no taxes were paid on the transfer.

**2.069** In unusual cases, the net tax effects of the intra-entity inventory transfer may result in a net credit. It may be appropriate to record that as a deferred credit in the consolidated financial statements. However, as that situation may arise when the fair value of the inventory transferred is less than its financial statement carrying amount, other applicable accounting literature should be considered to determine whether a write-down of the financial statement carrying amount is appropriate.

**2.070 Derecognition of Deferred Tax Effects of an Intra-entity Inventory Transfer.**

The deferred tax effects of intra-entity transfers of inventory generally would not be reversed into income tax expense until the inventory is sold outside the consolidated group.

**2.070a Subsequent Measurement.** A deferred charge for the deferred tax effects of an intra-entity inventory transfer is not a deferred tax asset and, therefore, is not subject to the valuation allowance assessment under ASC Topic 740 and is not adjusted for changes in the tax laws or rates. However, the deferred charge should be included with the financial statement carrying amount of the transferred inventory for any impairment evaluation. See also Paragraphs 3.095, 4.137, 5.044 and 9.171 for further discussion.

**2.071** Not used.

**2.071a Intra-entity Transfers with No Current Tax Effect.** An intra-entity transfer of an intangible asset may occur between a U.S. tax-paying entity and a foreign subsidiary where there is no current tax due on the transfer because the asset is exchanged for stock of the foreign subsidiary. For U.S. tax purposes, the transfer is treated as a deemed sale of the intangible asset in exchange for future annual royalty payments over the estimated useful life of the asset. The U.S. entity will be taxed on the transfer in future periods as the asset generates income in the foreign jurisdiction. The amount of U.S. taxable income is dependent on the level of income generated by the asset. If no income is ever generated from the asset, no U.S. taxes will ever be owed. The accounting for any future U.S. tax obligation is dependent on whether the intangible has book basis (e.g., when it has been acquired in a business combination or asset acquisition).

**2.071b Intangibles with Book Bases Transferred with No Current Tax.** Typically, intangible assets with book bases are those that are acquired in a business combination or asset acquisition. The book basis of such an intangible is based on the expected level of income to be generated from the use of the asset; therefore, the deferred tax liability recognized at acquisition generally represents the expected future U.S. tax liability on the income expected to be generated from the use of the intangible asset. While a U.S.-based

acquirer can transfer that intangible asset to a foreign subsidiary in exchange for stock, it cannot eliminate the consolidated book carrying amount or the future U.S. tax liability. We believe the U.S. tax-paying parent should continue to recognize the existing U.S. deferred tax liability after the intra-entity transfer to the extent recovery of the asset at the financial statement carrying amount by the subsidiary would result in taxable income to the parent. That deferred tax liability then should be reversed as the carrying amount changes and current taxes are recognized when the U.S. income tax becomes due. If the intangible asset is impaired after the transfer, the deferred tax liability would be adjusted to reflect the change in the consolidated carrying amount. We believe an entity generally should apply this guidance to the extent recovery of the intangible asset at its carrying amount in the consolidated financial statements considering the expected timing of that recovery would be expected to result in a future U.S. tax obligation. The consolidated entity may also need to recognize additional deferred taxes if a temporary difference in the foreign jurisdiction arises based on the income tax provisions of the foreign jurisdiction.

**2.071c Intangibles with No Book Bases Transferred with No Current Tax.** Typically, intangibles without book bases are those that are internally developed because the cost of an internally developed intangible asset is expensed rather than capitalized on the balance sheet. As a result, no U.S. deferred tax liability exists when those assets are transferred. Because the intangible asset has no book basis in the consolidated financial statements either before or after the transfer, and the future U.S. tax liability is contingent on future income being generated by an asset that has a financial statement carrying amount of zero, we believe a U.S. tax liability should not be recognized on the date of the intra-entity transfer. Rather, the U.S. tax expense should be recognized in the period in which the income is generated by the asset. An entity generally should apply this guidance because assuming recovery of the intangible asset at its carrying amount in the consolidated financial statements would not be expected to result in a future U.S. tax obligation. While the parent would not recognize a U.S. deferred tax liability on transfer, the consolidated entity may need to recognize deferred taxes if a temporary difference arises based on the income tax provisions of the foreign jurisdiction.

**2.071d** The question of whether to record a U.S. tax liability at the time of transfer for certain types of intra-entity intellectual property transfers was discussed informally with the SEC staff. Based on our understanding of the staff's positions, if intellectual property with a zero book basis is transferred for a lump sum upfront cash payment, the transferor should recognize its current U.S. taxes on the transfer date. If the intellectual property (with a zero book basis) is transferred for stock of the foreign subsidiary and any future U.S. tax liability is contingent on future income being generated by the transferred asset, the transferor generally would not recognize a U.S. tax liability on the transfer date. Entities that believe U.S. tax liability recognition is appropriate in those circumstances should consider consultation with the SEC staff.

Intangible Asset Generated	Book Basis?	Existing DTL?	Accounting for Taxes on Transfer	Subsequent Accounting for Taxes
Internally	No	No	No U.S. tax liability recognized	Recognize current taxes when income is generated from the asset
Through acquisition	Yes	Yes	Maintain existing DTL	Reverse DTL as income is generated from the asset or on asset impairment

### Example 2.5a: Intra-entity Transfer of an Intangible Asset to a Foreign Subsidiary Subject to IRC §367(d)

ABC Corp. acquired DEF Corp., a U.S. entity, in a business combination. The acquisition of DEF was a purchase of the stock of DEF for tax purposes. DEF's intellectual property (IP) was acquired with a book basis and fair value of \$6,800. A U.S. deferred tax liability of \$1,428 was recorded during acquisition accounting for the excess of the book basis in the IP (\$6,800) over tax basis (\$0).

Subsequent to the business combination DEF completed an IRC §367(d) transfer of the acquired IP to its foreign subsidiary, XYZ Corp., in exchange for stock of XYZ. The §367(d) transfer resulted in no current U.S. tax due at the time of transfer but will require ABC to recognize U.S. taxable income in future years for the deemed royalty income generated from the transferred IP.

We believe ABC should retain its \$1,428 deferred tax liability established during acquisition accounting because assuming recovery of the IP at its \$6,800 consolidated carrying amount, ABC would expect to have a future U.S. tax obligation. As taxes become due on the deemed royalty income generated by the IP, the recorded tax liability of \$1,428 will be reversed to deferred tax benefit and \$1,428 of current tax expense/payable will be recognized.

If the IP recorded by XYZ is impaired, ABC will reduce the recorded tax liability to reflect the change in the consolidated carrying amount of the IP.

If ABC did not have a tax liability recorded at the time of the §367(d) transfer, ABC would not record one when the transfer occurred and would instead recognize U.S. taxes paid in current tax expense as the income is generated by the IP.

**2.072 – 2.076** Not used.

**Example 2.6:** Not used.

**2.076a Intra-entity Operating Leases.** In some REIT structures - e.g., hotel and some healthcare REITs, the REIT (parent entity) owns a building and leases it under an operating lease to a TRS that operates the property (or contracts with a third-party to operate the property). The TRS accounts for the intra-entity lease in its stand-alone financial statements as if it was a lease between unrelated parties. Because the TRS is taxed like a corporate entity, it provides deferred taxes in its ledger for the book/tax basis differences related to its right of use asset and lease liability. The deferred taxes are based on the TRS' applicable tax rate.

**2.076b** Like the TRS, the REIT accounts for the intra-entity lease in its stand-alone financial statements as if it was a lease between unrelated parties. However, as an operating lease, the REIT will typically not recognize significant assets and liabilities related to the lease and because the REIT is effectively taxed at a zero rate, it does not provide deferred taxes in its ledger for its book/tax basis differences related to the lease. The operating lease is eliminated in consolidation.

**2.076c** We do not believe that the REIT must retain (or provide) deferred taxes in the consolidated financial statements for the intra-entity operating lease because there are no book/tax basis differences associated with the lease after the REIT makes its elimination entries. Basis differences are identified based on the difference between the tax basis of an asset or liability and its reported amount in the consolidated statement of financial position. ASC paragraph 740-10-25-20

**2.077 Intra-entity Transfers of Inventory Resulting in Payments of Tax Using Existing Operating Loss or Tax Credit Carryforwards.** The use of existing net operating loss (NOL) carryforwards or other carryforwards for which no valuation allowance is recognized to offset the tax triggered on an intra-entity inventory transaction, generally has the same effect as if taxes were paid in cash. That is, the income statement effect of the reversal of the deferred tax asset for the use of the NOL, like cash paid, is deferred along with the reversal of any existing temporary difference. In addition, the reversal of any existing valuation allowance for the reversing deferred tax assets generally would also be included in the deferred charge. See the discussion beginning in Paragraph 4.100 for additional information on the use of intra-entity transfers as potential tax-planning strategies in certain limited situations.

**2.078 Establishing a Valuation Allowance as a Consequence of an Intra-entity Inventory Transfer.** NOL and other carryforwards existing after an intra-entity inventory transfer and not used to offset tax triggered on the intra-entity transfer must be evaluated for realizability. The establishment of a valuation allowance as a result of the evaluation is not directly related to the intra-entity inventory transaction and therefore cannot be included in the deferred charge. The valuation allowance increase should be expensed in the period in which it is recognized and is not considered a cost of the intra-entity transfer.

### **Example 2.7: Establishing a Valuation Allowance as a Consequence of an Intra-entity Inventory Transfer**

ABC Corp., a U.S. entity, completed a routine intra-entity transfer of inventory to Entity DEF, a Swiss limited liability company (LLC) and will wind up its affairs after the inventory is sold. The transfer of inventory is considered a sale under general tax principles and income is recognized in ABC's separate financial statements for book purposes. Before the transfer, ABC had NOL carryforwards that were determined to be realizable as a result of the future taxable income expected to be generated from the inventory. The intra-entity transfer caused the NOLs to either be used against the taxable income triggered in connection with the transfer or to no longer be deemed realizable as ABC anticipates no future U.S. taxable income. ABC must establish a valuation allowance for the NOLs that are no longer determined to be more likely than not of being realized. The amount of the valuation allowance should be recognized as an expense in the period in which it is recorded.

#### **2.079 Transfers of Assets from a Consolidated Entity to an Equity Method Investee.**

Assets transferred to an equity method investee do not remain within the consolidated group. Accordingly, the intra-entity transfer provisions of ASC Topic 740 do not apply to transfers to an equity method investee. However, the profit eliminated on the transferred assets remaining with the equity method investee generally is recorded as a reduction of the equity method investment. Taxes paid and the deferred tax effect of the change in the difference between the financial statement carrying amount and the tax basis of the equity method investment should not be deferred. Those tax effects should be recognized in earnings.

**2.080 Intra-entity Transfer of Interests in a Corporate Subsidiary.** Certain transfers of assets may involve the transfer of an investment in one entity to another controlled entity. On the date of transfer, the buyer and seller will immediately recognize the current and deferred income tax consequences of a transfer of a subsidiary (because the subsidiary generally would not qualify as inventory). However, the accounting for a change in the assumption about the intent or ability to liquidate a subsidiary tax-free (see the discussion beginning in Paragraph 2.039) or a change in assumptions related to the ASC paragraph 740-30-25-17 (APB 23) indefinite reversal criterion (see Paragraph 2.037) may be necessary in reporting periods before the intra-entity transaction.

### **Example 2.8: Intra-entity Sale of Corporate Investment**

Parent has a domestic subsidiary, Subsidiary A, and a foreign subsidiary, Subsidiary B. The financial statement carrying amount of Subsidiary A exceeds its tax basis. No deferred taxes have been recognized on the excess of the financial statement carrying amount over the tax basis of the investment in Subsidiary A based on the provisions of ASC paragraphs 740-30-25-7 and 25-8. That is, Parent has historically expected to

recover the investment tax free. The financial statement carrying amount and tax basis of the Parent's investment in Subsidiary B are equal and therefore there is no outside basis difference related to Subsidiary B.

	Fair Value	Financial Statement Carrying Amount	Tax Basis
Parent's investment in Subsidiary A	300	200	100

Parent is currently considering the sale of Subsidiary A to Subsidiary B. For tax purposes, a gain of \$200 will be generated based on the fair value of Subsidiary A at the time of the transfer (\$300) and the tax basis of that investment (\$100). For financial reporting purposes, the financial statement gain of \$100 (\$300 fair value less \$200 carrying amount) will be eliminated in consolidation.

At the time that the Parent makes the decision to complete the sale, the Parent can no longer maintain that it expects to recover the excess of the financial statement carrying amount of the investment in Subsidiary A over the tax basis in a tax-free manner. Accordingly, a deferred tax liability should be recognized at the point in time when the Parent's expectations change in relation to the expected manner of recovery of its investment in the subsidiary. Assuming a tax rate of 21%, the amount of the deferred tax liability to be recognized on Parent's books is \$21  $((\$200 - \$100) \times 21\%)$ . Recognition of that deferred tax liability generally would be charged to tax expense.

#### Entry Recorded at Time of Parent's Decision to Sell (Parent's Books)

	Debit	Credit
Income tax expense	21	
Deferred tax liability		21

The taxable gain on sale of the subsidiary (\$300 - \$100) of \$200 would be taxed in the Parent's tax return resulting in a current tax liability of \$42, assuming a tax rate of 21%, because the tax results from an intra-entity transfer.

In the consolidated financial statements, Subsidiary B will take a \$200 carryover financial statement carrying amount as this is a transaction among entities under common control. Parent and Subsidiary B will immediately recognize the current and deferred income tax consequences of the transfer in net income. Parent will recognize \$42 of current tax expense and \$21 of deferred tax benefit and Subsidiary B likely will not recognize a deferred tax asset for the difference between the \$300 tax basis in its jurisdiction and the \$200 financial statement carrying amount, unless Subsidiary B expects to recover the investment in a deductible manner and it is apparent that the

deductible outside basis difference will reverse in the foreseeable future (see additional discussion in Paragraph 2.047).

#### Entry Recorded at Date of Sale (Parent's Books)

	Debit	Credit
Deferred tax liability	21	
Current tax expense	42	
Deferred tax benefit		21
Income taxes payable		42

#### Example 2.9: Change in Intent for Intra-entity Sale of Foreign Subsidiary

Parent has a foreign subsidiary, Subsidiary A. During the 20X1 reporting period Subsidiary A recorded a goodwill impairment that generated a deductible outside basis difference in the Parent's investment in Subsidiary A. Parent did not recognize a deferred tax asset for the outside basis difference when the impairment was recognized because it was not apparent that the deductible outside basis difference would reverse in the foreseeable future.

During 20X2, Parent decides to change the location of Subsidiary A in the corporate structure by selling Subsidiary A to Subsidiary B. On sale, the deductible outside basis difference will be realized for tax purposes. The sale of Subsidiary A occurred in the first quarter of 20X3.

We believe Parent should recognize a deferred tax asset in 20X2 (when it decides to sell Subsidiary A to Subsidiary B) because it is expected to be recovered in a deductible manner and it is then apparent that the deductible outside basis difference will reverse in the foreseeable future (in this situation, the first quarter of 20X3. See Paragraphs 2.047 through 2.049 for guidance about the concept of foreseeable future). We believe it should recognize the benefit to establish the deferred tax asset in income tax expense.

## EXCEPTIONS TO RECOGNITION OF DEFERRED TAXES – OTHER EXCEPTIONS

**2.081 Accounting for Temporary Differences on Goodwill.** At the date of a business combination, deferred taxes are recognized for the acquired entity's taxable and deductible temporary differences and operating loss and tax credit carryforwards, except for differences related to the portion of financial statement goodwill for which amortization is not deductible for tax purposes, leveraged leases, and the specific acquired temporary differences discussed in Paragraph 2.032. Taxable or deductible temporary differences result from differences between the amounts recognized in applying acquisition accounting and the tax bases of assets acquired and liabilities

assumed in the business combination. See Section 6, *The Tax Effects of Business Combinations*, for additional discussion. ASC paragraphs 740-10-25-3, 805-740-25-3

**2.082 Foreign Currency Translation at Historical Rates.** When a foreign operation does not keep its books and records in its functional currency (e.g., the foreign operation keeps its books and records in local currency, but its functional currency is the parent's reporting currency), ASC Topic 830, *Foreign Currency Matters*, requires nonmonetary assets and liabilities of the foreign operation to be remeasured into the functional currency using historical exchange rates. In these situations, there will be differences in the foreign tax jurisdiction between the current local currency equivalent of the historical cost or proceeds as measured in the functional currency and the local currency tax basis of those assets and liabilities after a change in exchange rates. Technically, these differences would meet the definition of temporary differences and would therefore be subject to deferred taxes. However, because the substance of this accounting would be to recognize deferred taxes on exchange gains and losses that are not required to be recognized under ASC Topic 830, ASC Topic 740 prohibits the recognition of deferred taxes on such temporary differences. A similar prohibition applies to temporary differences in these situations when a basis difference arises due to indexing for income tax purposes. See Section 7 for additional guidance. ASC subparagraph 740-10-25-3(f)

**2.083 Monetary Assets and Liabilities Denominated in Functional Currency.** While ASC Topic 740 provides the exception to recognition of deferred taxes on temporary differences associated with nonmonetary assets and liabilities resulting from changes in exchange rates or indexing for tax purposes when a foreign operation does not keep its books and records in its functional currency (and, therefore, remeasures its local-currency books and records into the functional currency under ASC Topic 830), it provides no similar exception for monetary assets and liabilities denominated in the entity's functional currency. Accordingly, deferred taxes would be provided for the difference between the current local-currency-equivalent financial statement carrying amount (based on current exchange rates) and the local currency tax basis if settling the asset or liability at its local-currency-equivalent financial statement carrying amount would result in taxable income or loss in the local tax jurisdiction. These deferred taxes would be provided notwithstanding that the change in exchange rates that gives rise to the change in the local-currency-equivalent financial statement carrying amount does not result in transaction gain or loss (or a change in the functional currency financial statement carrying amount) under ASC Topic 830. A similar issue relates to a foreign operation's monetary assets and liabilities that are denominated in the local currency when the local currency is not its functional currency. Monetary assets and liabilities denominated in the local currency give rise to transaction gains or losses in the functional currency financial statements under ASC Topic 830 (resulting in a change in the functional currency financial statement carrying amounts), but generally would not result in the recognition of deferred taxes in the foreign tax jurisdiction because no basis difference generally exists between the local-currency-equivalent financial statement carrying amount and the local currency tax basis. See the discussion beginning in Paragraph 7.046.

**2.084 Leveraged Leases.** Under the provisions of ASC Topic 840, *Leases*, the value assigned for financial reporting purposes to a leveraged lease acquired in a business



combination (or in the acquisition by a not-for-profit entity) is based on the remaining future cash flows and the future tax effects of those cash flows. The tax effects of differences between the assigned value and the tax basis of the leveraged lease in a business combination should not be accounted for separately as a deferred tax liability but should instead be accounted for in conjunction with the ASC Topic 840 components of the net investment in the leveraged lease. Accounting for such components of the net investment should not be offset by the tax effects of other temporary differences or net operating loss or tax credit carryforwards. ASC subparagraph 740-10-25-3(c), and paragraphs 840-30-30-15, 45-6 and 45-7, 55-18, and 55-39 through 55-46

**2.085** In February 2016, the FASB issued ASU 2016-02, *Leases*. The new standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date.

**2.086 Bad Debt Reserves of Qualified Savings and Loan Institutions.** Historically, qualified savings and loan associations and other qualified thrift lenders (thrifts) were able to deduct an amount for bad debts based on a formula. Subsequent changes now generally allow a bad debt deduction only when a loan is charged off, unless the thrift is a "small thrift" as discussed in Paragraph 2.087. The balance of the reserve on December 31, 1987 (base-year amounts) is subject to recapture on the occurrence of: (i) the thrift no longer meeting the definition of a "bank", (ii) certain corporate actions (e.g., liquidations and redemptions), or (iii) certain distributions in excess of current earnings and profits accumulated in tax years beginning after December 31, 1951. ASC subparagraph 740-10-25-3(a), paragraph 942-740-35-3

**2.087** A thrift that is a small thrift, one with adjusted basis of assets of \$500 million or less, on a controlled group basis, may use a bad debt reserve method. Under the reserve method, small thrifts generally are allowed tax deductions to increase their bad debt reserve to the greater of: (i) a level computed using a six-year moving average based on the total loans outstanding at the close of the tax year or (ii) a level proportional to the base-year amount (taking into account reductions, but not increases, in the amount of loans outstanding). That base-year amount generally is set at the amount of the bad debt reserve as of the end of the last tax year beginning before 1988.

**2.088** ASC Subtopic 942-740, *Financial Services—Depository and Lending - Income Taxes*, provides specific guidance on the treatment of thrift bad debt reserves in the deferred tax calculation. Under those requirements, thrifts:

- (1) Should not recognize a deferred tax liability for the tax effects of the base-year tax bad debt reserve unless it becomes apparent that the difference will reverse in the foreseeable future;
- (2) Should recognize a deferred tax liability for increases in the tax bad debt reserve over the base-year tax bad debt reserve, if any (only certain small thrifts continue to have an excess of a bad debt reserve over the base-year

reserve after section 1616 of the Small Business Job Protection Act of 1996 generally repealed it); and

- (3) Should recognize a deferred tax asset, reduced by any necessary valuation allowance, for the allowance for loan losses for financial reporting purposes.

Acquirers of thrifts also apply this guidance unless pre-1988 deductions are recaptured as a result of the acquisition. See Paragraph 6.109a for additional discussion.

### **Example 2.10: Temporary Differences Related to Bad Debt Reserves**

At December 31, 20X8, Small Thrift XYZ has a base-year bad debt reserve for tax purposes of \$3,000. The bad debt reserve for tax purposes at December 31, 20X8 is \$7,000. (The excess of the tax bad debt reserve over the base-year reserve was caused by increased bad debt reserves computed under the experience method for small thrifts.) For financial reporting purposes, the allowance for loan losses is \$5,000 as of December 31, 20X8. The enacted tax rate is 21%. Under ASC Subtopic 942-740, Small Thrift XYZ should recognize a deferred tax liability at December 31, 20X8 of \$840 (\$4,000 at 21%) for the amount of the tax bad debt reserve (\$7,000) in excess of the amount of the base-year tax bad debt reserve (\$3,000). Small Thrift XYZ also would recognize a potential deferred tax asset at December 31, 20X8 of \$1,050 (\$5,000 at 21%) for the entire amount of the loan loss allowance for financial reporting purposes (\$5,000). Small Thrift XYZ then would evaluate whether a valuation allowance is necessary for any portion of that potential deferred tax asset.

If management of Small Thrift XYZ does not expect that the taxable temporary difference related to the base-year tax bad debt reserve (\$3,000) will reverse in the foreseeable future, no deferred tax liability would be recognized for the base-year tax bad debt reserve.

**2.089** In certain situations, the bad debt reserve for tax purposes after December 31, 1987 may be less than the amount of the base-year tax bad debt reserve (unfilled base year). If the thrift currently has the ability under the tax law to obtain a tax deduction to refill the base-year tax bad debt reserve but has elected not to take the tax deduction to refill the base-year reserve, the excess of the base-year tax bad debt reserve over the current balance for the tax bad debt reserve represents a potential tax deduction for which a deferred tax asset should be recognized. However, if the base-year reserve has been reduced due to a reduction in the amount of qualifying loans outstanding or other factors, the exception to recognition of deferred taxes should be applied only to the current remaining (reduced amount) base-year reserve. Future increases in the base-year amount should not be anticipated. See the discussion beginning in Paragraph 5.047 about changes in thrift status.

**Example 2.11: Unfilled Base-Year Reserve**

Small Thrift XYZ, a qualified thrift lender with a calendar year-end has a bad debt reserve for tax purposes of \$5,000 as of December 31, 20X8 and a base-year bad debt reserve for tax purposes of \$8,000. Small Thrift XYZ elects as of December 31, 20X8 not to refill the base-year tax bad debt reserve and forgo a tax deduction of \$3,000 in 20X8. The tax benefit of the unused deduction of \$3,000 represents a deferred tax asset for 20X8. However, the reasons for not taking the deduction should be considered in assessing whether a valuation allowance should be recognized for that deferred tax asset.

If the base-year reserve was reduced to \$4,500 in this example due to a reduction in the amount of qualifying loans outstanding, a deferred tax liability is recognized for the tax effects of the \$500 excess of the tax bad reserve (\$5,000) over the current base-year reserve (\$4,500).

**TEMPORARY DIFFERENCES – SPECIFIC APPLICATION MATTERS**

**2.090** This subsection discusses other matters that should be considered when identifying temporary differences.

**2.091** Not used.

**2.092 Prohibition against Applying the Indefinite Criterion by Analogy.** The indefinite reversal criterion in ASC paragraph 740-30-25-17 (APB 23) should not be applied by analogy to other types of temporary differences. Absent provisions of the tax law that would allow a basis difference to be recovered or settled in a tax-free transaction or a special provision in ASC Topic 740 that provides an exception to comprehensive recognition of deferred taxes, deferred taxes are required to be recognized on all temporary differences. Accordingly, deferred taxes should be recognized for other temporary differences even when the reversal of the differences may be indefinitely postponed. For example, an entity may own land or an intangible asset that it intends to use indefinitely. The indefinite reversal criterion would not apply to an excess of the financial statement carrying amount over the tax basis of these assets and a deferred tax liability should be recognized on that taxable temporary difference. ASC paragraphs 740-10-25-3, 25-28, 740-30-25-17 and 25-18, 830-740-25-7 and 25-8

**2.093 Revaluation Surplus.** Fixed assets in certain countries are occasionally restated for tax purposes to compensate for the effects of inflation. The offsetting increase in the inside tax basis is credited to revaluation surplus. The surplus becomes taxable when the subsidiary is liquidated, or when the surplus is distributed. Deferred taxes should be provided for the basis difference related to the revaluation surplus even though the tax consequence of distributing the revaluation surplus may be deferred indefinitely. Because the revaluation surplus relates to the inside basis of the assets and will eventually be

taxed, it is a temporary difference for which deferred taxes should be recognized. ASC Topic 740 limits the application of the indefinite reversal criterion in ASC paragraph 740-30-25-17 (APB 23) to outside basis differences of foreign subsidiaries and foreign corporate joint ventures and other specified exceptions. ASC paragraphs 830-740-25-6 through 25-8

**2.094 Intangible Assets.** In certain cases, identifiable intangible assets may be recognized for financial statement purposes. If there is no corresponding asset for tax purposes, the carrying amount of the identifiable intangible asset for financial statement purposes is a taxable temporary difference for which deferred taxes are recognized. Also, there are situations when the financial statement carrying amount and tax basis of the identifiable intangible asset initially are the same (no temporary difference exists at that time) but temporary differences arise in future periods because of different amortization methods, different lives, or write-offs. In some cases, identifiable intangible assets may not be amortized for financial statement purposes because they have indefinite useful lives. However, deferred taxes are recognized on temporary differences related to those identifiable intangible assets. In summary, a temporary difference exists, and deferred taxes are recognized, when the financial statement carrying amount differs from the tax basis of identifiable intangible assets. ASC paragraphs 805-740-25-3 and 25-4

**2.095 Accounting for Temporary Differences in Purchase Transactions Which Are Not Business Combinations.** ASC Topic 740 provides specific guidance on how to account for deferred taxes which may arise through asset purchases or other purchase transactions that are not business combinations. When an asset purchase not accounted for as a business combination results in temporary differences that require deferred tax recognition under ASC Topic 740, the simultaneous equation method should be used to allocate the purchase price to the asset and the related deferred tax asset or liability, generally resulting in no immediate income statement recognition. See Paragraph 10.001 for additional discussion. ASC paragraph 740-10-25-51

**2.096 Changes in Tax Accounting Methods.** Temporary differences may arise from changes in tax methods of accounting. In certain situations, the cumulative catch-up adjustment (section 481 adjustment) resulting from a change in a method of accounting for tax purposes may be deferred and recognized in taxable income over a period of years. Effectively, a tax-basis asset or liability is created that does not exist for financial statement purposes. That tax-basis asset or liability represents a temporary difference because there is no corresponding GAAP-basis asset or liability for financial statement purposes. Accordingly, deferred taxes should be recognized on those temporary differences. ASC paragraphs 740-10-55-59 and 55-61

**2.097 Foreign Assets and Liabilities.** Temporary differences may exist in a foreign tax jurisdiction for differences between the financial statement carrying amount in the consolidated financial statements and the tax basis of its assets and liabilities in the foreign jurisdiction. Deferred taxes in the foreign jurisdiction should be recognized for these temporary differences; however, exceptions may apply in certain circumstances. The determination of the temporary differences in the foreign jurisdiction should include

consideration of any adjustments made in consolidation for assets and liabilities of the foreign subsidiary. See Paragraphs 2.082-2.083, and Section 7 for additional discussion.

### **2.098 Taxation of Unrealized versus Realized Foreign Exchange Gains and Losses.**

Some jurisdictions include unrealized transaction gains and losses associated with foreign-currency-denominated monetary assets and liabilities in taxable income in the period in which such gains and losses arise. This results in a corresponding increase/decrease in the tax basis of the assets and liabilities. Such increase/decrease generally mirrors the increase/decrease in the financial statement carrying amount as a result of the application of ASC Topic 830 when the monetary asset or liability is denominated in a currency other than both the entity's functional currency and the currency used for tax purposes. Accordingly, no basis difference will arise and no deferred tax asset or liabilities will be recognized. However, the entity will have current tax expense or benefit in these situations.

**2.098a** When the monetary asset or liability is denominated in the entity's functional currency and unrealized foreign currency gains and losses are taxed currently in the local tax jurisdiction due to the tax basis being denominated in the local currency, no basis difference will exist because the local-currency-equivalent financial statement carrying amount (based on current exchange rates) will correspond with the local currency tax basis. However, there will be current tax expense or benefit related to the change in exchange rates. Because there is no transaction gain or loss recognized under ASC Topic 830 for monetary assets and liabilities denominated in an entity's functional currency, the current tax will affect the entity's effective tax rate.

**2.099** Other jurisdictions, including most situations in the United States, do not include foreign currency gains and losses within taxable income until the gains and losses are realized. This means that temporary differences arise between the financial statement carrying amounts of foreign currency denominated monetary items and the tax basis of such items. The tax basis would normally be the value of the asset or liability when measured at the exchange rate on the acquisition date for that particular asset and liability. When the monetary asset or liability is denominated in the entity's functional currency and unrealized foreign currency gains and losses are not taxed until realized in the local tax jurisdiction and have a tax basis denominated in local (foreign currency), a basis difference will arise because the local-currency-equivalent financial statement carrying amount (based on current exchange rates) will differ from the local currency tax basis (see Paragraph 2.083).

**2.100 LIFO Inventory.** ASC Topic 740 requires comprehensive recognition of deferred tax liabilities and assets for temporary differences and operating loss and tax credit carryforwards. LIFO inventory temporary differences are not exceptions to that basic principle. Accordingly, deferred taxes should be recognized for temporary differences related to LIFO inventory. Recognition of a deferred tax liability for an excess of the financial statement carrying amount over the tax basis of LIFO inventory is required even if it is expected that the reversal of the difference will be postponed indefinitely. ASC paragraph 740-10-55-52

**2.101 Tax-to-Tax Differences.** ASC Topic 740 permits recognition of deferred taxes only for temporary differences and carryforwards. Temporary differences are book-tax differences. Tax-to-tax differences, such as an excess of the tax basis of an investment in a subsidiary over the tax basis of the net assets of the subsidiary, are not temporary differences under ASC Topic 740 and therefore, recognition of a deferred tax asset for a tax-to-tax difference is not permitted. ASC paragraph 740-10-25-31

**2.102 Partnership (and Other Pass-Through) Investments.** The exceptions to the recognition of deferred taxes on outside basis differences (both taxable and deductible) related to investments in subsidiaries provided in ASC Topic 740, generally do not apply to investments in partnerships or other pass-through entities even if those partnerships are consolidated. The temporary difference related to an investment in a partnership (and other pass-through entities for which outside basis differences exist) generally is based on the difference between the financial statement carrying amount and the tax basis of the investment in the partnership interest. That difference often will be equal to the net basis differences in the assets and liabilities of the partnership. However, to the extent that the basis difference related to the investment in a consolidated partnership is caused by nondeductible goodwill in the partnership, it is acceptable to look-through the partnership investment. In that case, the partner's temporary difference related to its partnership investment may be reduced by the partner's share of the nondeductible goodwill. The look-through for a partnership is acceptable in jurisdictions where the partner's taxable income includes its share of the taxable income of the partnership (i.e., the partnership is a pass-through entity). Furthermore, to the extent that all or a portion of the outside basis difference in the investment in a consolidated partnership relates to an outside basis difference related to an investment of the partnership in another entity (i.e., the partnership is the immediate parent and its investment is a second-tier subsidiary of the ultimate tax-paying parent) for which an exception to the recognition of deferred taxes exists, it would also be acceptable for that portion of temporary difference related to the partnership investment to be excluded when recognizing deferred taxes.

**2.102a** We believe the guidance in Paragraph 2.102 about excluding portions of the outside basis difference (e.g., nondeductible goodwill) when recognizing deferred taxes for the outside basis difference in a consolidated partnership investment is also generally acceptable for other investments in partnerships, including those accounted for under the equity method. However, we believe the only portions of the outside basis difference that may be excluded are those for which an exception to the recognition of deferred taxes would apply if the ultimate tax-paying parent entity held its proportion of the underlying asset or liability directly (see Paragraph 10.100a).

**2.102b** See additional discussion of investments in pass-through entities beginning in Paragraph 10.098 and also Paragraph 2.053 for the discussion of investments accounted for under the equity method.

**2.103 Debt with Detachable Warrants.** Net proceeds from the issuance of debt with detachable warrants are allocated to the debt and the warrant features under ASC Subtopic 470-20, *Debt - Debt with Conversion and Other Options*. The allocation of proceeds to the two components of the issuance for financial statement purposes may be

different from the allocation for tax purposes. The entity should recognize deferred taxes for the difference between the financial statement carrying amount of the debt and the tax basis of the debt. Deferred taxes should also be recognized for the difference between the financial statement carrying amount and the tax basis of the warrants if the warrants are classified as liabilities or temporary equity and there are possible future tax consequences related to their exercise (see Paragraph 2.030c).

**2.103a** However, if the warrants are classified in equity for financial statement purposes, deferred taxes should not be recognized for the basis difference of the warrants, but their classification as equity instruments typically results in a deferred tax liability associated with the debt being recognized with an adjustment to equity (with subsequent changes being recognized as a component of income tax expense). See Paragraphs 9.057 and 9.069 for additional discussion about the intraperiod tax allocation associated with these transactions (including considerations when the entity has an existing valuation allowance). ASC paragraph 740-10-55-51

**2.104 - 2.105** Not used.

**2.106 Convertible Debt.**<sup>2</sup> When convertible debt (debt that is convertible into equity shares at the election of the holder) is issued it will generally have an interest rate that is lower than it otherwise would have if the debt were issued without the conversion feature (straight debt). U.S. federal tax provisions allow the issuer of certain convertible debt instruments to deduct for tax purposes an interest payment calculated using the rate that could be obtained for straight debt with a comparable maturity. If the debt does not convert into equity shares, the difference between what was deducted for tax purposes and what was actually paid is recaptured on the tax return when the debt is repaid. If the debt is converted into equity, the difference between the amount of interest deducted for tax purposes and interest expense recognized for financial statement purposes is not recaptured.

**2.107** As convertible debt is typically convertible at the option of the holder/investor, the issuer of the debt does not control whether or not the debt is converted into equity. Thus, a deferred tax liability should be recognized on the temporary difference between the financial statement carrying amount of the debt and the tax basis of the debt caused by the interest deduction for tax purposes that exceeds interest expense for financial statement purposes because that difference is subject to recapture. The tax benefit of the excess interest deducted for tax purposes over interest expense recognized for financial statement purposes that is subject to recapture if the debt is settled for cash increases the tax basis of the debt and creates a taxable temporary difference related to the debt. If the debt is settled for cash, that temporary difference will reverse on settlement. If on conversion of the debt instrument, the additional interest expense deduction for tax purposes for which a deferred tax liability is recognized is not recaptured, the deferred tax liability should be reversed with an adjustment to equity (not as a benefit in the income statement) in connection with the conversion of the debt. ASC subparagraph 740-20-45-11(c)

**2.108 Convertible Debt with a Beneficial Conversion Feature.** In addition to the temporary difference which may arise on convertible debt due to the differences in tax basis interest deductions and financial statement interest expense (see Paragraph 2.106) an additional deferred tax liability will arise if there is a beneficial conversion feature. When a conversion feature is issued in-the-money (i.e., the conversion price is less than the current market price of the shares into which the debt converts), ASC Subtopic 470-20 requires that the beneficial conversion feature be separately measured and recorded in additional paid-in capital via allocation of debt proceeds. The value attributed to the beneficial conversion feature recorded in additional paid-in capital is the intrinsic value measured at the commitment date as defined by ASC paragraphs 470-20-30-9 through 30-12. The debt is therefore recognized at a discount and this discount is accreted from the date of issuance to the stated redemption date of the convertible instrument. As discussed in ASC paragraph 740-10-55-51, the tax basis of the debt would be the entire amount of the proceeds received and therefore a temporary difference arises for which a deferred tax liability should be recorded. Like the guidance about debt issued with detachable warrants in Paragraph 2.103, this deferred tax liability should be established initially as an adjustment to additional paid-in capital with subsequent changes recognized as a component of income tax expense. See ASC paragraph 470-20-55-73 for an example illustrating the initial recognition of a deferred tax liability on issuance of a convertible debt instrument within the scope of the Cash Conversion subsections of ASC Subtopic 470-20. See also Paragraphs 9.057 and 9.069 for additional discussion about the intraperiod tax allocation associated with these transactions (including considerations when the entity has an existing valuation allowance). ASC paragraph 740-10-55-51 and subparagraph 740-20-45-11(c)

**2.108a Convertible Debt – ASU 2020-06.** In August 2020, the FASB issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. Among other items, the ASU eliminates the specialized accounting for cash conversion options and beneficial conversion features embedded in convertible debt instruments. The ASU will result in fewer embedded conversion features being separately recognized from the host debt instrument (resulting in the debt being accounted for as a single unit), and therefore fewer temporary differences being identified at initial recognition of those instruments. Under the ASU, separation of a conversion feature from a convertible debt instrument will be required only if the (1) conversion feature is required to be separately accounted for under Topic 815, *Derivatives and Hedging*, based on amended conditions, or (2) convertible debt is issued at a substantial premium. The ASU is effective for public business entities that are SEC filers and are not eligible to be smaller reporting companies for annual and interim periods in fiscal years beginning after December 15, 2021. For all other entities, the ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2023. Early adoption is allowed no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. An entity should adopt the guidance at the beginning of its annual fiscal year.

**2.108b** On adoption of ASU 2020-06, an entity makes adjusting entries to reflect affected instruments as if those instruments were always accounted for as a single unit under the new guidance. As a result, the separated conversion feature and related deferred tax



consequences originally recognized are reversed through a combination of adjusting entries to the liability, retained earnings and other equity components.

**Example 2.11a: Effects of ASU 2020-06 on Convertible Debt Instrument with Cash Conversion Feature**

On January 1, Year 1, ABC Corp., a U.S. corporation, issues a series of 1,000 fixed-rate bonds with a 20-year maturity. The bonds are issued for the aggregate par amount of \$1,000,000 and have a 4% stated interest rate. Cash interest payments are made annually on December 31 and the holder has the option to convert each bond at any time to 20 of ABC’s \$1 par value common shares (representing a conversion price of \$50 per share).

On conversion, ABC may elect to settle by delivering a combination of cash and/or common shares with an aggregate value equal to the current market price of 20 of ABC’s common shares (the conversion value). ABC has a stated policy and past practice of settling the bond principal in cash instead of common shares. The bonds do not contain embedded features other than the conversion option.

The tax basis of the bonds is \$1,000,000 and ABC is entitled to U.S. federal income tax deductions based on cash interest payments. ABC does not receive a tax deduction for the payment of consideration on conversion in excess of the tax basis of the convertible notes, regardless of the form of that consideration (cash or shares). ABC’s income tax rate is 21%. For all years considered, ABC has income from continuing operations and sufficient taxable income to realize the tax benefits arising from its interest deductions.

This example does not reflect debt issuance costs and presumes that ABC issues only annual financial statements.

**Year 1: Recognition and Initial Measurement**

Before the adoption of ASU 2020-06, the liability component under the cash conversion separation model is recorded based on the fair value of a similar liability without the cash conversion option and the remaining proceeds are allocated to the equity component. As a result, ABC records the following pretax journal entry if, at issuance, the fair value of a similar liability that does not have the cash conversion option is \$600,000.

	<b>Debit</b>	<b>Credit</b>
Cash	1,000,000	
Note payable, net		600,000
Additional paid-in capital		400,000

The income taxes consequences of the issuance of the convertible instrument would be reflected by the following entry.

Additional paid-in capital	84,000	
Deferred tax liability		84,000 <sup>1</sup>

<sup>1</sup>  $21\% \times (\$1,000,000 \text{ (tax basis)} - \$600,000 \text{ (financial statement carrying amount)})$ .

Before the adoption of ASU 2020-06, the discount on the liability component arising from allocating proceeds to equity for the cash conversion option is accreted using the effective interest method in ASC Topic 835. At December 31, Year 1, ABC records the following pretax journal entry to reflect the interest on the convertible debt instrument.

	Debit	Credit
Interest expense	48,600	
Cash		40,000 <sup>1</sup>
Note payable, net		8,600 <sup>2</sup>

<sup>1</sup>  $\$1,000,000 \text{ par value} \times 4\% \text{ coupon}$ .

<sup>2</sup> Discount accretion under the effective interest rate method.

The income taxes consequences of the interest on the convertible instrument would be reflected by the following entry.

Income taxes payable	8,400 <sup>1</sup>	
Deferred tax liability	1,800 <sup>2</sup>	
Current tax benefit		8,400
Deferred tax benefit		1,800

<sup>1</sup> Tax effect of current deduction for interest payments:  $\$40,000 \times 21\%$ .

<sup>2</sup> Partial reversal of the deferred tax liability due to accretion of the debt discount:  $\$8,600 \times 21\%$  (rounded).

Selected balance sheet accounts immediately prior to adoption of ASU 2020-06 as of December 31, Year 1 are presented in the following table.

Account	Debit (credit)	Notes
Notes payable, net	(\$608,600)	\$600,000 initial fair value of debt without the cash conversion option, adjusted for the \$8,600 Year 1 accretion
Deferred tax liability	(\$82,200)	Represents the difference between the financial statement carrying amount of \$608,600 and tax basis of \$1,000,000 of $\$391,400 \times 21\%$

### Year 2: Adoption of ASU 2020-06 and subsequent measurement

In Year 2, ABC adopts ASU 2020-06 using the modified retrospective method with a cumulative effect adjustment to the opening balance of retained earnings at January 1, Year 2. ABC records the following pretax journal entry on adoption.

	Debit	Credit
Additional paid-in capital	400,000 <sup>1</sup>	
Retained earnings		8,600 <sup>2</sup>
Notes payable, net		391,400 <sup>3</sup>

<sup>1</sup> Reversal of the proceeds on initial issuance allocated to equity.

<sup>2</sup> Cumulative effect adjustment due to the accretion that was recognized in Year 1 as a component of pretax income from continuing operations that would not have been incurred if the instrument were treated as a single unit from inception.

<sup>3</sup> Adjustment to reflect the financial statement carrying amount of the instrument as if it were accounted for as a single unit from inception.

The income taxes consequences of the adoption of ASU 2020-06 would also be reflected by the following journal entry.

Deferred tax liability	82,200 <sup>1</sup>	
Retained earnings	1,800 <sup>2</sup>	
Additional paid-in capital		84,000 <sup>3</sup>

<sup>1</sup> Reversal of the deferred tax liability as the financial statement carrying amount and tax basis subsequent to adoption are equal at \$1,000,000 resulting in no remaining temporary difference.

<sup>2</sup> Adjusts for deferred tax benefit from the reversal of the deferred tax liability in Year 1 for the tax effect of the accretion that was reflected in pretax income from continuing operations.

<sup>3</sup> Reversal of the deferred tax expense allocated to additional paid-in capital as if the transaction were originally accounted for as a single unit, no deferred tax liability would have been recognized and no amount of income tax expense would have been allocated to additional paid-in capital.

Selected balance sheet accounts immediately following adoption of ASU 2020-06 are presented in the following table.

Account	Debit (credit)	Notes
Notes payable, net	(\$1,000,000)	\$1,000,000 financial statement carrying amount of the convertible debt instrument subsequent to adoption of ASU 2020-06
Deferred tax liability	—	Represents the difference between the financial statement carrying amount of \$1,000,000 and tax basis of \$1,000,000 of zero × 21%

At December 31, Year 2, subsequent to the adoption of ASU 2020-06, ABC records the following pretax journal entry to reflect the interest on the convertible debt instrument.

	Debit	Credit
Interest expense	40,000 <sup>1</sup>	
Cash		40,000

<sup>1</sup> \$1,000,000 par value × 4% coupon.

The income taxes consequences of the activity for the year ended December 31, Year 2 is reflected as part of the following journal entry.

Income taxes payable	8,400 <sup>1</sup>	
Current tax benefit		8,400

<sup>1</sup> \$40,000 of interest expense deductions × 21%.

In years following the adoption of ASU 2020-06, ABC subsequently measures the bonds at amortized cost. Because the convertible debt was issued at par, interest expense is recorded each period based on the debt's stated interest rate and a current tax benefit is recognized for the associated deduction related to the interest payments.

**2.109 Convertible Debt With Call Options.** Some convertible debt offerings are undertaken concurrently with the purchase of call options on the issuer's own stock, and those call options might be combined with the convertible debt for tax purposes to create an original issue discount that will result in tax deductions as the discount is amortized. In that circumstance, the initial tax basis of the convertible debt may be based on the net proceeds from issuing the convertible debt and purchasing the call options. As a result, the initial tax basis of the convertible debt could be more or less than the book basis of the liability component, resulting in either a deductible temporary difference (if the book basis exceeds the tax basis) or a taxable temporary difference (if the tax basis exceeds the book basis). Consistent with Paragraph 2.108, the deferred tax asset related to a deductible temporary difference or the deferred tax liability related to a taxable temporary difference is recognized at issuance as an adjustment to additional paid-in capital.

**2.110 Embedded Derivatives.** When a hybrid instrument requires bifurcation of an embedded derivative for financial statement purposes, deferred taxes should be established related to both the host instrument and the bifurcated embedded derivative. Similar to the previous discussion of beneficial conversion features, bifurcation of an embedded derivative results in the allocation of proceeds into two separate instruments for financial statement purposes (i.e., the host contract and the bifurcated embedded derivative); however, the hybrid instrument remains one instrument for tax purposes. Unlike beneficial conversion features, two temporary differences arise because the

bifurcated embedded derivative is recognized as an asset or liability rather than as an adjustment to equity. Accordingly, deferred taxes would be established for both the host contract and the bifurcated embedded derivative, subject to any tax law restrictions. While those deferred tax balances will be equal and opposite amounts at issuance, the temporary differences will not remain in lock-step because the bifurcated embedded derivative will be marked to fair value on an ongoing basis while the premium or discount on the host contract will be accounted under the applicable GAAP for that host contract (e.g., under the effective interest rate method if the host contract were a debt instrument or a note receivable).

**2.110a** As discussed in Paragraph 2.108a, in August 2020, the FASB issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. Among other items, the ASU amends certain conditions that preclude equity classification of a conversion option under Topic 815, *Derivatives and Hedging*. The ASU will result in fewer embedded conversion features being separately recognized from the host debt instrument, and therefore fewer temporary differences being identified at initial recognition of those instruments.

### Example 2.12: Convertible Note with Separation of a Call Option as a Liability

On January 1, 20X7, ABC Corp. issues a 10-year note that has a \$1,000 par value, accrues interest at an annual rate of 4%, and is convertible into 100 shares.

On the conversion date ABC must settle the accreted value of the note in cash and has the option to settle the conversion spread in either cash or stock. Because ABC does not have a sufficient number of shares available to share-settle the conversion spread, ABC concludes that it must bifurcate the conversion option and account for it separately under ASC Topic 815, *Derivatives and Hedging*.

The conversion option is valued at \$50 on January 1, 20X7 and the discount will accrete on the convertible note at \$5 each year (straight-line accretion is assumed for simplicity). The tax rate for ABC is 21%.

#### Accounting on January 1, 20X7

	Debit	Credit
Cash	1,000	
Discount – convertible note	50	
Deferred tax asset $((\$50 - \$0) \times 21\%)$	10	
Convertible note		1,000
Conversion option liability		50
Deferred tax liability $((\$1,000 - \$950) \times 21\%)$		10

A deferred tax liability will be recorded on the difference between the tax basis of the convertible note of \$1,000 and the carrying amount (net of the discount) of \$950.

A deferred tax asset will also be recorded on the difference between the tax basis of the bifurcated conversion option (i.e., zero) and the carrying amount of \$50.

As of December 31, 20X7 the fair value of the conversion option liability has decreased to \$20 (change in fair value of \$30). Accretion on the note is \$5.

### Accounting on December 31, 20X7

	Debit	Credit
Interest expense – convertible note	5	
Deferred tax expense	5	
Conversion option liability	30	
Deferred tax liability (\$5 × 21%)	1	
Discount – convertible note		5
Other income		30
Deferred tax asset (\$30 × 21%)		6

The deferred tax liability on the convertible note has decreased as the interest accretes on the note. The deferred tax asset on the conversion option has decreased in line with the decrease in its fair value.

#### 2.111 Not used.

**2.112 Temporary Differences Not Pushed Down.** Deferred taxes are recognized on inside basis temporary differences in both the parent entity's consolidated financial statements and the separate financial statements of the subsidiary. However, the amounts of those temporary differences for the subsidiary's assets and liabilities may not be the same in both the consolidated and separate financial statements because business combination accounting adjustments reflected in the consolidated financial statements may not have been *pushed down* to the subsidiary's separate financial statements. Deferred taxes are based on the difference between the financial statement carrying amounts of the subsidiary's assets and liabilities as reflected in the respective financial statements (consolidated or subsidiary's own) and related tax bases. Paragraph 6.117 begins additional discussion of acquisition date adjustments when push down accounting is not used.

**2.113 Statutory Depletion.** Statutory depletion is a calculated tax deduction. Depletion (like depreciation of a fixed asset) allocates the cost of mineral or other extractive-industry deposits over a period of time based on actual extractions. Under certain tax laws, statutory depletion may be calculated based on extractions and not necessarily the cost of the mineral deposit. Over the life of the mineral deposit, the amount of statutory

depletion may exceed the asset's historical cost. Statutory depletion in excess of book depletion that reduces the tax basis of the asset results in a taxable temporary difference for which a deferred tax liability should be recognized. Statutory depletion deductions taken after the tax basis has been reduced to zero are a permanent item when reported on the tax return.

**2.114** Many entities have existing statutory depletion carryforwards that are unused deductions for statutory depletion resulting from annual limitations of use of such carryforwards under the tax law. Deferred tax assets should be recognized for these existing statutory depletion carryforwards, subject to any necessary valuation allowance. (A valuation allowance may be necessary if the statutory depletion deductions typically exceed the limitations.) Deferred tax assets should not be recognized for anticipated future differences between statutory depletion and financial statement depletion expense as these amounts are accounted for as special deductions under ASC Topic 740. See additional discussion of special deductions beginning in Paragraph 3.074 of Section 3. ASC paragraphs 740-10-25-37, 30-13

**2.115 Tax Credits.** A tax credit that an entity earns and uses in the same year does not give rise to a temporary difference; however, a credit that an entity earns that it cannot use or has chosen not to use in the current year results in a deferred tax asset if the credit can be carried forward.

**2.115a R&E Expenditures.** The 2017 Tax Cuts and Jobs Act requires that taxpayers capitalize and amortize specified research and experimental (R&E) expenditures (including software development) that are paid or incurred in tax years beginning after December 31, 2021. R&E expenditures are amortized ratably over a five-year period if the research is conducted in the United States, and over a 15-year period for research conducted outside of the United States. Amortization begins at the midpoint of the tax year in which the specified R&E expenditures are paid or incurred.

**2.115b** The requirement to capitalize and amortize R&E expenditures for tax purposes will affect an entity's current and deferred taxes related to R&E expenditures made after the effective date. If the R&E expenditures relate to a previously acquired asset with a financial statement carrying amount, any amortization, sale or other realization of the asset will not result in a deduction for the capitalized amount, the tax basis is not considered to be part of the temporary difference for the asset. Instead, those expenditures will result in tax basis with no corresponding asset for financial statement purposes. For example, an entity that recognizes a \$100 R&E expenditure as an expense for financial reporting purposes will obtain \$100 tax basis and a \$100 deductible temporary difference. In that case, the tax benefit will be recognized with an increase to deferred tax assets and deferred tax benefit. Entities will need to assess the need for a valuation allowance for that deferred tax asset, along with their other deferred tax assets. ASC paragraph 740-10-25-25

**2.115c** The requirement to capitalize R&E expenditures may also affect an entity's effective tax rate if it has operations outside the United States. This is because the R&E capitalization requirement may affect an entity's reported FDI or GILTI, the tax effects

of which are typically recognized in the period incurred (unless an entity provides deferred taxes for GILTI; see Paragraph 2.037c). The requirement may affect valuation allowance assessments for an entity using the with-and-without approach to evaluate future taxable income because the deductibility of the expenses over time will increase projections of income in the year of the expenditure, and decrease projections of such income in later years (see Paragraph 4.048a).

**2.116 Gain or Loss on Involuntary Conversion.** A gain or loss that results from an involuntary conversion of a nonmonetary asset to monetary assets that an entity does not recognize for income tax reporting purposes in the same period in which it recognizes the gain or loss for financial reporting purposes is a temporary difference for which recognition of deferred taxes is required. ASC paragraph 740-10-55-66

**2.117 Credit Losses.** Recognizing an allowance for credit losses under Topic 326 often creates a book-tax basis difference (see KPMG Handbook, *Investments*, for further discussion). For U.S. federal income tax purposes, except in limited circumstances, there is no deduction for credit losses until there is a write-off of the financial asset balance or an equivalent accounting event. Therefore, generally an allowance for credit losses is recognized before a tax deduction for the credit losses is permitted, resulting in a deductible temporary difference for which a deferred tax asset is recognized. Similarly, for U.S. federal income tax purposes, recovery of an amount previously written off generally does not represent taxable income until it is received. An estimated recovery that reduces the allowance for credit losses likewise reduces the deductible temporary difference associated with the allowance. Topic 326 is expected to generally increase the allowance for credit losses, which will result in an increase in deferred tax assets.

**2.117a** If the adoption of Topic 326 increases the deferred tax assets, the entity may need to reassess its need for a valuation allowance. For example, management may need to consider tax-planning strategies if it can no longer support the realization of the entire asset through future reversals of existing taxable temporary differences, taxable income in carryback years and projections of future taxable income.

**2.117b** Subtopic 326-20 requires an entity to estimate expected credit losses on a collective basis when a financial asset shares similar risk characteristics with other financial assets. This requirement may affect the timing of federal income tax deductions. It is unlikely that an allowance for credit losses established based on a collective assessment will support a tax deduction. Under legacy US GAAP, an entity identifies individual impaired loans when it is probable that it will be unable to collect all amounts due according to an asset's contractual terms. After that individual identification, it estimates credit losses on an individual basis. Collective assessment of credit losses is permitted, but not required, when impaired loans share common risk characteristics. For U.S. federal income tax purposes, when the allowance for loan losses (commonly 'specific reserves') is established on an individual loan basis, under certain circumstances, it can often be used to support a tax deduction even though the financial asset has not yet been written off under the entity's US GAAP write-off policies. We expect that there will be circumstances in which loans that were considered impaired under legacy US GAAP will be individually assessed for credit losses under Subtopic



326-20 because they do not share similar risk characteristics with other financial assets. This may result in an allowance for expected credit losses that is similar to the specific reserves under legacy US GAAP, which may under certain circumstances be used to support some level of tax deduction.

**2.118 AFS Securities.** Subtopic 326-30 requires credit losses to be recognized on an individual AFS debt security through an allowance for credit losses. In addition, when credit losses on an AFS debt security decrease, the Subtopic requires the allowance to be reversed through net income on an individual security basis. If a deferred tax asset has been recognized for an AFS debt security's allowance for credit losses, any subsequent reversals of credit losses recognized under Subtopic 326-30 for that AFS debt security when its expected cash flows or fair value floor increase will result in a need to adjust the deferred tax asset.

**2.118a** An allowance for credit losses on an AFS security may create a deferred tax asset or result in a current tax benefit. The analysis depends on when the allowance for credit losses results in a current tax deduction. For U.S. federal income tax purposes, bad debt deductions are generally evaluated under sections 165(g) and 166 of the Internal Revenue Code, as applicable. These sections generally require a facts and circumstances-based analysis to determine if a debt is wholly, or in some cases, partially worthless. The timing and character of such amounts can vary depending on the taxpayer's facts. Special rules that generally seek to simplify the bad debt analysis may apply for banks under Treasury regulations. Proposed regulations were released in December of 2023 that could adjust these rules (if finalized). The allowance for credit losses would give rise to a deferred tax asset if it is determined to not result in a deduction for income tax purposes in the current period, but would result in a deduction in a future period if recovered at its financial statement carrying amount. The deferred tax asset would then be increased or decreased as the related allowance for credit losses changes. If the allowance for credit losses can substantiate a current tax deduction, there will be no deferred tax asset or related deferred tax benefit; instead, a reduction to income taxes payable and related current tax benefit would generally arise.

### **Example 2.13: Tax implications arising from recognizing credit losses on AFS debt securities**

In Year 1, Bank acquires a \$1,000 par amount AFS debt security for \$1,000. Therefore, the amortized cost basis is \$1,000 for both book and tax purposes.

At the end of Year 1, the fair value has declined to \$900 and Bank determines that the entire decline is due to credit risk and estimates credit losses of \$100.

In Year 2, the fair value has declined further to \$840 and Bank estimates that the credit losses have increased to \$160. Bank therefore recognizes additional credit losses of \$60 through the allowance account.

The security is redeemed for \$840 in Year 3.

The following table summarizes the fact pattern.

	Year 1	Year 2	Year 3
Amortized cost	\$1,000	\$1,000	\$1,000
Fair value	900	840	840
Credit loss	100	160	160

Bank's tax rate is 30%.

This example assumes that Bank does not establish a valuation allowance because it determines that it is more likely than not that it will realize its deferred tax assets in Years 1-3.

**Scenario 1: The allowance for credit losses is not a deduction for income tax purposes until the security is redeemed**

In Year 1, Bank establishes a deferred tax asset of \$30 and records a deferred tax benefit of \$30 as a result of recognizing an allowance for credit losses for book purposes.

	Debit	Credit
Credit loss expense	100	
Allowance for credit losses		100

To record allowance for credit losses.

Deferred tax asset <sup>1</sup>	30	
Deferred tax benefit		30

To record tax effect of allowance for a future deduction based on recovery at the financial statement carrying amount.

Note:

<sup>1</sup> The allowance for credit losses of  $\$100 \times 30\%$  tax rate.

In Year 2, Bank increases the deferred tax asset by \$18 to \$48 and records a deferred tax benefit of \$18 as a result of the increase in the allowance for credit losses for book purposes.

Credit loss expense	60	
Allowance for credit losses		60

To record increase in allowance for credit losses.

	Debit	Credit
Deferred tax asset <sup>1</sup>	18	
Deferred tax benefit		18

To record tax effect of increase in allowance for a future deduction based upon recovery at the financial statement carrying amount.

Note:

<sup>1</sup> The increase in the allowance for credit losses of  $\$60 \times 30\%$  tax rate.

When the security is redeemed for \$840 in Year 3, Bank is allowed a current tax deduction of \$160 and records a current tax benefit of \$48. It also reduces its deferred tax asset by \$48 and records a deferred tax expense of \$48 (resulting in no net tax expense).

Cash	840	
Allowance for credit losses	160	
AFS debt security		1,000

To record redemption of security and write-off of allowance.

Income tax receivable <sup>1</sup>	48	
Current tax benefit		48
Deferred tax expense <sup>2</sup>	48	
Deferred tax asset		48

To record tax effect of loss on redemption and write-off of allowance.

Note:

<sup>1</sup> The redemption loss of  $\$160 \times 30\%$  tax rate.

<sup>2</sup> Written off allowance for credit losses of  $\$160 \times 30\%$  tax rate.

### **Scenario 2: The allowance for credit losses is a deduction for income tax purposes as recognized for financial statement purposes**

In Year 1, Bank takes a current deduction of \$100 and records a current tax benefit of \$30 as a result of the deduction for the establishment of the allowance for credit losses. No deferred taxes are recorded.

Credit loss expense	100	
Allowance for credit losses		100

To record loss allowance for credit losses.

	Debit	Credit
Income tax receivable	30	
Current tax benefit <sup>1</sup>		30
To record tax effect of allowance for which current tax deduction is allowed.		
Note:		
<sup>1</sup> The allowance for credit losses of $\$100 \times 30\%$ tax rate.		
In Year 2, Bank takes a further current deduction of \$60 and records a current tax benefit of \$18 as a result of the reduction for the increase in the allowance for credit losses.		
Credit loss expense	60	
Allowance for credit losses		60
To record increase in allowance for credit losses.		
Income tax receivable <sup>1</sup>	18	
Current tax benefit		18
To record tax effect of increase in allowance for which current tax deduction is allowed.		
Note:		
<sup>1</sup> Increase in the allowance for credit losses of $\$60 \times 30\%$ tax rate.		
In Year 3, Bank does not recognize taxable income or a deduction and does not record any financial statement income tax benefit or deduction. This is because its tax basis equals the redemption amount of the security of \$840.		
Cash	840	
Allowance for credit losses	160	
AFS debt security		1,000
To record redemption of security and write-off of allowance.		

**2.119 PCD Financial Assets.** For purchased financial assets with credit deterioration (PCD assets), the amount of any net book-tax basis difference on the acquisition date will likely be the same under Topic 326. Subsequent to the acquisition date, there will be book-tax basis differences due to differences in the timing and amount of income recognized for book and tax purposes and the timing of tax deductions related to changes to the allowance for credit losses.

**2.119a** For PCD financial assets, Topic 326 requires the acquisition discount – i.e. the difference between the contractual par amount of a financial asset and the purchase price – to be separated into an allowance for credit losses and a non-credit premium or

discount. Therefore, the net carrying amount in the financial statements comprises three elements: the contractual par amount, the allowance for credit losses, and the non-credit premium or discount. However, for tax purposes, when a PCD asset is acquired at a discount in a taxable acquisition, the tax basis in the PCD asset is represented solely by the purchase price – i.e. the allowance for credit losses and the non-credit premium or discount are not recognized for tax purposes. Although the net carrying amount of a PCD asset for financial statement purposes frequently equals the federal tax basis at acquisition in a taxable acquisition, offsetting temporary differences exist at acquisition that relate to the:

- allowance for credit losses;
- non-credit premium or discount recognized for book purposes; and
- difference between the face/contractual amount and the purchase price (tax market discount).

Although these temporary differences initially offset, they should be considered separate temporary differences for scheduling, assessment of character and disclosure in the notes to the financial statements.

**2.119b** Temporary differences can change through subsequent adjustments to the allowance for credit losses for PCD assets. As the allowance for credit losses is subsequently increased or decreased, the related deferred tax asset also changes. The treatment is generally consistent with the deferred tax effects of changes in the allowance for credit losses recognized for purchased credit impaired (PCI) assets under legacy US GAAP.

**2.119c** Temporary differences can change after the acquisition date of a PCD asset due to differences in the timing and amount of income recognized for book and tax purposes. For financial statement purposes, the difference between the purchase price and the cash flows ultimately collected is recognized as income over the life of the PCD asset. This income is recognized as either interest income attributable to the non-credit premium/discount or credit loss expense/recovery attributable to the allowance for credit losses. However, for U.S. federal income tax purposes, the entire difference between the face/contractual par amount of the asset and its acquisition price (the tax market discount) is generally recognized as taxable income over the life of the PCD asset as principal payments are received. When the PCD asset is sold, matures, or is otherwise settled or disposed of, the difference between the tax basis of the asset (i.e. the initial tax basis of the loans plus the taxable interest income recognized) and the cumulative amounts collected is generally recognized as an adjustment to taxable income. If the entity ultimately collects less than the contractual amounts due, the maturity of a PCD asset often results in a bad debt deduction under IRC Section 166. The deduction arises because the acquisition price plus the accretion of the tax market discount typically exceeds the cumulative amounts collected from the borrower. These temporary differences in the timing and amount of income recognition arise in a similar manner under legacy US GAAP. However, once an entity establishes a Day 1 allowance for credit losses for financial statement purposes, it will also need to consider the timing of

the write-off of that allowance and any remaining amortized cost of the PCD assets when recognizing the bad debt deduction under section 166.

### Example 2.14: Temporary Differences for PCD Assets

Bank acquires a portfolio of PCD loans for \$600,000 that have the following characteristics at the end of Year 1 of their five-year life.

Term	Five years
Amortizable?	Yes
Prepayable?	No
Initial par amount:	\$1,000,000
Coupon:	5%
Annual payments (contractual):	\$230,975

After using a discounted cash flow method to determine the Day 1 allowance for credit losses, Bank records the following journal entry on the acquisition date.

	Debit	Credit
Loans	819,025	
Cash		600,000
Allowance for credit losses		165,464
Loans – non-credit discount		53,561

To record acquisition of PCD loans, estimate of expected credit losses and non-credit discount.

Bank will subsequently recognize interest income for book purposes at the EIR of 7.97% (rounded) used to discount the expected credit losses.

The temporary differences are determined on the acquisition date as follows.

Item	Financial statement basis DR/(CR)	Tax basis	Temporary deductible/ (taxable) difference
Loans	\$ 819,025	\$600,000	\$(219,025)
Allowance for credit losses	(165,464)	0	165,464
Loans – non-credit discount	<u>(53,561)</u>	<u>0</u>	<u>53,561</u>
Total	\$ 600,000	\$600,000	\$ 0

The following summarizes the activity for financial statement purposes in Years 2–5.

Year	Cash payments received (actual)	Ending tax basis – loan balance <sup>1</sup>	Ending allowance for credit losses	Ending non-credit discount balance
2	\$230,975	\$629,001	\$178,658	\$33,476
3	161,682	429,476	123,611	17,440
4	161,682	219,975	64,175	6,059
5	<u>161,681</u>	0	0	0
Total	\$716,020			

Note:

<sup>1</sup> Equals the ending loan balance based on contractual amortization, after the effect of the cash payments received and amounts written off.

The following summarizes the activity for tax purposes in Years 2–5.

Year	Cash payments received (actual)	Ending tax basis – loan balance <sup>1</sup>	Tax deduction for write-off <sup>2</sup>	Taxable income recognized <sup>3</sup>
2	\$230,975	\$487,933	\$ 0	\$118,908
3	161,682	422,950	0	96,699
4	161,682	334,349	0	73,081
5	<u>161,681</u>	0	217,007	44,339
Total	\$716,020			

Notes:

<sup>1</sup> The ending tax basis loan balance includes the application of borrower payments and accrued interest income.

<sup>2</sup> At the end of Year 5, management concludes that the remaining loan balances are worthless and the entity is entitled to a bad debt deduction under section 166. The deduction equals Bank's remaining tax basis in the loans; this is the difference between the cumulative amounts recognized for tax purposes (the initial tax basis of the loans plus the taxable income recognized) and the cumulative amounts collected from the borrowers.

<sup>3</sup> Amounts include both the contractual stated interest on the loans – assuming no principal write-offs – and recognition of the entire difference between the face value of the loans and the acquisition price (the tax market discount). This example assumes that the discount for each loan in the pool is (1) a tax market discount and (2) Bank has made the election under section 1276(b)(2) to accrue the tax market discount for each loan in the pool using constant yield principles.

The following summarizes the amortization of the tax market discount in Years 2–5.

Year	Beginning tax market discount <sup>1</sup>	Recognition of tax market discount as income <sup>2</sup>	Ending tax market discount
2	\$219,025	\$ 77,957	\$141,068
3	141,068	65,249	75,819
4	75,819	48,614	27,205
5	27,205	<u>27,205</u>	0
Total		<u>\$219,025</u>	

Notes:

<sup>1</sup> The Day 1 tax market discount represents the difference between the purchase price and the outstanding principal balance on the acquisition date. This example assumes that the tax discount for each loan in the pool is (1) a tax market discount and (2) ABC has made the election under section 1276(b)(2) to accrue the tax market discount for each loan in the pool using constant yield principles.

<sup>2</sup> Income recognition is based on the loans' contractual amortization.

The following summarizes the cumulative income recognized for book and tax purposes.

Year	<u>Financial statement basis</u>		<u>Tax basis</u>		Change in temporary differences
	Interest income <sup>1</sup>	Credit loss expense <sup>2</sup>	Interest income <sup>3</sup>	Tax deduction <sup>4</sup>	
2	\$ 61,036	\$13,194	\$118,908	\$ 0	\$ 71,066
3	47,486	14,246	96,699	0	63,459
4	32,855	9,857	73,081	0	50,083
5	<u>17,058</u>	<u>5,118</u>	<u>44,339</u>	<u>217,007</u>	<u>(184,608)</u>
Cumulative	\$158,435	\$42,415	\$333,027	\$217,007	\$ 0

Notes:

<sup>1</sup> Represents interest income at the loans' EIR.

<sup>2</sup> Represents the change in the present value of expected credit losses due to the passage of time.

<sup>3</sup> Amounts include both the contractual interest on the loans – assuming no principal write-offs – and recognition of the entire difference between the face value of the loans and the acquisition price (the tax market discount).

<sup>4</sup> At the end of Year 5, management concludes that the remaining loan balances are worthless and Bank is entitled to a bad debt deduction under IRC Section 166. The deduction equals Bank's remaining tax basis in the loans; this is the difference between the cumulative amounts recognized for tax purposes (the initial tax basis of the loans plus the taxable interest income recognized) and the cumulative amounts collected from the borrowers.



The following summarizes the temporary differences in Years 2–5.

<b>Loans</b>	<b>Financial statement carrying amount DR/(CR)</b>	<b>Tax basis</b>	<b>Temporary deductible/ (taxable) difference</b>
Acquisition date (Year 1)	\$819,025	\$600,000	\$(219,025)
2	629,001	487,933	(141,068)
3	429,476	422,950	(6,526)
4	219,975	334,349	114,374
5	0	0	0

<b>Allowance for credit losses</b>	<b>Financial statement carrying amount DR/(CR)</b>	<b>Tax basis</b>	<b>Temporary deductible/ (taxable) difference</b>
Acquisition date (Year 1)	\$(165,464)	\$ 0	\$165,464
2	(178,658)	0	178,658
3	(123,611)	0	123,611
4	(64,175)	0	64,175
5	0	0	0

<b>Allowance for credit losses</b>	<b>Financial statement carrying amount DR/(CR)</b>	<b>Tax basis</b>	<b>Temporary deductible/ (taxable) difference</b>
Acquisition date (Year 1)	\$(53,561)	\$ 0	\$53,561
2	(33,476)	0	33,476
3	(17,440)	0	17,440
4	(6,059)	0	6,059
5	0	0	0

Total temporary differences related to PCD loans	Total financial statement carrying amount	Total tax basis	Total of temporary deductible/ (taxable) differences	Change in temporary differences
Acquisition date (Year 1)	\$600,000	\$600,000	\$ 0	\$ 0
Year 2	416,867	487,933	71,066	71,066
Year 3	288,425	422,950	134,525	63,459
Year 4	149,741	334,349	184,608	50,083
Year 5	0	0	0	(184,608)

**2.119d** Not all PCD assets have a ‘market discount’ that subjects them to the tax treatment for assets acquired at a discount. Under Subtopic 326-20, it is possible that financial assets purchased at a premium could include a more-than-insignificant discount for deterioration in credit quality since origination and be accounted for as PCD assets. Similarly, under Subtopic 326-30, it is possible that an AFS debt security purchased at a premium could have indicators of credit losses and be accounted for as a PCD asset. PCD assets purchased at a premium are not subject to the same tax treatment as assets acquired at a discount. For U.S. federal income tax purposes, when a financial asset is acquired at a discount, the discount is generally taken into taxable income as payments are received. When the asset is sold, matures or is otherwise settled or disposed of, the difference between the tax basis of the asset (i.e. the initial tax basis of the loans plus the taxable interest income recognized) and the cumulative amounts collected is generally recognized as an adjustment to taxable income. If the entity ultimately collects less than the contractual amounts due, the maturity of a PCD asset often results in a bad debt deduction under section 166. The deduction arises because the acquisition price plus the accretion of the tax market discount typically exceeds the cumulative amounts collected from the borrower. PCI financial assets under legacy US GAAP generally qualify for this tax treatment because they typically are not considered PCI assets under Subtopic 310-30 unless they are purchased at a discount.

## ENDNOTES

<sup>1</sup> In August 2020, the FASB issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity*. Among other items, the ASU eliminates the accounting for beneficial conversion features embedded in convertible debt instruments. The ASU will result in fewer embedded conversion features being separately recognized from the host debt instrument, and therefore fewer temporary differences being identified at initial recognition of those instruments. Under the ASU, separation of a conversion feature from a convertible debt instrument will be required only if (1) the conversion feature is required to be separately accounted for under ASC Topic 815, *Derivatives and Hedging*, based on amended conditions, or (2) the convertible debt is issued at a substantial premium. The ASU is effective for public business entities that are SEC filers and are not eligible to be smaller reporting companies for annual and interim periods in fiscal years beginning after December 15, 2021. For all other

entities, the ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2023. Early adoption is allowed no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. An entity should adopt the guidance at the beginning of its fiscal year.

<sup>2</sup> In August 2020, the FASB issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. Among other items, the ASU eliminates the accounting for beneficial conversion features embedded in convertible debt instruments. The ASU will result in fewer embedded conversion features being separately recognized from the host debt instrument, and therefore fewer temporary differences being identified at initial recognition of those instruments. Under the ASU, separation of a conversion feature from a convertible debt instrument will be required only if (1) the conversion feature is required to be separately accounted for under ASC Topic 815, *Derivatives and Hedging*, based on amended conditions, or (2) the convertible debt is issued at a substantial premium. The ASU is effective for public business entities that are SEC filers and are not eligible to be smaller reporting companies for annual and interim periods in fiscal years beginning after December 15, 2021. For all other entities, the ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2023. Early adoption is allowed no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. An entity should adopt the guidance at the beginning of its fiscal year.

## Section 3 - Tax Calculation

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**3.000** This section explains how to calculate, recognize, and measure total income tax expense, as well as current tax payable or refundable, and deferred tax assets and liabilities. Unless otherwise stated, the section's examples are based on the provisions of U.S. federal tax law. The effects of graduated tax rates, alternative minimum taxes, and taxes in other tax jurisdictions are addressed separately within this section.

## **BASIC PRINCIPLES FOR CALCULATING TOTAL INCOME TAX EXPENSE**

**3.001** ASC Topic 740, *Income Taxes*, requires the reporting entity to recognize (a) taxes payable or refundable for current year taxable income or loss, and (b) deferred tax assets and liabilities for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns (e.g., temporary differences and carryforwards – see Section 2, *Temporary Differences*). ASC paragraph 740-10-25-6 (from FIN 48) requires that the tax effects of a position be recognized only if the position is *more likely than not* to be sustained based on its technical merits. The benefit recognized for a tax position meeting the more-likely-than-not criterion is measured based on the largest amount of tax benefit that is greater than 50% likely to be realized upon settlement with the taxing authority. ASC paragraph 740-10-30-7

**3.002** *Current tax expense or benefit* is the amount of income taxes payable or receivable for the current year as determined by applying the provisions of the tax law to taxable income or loss for the year. *Deferred tax expense or benefit* generally represents the change in the sum of the deferred tax assets, net of any valuation allowance (see Section 4, *Valuation of Deferred Tax Assets*), and deferred tax liabilities during the year. *Total income tax expense* is the sum of current tax expense or benefit and deferred tax expense or benefit. Total tax expense, both current and deferred, generally should be calculated for each tax-paying component of the entity in each tax jurisdiction. ASC paragraphs 740-10-10-1 and 10-2, 30-3

$$\text{Total tax expense} = \text{current tax expense (benefit)} + \text{deferred tax expense (benefit)}$$

**3.003** The *applicable enacted tax rate* for current taxes is the tax rate dictated by the provisions of the tax law for the current year. The applicable enacted tax rate for deferred taxes is the rate under current enacted tax law that would apply when the temporary differences are expected to reverse. The effects of future changes to currently enacted tax rates are not anticipated in the measurement of deferred tax assets and liabilities. ASC paragraphs 740-10-30-2, 30-8 through 30-9

**3.004** Income tax expense or benefit for the year is allocated among continuing operations, discontinued operations, other comprehensive income, and items charged or credited directly to shareholders' equity. Intraproduct tax allocation is discussed in detail in Section 9, *Financial Statement Presentation and Disclosure*. ASC paragraph 740-20-45-2

**3.005** The following procedures should be performed when calculating total income tax expense or benefit for each tax-paying component in each tax jurisdiction.

- (1) Compute current tax expense or benefit for the estimated amount of income taxes due or refundable for the current year under the provisions of the tax law and recognize a current tax payable or refundable for amounts not yet paid or received. ASC paragraph 740-10-30-2
- (2) Identify and accumulate all temporary differences that exist as of the balance sheet date. Separate the taxable temporary differences (temporary differences that will result in taxable amounts in future years) from the deductible temporary differences (temporary differences that will result in deductible amounts in future years). ASC subparagraph 740-10-30-5(a)
- (3) Identify operating loss and tax credit carryforwards for tax purposes, including the nature and amount of each type of carryforward and its remaining carryforward period. ASC subparagraph 740-10-30-5(a)
- (4) Recognize deferred tax liabilities for taxable temporary differences based on the applicable enacted tax rate that would apply when those temporary differences are expected to reverse. ASC subparagraph 740-10-30-5(b)
- (5) Recognize deferred tax assets for deductible temporary differences and loss and tax credit carryforwards based on the applicable enacted tax rate that would apply when those differences are expected to reverse or when those carryforwards are expected to be used. ASC subparagraphs 740-10-30-5(c) and (d)
- (6) Evaluate whether a valuation allowance should be recognized related to any of the deferred tax assets. A valuation allowance is recognized to reduce a deferred tax asset if, based on the evaluation of all available evidence, it is more likely than not that all (or some portion of) the deferred tax asset will not be realized. ASC subparagraph 740-10-30-5(e)
- (7) Calculate the change in deferred taxes as the difference between the sum of the deferred tax assets, valuation allowances, and deferred tax liabilities as of the beginning and end of the year (excluding the effect of deferred tax assets and liabilities initially recognized in business combinations). Add the change in deferred taxes to the current tax expense or benefit to arrive at total tax expense or benefit. Allocate total income tax expense or benefit to: continuing operations, discontinued operations, other comprehensive income, and items charged or credited directly to shareholders' equity. Intraproduct tax allocation is discussed in detail in Section 9. ASC paragraph 740-20-45-2

In performing the steps above, an entity should include the current and deferred tax effects of its tax positions in the financial statements only when it is more likely than not (likelihood of greater than 50%) that the taxing authorities will sustain such positions based on the technical merits of those positions. The entity should base the measurement of the tax effects of positions that pass that recognition threshold on the largest amount, considering possible settlement outcomes, that is greater than 50% likely of realization upon settlement with the taxing authorities. See Paragraph 3.015 for additional discussion.

**Example 3.1: Tax Calculation**

Assumptions:

- 20X6 is ABC Corp.'s first year of operation.
- ABC had pretax financial reporting income of \$25,000 in 20X6 and taxable income of \$25,500. The difference between financial reporting income and taxable income is due to additional depreciation for tax purposes of \$1,500, an accrued warranty liability for financial reporting of \$4,500, and deferred profit for tax purposes of \$2,500.
- ABC is subject to U.S. federal income taxes but is not subject to state or local income taxes and does not operate in any foreign tax jurisdictions.
- The applicable enacted tax rate for 20X6, and all future years, is 21% and ABC has made no estimated tax payments during 20X6.

The following is a comparison of ABC's balance sheet for financial reporting purposes and tax purposes as of December 31, 20X6 before recognition of the 20X6 income tax expense.

	Book Value	Tax Basis	(Taxable) Deductible Temporary Difference
Cash	\$ 4,000	\$ 4,000	—
Accounts receivable	6,000	6,000	—
Inventory	10,000	10,000	—
Fixed assets	30,000	28,500	(1,500)
Total assets	<u>\$ 50,000</u>	<u>\$ 48,500</u>	
Accounts payable	\$ 10,000	\$ 10,000	—
Accrued warranty liability	4,500	—	4,500
Deferred profit	—	2,500	(2,500)
Total liabilities	<u>14,500</u>	<u>12,500</u>	
Equity	<u>35,500</u>	<u>36,000</u>	
Total liabilities and equity	<u>\$ 50,000</u>	<u>\$ 48,500</u>	

**Step 1—Compute Current Tax Expense:**

Current tax expense for 20X6 and income taxes payable as of December 31, 20X6 would be calculated as follows:

Pretax financial reporting income	\$	25,000
Additional depreciation for tax purposes		(1,500)
Increase in accrued warranty liability		4,500
Deferred profit for tax purposes		<u>(2,500)</u>
Taxable income	\$	25,500
Tax rate		<u>21%</u>
Current tax expense and income taxes payable	\$	<u><u>5,355</u></u>

**Step 2—Identify Temporary Differences:**

As indicated in the comparison of the balance sheets for financial reporting and tax purposes, ABC has the following temporary differences at December 31, 20X6:

Taxable temporary differences:		
Depreciable assets	\$	(1,500)
Deferred profit for tax purposes		<u>(2,500)</u>
Total taxable temporary differences	\$	<u><u>(4,000)</u></u>
Deductible temporary differences – warranty liability		
	\$	<u><u>4,500</u></u>

**Step 3—Identify Carryforwards for Tax Purposes:**

ABC has no operating loss or tax credit carryforwards as of December 31, 20X6.

**Step 4—Recognize Deferred Tax Liabilities:**

ABC would recognize total deferred tax liabilities of \$840 for the \$4,000 of taxable temporary differences based on the enacted rate of 21%.

**Step 5—Recognize Deferred Tax Asset:**

ABC would recognize a deferred tax asset of \$945 for the \$4,500 deductible temporary difference based on the enacted rate of 21%.

**Step 6—Reduce Deferred Tax Assets by a Valuation Allowance (to the Amount That Is More Likely Than Not to Be Realized):**

ABC would recognize a valuation allowance on the deferred tax asset of up to \$945 if it is more likely than not that all or some portion of the deferred tax asset will not be realized. In this example, it is assumed a valuation allowance is not necessary.



**Step 7--Calculate Total Income Tax Expense:**

ABC has a deferred tax benefit of \$105, which represents the change in the sum of the deferred tax assets, valuation allowances, and deferred tax liabilities from the beginning of the year (zero) to the end of the year (\$105).

Total income tax expense for the year is \$5,250 (current tax expense of \$5,355 less deferred tax benefit of \$105).

ABC would record the following gross entries (without regard to balance sheet netting - see Section 9 for additional discussion of balance sheet presentation) to recognize income taxes payable and deferred tax assets and liabilities as of December 31, 20X6:

	<b>Debit</b>	<b>Credit</b>
Current tax expense	5,355	
Income taxes payable		5,355
Deferred tax asset	945	
Deferred tax benefit		105
Deferred tax liabilities		840

**3.006 Tax Calculation by Jurisdiction.** An entity should generally perform separate calculations of current and deferred tax expense for each of its tax-paying components in each tax jurisdiction (federal, state, local, and foreign). Current tax expense is income taxes payable as calculated based on the provisions of the tax law in each jurisdiction. To calculate deferred tax expense, an entity should separately identify changes in deferred tax assets and liabilities for each tax jurisdiction in which they operate. ASC paragraph 740-10-30-5

**3.007** An entity should identify all temporary differences for all tax jurisdictions to determine total tax expense; however, a calculation that combines multiple tax jurisdictions, such as a single calculation for multiple states or a combined federal and state calculation, may be acceptable if the combined calculation approximates the tax expense and deferred tax assets and liabilities that would result from separate calculations for each tax jurisdiction. When assessing whether a separate calculation is necessary for a particular tax jurisdiction, the entity should consider differences in tax rates, loss carryback and carryforward periods, temporary differences, and other provisions of the tax law in those tax jurisdictions. Significant differences in law generally will require separate income tax calculations. See Paragraph 2.012 for additional discussion. ASC paragraph 740-10-55-25

**3.008** If tax calculations are combined for different tax jurisdictions, the interaction between the jurisdictions should be considered in determining the appropriate tax rate to use. For example, because state income taxes are deductible for U.S. federal tax purposes, a deferred state tax asset or liability represents a temporary difference for U.S. federal tax purposes. If the calculations of U.S. federal and state deferred taxes are combined, the

effect of the state deferred taxes on the U.S. federal deferred taxes should be considered. ASC paragraph 740-10-55-20

**3.009** The applicable combined tax rate for an aggregate calculation of U.S. federal and state and local jurisdictions is (1) the U.S. federal statutory rate, (2) plus the enacted state and local tax rates, (3) less the U.S. federal tax effect of the deductibility of state and local taxes at the applicable U.S. statutory rate. For instance, the appropriate tax rate to use for an aggregate calculation assuming a U.S. federal statutory rate of 21% and an enacted state rate of 10% is 28.9% [ $21\% + 10\% - (10\% \times 21\%)$ ].

**3.010** Required financial statement presentation and disclosures should also be considered when determining whether to combine the tax calculations for separate jurisdictions. For example, ASC Topic 740 does not allow offsetting of deferred tax assets and liabilities in different tax jurisdictions or related to different tax-paying components of an entity. Also, Regulation S-X requires entities to disclose amounts applicable to U.S. federal income taxes, foreign income taxes, and other income taxes. Accordingly, financial statement disclosure of federal, state, local, or foreign income tax may require separate tax calculations for purposes of presentations and disclosures. ASC paragraph 740-10-45-6

**3.011** Given the significant differences between U.S. tax laws and those of foreign jurisdictions and the prohibition on offsetting deferred tax assets and liabilities of different jurisdictions, separate calculations generally will be necessary for foreign jurisdictions. ASC paragraph 740-10-45-6

**3.012 Consolidated Tax Returns.** Current and deferred tax expense for a group that files a consolidated tax return (or other form of combined or group filing) should be allocated among the members of the group for purposes of their separate financial statements (intercorporate tax allocation) using a method that is systematic, rational, and consistent with the broad principles of ASC Topic 740. However, an entity is not required to allocate consolidated income taxes to a legal entity that is not subject to tax for purposes of that legal entity's separate financial statements, but an entity can elect to allocate consolidated income taxes to a legal entity if it is not subject to income tax and is disregarded by the taxing authority. The election is not available to legal entities that are partnerships or other pass-through entities that are not wholly owned. The election can be made on an entity-by-entity basis. ASC paragraph 740-10-30-27

**3.012a** Intercorporate tax allocations generally are calculated using the separate return method, the pro rata method, or the benefits for losses method. In some cases, the separate return method is modified so that the subsidiary recognizes tax attributes that are realizable by the consolidated group (e.g., for net operating loss carryforwards) even if those attributes would not be realizable by the subsidiary on its own. This method is sometimes referred to as the *benefits for losses* method. See the discussion beginning in Paragraph 10.043 related to intercorporate tax allocation. ASC paragraph 740-10-30-27

**3.013 Separate Subsidiary Tax Returns.** A subsidiary that files a separate tax return is a separate tax-paying component from its parent and should determine income tax expense

based on the separate tax return filed for that subsidiary. In addition, ASC Topic 740 does not allow offsetting of deferred tax assets and liabilities related to different tax-paying components of the entity. Therefore, a parent entity with a subsidiary that files a separate return should not offset its deferred taxes and liabilities against those of the subsidiary.

**3.014 Different Financial Reporting and Tax Year-Ends.** When different year-ends are used for financial reporting and tax purposes, current and deferred taxes should be calculated as of the financial reporting year-end, as if it were the tax year-end. Accordingly, the tax bases of assets and liabilities as of the financial reporting year-end should be estimated to identify and quantify temporary differences and calculate the related deferred taxes. Income taxes payable and carryforwards should be estimated by considering the amount of taxable income that would be generated during a hypothetical short period from the end of the last tax year through the end of the financial reporting year.

**3.014a Accruing GILTI for a Fiscal Year-end CFC.** As discussed beginning in Paragraph 2.037b, a U.S. shareholder of a controlled foreign corporation (CFC) must include in taxable income its GILTI but also may be eligible to deduct a portion of its GILTI and apply a limited deemed paid credit for foreign income taxes incurred by its CFCs. A U.S. shareholder includes GILTI in its U.S. federal tax return in the tax year that includes the last day of the foreign corporation's U.S. federal tax year. For example, a U.S. parent with a December 31, 2020 tax year-end that has an investment in a November 30 tax year-end CFC would include the CFC's GILTI from December 1, 2019 to November 30, 2020 in its 2020 tax return.

**3.014b** We believe that if (a) a U.S. parent elects to account for taxes on GILTI as a period cost, (b) the CFC has a calendar year-end for financial reporting purposes and a non-calendar fiscal year-end for U.S. federal tax purposes, and (c) the U.S. parent expects a portion of the CFC's calendar-year financial reporting income to result in a GILTI inclusion in the parent's next tax year, the U.S. parent should accrue an estimate of the related tax for that calendar year at the balance sheet date. We believe the U.S. parent would classify the accrual as income taxes payable. We believe a similar approach would apply anytime the CFC has a different year-end for financial reporting purposes than it uses for U.S. federal income taxes.

**3.014c** For example, a U.S. parent with a December 31, 2020 financial reporting and federal tax year-end that has an investment in a CFC with a December 31, 2020 financial reporting year-end and a November 30 U.S. federal tax year-end would include in its 2020 income tax expense an estimate of the expected GILTI tax for that CFC based on tested income earned for the period from January 1 to December 31, 2020, if any, even though the U.S. parent will not include in its 2020 tax return the CFC's tested income for that period. The estimate of GILTI tax expense for calendar year 2020 would include an estimate for December 1, 2020 to December 31, 2020 as if a separate tax return were filed for that period, in addition to an expense for the period from January 1, 2020 to November 30, 2020. The U.S. parent's income taxes payable as of December 31, 2020 also would include the expected GILTI tax for that CFC based on tested income earned

for the period from December 1, 2019 to December 31, 2019, but those amounts would have been previously expensed in the U.S. parent's 2019 financial statements.

**3.014d** When estimating the expected GILTI tax for the CFC, we believe the U.S. parent also would estimate the effect of foreign tax credits. If the CFC has a calendar year-end for foreign tax purposes, those estimated foreign tax credits (subject to the 80% and other limitations as applicable under operation of tax law) may result in the generation of a tax credit in December, but the credit may only be utilized to the extent of the expected tax on GILTI. Under this approach, we believe that the U.S. parent should evaluate the ability to use foreign tax credits based only on the attributes arising from the CFC's activity for the applicable financial reporting period. For example, a U.S. parent that includes in its 2020 income tax expense its taxes on GILTI for the period from January 1 to December 31, 2020 would separately consider tax credits generated in the period through November 30, 2020 from credits generated during December 2020 when computing the expense, but would not consider attributes, including expense allocation, that it expects to generate during 2021 and report on its 2021 tax return. There may be other acceptable approaches.

### **Example 3.1a: Accruing GILTI for a CFC with a Fiscal Tax Year-end**

U.S. Parent has an investment in a CFC that was formed during 20X0. U.S. Parent has a December 31, 20X0 U.S. federal tax year-end and CFC has a November 30 U.S. federal tax year-end and a calendar year-end for local (foreign) tax purposes. All entities in the group have a December year-end for U.S. GAAP reporting and U.S. Parent has elected to account for GILTI as a period cost.

CFC has \$1,000 of income from formation through November 30 and has \$200 of income in December with no net deemed tangible return. CFC accrues \$240 of local income taxes on December 31. The enacted U.S. federal tax rate is 21%.

As discussed in Paragraph 3.014c, U.S. Parent accrues an estimate of income taxes for its entire 20X0 calendar tax year. As a result, it recognizes (before considering foreign tax credits):

- \$105  $((\$1,000 - \$500 \text{ section } 250(a) \text{ deduction}) \times 21\%)$  of GILTI for the period from CFC's formation through November 30, and
- \$21  $((\$200 - \$100 \text{ section } 250(a) \text{ deduction}) \times 21\%)$  of GILTI for December.

As discussed in Paragraph 3.014d, U.S. Parent also estimates the effects of foreign tax credits. In this case, U.S. Parent computes \$192  $(\$240 \times 80\%)$  of possible foreign tax credits that will arise in December as a result of the \$240 of foreign taxes accrued. Because those foreign tax credits arise in December and will not be included in U.S. Parent's 20X0 tax return, they are not eligible to offset tax on GILTI incurred through November 30, 20X0. However, U.S. Parent would be able to use those credits to offset

the \$21 of preliminary taxes on GILTI estimated for December 20X0 and therefore recognizes zero net tax on GILTI for that month.

When estimating tax on GILTI for December 20X0, U.S. Parent does not consider other attributes that it expects to generate during 20X1 and report on its 20X1 tax return.

## ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

**3.015** Current tax expense as well as deferred tax assets and liabilities are recognized and measured based on the provisions of the tax law for the relevant tax jurisdiction. While an entity may have a high degree of confidence that a tax position will be sustained for some positions, it may have a lower degree of confidence with respect to other positions where the tax law is subject to varied interpretation. An entity should include the current and deferred tax effects of its tax positions in the financial statements only when it is more likely than not (likelihood of greater than 50%) that the taxing authorities will sustain the positions based on their technical merits. The entity should base the measurement of the tax effects of positions that meet that recognition threshold on the largest amount, considering possible settlement outcomes, that is greater than 50% likely of realization upon settlement with the taxing authorities. ASC paragraphs 740-10-25-6, 30-7

**3.016** Tax positions include a reduction in taxable income reported in a previously filed tax return or expected to be reported on a future tax return that affects the measurement of current taxes payable and/or deferred tax assets or liabilities in the period being reported. Accordingly, tax positions are not limited to items reported separately in the tax return as deductions or credits but also include the decision not to report a transaction in a tax return, decisions that affect the tax bases of assets or liabilities, the allocation of income between jurisdictions, the characterization of income from a transaction (e.g., capital versus ordinary), the consideration of tax-planning strategies to support the realizability of deferred tax assets, and an assertion that an entity is not subject to taxation. Examples of common tax positions that may involve uncertainty include:

- A deduction taken on the tax return for a current expenditure that the taxing authority may assert should be capitalized and amortized over future periods;
- The acceleration of a deduction that otherwise would be available in a later period;
- A decision that certain income is nontaxable under the tax law;
- The determination of the amount of deductions/taxable income to report on intra-entity transfers between entities in different tax jurisdictions;
- The calculation of the amount of a research and experimentation benefit;
- The determination as to whether a spin-off transaction is taxable or nontaxable;
- The determination as to whether an entity qualifies as a real estate investment trust or regulated investment company;

- The determination as to whether an entity is subject to tax in a particular jurisdiction; and
- For a tax-exempt entity, the determination and allocation of unrelated business income.

**3.017 A Practical Approach to Evaluating Uncertainty in Income Taxes.** The procedures described below provide a practical approach that may be useful for evaluating tax positions under ASC Subtopic 740-10, *Income Taxes - Overall* (the guidance from FIN 48 is incorporated primarily in ASC Subtopic 740-10).

Step 1: Identify tax positions.

An entity should begin by accumulating an inventory of tax positions that may include uncertainties. The inventory process may involve establishing a *screen* to scope the population of positions for which sustainability under the tax law is uncertain (see Step 3 below) or for which measurement may be less than 100% of the benefit claimed. Tax positions should be identified on an individual tax jurisdiction basis and include positions for which benefits relate to open tax years. An entity will need to consider in its population of positions the conclusion that it is not subject to tax in a particular jurisdiction where it could possibly be considered to have nexus. During this phase an entity might:

- Review current documentation of income tax positions with uncertainty;
- Review open tax returns (on a jurisdiction by jurisdiction basis) as well as supporting documentation used to prepare and support those tax returns;
- Consider information obtained from and results of tax examinations (e.g., Revenue Agent Reports, Form 870-AD);
- Determine whether tax returns have been filed in appropriate jurisdictions;
- Review existing schedules of permanent and temporary differences;
- Consider intra-entity transactions that shift income among tax jurisdictions or transactions with shareholders or others that have been deemed nontaxable;
- Consider tax-planning strategies that have been considered to support realization of deferred tax assets; and
- Consider changes in circumstances that have occurred since the prior period's evaluation of tax uncertainties, including tax examination, court rulings, new rulings, and other information from tax authorities.

Many tax positions taken in returns represent highly certain positions where little doubt exists that the full benefit of the tax position will be sustained. As discussed in Step 3 below, we do not believe extensive analysis is necessary to support recognition and measurement of positions that are supported by clear and unambiguous tax law. ASC Subtopic 740-10 (FIN 48) does not impose specific documentation requirements and does not address how to identify the population

of positions that should be evaluated using the ASC Subtopic 740-10 requirements. The population of positions to be evaluated using the ASC Subtopic 740-10 requirements should include positions where there is uncertainty about the recognition threshold and positions where, even if the recognition threshold is clearly met, the measurement may be at less than 100% of the benefit reflected or to be reflected on the tax return. Because the recognition and measurement steps in applying ASC Subtopic 740-10 include significant judgment, including judgments in the measurement step about management's intent related to potential settlement of tax positions, there is no standard threshold that applies to all entities on identification of positions to evaluate under ASC Subtopic 740-10. Accordingly, entities should develop their processes and controls to identify tax positions to be evaluated under ASC Subtopic 740-10 based on their specific circumstances.

Step 2: Determine the appropriate unit of account.

The unit of account used to identify an individual tax position is a matter of judgment that should consider the manner in which an entity prepares and supports its income tax returns and the approach expected to be taken by the taxing authority during an examination. An entity should identify the same unit of account to conclude on both recognition (Step 3) and measurement (Step 4). See Paragraph 3.018 for additional discussion of unit of account.

Step 3: Determine if tax positions meet the recognition threshold.

ASC Subtopic 740-10 (FIN 48) requires that the tax effects of a position be recognized only if it is more likely than not to be sustained based on its technical merits and facts and circumstances as of the reporting date. In performing this evaluation tax positions may be grouped into the following three categories:

- (a) Highly certain positions – For positions that clearly meet the recognition threshold by way of unambiguous tax law or previous treatment agreed to by the taxing authority for which the entity has no reason to believe it will not sustain 100% of the benefit, recognize full benefit in the financial statements. No further evaluation is required.
- (b) Positions that **do not** meet the more-likely-than-not recognition threshold – For those positions that do not meet the more-likely-than-not threshold, no benefit of the position is recognized in the financial statements. Evaluation of these positions is continued in Step 5 below.
- (c) Positions that meet the more-likely-than-not recognition threshold but are not highly certain – These positions have greater than a 50% likelihood of being sustained but it is not highly certain that the full amount of tax benefit taken will be realized upon examination. Measurement of these positions is addressed in Step 4 below.

Entities should develop appropriate policies related to documenting the process and decisions reached in the ongoing application of ASC Subtopic 740-10. See Paragraph 3.019 for additional discussion of the recognition threshold.

Step 4: For tax positions that meet the more-likely-than-not recognition threshold but the full benefit of the tax position taken is not highly certain of being sustained, determine the largest amount that is greater than 50% likely of being realized upon settlement with the taxing authority.

A tax position that meets the more-likely-than-not recognition threshold that is not highly certain is initially and subsequently measured based on the largest amount of benefit that is greater than 50% likely of being realized upon settlement with the taxing authority. See Paragraph 3.048 for additional discussion of measuring tax benefits.

Step 5: Recognize a liability (or reduce an asset) for each position or portion of each position not recognized.

ASC Subtopic 740-10 (FIN 48) requires that the difference between the benefit recorded for financial statement purposes and the amount reflected in the tax return (the unrecognized tax benefit) generally be recognized as an increase in income taxes payable or reduction in income taxes receivable. An unrecognized tax benefit should not be combined with deferred taxes unless (a) the tax law requires the taxpayer to satisfy the obligation with the benefit from a net operating loss or similar loss or credit carryforward for which a deferred tax asset has been recognized (or the tax law allows it and the taxpayer intends to settle it that way), or (b) the unrecognized tax benefit directly affects the measurement of the deferred tax for a carryforward or temporary difference (e.g., disallowance would increase or decrease the tax basis). See Paragraph 9.014 for additional discussion of presentation of unrecognized tax benefits. Also see Paragraphs 3.058 and 3.059 for discussion of considering uncertainty in income taxes when measuring deferred taxes.

Tax positions should be re-evaluated in each period when new information about recognition and measurement becomes available.

Step 6: Determine the classification of any liabilities for unrecognized tax benefits on the balance sheet.

Liabilities for the taxes payable resulting from unrecognized tax benefits should be classified as current or noncurrent based on the timing of expected cash payment. See Paragraph 9.018 for additional discussion of classification of unrecognized tax benefits.

Step 7: Calculate interest and penalties related to unrecognized tax benefits.

ASC paragraph 740-10-25-56 (FIN 48) requires entities to accrue interest expense on the underpayment of taxes if the full benefit of a tax position is not recognized in the financial statements and interest would be required to be paid on underpayments of income tax under the tax laws. See Paragraph 3.120 for additional discussion of calculating interest and penalties related to unrecognized tax benefits.



Step 8: Prepare related disclosures.

ASC Subtopic 740-10 (FIN 48) requires certain quantitative and qualitative disclosures. See Paragraphs 9.097 through 9.109 for additional discussion of disclosures related to uncertainty in income taxes.

**3.018 Unit of Account.** Each tax position must be considered on its own, regardless of whether the related benefit is expected to be negotiated with the taxing authority as part of a broader settlement involving multiple tax positions. In some cases, it may be unclear how a *tax position* should be defined. The unit of account used to identify an individual tax position is a matter of judgment that should consider how an entity prepares and supports its income tax returns and the approach expected to be taken by the taxing authority during an examination. The determination of the unit of account may affect the amount of tax benefits recognized, particularly if a deduction or other benefit involves multiple issues that may be evaluated independently under the tax law and vary widely in their degree of uncertainty. Because of this sensitivity, it generally will be appropriate to define the unit of account at the lowest level necessary to ensure that benefits with widely varying levels of uncertainty or issues that may be treated differently under the tax law are not included in the same unit of account, assuming such disaggregation is consistent with the manner in which an entity prepares and supports its income tax returns and the approach expected to be taken by the taxing authority during an examination. Factors to consider in determining the approach expected to be taken by the taxing authority may include the nature of the benefit, its significance relative to the entity's tax return as a whole, and the level of interdependency with other positions. An entity should consistently apply the unit of account for similar positions from period to period unless current facts and circumstances justify a change. ASC paragraphs 740-10-25-7, 25-13, 55-89

**3.019 More-Likely-Than-Not Recognition Threshold.** In determining whether it is more likely than not that a tax position will be sustained based on its technical merits as of the reporting date, an entity must assume the taxing authority will examine the position (detection risk is not considered) and have full knowledge of all relevant information. Inherent in concluding on the sustainability of a tax position is the expected result of any applicable appeals and litigation processes (i.e., the recognition threshold focuses on sustainability of the position assuming the taxpayer takes any dispute to the court of last resort). While very few disputes are ultimately taken to the court of last resort (i.e., the highest court that has discretion to hear the case), the possibility of negotiation with the taxing authority is not considered in evaluating whether the recognition threshold has been met. Each tax position should be considered on its own, regardless of whether the related benefit is expected to be negotiated with the taxing authority as part of a broader settlement involving multiple tax positions. ASC paragraphs 740-10-25-6 and 25-7, 55-3

**3.020** Meeting the more-likely-than-not threshold represents a positive assertion by management that an entity is entitled to some level of economic benefits of a tax position. If a tax position is not considered more likely than not to be sustained based on its technical merits, no benefits of the position should be recognized. Moreover, an entity must continue to meet the more-likely-than-not recognition threshold in each reporting

period to support continued recognition of a benefit. If the threshold ceases to be met, the previously recorded benefit must be derecognized - that is, reversed. The use of a valuation allowance, as discussed in Section 4, is not a permitted alternative to the reversal of a tax position that no longer meets the more-likely-than-not recognition threshold. See Paragraphs 3.114 and 3.115 for additional discussion on valuation and timing uncertainties. ASC paragraphs 740-10-25-6, 40-2

**3.021** The type of evidence required to support meeting the more-likely-than-not recognition threshold depends on the individual facts and circumstances. An entity's position may be supported, in whole or in part, by unambiguous tax law, prior experience with the taxing authority, and analysis that considers all relevant facts, circumstances, and regulations, including widely understood administrative practices and precedents of the taxing authority. Entities should consider all available information both supporting and refuting their positions. Information obtained during an ongoing examination may also be considered for subsequent recognition and derecognition when interaction with the taxing authority is relevant to the technical merits of a tax position. See Paragraph 3.026 for additional discussion of reevaluating tax positions. ASC paragraphs 740-10-25-6 and 25-7

**3.022** An entity may obtain a tax opinion from a qualified tax advisor as evidence to support management's conclusion that a tax position meets the recognition threshold. However, an opinion from a tax professional is not required before a tax benefit can be recognized in the financial statements. The determination of whether a third-party tax advisor is used should be based on the facts and circumstances associated with the individual position. For example, management may engage a third party in situations where it lacks adequate in-house expertise to sufficiently evaluate a particular fact pattern. Alternatively, the entity may be capable of reaching a conclusion on many tax positions internally without the use of a third-party tax advisor. Further, the more-likely-than-not recognition threshold is not intended to represent a strictly legal determination, but is instead a financial reporting threshold that should consider all relevant information on whether it is more likely than not that the position can be sustained upon examination based on the technical merits. In certain circumstances, an entity may be able to conclude that a tax position meets the more-likely-than-not recognition threshold based on administrative practices and precedents of the taxing authority even if a tax advisor would not consider such practices in developing a formal tax opinion under the tax law.

#### **Example 3.1b: Consideration of a Tax Opinion**

ABC Corp. wholly owns a subsidiary in Germany that has generated historical losses. ABC believes the German subsidiary became insolvent in 201X and obtained a tax opinion from a qualified tax advisor indicating ABC "should" be able to sustain a worthless stock deduction (under Internal Revenue Code (IRC) §165(g)(3)) for the German subsidiary. However, the qualified tax advisor's opinion assumed, at ABC's direction, that the German subsidiary was insolvent. If the German subsidiary is not deemed to be insolvent, the worthless stock deduction would not be sustained.

ABC requested its tax advisor to assume insolvency when rendering its tax opinion because it had previously engaged a third-party valuation specialist to prepare a valuation, the results of which indicated the German subsidiary was insolvent by an insignificant amount (i.e., the fair market value of its assets was slightly less than its liabilities). The valuation used the discounted cash flow method (the DCF Method) to determine the subsidiary's equity value. The DCF Method requires that ABC's management make various assumptions, including the appropriateness of the discount rate. The discount rate used in the DCF Method is based on consideration of the risks inherent in the investment and market rates of return available from investment alternatives of similar type or quality as of the valuation date.

The assumptions used and calculations prepared by the valuation specialist were considered reasonable. However, changes in certain variables used in the analysis based on alternative assumptions that are also deemed reasonable could result in a positive equity valuation for the German subsidiary, which would indicate that the subsidiary is solvent. Specifically, there is a range of reasonable estimates that a qualified and independent appraiser could use for components of the weighted average cost of capital used in the discount rate analysis, including the equity/debt capital structure, size premium, and specific risk premium.

Because of the uncertainty associated with the valuation of the German subsidiary, ABC determined that the IRS would likely challenge the assumptions used in the valuation and conclude that the German subsidiary was solvent. Therefore, ABC concluded it was *not* more likely than not that the worthless stock deduction would be sustained and thus (a) did not recognize an income tax benefit for the worthless stock loss deduction and (b) disclosed an increase to its unrecognized tax benefits in its rollforward in the notes to the financial statements.

**3.023 Administrative Practices and Precedents.** Tax positions supported by administrative practices and precedents are those positions that are expected to be accepted by the taxing authority even though the treatment may not be specified by the tax law or the positions may be considered technical violations of the tax law. For example, the tax law in a particular jurisdiction may not establish a capitalization threshold below which fixed-asset expenditures may be considered deductions in the period they are incurred, but management may be able to conclude based on previous experience that the taxing authority has not historically disallowed current deductions for individual fixed-asset purchases below a specific dollar amount. Another example is how administrative practices may affect evaluations of whether an entity may be subject to tax in a jurisdiction. ASC paragraphs 740-10-25-7, 55-90 through 55-95

**3.024** ASC Topic 740 permits an entity to conclude that the recognition threshold has been met through the consideration of administrative practices and precedents for tax positions that reflect widely known and consistently applied practices of the taxing authority. The determination of what constitutes a widely known and consistently applied practice may depend significantly on the particulars of the position, including industry-

specific considerations. For example, it may be appropriate to consider taxing authority administrative practices and precedents with respect to a specific group of entities when evaluating whether a position is more likely than not to be sustained. For example, the investment company industry approached the SEC staff in conjunction with the adoption of ASC Subtopic 740-10 (FIN 48) about the practice of the IRS to provide prospective transition to investment companies to cure underlying deficiencies, resulting in no taxes being due for prior periods. The Chief Accountant communicated the SEC staffs' belief that FIN 48 (included in ASC Subtopic 740-10) requires an investment company's management to weigh all forms of evidence, including informal IRS practices and guidance, in evaluating the recognition threshold of ASC paragraphs 740-10-25-5 through 25-17 and thus such practice should be considered in the investment company's analysis of the implication of the deficiency under FIN 48. When evaluating the applicability of administrative practices and precedents, consideration should be given to the technical merits of the tax position, any known views of the taxing authority with respect to the position, the history of the taxing authority with respect to resolving issues with similar levels of technical support, and any other relevant information in concluding on the technical merits of a tax position.

**3.025** In another example, an entity must satisfy certain income tests each tax year to qualify as a REIT. If the IRS has issued numerous and recent private rulings to other REITs about the qualification of certain types of income, those rulings may reflect IRS administrative practice, notwithstanding that they may not be relied upon as legal precedent. Administrative practices and precedents may be used to support the recognition threshold only when the entity has a reasonable basis to conclude (considering the provisions of law, the results of relevant tax cases or examinations, consistently applied taxing authority practice, or a combination thereof) that if the position were specifically examined by the taxing authority it is more likely than not to be sustained. Accordingly, concluding that an entity may avail itself of an administrative practice requires consideration of whether the practice is expected to be applied assuming the taxing authority had full knowledge of the entity's specific facts and circumstances. For example, if a REIT fails to meet the income tests, it may still qualify as a REIT (but be subject to a tax specified by the tax code) provided that it identifies the failure on a separate schedule prescribed by the IRS and the failure is due to reasonable cause and not willful neglect. If an entity has failed an income test and has not reported and does not intend to report the violation to the IRS, it generally would not be appropriate to consider this mitigation provision in evaluating REIT qualification. Similarly, there may be positions in which an administrative practice may differ depending on whether an item is proactively identified and reported by a taxpayer or whether it is identified through the course of an examination. If reliance on an administrative practice is contingent on self-reporting, an entity must intend to self-report to be able to consider the administrative practice in concluding the tax position meets the recognition threshold. We expect that an entity's intent to self-report information to the taxing authority would be supported by actions that support its intent (i.e., preparing and submitting the information to the taxing authority in a timely manner).

**3.026 Reevaluation of Tax Positions.** New information about the recognition and measurement of a tax position should trigger a reevaluation. The reevaluation could lead

an entity to derecognize a previously recognized tax position, recognize a previously unrecognized tax position, or remeasure a previously recognized tax position (see Paragraph 3.048 for additional information on measurement of tax benefits). New information may include, but is not limited to, changes in the tax law, developments in relevant case law, interactions with the taxing authority, and recent rulings by the taxing authority or the courts. An entity should consider whether new information has become available about an existing tax position at each reporting date (including interim reporting dates if the entity reports on an interim basis). ASC paragraphs 740-10-25-8 through 25-15, 35-2, 40-2 and 40-3, 55-118 and 55-119

**3.027** Only information that is available at the reporting date is considered in the recognition and measurement analyses under ASC paragraphs 740-10-25-8 and 35-2. An entity should recognize a change in available facts after its reporting date but before issuance of the financial statements in the period in which the change in facts occurs, even if that new information provides a better estimate of the ultimate outcome of an uncertainty. Notwithstanding that such information is not considered in the accounting as of the reporting date, entities should make appropriate disclosures in the notes to the financial statements if the effect of subsequent facts is considered material.

**3.028** Not used.

**3.029** The analysis of subsequent facts under ASC Subtopic 740-10 (FIN 48) is different from how other subsequent events may be considered under ASC Topic 855, *Subsequent Events*. Under ASC Topic 855, an entity should recognize in its financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the balance sheet date, and related adjustments are required to be made as of the balance sheet date, notwithstanding that the facts may not have been available as of that date. ASC paragraphs 855-10-15-4 and 15-5 specifically exclude the reevaluation of uncertainty in income taxes from the scope of ASC Topic 855 and instead require entities to consider the reevaluation guidance in ASC Subtopic 740-10. In contrast to ASC Topic 855, ASC Subtopic 740-10 (FIN 48) takes the perspective that an event that arises after the reporting date (date of the balance sheet) should be accounted for as a change in circumstances in the period in which the change occurs.

**3.030** An entity needs to be cautious in distinguishing between (a) information that is available as of the reporting date but analyzed after period end, and (b) facts that arise and become available after the reporting date. For example, if information about the resolution of an important tax case becomes available in the weeks following the reporting date, the resolution of the case should not be considered in recognizing and measuring the entity's tax positions as of the reporting date, although disclosure of the potential effects of the case on subsequent financial information may be required. Assume, for example, that a ruling on a tax case involving ABC Corp. that provides new information about the recognition and measurement of one of DEF Corp.'s tax positions was made publicly available on January 4, 20X8 when it was filed. For purposes of applying ASC paragraphs 740-10-25-8 and 35-2, because only information that is available at the reporting date (i.e., the date of the entity's most recent balance sheet) should be considered in recognizing and measuring a tax position and the ruling was not

filed and made publicly available until January 4, 20X8, the effect of the case should be accounted for in the period including January 4, 20X8. DEF should, however, consider subsequent event disclosures in the notes to the December 31, 20X7 financial statements. Note that the same guidance applies if it were DEF's actual tax position that was the subject of the January 4, 20X8 ruling (i.e., DEF was in litigation with the taxing authority on the position). The uncertainty associated with the tax position remains subject to ASC Topic 740 as (a) ASC Topic 740 requires evaluating uncertainty in income taxes through the court of last resort (see ASC paragraph 740-10-55-3), and (b) ASC Topic 855 specifically excludes the reevaluation of uncertainty in income taxes from its scope as discussed above.

**3.031** In contrast, if information about the resolution of a case was available before the reporting date, notwithstanding that management may not have become aware of the information until after the reporting date, it should be considered in preparing the financial statements as of the reporting date. For the example in Paragraph 3.030, if the ruling became publicly available on December 31, 20X7, DEF would have accounted for the effect of the ruling in the period that included December 31, 20X7, even if DEF did not become aware of the ruling until January 20X8.

### Example 3.2: Information Available as of the Reporting Date

#### Background

ABC Corp. has employment agreements with certain executives that allow for payment of incentive compensation upon attainment of a goal or voluntary retirement. ABC believes that these compensation arrangements are fully deductible because the employment agreements were executed before November 2, 2017 (the transition date for compensation plans under the U.S. tax reforms enacted on December 22, 2017) and performance based compensation is not subject to the \$1 million deduction limit for executive compensation subject to a written, binding contract in effect before that date. Based on the fact that ABC believes that the deduction is certain, ABC has recognized the tax benefit related to the executive compensation accruals. On January 25, 20X8 the IRS held in a Private Letter Ruling that certain provisions in an individual's existing employment agreement prevented incentive compensation from being treated as *performance based compensation* under the Code. Due to the specific employment agreement provision, the IRS ruled that the incentive compensation in such plans was subject to the \$1 million deduction limit, including for employment agreements executed before November 2, 2017.

On February 21, 20X8 the IRS released a separate Revenue Ruling that supports the Private Letter Ruling. However, the Revenue Ruling states it will not disallow a deduction for compensation arrangements similar to that of ABC if the compensation is paid under the terms of an employment contract executed before November 2, 2017 and in effect on February 21.

*Scenario 1*

ABC has a January 31, 20X8 fiscal year-end and is preparing its financial statements on March 15. The information available at the reporting date (January 31) was that the compensation under the current executive compensation agreements was not fully deductible. Therefore, ABC derecognized the tax benefit for the portion of the compensation that would not be deductible as of January 31. Because the unrecognized tax benefit is considered material to the financial statements and ABC is aware that the unrecognized tax benefit will meet the more-likely-than-not threshold as of February 21 (the date additional information is available), ABC will disclose the Revenue Ruling as a subsequent event (non-recognized) in its January 31 financial statements.

*Scenario 2*

ABC has a February 28, 20X8 fiscal year-end and is preparing its financial statements on April 15. The information available at the reporting date (February 28) was that the compensation under the current executive compensation agreements was fully deductible because the arrangements were executed before November 2, 2017 and in place as of February 21. Therefore, there is no effect on ABC's February 28 financial statements.

**3.032 Derecognition of Tax Positions.** If, based on an analysis of new information, a tax position is no longer more likely than not of being sustained, it should be derecognized in the first period in which it no longer meets the more-likely-than-not recognition threshold. If a tax position no longer meets the more-likely-than-not recognition threshold, the tax position must be derecognized in its entirety by increasing income taxes payable, decreasing income taxes receivable, or adjusting a deferred tax asset or liability, as appropriate. Additionally, if a benefit is subsequently derecognized, the entity must calculate the cumulative amount of interest and penalties, if any, to be accrued under applicable tax laws assuming the position was disallowed for the period in which it was reflected on the tax return (see Paragraph 3.120 for additional discussion of interest and penalties). Use of a valuation allowance to derecognize a tax position is not permitted. A valuation allowance should only be used to reduce the carrying amount of deferred tax assets that meet the recognition and measurement provisions of ASC Subtopic 740-10 (FIN 48) but are not expected to be realized due to insufficient taxable income. See Section 4 for additional discussion. ASC paragraphs 740-10-40-2 and 45-11

**3.033** If a tax position was considered effectively settled and the reporting entity determines that it is no longer remote that the taxing authority would examine or reexamine the position, the tax position should no longer be considered effectively settled. At that time, the benefits of the tax position would be derecognized if the position did not meet the more-likely-than-not recognition threshold. See Paragraph 3.039 for additional discussion of when a tax position becomes effectively settled.

**3.034 Subsequent Recognition of Previously Unrecognized Tax Positions.** ASC subparagraph 740-10-25-8(a) indicates that the benefit of a tax position that initially fails to meet the more-likely-than-not recognition threshold should be recognized in a

subsequent period if changing facts and circumstances enable management to conclude that the position now meets the recognition threshold. However, ASC paragraphs 740-10-25-14 and 35-2 indicate that such changes in judgment should result from the evaluation of new information rather than a new interpretation by management of information that was available in prior periods. ASC paragraph 740-10-25-8 also indicates that if the more-likely-than-not threshold has not been met, the benefit should be recognized in the period the matter is effectively settled with the taxing authority (ASC subparagraph 740-10-25-8(b)) or the statute of limitations expires. ASC subparagraph 740-10-25-8(c)

**3.035** In some circumstances, it may appear that a tax matter will be resolved favorably or will not be raised by the tax authority. This may be the case when the statute of limitations is nearing expiration or when the entity is undergoing an examination that is near completion and an issue has either not been raised or has been raised but the entity believes it has reached resolution with taxing authority. In these situations, careful consideration of the facts and circumstances is required to determine which, if any, of the subsequent recognition criteria of ASC Subtopic 740-10 (FIN 48) has been met.

**3.036** To subsequently recognize the benefits of a previously unrecognized tax position, the position must be (a) more likely than not of being sustained based on its technical merits (without consideration of detection risk), (b) effectively settled through examination, negotiation, or litigation, or (c) settled through actual *expiration* of the statute. If the entity is relying on the expiration of the statute (ASC subparagraph 740-10-25-8(c)), meeting this criterion is a matter of fact. No benefit recognition would be permitted until the period in which the statute actually expires. Further, if a tax examination has been completed, a tax position may be considered effectively settled (ASC subparagraph 740-10-25-8(b)) if certain criteria are met, as discussed further in Paragraph 3.039. Interactions with the taxing authority may also provide additional evidence with respect to the technical merits of the position (ASC subparagraph 740-10-25-7(b)) before effective settlement or the expiration of statute.

**3.037** We would expect that when an entity believes that interactions with the taxing authority provide direct evidence with respect to the technical merits of a tax position (i.e., whether that position meets the more-likely-than-not recognition threshold), the taxing authority will have specifically addressed the position and provided the entity with its views on the relevant application of the tax law so that the entity may be able to conclude, based on all available evidence, that it has become more likely than not that the position will be sustained based on its technical merits. Effective settlement of a tax position not specifically reviewed would not in and of itself support a conclusion that the position is more likely than not of being sustained on its technical merits. If similar or identical tax positions are taken in other open tax years, effective settlement of the prior position would not provide support for recognition of the benefits of similar positions in other open tax years. ASC paragraphs 740-10-25-9 through 25-12

**3.038** Interactions with the taxing authority may occur in the context of negotiation and settlement of an issue, which may not necessarily support a change in the analysis of the technical merits of a tax position. In those cases, recognition would not be appropriate until the tax position is effectively settled or expiration of the statute of limitations. ASC



subparagraph 740-10-25-8(b) requires recognition of a previously unrecognized tax position when it is effectively settled. ASC paragraphs 740-10-25-8 through 25-12

**3.039 Meaning of Effectively Settled.** ASC subparagraph 740-10-25-8(b) requires recognition of a previously unrecognized tax position when it is effectively settled. The term effectively settled is intended to recognize that in practice many taxing authorities with the right to subsequently examine or reexamine tax positions do not reopen tax years once an examination has been completed. As such, completion of a tax examination may effectively settle previously unrecognized tax positions if certain criteria are met.

**3.040** A tax position should be considered effectively settled and any previously unrecognized tax benefits should be recognized based on the terms of settlement, when all three of the following conditions have been satisfied:

- 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.
- The entity does not intend to appeal or litigate any aspect of the tax position included in the completed examination.
- It is remote that the taxing authority would examine or reexamine any aspect of the tax position. In making this assessment management should consider the taxing authority's policy on reopening closed examinations and the specific facts and circumstances of the tax position. Management should presume the taxing authority has full knowledge of all relevant information in assessing whether it would reopen a previously closed examination. ASC paragraph 740-10-25-10

**3.041** A tax position would not need to have been explicitly reviewed during an examination to meet the three criteria in Paragraph 3.040 (see Paragraph 3.128 for additional discussion and Example 3.15 for an illustration). However, a completed examination alone does not necessarily qualify a tax position for recognition. If the tax position can legally be examined or reexamined in the future, the reporting entity must assess whether the taxing authority would review the tax position after the examination had otherwise been completed. The analysis of whether it is remote that the taxing authority will examine or reexamine the tax position should be based on the taxing authority's policies and practices and assuming it has full knowledge of the facts and circumstances of the tax positions. Accordingly, the entity must assess whether the taxing authority would review the tax position after the examination has otherwise been completed if the facts and circumstances of the individual tax position were later obtained. For example, a taxing authority may have a practice of reviewing a previously examined tax position when information about that tax position is acquired while examining similar tax positions in subsequent years. In those cases, the tax position subject to the earlier examination would not meet the criteria for being effectively settled and would not be recognized until it became more likely than not of being sustained based on its technical merits or the statute of limitations expired.

**3.042** A taxing authority may also reevaluate its existing practices as a result of disclosures in financial reports that are based on the requirements of ASC Subtopic 740-10 (FIN 48). Changes in practices may affect conclusions about whether it is remote that the taxing authority would review positions previously subject to completed examinations. If a tax position is considered effectively settled and the reporting entity determines that it is no longer remote that the taxing authority would examine or reexamine the position, the tax position should no longer be considered effectively settled. ASC paragraph 740-10-40-3

**3.043** The effectively settled evaluation should be performed on a tax position by tax position basis. When similar or identical tax positions are taken in a number of separate tax periods, the position taken in each period is considered an individual tax position. Effective settlement of a position subject to an examination does not result in effective settlement of similar or identical tax positions in periods that have not been examined. For example, effective settlement of a position that was not specifically reviewed would not provide support for recognition of the benefits related to similar positions for other years that had not reached effective settlement. In addition, prior closing agreements and examination history on a specifically reviewed position may not be determinative for the same position in later years if the agreements are not binding on the taxing authority (see additional discussion of reliance on prior interactions with the taxing authority in Paragraph 3.051a). ASC paragraphs 740-10-25-9 and 25-12

**3.044 Expiration of the Statute of Limitations.** As stated in Paragraph 3.036, previously unrecognized tax benefits should be recognized when the position is settled through the expiration of the statute of limitations. Under a general rule in the U.S. Internal Revenue Code, the IRS has three years from the filing of the applicable return to assess a tax that is imposed under the Code. However, there is an exception to that general rule for a taxpayer that fails to furnish certain IRS international-related information returns or furnishes those forms *substantially incomplete*. In that situation, the statute of limitations for the entire tax return (not just for the tax consequences attributable to the unfurnished information) may not expire until three years from the date on which the entity files the required information with the IRS. The extension of the statute of limitations would not apply to the entire tax return if the failure to furnish that information is due to reasonable cause and not willful neglect. Whether the information furnished is substantially complete is a question of fact for which there is no clear guidance.

**3.045** Not used.

**3.046** Significant judgment is required when evaluating whether:

- An entity filed all required forms;
- The information included on the required forms is substantially complete; and
- The failure to file the information is due to reasonable cause and not willful neglect.

If an entity determines that it failed to comply with the requirements, the statute of limitations for the entire tax return could remain open indefinitely until it files the necessary information with the IRS, at which time the three-year statute of limitations would commence. The more-likely-than-not recognition threshold of ASC paragraph 740-10-25-6 would be applied in determining whether or not the statute of limitations has expired so that the affected tax positions are effectively settled.

**3.047** Many states also provide an exception from the general statute of limitations on income tax assessments when the taxpayer makes a substantial understatement or omission. These state exceptions are generally similar to Internal Revenue Code section 6501(e)(1), which extends the general three-year statute of limitations for tax assessments to six years when the taxpayer understates its gross income by more than 25%. While the exceptions generally are similar in concept, some states provide a different extended limitation period and some provide a different omission percentage threshold that triggers the extended statute. One of the most significant differences among the states is often the basis on which the omission is measured (e.g., *gross income*, *taxable income*, *tax liability*, etc.). The more-likely-than-not recognition threshold of ASC paragraph 740-10-25-6 would be applied in determining whether or not individual state statutes of limitations have expired.

**3.048 Measuring Tax Benefits.** The benefit recognized for a tax position meeting the more-likely-than-not criterion (see Paragraph 3.019 for additional discussion) is measured based on the largest amount of tax benefit that is greater than 50% likely of being realized upon settlement. This measurement is determined by considering the probabilities of the amounts that could be realized upon settlement, assuming the taxing authority has full knowledge of all relevant facts and including expected negotiations. The measurement process is applied only to tax positions that meet the more-likely-than-not recognition threshold. A tax position that does not meet the recognition threshold is measured at zero, even if some part of the benefit associated with the position is greater than 50% likely of being realized. ASC paragraphs 740-10-30-7, 55-100 through 55-109

**3.049** The measurement provisions of ASC paragraph 740-10-30-7 differ from the recognition provisions because measurement considers the effect of possible negotiated settlements with the taxing authority. Possible negotiated settlement outcomes may be identified based on a history of negotiating and settling similar positions with the taxing authority (the entity's history or the available history of other entities), guidance from appropriately qualified tax advisors, and other available information. Further, the probabilities assigned to possible outcomes should consider the entity's intent related to negotiation and litigation (e.g., how far the entity is likely to appeal the results of examination). The consideration of possible settlement outcomes as well as their associated probabilities is based on the facts, circumstances, and information available at the reporting date. In some cases, a tax position may have very few possible settlement outcomes (e.g., for some tax positions the entity will either realize 100% of the benefit or none of the benefit); in other cases, there may be several possible settlement outcomes.

**3.050** When multiple settlement outcomes are possible, we believe an entity may first evaluate the likelihood of the largest possible benefit being realized (i.e., the benefit

claimed or expected to be claimed on the tax return). If the largest possible benefit is greater than 50% likely of being realized, the entity would recognize that amount. If not, the entity may determine whether the next largest possible benefit is greater than 50% likely of being realized and continue the analysis until it identifies the largest amount of benefit that is greater than 50% likely of being realized. While the level of benefit measured is not based solely on the level of probability associated with sustaining the position on its technical merits, measurement of a tax benefit at an amount less than 50% of the tax benefit claimed on the tax return may raise questions as to whether the tax position is more likely than not to be sustained based on its technical merits. However, measurement at less than 50% of the benefit may be appropriate under certain circumstances - see additional discussion in Paragraph 3.116a.

### Example 3.3: Measurement of Tax Benefits

ABC Corp. is evaluating the interest cost associated with its convertible debt for its December 31, 20X7 financial statements and plans to take an interest deduction on its 20X7 tax return. This deduction will reduce its income taxes payable by \$100 for the year. ABC discusses the tax position with its tax advisors, analyzes similar deductions specifically challenged and accepted by the taxing authority in previous examinations, and concludes that the cost qualifies as a valid interest deduction (i.e., ABC is entitled to a deduction in 20X7 for its interest cost related to its convertible debt) and is therefore more likely than not to be sustained on its technical merits. ABC therefore concludes the interest deduction meets the more-likely-than-not recognition threshold and that it should measure the related tax benefit for financial reporting.

If the taxing authority subsequently examines the deduction, several negotiated settlement outcomes are possible, because of the judgment involved in determining the appropriate rate of interest (i.e., the amount of the interest deduction to be allowed on the tax return). In fact, because at least some level of uncertainty remains as to whether the interest cost is deductible at all, it is possible that ABC will sustain no benefit. Based on its previous experience in negotiating similar deductions with the taxing authority, ABC's management believes the possible outcomes of negotiations with the taxing authorities will be:

Probability of Outcome	Cumulative Probability	Tax Benefit
30%	30%	\$ 100
30%	60%	\$ 80 <sup>1</sup>
40%	100%	\$ 0

<sup>1</sup> \$80 is the largest amount that is greater than 50% likely of being realized.

ABC should recognize an \$80 benefit in its 20X7 financial statements because \$80 is the largest amount of benefit that is more than 50% likely of being sustained. ABC cannot recognize the full \$100 benefit claimed on its tax return in its financial statements

because there is only a 30% probability that the entire benefit would be allowed, if examined by the taxing authority. ABC should record a \$20 liability as an increase to income taxes payable and increase in tax expense, representing the difference between the benefit measured under ASC paragraph 740-10-30-7 of \$80 and the benefit claimed on the tax return of \$100. ABC would classify this income tax liability as noncurrent if it does not expect to pay the amount in cash within one year of the balance-sheet date. Interest must be accrued on the \$20 liability beginning in the first period interest would begin to accrue under the tax law.

**3.051 Interactions with the Taxing Authority – Effect on Measurement of Tax Benefits.** As discussed in Paragraph 3.026, new information such as information obtained from interactions with the taxing authority, should trigger a reevaluation about the measurement of a recognized tax position (i.e., a position that meets the more-likely-than-not recognition threshold). In determining whether a new measurement is appropriate, the entity should consider how and to what extent those interactions provide evidence that would result in a change to the largest amount that is greater than 50% likely of being realized upon settlement (assuming the taxing authority has full knowledge of all relevant information). Because the measurement model of ASC Subtopic 740-10 (FIN 48) contemplates negotiation and the behavior of the taxing authority, information obtained through interaction with the taxing authority may result in a change in the largest amount that is greater than 50% likely of being realized.

**3.051a Reliance on Prior Interactions with the Taxing Authority.** Although interaction with the taxing authority may provide additional information about the measurement of a recognized tax position, prior closing agreements, expired advance pricing agreements, and examination history are not determinative that the methodology in those agreements will not be challenged by the taxing authority in later years not covered by the agreements, or that the methodology otherwise will be sustained by courts. Although such prior settlements can (and should) be taken into account to the extent they are consistent with the taxpayer's facts, market conditions, and available market comparables in the later years, they should not be treated as inherently conclusive. For example, a taxpayer's transfer pricing methods should reflect its current facts and available comparable information relevant to the selection and application of the most reliable transfer pricing method. In addition, the reliability of a closing agreement in prior tax years may be reduced if it was a single element in a settlement covering multiple contested issues (see additional discussion of unit of account in Paragraphs 3.018 and 3.043).

## MEASURING DEFERRED TAX ASSETS AND LIABILITIES

**3.052 Enacted Tax Rate.** An entity measures deferred tax assets and liabilities using the enacted tax rate(s) expected to apply to taxable income when the assets and liabilities that give rise to the future deductible and taxable temporary differences are recovered or settled. In the U.S. federal tax jurisdiction, the applicable enacted tax rate for purposes of measuring deferred tax assets and liabilities is the regular tax rate (not the BEAT rate). In determining the applicable tax rate, an entity should consider, among other things, the

expected timing of reversals (including relevant elections such as use of carryback or carryforward, see Paragraph 3.082 for additional discussion) as well as the character of the taxable income (e.g., ordinary versus capital). However, the effects of future changes in tax rates are not anticipated in the measurement of deferred tax assets and liabilities. ASC paragraphs 740-10-30-8 through 30-10, 55-23 and 55-24

**3.053 Graduated Tax Rates.** Under current U.S. federal tax law all taxable income is taxed at a single 21% flat tax rate. However, in other tax jurisdictions, there may be graduated rates depending on the level of taxable income. When graduated tax rates are not expected to be a significant factor, a single flat tax rate may be used to measure deferred tax assets and liabilities. If graduated tax rates are expected to be a significant factor in determining taxes payable or refundable in future years, deferred tax assets and liabilities should be measured using the average graduated tax rate that is expected to apply (under currently enacted tax law) to the amount of estimated average annual taxable income for the period in which the deferred tax asset or liability is expected to reverse. ASC Topic 740 permits an aggregate calculation using a single estimated average graduated tax rate based on estimated annual taxable income in future years because taxable income or loss for the future years is itself no more than an estimate such that a detailed analysis to determine net reversals of temporary differences in each future year is not necessary. When graduated rates are a significant factor but the estimated future graduated tax rate is zero, for example, because the entity expects to incur losses, the lowest graduated tax rate should be used to measure deferred taxes rather than a zero tax rate. ASC paragraphs 740-10-30-9, 55-136 through 55-138

#### Example 3.4: Calculating the Average Graduated Tax Rate

At December 31, 20X6, ABC Corp. has taxable temporary differences of FC 900,000 and deductible temporary differences of FC 500,000 that are expected to result in net taxable amounts of approximately FC 50,000 in each of the next eight years.

Taxable income is subject to the following rates:

Taxable Income	Tax Rate
FC 0 - FC 50,000	15%
FC 50,001 - FC 75,000	25%
FC 75,001 – FC 100,000	34%
FC 100,001 - FC 335,000	39%
FC 335,001 - FC 10,000,000	34%

The following table illustrates the determination of the average graduated tax rate and the measurement of the deferred tax asset and liability in each of the independent scenarios presented below.

Scenarios	A		B		C		D	
1. Expected future taxable income (loss) exclusive of reversing temporary differences in each future year	FC	300,000	FC	150,000	FC	25,000	FC	(100,000)
2. Reversal of existing temporary differences in each future year		50,000		50,000		50,000		50,000
3. Expected future taxable income (loss)	FC	350,000	FC	200,000	FC	75,000	FC	(50,000)
4. Expected future regular tax liability (1)	FC	119,000	FC	61,250	FC	13,750		–
5. Applicable tax rate (4÷3)		34%		30.625%		18.33%		15% (2)
6. Deferred tax liability at 12/31/X6 (3)	FC	306,000	FC	275,625	FC	164,970	FC	135,000
7. Deferred tax asset at 12/31/X6 (3)	FC	170,000	FC	153,125	FC	91,650	FC	75,000

(1) Calculated using the tax rate table presented above. For example, in Scenario B the expected future tax liability is calculated as follows:

FC 50,000	×	15%	=	FC 7,500
25,000	×	25%	=	6,250
25,000	×	34%	=	8,500
100,000	×	39%	=	39,000
FC 200,000				FC 61,250

(2) Assuming that the entity in Scenario D cannot carry back the expected average annual future loss to recover taxes previously paid and cannot realize a tax benefit through carryforward, the lowest graduated tax rate should be used. The lowest graduated tax rate should be used whenever the estimated average graduated tax rate is otherwise zero.

(3) The deferred tax balances would be recalculated at each reporting date based on the most recent forecasts of taxable income and the existing temporary differences at that reporting date.

**3.054** Using an average graduated tax rate based on estimated average taxable income in future years generally is sufficient to measure deferred tax assets and liabilities. However, a more detailed calculation may be necessary when an entity expects significant temporary differences to reverse in a particular future year or when an unusually high or low level of taxable income is anticipated in a particular future year. In those circumstances, the use of specific tax rates to calculate deferred tax assets and liabilities for the portion of a temporary difference expected to reverse in the period of the unusual event will increase the appropriateness of the deferred tax calculation. The entity should reflect a change in the estimated average graduated tax rate in the period of change similar to a change in tax rate. See Paragraph 5.004 for additional discussion. ASC paragraph 740-10-55-138

**3.054a** Some jurisdictions impose taxes that are only partially based on income. For example, a taxpayer may be subject to the greater of an amount that is computed on an income-based measure or a non-income-based measure (e.g., capital). Such a regime may be viewed as a graduated tax rate system that includes a zero-rate tax bracket. See

Paragraph 9.138 for additional guidance on how an entity would determine the amount of deferred taxes under such systems.

**3.055 State Apportionment Factors.** State apportionment factors are determined under specific states' income tax laws and are used to allocate an entity's total taxable income to various states. The factors are generally based on the percentage of sales, payroll costs, and/or assets located in a particular state and have the effect of adjusting the applicable tax rate applied to the entity. The apportionment factors used to determine the applicable tax rate used to measure deferred tax assets and liabilities for a particular state generally should be those that are expected to apply when the asset or liability underlying the temporary difference is recovered or settled based on existing facts and circumstances. An entity may use the actual apportionment factors for recent years to measure deferred taxes in most cases unless it expects significant changes to occur. For example, if an entity expects to dispose of a subsidiary and that disposal will affect the consolidated entity's apportionment factors, for the operations to be retained, the entity should adjust the factors used to measure deferred taxes related to temporary differences that will reverse after the disposal based on the applicable tax rates expected to apply after the disposal. For temporary differences that will carry over to the acquiror in a disposal, deferred taxes are generally measured based on the pre-disposal apportionment factors. Similarly, if an entity expects to move its operations from one state to another state, begin operations in a new state, transfer operations between legal entities in a carryover basis transaction, add or move employees, etc., the entity should adjust the applicable tax rate based on the apportionment factors expected to exist after the changes have been implemented. An entity generally adjusts its factors in the period in which it commits to its plan and the plan is primarily within the entity's control.

**3.055a** Other circumstances not controlled by the entity that might affect apportionment include changes in state apportionment laws or regulations, resolution of income tax uncertainties, changes in tax status and business combinations. These circumstances are generally not anticipated and are reflected in the period in which they occur.

**3.055b Measuring State Deferred Taxes.** For measuring state deferred tax assets and liabilities, an entity generally should assume that temporary differences will reverse in the entity where the related assets or liabilities exist and therefore would apply the applicable tax rate for that entity for measuring deferred taxes. Entities generally should not assume that temporary differences in an entity will be shifted to a different entity through future taxable intra-entity transactions; however, it may be appropriate to consider planned carryover basis transactions where the entity has committed to a plan and the plan is primarily within the entity's control.

**3.056 Foreign Tax Rates.** The complexity of foreign tax laws and how they interact with U.S. laws may affect the determination of temporary differences and the appropriate applicable enacted tax rate in foreign jurisdictions. Given the significant differences between U.S. tax laws and those of foreign jurisdictions, a calculation that combines foreign and U.S. tax generally is not appropriate.



**3.057 Tax Rates That Vary by Source of Income.** Tax laws may require an entity to apply different tax rates to ordinary income and capital gains or otherwise establish different rates on income of different character. In such circumstances, the entity should measure deferred tax assets and liabilities by applying the appropriate enacted tax rate based on the type of taxable or deductible amounts expected to result from the reversal of existing temporary differences – i.e. based on the expected manner of recovery. For example, if an entity expects a taxable temporary difference related to an asset to reverse upon the sale of the asset and the sale would result in a capital gain taxed at a rate different from the rate applied to ordinary income, the entity should measure the deferred tax liability using the enacted capital gains tax rate. An entity should consider all available evidence - based on facts and circumstances existing at the balance sheet date - in determining the type of income or deduction that is expected to occur upon reversal of the temporary differences. See additional discussion on measuring deferred taxes for indefinite-lived intangible assets and goodwill at Paragraphs 4.017a and 6.016. ASC paragraphs 740-10-30-8, 55-23 and 55-24

**3.058 Measuring Deferred Tax Assets and Liabilities under ASC Subtopic 740-10 (FIN 48).** Deferred tax assets and liabilities generally should be calculated based on the difference between the carrying amounts of the assets and liabilities for financial reporting purposes and the tax bases of those assets and liabilities as determined using ASC Subtopic 740-10. See additional discussion of the recognition and measurement principles of ASC Subtopic 740-10 in Paragraph 3.015.

**3.059 Indirect Effects of Unrecognized Tax Benefits.** If a tax position does not meet the more-likely-than-not recognition threshold, or is measured at less than 100% (see Paragraph 3.048 for additional discussion on measurement of tax benefits) such that some portion of the benefit claimed on the tax return is not recognized, the resulting liability (or reduction in a deferred tax asset or increase in a deferred tax liability) for the unrecognized tax benefit should be measured using the enacted tax rate that would apply if the tax position is ultimately disallowed. In some cases, an unrecognized tax benefit will result in indirect effects, for example, generating benefits in another jurisdiction. In these situations, the indirect effects must also be considered. For example, if an entity increased its income taxes payable due to a state tax issue, in addition to evaluating whether the issue represents a similar exposure for federal tax purposes, a deferred tax asset would need to be established for the related federal benefit, provided it is more likely than not that the federal benefit would be sustained if the entity is required to pay the liability for the state position. Similar situations arise in the context of certain intra-entity transactions as well as foreign attributes that may generate U.S. tax effects. See Example 3.14 and Paragraph 9.123 for additional discussion of the presentation and disclosure of indirect tax effects under ASC Subtopic 740-10 (FIN 48). Liabilities for taxes payable resulting from unrecognized tax benefits on positions taken or expected to be taken on the tax return for the current year or prior years should be classified based on the timing of expected cash payment. See the discussion beginning in Paragraph 9.014 for additional information about balance sheet classification.

**3.060 Measurement When the Recognition Threshold Has Not Been Met.** To recognize a benefit for a tax position, an entity must be able to demonstrate that it is more

likely than not that the tax position for the identified unit of account would be sustained if litigated to the court of last resort. If the position has not met that threshold, ASC paragraph 740-10-25-8 prohibits recognition of any benefit until the more-likely-than-not threshold is met, the tax matter is effectively settled, or the statute of limitations has expired. See Paragraph 3.034 for additional discussion of subsequent recognition.

**3.061 Tax Elections.** As discussed in Paragraph 5.014, an entity should recognize and measure income taxes based on its expectations of elections that will be made in filing its tax return. For example, assume the tax law allows an entity to choose between taking a deduction or a credit for an existing future deductible amount. The entity's tax calculations should be based on management's expectations as to whether the entity will elect to take the deduction or the credit on its tax return (subject to its analysis of the uncertainty associated with the position, if any). ASC paragraph 740-10-55-23

**3.062 Amended Returns.** In some cases, an entity may expect to change a prior tax position and file an amended return. The period in which to recognize the effect of the change will depend on why the entity plans to file an amended return. For example, if the amended return is:

- The remeasurement or effective settlement of a previous tax position or the indirect effect of the remeasurement or effective settlement of a tax position in another jurisdiction, it is recognized in the period in which the change in facts or effective settlement occurs (see discussion in Paragraphs 3.026 through 3.051).
- A permitted alternative election (e.g., certain changes in tax accounting methods), it generally is recognized in the period in which management commits to the change, assuming the position meets the more-likely-than-not recognition threshold (see discussion beginning in Paragraph 3.063); however, there is a presumption that beneficial tax positions will be claimed.
- An error, it is recognized as an adjustment to the prior period financial statements, if material (see discussion beginning in Paragraph 10.096).
- A change in estimate, it is recognized in the period of change (see discussion beginning in Paragraph 10.096).
- A retroactively claimed credit, it should be analyzed to determine whether it is a change in estimate that is recognized in the period of the change in facts or an error that is recognized as an adjustment to the prior period financial statements, if material (see discussion beginning in Paragraph 10.096).
- A new filing position that becomes available or required as the result of the enactment of a new law or the issuance of regulations, it is recognized on enactment of the law or issuance of the regulations (see discussion beginning in Paragraphs 5.004 and 5.046).

An entity that expects to file an amendment as of the reporting date (and intends to account for the changes arising from the amendment) generally prepares and submits the amendment before the period-end financial statements are issued (i.e., before Form 10-Q

or 10-K is filed for domestic SEC registrants) or are available to be issued (for private companies). However, all relevant facts and circumstances should be considered in determining when to account for an amended return.

**3.063 Changes in Tax Accounting Methods.** Entities may change their method of accounting for tax purposes because there is a choice of tax accounting methods permitted (e.g., inventory valuation) or the existing method may be viewed as an impermissible method. The IRS has a policy whereby an entity can file Form 3115 to change tax accounting methods in the current year and receive protection from an IRS initiated tax accounting method change in the earliest open year along with protection from the related interest and penalties (the terms of the settlement of the unrecognized tax benefit, if any, will vary depending on the facts and circumstances of the change). Periodically updated IRS Revenue Procedures list certain tax accounting method changes that are automatically approved by the IRS (i.e., a consent letter is not required by the IRS) such that the entity would not be subject to an IRS initiated tax accounting method change and the related interest and penalties provided a copy of the form has been received by the IRS before an announcement of an audit of the entity's tax return. If an entity chooses to change to a tax accounting method that is not eligible for automatic consent procedures, the entity must receive approval from the IRS to change its tax accounting methods.

**3.064** If an entity is changing a tax accounting method that is eligible for automatic consent procedures, whether from a permissible method or from an impermissible method, the entity generally should account for the change (including avoiding an IRS initiated tax accounting method change in the earliest open year and the related interest and penalties) when it commits to making the change. The accounting for the change could include recognizing new, or derecognizing existing, deferred tax assets and liabilities (including related to the section 481(a) adjustment, if any; see Paragraph 2.096) and derecognizing unrecognized tax benefits.

**3.064a** All relevant facts and circumstances should be considered when determining when an entity has committed to making the change in accounting method. Consistent with the application of ASC subparagraph 740-10-25-7(b) (FIN 48) in other situations involving self-reporting to the taxing authority (see the discussion beginning in Paragraph 3.023), because the change in tax accounting method is contingent on receipt of a copy of a Form 3115 before an IRS audit is announced, an entity generally demonstrates its commitment to making the change by preparing and submitting a copy of the Form 3115 before the period-end financial statements are issued (i.e., before Form 10-Q or 10-K is filed for domestic SEC registrants) or are available to be issued (for private companies).

**3.065** If an entity is changing a tax accounting method from either a permissible or impermissible tax accounting method that is not automatic, the entity should apply the provisions of ASC Subtopic 740-10 (FIN 48) at the balance sheet date to determine whether it is appropriate to account for the change (including avoiding an IRS initiated change) before receipt of a consent letter. The entity would need to determine whether the requested change is more likely than not of being sustained as well as whether it is more likely than not that the taxing authority will not initiate a tax accounting method

change in the earliest open year. In evaluating whether the change is more likely than not, the entity should consider the administrative practices and precedents of the taxing authority (see Paragraphs 3.023 and 3.123). If the entity cannot conclude it is more likely than not that the change in tax accounting method will be sustained, the entity should account for the change when new information is available, generally in the period in which the IRS issues its consent letter. The entity should also consider required disclosures under ASC Subtopic 740-10 (FIN 48).

### **Example 3.4a: Unrecognized Tax Benefits – Change in Tax Accounting Method during the Subsequent Events Period**

ABC Corp. is a C Corporation that has a December 31 year-end for financial reporting and tax purposes. During 20X4, ABC determined that it was using an impermissible, unfavorable tax accounting method.

ABC believes that if the taxing authority had full knowledge of all relevant information, the largest amount of tax benefit that is greater than 50% likely of being realized would be an adjustment to 20X1 taxable income (the earliest open tax year) through an IRS initiated tax accounting method change. Interest and penalties would be owed as a result of this adjustment.

During 20X4, as a result of consultation with its tax advisors, ABC committed to filing a Form 3115 for an automatic tax accounting method change to correct the impermissible tax accounting method. If the Form 3115 is filed with the IRS national office before an examination is announced, ABC will have protection from an IRS initiated method change in 20X1.

On February 2, 20X5, before the 20X4 financial statements are issued, ABC files the Form 3115 with the IRS national office to change the tax accounting method effective January 1, 20X5.

ABC should not record an unrecognized tax benefit or liabilities for the related interest and penalties in its 20X4 financial statements assuming an IRS initiated tax accounting method change back to 20X1.

If an entity is changing a tax accounting method that is eligible for automatic consent procedures (whether from a permissible method or from an impermissible method) the entity generally should account for the change (including avoiding an IRS initiated tax accounting method change in the earliest open year and the related interest and penalties) when it commits to making the change.

An entity generally demonstrates its commitment to making a change in a tax accounting method by preparing and submitting the Form 3115 before the period-end financial statements are issued (or available to be issued). However, all relevant facts and circumstances should be considered when determining when to account for the change.

**3.066 Changes in Tax Laws or Rates.** The calculation of deferred tax assets and liabilities is based on enacted tax laws and rates. An entity should not anticipate the effects of future changes in tax laws and rates in measuring deferred tax assets and liabilities unless those changes are included in a currently enacted law. Deferred tax assets and liabilities should be adjusted for changes in enacted tax rates and other changes in the tax law when the law is enacted. ASC paragraph 740-10-35-4

**3.067** As discussed in Section 5, *Changes in Tax Laws, Rates, or Status*, the effect of changes in tax laws or rates on deferred tax assets and liabilities is reflected in the period that includes the enactment date, even though the changes may not be effective until future periods. Changes in tax laws or rates that are enacted after the balance sheet date should not be reflected in the financial statements of the period before enactment, even if the financial statements for the prior period are issued after the changes are enacted. Disclosure in the notes to the financial statements of the effects of the subsequent enacted change in tax laws or rates may be appropriate. ASC paragraphs 740-10-35-4, 45-15

**3.068** The effects of changes in tax laws or rates on deferred tax assets and liabilities are charged or credited to income tax expense as part of deferred tax expense or benefit of the period that includes the enactment date, even when the change is retroactive to an earlier date. The income tax effect of a change in tax law or rate is recorded as a component of income tax expense in continuing operations even if the deferred tax balances related to a prior year or interim period gain or loss that was reported as a discontinued operations or an item of other comprehensive income. ASC paragraph 740-10-45-15

**3.069 Alternative Minimum Tax Before 2017 U.S. Tax Reform (Pre-2018 AMT).** Before the 2017 U.S. tax reform was enacted, the U.S. corporate income tax consisted of two components - regular tax and alternative minimum tax (AMT). AMT was designed to ensure that all corporations paid a minimum amount of tax. Tentative minimum tax (TMT) was the minimum amount of tax a corporation was required to pay. The total federal tax liability for each year was the greater of regular taxes payable and the calculated TMT. If TMT exceeded the regular taxes payable, the amount by which TMT exceeded regular tax was the AMT. That is, if TMT exceeded regular taxes payable, the total tax obligation was the sum of AMT and regular tax. If TMT was less than the regular tax, the regular tax was payable.

**3.070** Not used.

**3.071** Because the AMT system functioned to ensure a neutral or higher level of taxes currently payable, entities often generated AMT credit carryforwards equal to the AMT paid (i.e., the difference between the TMT and the amount payable under the regular tax system) in a particular year. AMT credit carryforwards could be used to offset regular taxes payable in future years but not below the amount of TMT for that year. AMT credits could be carried forward indefinitely but could not be carried back.

**3.072** ASC Topic 740 states that the applicable tax rate used in the deferred tax calculation should be based on the regular tax system, not the AMT system on the

premise that no one can predict whether an entity will always be an AMT taxpayer and application of the AMT rate may result in the understatement of deferred tax liabilities under certain circumstances. While this guidance is no longer applicable in the United States to the pre-2018 AMT system, it is relevant when accounting for alternative minimum tax systems in other jurisdictions and the Corporate AMT (see Paragraph 3.073) that was enacted in 2022. This guidance may also serve as a basis for the accounting for the base erosion and anti-abuse tax (BEAT, see Paragraph 3.072b) that was enacted in the United States in 2017. ASC paragraphs 740-10-30-10 through 30-12 and 55-31 through 55-33

**3.072a** Not used.

**3.072b BEAT After 2017 U.S. Tax Reform.** Along with the repeal of the pre-2018 AMT system, the Act introduced a BEAT. The BEAT partially disallows deductions for certain related-party transactions, but applies a tax rate to a taxpayer's modified taxable income lower than the 21% corporate rate. BEAT applies only to taxpayers with annual domestic gross receipts in excess of \$500 million. BEAT functions like a minimum tax, but unlike the pre-2018 AMT (see additional discussion in Paragraph 3.069), there is no interaction through a credit mechanism with the regular tax system.

**3.072c** As discussed in Paragraph 3.072, for operations subject to tax in the United States before 2017 U.S. tax reform, ASC Topic 740 required all entities to measure deferred taxes for temporary differences using regular tax rates regardless of whether the entity expected to be a perpetual AMT taxpayer. This requirement was based primarily on the fact that pre-2018 AMT credit carryforwards (i.e. the amount of tax paid under the pre-2018 AMT system in excess of the amount payable under the regular tax system) could be used to offset future taxes paid under the regular tax system and those carryforwards were available indefinitely. As a result, an entity could expect to be subject to regular income tax rather than pre-2018 AMT over the course of its life. Unlike the pre-2018 AMT system, amounts paid under the BEAT in excess of the tax that would otherwise be payable under the regular income tax system are not permitted to be carried forward to offset future taxes payable under the regular income tax system. Due to the differences in how the BEAT interacts with regular tax, there were differing views on whether the accounting for AMT required by ASC Topic 740 should be applied.

**3.072d** A FASB staff Q&A states that the FASB believes that because BEAT is similar to the AMT in that it is designed so that an entity can never pay less than it would under the regular tax system, entities should measure their deferred taxes using the statutory rate based on the regular tax system (as they have historically for pre-2018 AMT) and account for the incremental tax owed under the BEAT system as it is incurred. The FASB believes measuring deferred tax liabilities at the lower BEAT rate would not reflect the amount a taxpayer would ultimately pay because the BEAT would exceed the tax under the regular tax system. By accounting for the incremental effect of BEAT in the year BEAT is incurred, profitable entities will recognize an effective tax rate (excluding other reconciling items) equal to or in excess of the statutory rate under the regular tax system. The Q&A also indicates that an entity does not need to evaluate the effect of potentially paying the BEAT in future years when assessing the realizability of its deferred tax assets

under the regular tax system. See Paragraph 4.109a for additional discussion about how BEAT status may affect valuation allowance assessments.

**3.073 Corporate AMT.** The Inflation Reduction Act (IRA) of 2022 introduced a new AMT for tax years beginning after December 31, 2022. The Corporate AMT is a 15% minimum tax levied on certain large corporations – generally, those with three-year average adjusted financial statement income (AFSI) of \$1 billion or more. For foreign-parented multinational groups, there is also a \$100 million AFSI test that takes into account only the group’s U.S.-related AFSI. The minimum tax is equal to the amount by which:

- The TMT, 15% of AFSI, reduced by AMT foreign tax credits, exceeds
- The regular tax for the year, including any BEAT liability but before consideration of general business credits.

Companies may claim a credit against regular tax in future years for Corporate AMT previously paid. However, the credit cannot reduce the future year's tax liability below the computed minimum tax that year. Similar to the pre-2018 AMT regime, we believe companies should account for the incremental tax owed under Corporate AMT as it is incurred and continue to measure their deferred taxes at regular rates.

**3.073a** The applicability and calculation of Corporate AMT is based on AFSI. Although AFSI generally starts with net income as reported on the applicable financial statement, its calculation includes a series of adjustments that draw on both financial reporting and tax concepts, many of which can be viewed as 'remove-book-and-replace-with-tax' adjustments (i.e., the ability to use tax depreciation instead of book depreciation). The calculation may be complex, particularly as it relates to adjustment for investments in entities that are not consolidated for tax. An applicable financial statement includes a corporation's Form 10-K filed with the SEC, certain audited financial statements, and certain other similar financial statements filed with a federal agency. Use of AFSI to determine Corporate AMT may prompt some companies to analyze how different pretax accounting policy elections change AFSI. Companies considering a voluntary change in accounting policy should evaluate preferability. Preferability is determined based on the accounting principle – i.e., whether it is an improvement in financial reporting. Preferability cannot be justified on the basis of the income tax effect alone. See section 3.3 of KPMG Handbook, *Accounting changes and error corrections*.

**3.074 Special Deductions.** The tax benefits of special deductions are recognized no earlier than the year in which those special deductions are available for deduction on the tax return. ASC Topic 740 does not permit offsetting a deferred tax liability for taxable temporary differences by anticipating the tax benefits of special deductions in future years. For example, a deferred tax liability for an existing taxable temporary difference related to an oil and gas property should not be reduced by anticipated statutory depletion deductions expected for future years. ASC paragraph 740-10-25-37

**3.075** Although ASC Topic 740 does not permit anticipating future special deductions in measuring deferred tax assets and liabilities, the future tax effects of special deductions

may affect (1) the average graduated tax rate used to measure deferred taxes when graduated tax rates are a significant factor and (2) the need for a valuation allowance on deferred tax assets. Accordingly, an entity may implicitly recognize the future tax effects of special deductions by reducing the expected future taxable income estimated for purposes of computing of the average graduated rate and/or determining the need for a valuation allowance. See Paragraph 4.142 for additional discussion. ASC paragraphs 740-10-25-37, 30-13

### Example 3.5: Determining Applicable Enacted Tax Rate When Special Deductions Exist

ABC Corp. has a single taxable temporary difference of FC 400,000 that it expects to reverse in 20X8. Taxable income is taxed in tranches at the following rates (e.g., the first \$50,000 in taxable income is taxed at 15%, the next FC 25,000 is taxed at 25% and so on):

Taxable Income	Tax Rate
FC 0 - FC 50,000	15%
FC 50,001 - FC 75,000	25%
FC 75,001 - FC 100,000	34%
FC 100,001 - FC 335,000	39%
FC 335,001 - FC 10,000,000	34%

ABC is entitled under the tax law to a special deduction that is equal to 60% of taxable income before the special deduction.

The following table illustrates the determination of the average graduated tax rate and the measurement of the deferred tax liability in each of the independent scenarios presented below.

Scenarios	A	B	C	D
1. Expected future taxable income exclusive of reversing temporary differences and special deduction	FC 800,000	FC 287,500	FC (150,000)	FC (500,000)
2. Taxable temporary difference	400,000	400,000	400,000	400,000
3. Special deduction $[(1 + 2) \times 60\%]$	FC <u>(720,000)</u>	FC <u>(412,500)</u>	FC <u>(150,000)</u>	FC <u>—</u>
4. Expected future taxable income (loss)	FC <u>480,000</u>	FC <u>275,000</u>	FC <u>100,000</u>	FC <u>(100,000)</u>
5. Expected future regular tax liability (1)	FC <u>163,200</u>	FC <u>90,500</u>	FC <u>22,250</u>	FC <u>—</u>
6. Applicable tax rate $(5 \div 4)$	<u>34%</u>	<u>32.9%</u>	<u>22.3%</u>	<u>15.0%</u> (2)
7. Deferred tax liability $(2 \times 6)$	FC <u>136,000</u>	FC <u>131,600</u>	FC <u>89,200</u>	FC <u>60,000</u>

(1) Calculated using tax rate table presented above.



- (2) Assuming that the entity in Scenario D cannot carry back the expected future loss to recover taxes previously paid or to realize a tax benefit through a carryforward, the lowest graduated tax rate should be used. That rate should be used whenever the estimated average annual future tax rate otherwise would be zero. ASC paragraphs 740-10-55-136 through 55-138

As illustrated above, the effect of the special deductions on future income is used only to determine the applicable graduated tax rate (i.e., no deferred tax asset was established for the special deduction itself); however, a portion of future special deductions is implicitly reflected in the deferred tax liability in certain cases. For example, had the special deduction not been considered for purposes of determining taxable income in Scenario B, the applicable tax rate would have been 33.9% rather than 32.9%.

**3.075a Foreign-Derived Intangible Income (FDII) Deduction.** The 2017 U.S. tax reform introduced a new deduction that allows a U.S. corporation a deduction equal to 37.5% of its "foreign-derived intangible income." Starting in 2026, the deduction percentage is reduced to 21.875%. The deduction for FDII is limited, however, when a taxpayer's global intangible low-taxed income (GILTI) inclusion (see Paragraph 7.087a for additional discussion about GILTI) and its FDII exceed taxable income. We believe the FDII deduction is akin to a special deduction, even though that term is not defined in ASC Topic 740. We believe accounting for the FDII deduction as a special deduction is appropriate because the amount is contingent on future deemed tangible income return.

**3.075b GILTI: Section 250(a) Deduction.** As discussed in Paragraphs 2.037b and 7.087e, for tax years of foreign corporations beginning after December 31, 2017, the 2017 tax reform Act provides that a U.S. shareholder of any controlled foreign corporation (CFC) must include in taxable income its pro rata share of GILTI. GILTI is considered the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. Additionally, a deduction is permitted for 50% of an entity's GILTI (referred to as the section 250(a) deduction) for tax years beginning after December 31, 2017 and before January 1, 2026, with a reduction to 37.5% after December 31, 2025.

**3.075c** If an entity believes that it will have positive taxable income and a GILTI inclusion (and has chosen to recognize deferred taxes to reflect that – see Paragraph 2.037c for additional discussion), the section 250(a) deduction will immediately follow in most cases. As a result, we believe an entity in that situation generally should reduce from 21% the rate it applies when measuring deferred taxes to the extent it can reasonably expect taxable income adequate to realize some or all of the section 250(a) deduction in the periods the related temporary differences are expected to reverse. However, if an entity is unable to make reliable estimates of taxable income, does not expect to have US taxable income, or expects to offset taxable income with existing NOL carryforwards or other tax attributes, we believe that it would be inappropriate for that entity to reduce the rate applied to its GILTI temporary differences for the section 250(a) deduction. In other words, it would be inappropriate for an entity to reduce the rate it applies to its GILTI temporary differences to the extent it does not expect to be eligible to take a section 250(a) deduction. We understand that the FASB and SEC staffs do not believe this approach is inconsistent with the principles of ASC Topic 740.

**3.075d GILTI: Net Deemed Tangible Income Return.** As discussed in Paragraph 3.075b, under the new law, GILTI is determined after deducting a shareholder's net deemed tangible income return. The "net deemed tangible income return" is generally defined as the excess of 10% of the aggregate of the shareholders' pro rata share of the qualified business asset investment (QBAI) of each CFC's QBAI over the amount of interest expense taken into account in determining the shareholder's net CFC tested income. QBAI is determined as the average of the adjusted bases in certain "specified tangible property."

**3.075e** We believe the deduction for the net deemed return on the taxpayer's tangible business property, like the FDII deduction discussed in Paragraph 3.075a, may be akin to a special deduction because the amount of the deduction depends on current year qualified business asset investment and interest expense. However, we believe it is also acceptable for an entity to consider the return on its existing tangible business property (after consideration of the interest expense limitation) in its measurement of GILTI deferred taxes as long as it has the ability to reliably estimate its qualified business asset investment and the effect of the interest expense limitation.

**3.075f** An entity that includes the return in its measurement of deferred taxes may do so by considering the deemed return as taxable income that is subject to a 0% tax rate in a graduated tax rate structure. If an entity expects the effect of graduated tax rates to be significant in determining taxes payable or refundable in future years, it measures its deferred tax assets and liabilities using the average graduated tax rate that is expected to apply when those deferred tax balances are expected to reverse. See Paragraph 3.053 for additional discussion of accounting for graduated tax rate structures.

**3.075g** We understand that the FASB and SEC staffs do not believe either of these approaches are inconsistent with the principles of ASC Topic 740. An entity should consistently apply its policy choice and consider disclosure in the notes to financial statements.

**3.076 Expected Future Losses.** The expectation that future tax losses will offset taxable amounts related to existing temporary differences does not eliminate the requirement to recognize a deferred tax liability on the existing taxable temporary differences. However, the expectation of future tax losses may affect the determination of the appropriate enacted tax rate used to measure deferred tax assets and liabilities. For example, if an entity operates in a tax jurisdiction where carryback is available (certain U.S. net operating losses generally cannot be carried back after tax reform was enacted in 2017, see additional discussion beginning in Paragraph 4.016a) and has a deferred tax asset that it expects to realize in future years through a carryback, the deferred tax asset should be measured using the tax rate that applies to the period in which taxes paid or payable are expected to be recovered or reduced as a result of use of the deferred tax asset. However, if an entity is required to apply graduated tax rates, the deferred tax liabilities for those taxable temporary differences that it expects to reduce future tax losses should be measured at the lowest graduated tax rate. See Scenario D in Example 3.5. ASC paragraphs 740-10-25-38, 55-23, 55-131 through 55-135

### **Example 3.6: Measurement of a Deferred Tax Asset Expected to Be Recovered by Carryback**

At December 31, 20X7 ABC Corp. has a deductible temporary difference of FC 10,000 that it expects will result in a tax deduction in 20X8. ABC reported taxable income of FC 100,000 in 20X6 and a tax loss of FC 35,000 in 20X7. The enacted tax rates under the tax law were 35% for 20X6, 40% for 20X7, and 45% for 20X8 and later years. The tax law in ABC's tax jurisdiction permits a two-year carryback and a 20-year carryforward for tax losses.

Assuming ABC carried the tax losses in 20X7 back to 20X6 to recover taxes paid for 20X6, ABC would have FC 65,000 of taxable income remaining from 20X6 that remains available for carryback of future (post-20X7) year losses.

ABC expects to report a tax loss in 20X8 of FC 75,000, including the reversal of the FC 10,000 deductible temporary difference. If ABC expects to carry back forecasted 20X8 losses, it should measure the deferred tax asset for the FC 10,000 deductible temporary difference using the 35% tax rate that applies to 20X6. At December 31, 20X7, ABC would report a deferred tax asset of FC 3,500 ( $\text{FC } 10,000 \times 35\%$ ) for the deductible temporary difference. Alternatively, if ABC expected to carry forward the 20X8 loss, it would measure the deferred tax asset using the 45% tax rate. Note that ABC must evaluate the deferred tax asset to determine if a valuation allowance is necessary.

**3.077** The expectation of future losses may also affect the measurement of deferred tax liabilities. A deferred tax liability for taxable temporary differences that are expected to reduce a future tax loss that will be carried back to the current year or prior years (and thereby reduce the refund of taxes previously paid resulting from the carryback of the future loss) should also be measured using the tax rate that applies to the year(s) for which a refund is expected to be ultimately received. For example, assume at December 31, 20X6, ABC Corp, which operates in a tax jurisdiction where carryback is available (post-2017 U.S. net operating losses generally cannot be carried back after tax reform was enacted in 2017, see Paragraph 4.016a for additional discussion), expects an overall future loss in 20X7, inclusive of the taxable income associated with a reversing taxable temporary difference for which there is an existing \$1,000 deferred tax liability. If ABC expects to pay tax in 20X6 (and thus will be able to carry back the 20X7 expected loss), the \$1,000 deferred tax liability would be measured using the enacted tax rate applicable for 20X6. ASC paragraph 740-10-55-23

### **Example 3.7: Measurement of a Deferred Tax Liability Expected to Reduce a Refund**

Assume the same facts as in Example 3.6 except that ABC Corp. has a taxable temporary difference of FC 10,000 at December 31, 20X7 instead of a FC 10,000 deductible

temporary difference. ABC expects to report a tax loss of FC 55,000 for 20X8, net of the reversal of the FC 10,000 taxable temporary difference.

If ABC expects to carry back the forecasted future tax loss to recover the taxes paid in 20X6, it should measure the deferred tax liability using the 35% tax rate that applied in 20X6. Accordingly, at December 31, 20X7, ABC should report a deferred tax liability of FC 3,500 (FC 10,000 × 35%) for the taxable temporary difference. However, if sufficient evidence does not support ABC's forecasted future tax loss and intent to carry back the loss to recover the taxes paid in 20X6, the deferred tax liability should be measured using the 45% tax rate applicable to 20X8.

## TAX CALCULATION – SPECIFIC APPLICATION MATTERS

**3.078** This subsection discusses other matters that should be considered when calculating tax expense and matters that arise in specific circumstances.

**3.079 Considerations for Negative Economic Conditions.** In addition to requiring a valuation allowance on deferred tax assets (discussed in Section 4, see Paragraph 4.134a), negative economic conditions may have significant effects on many aspects of an entity's accounting and reporting for income taxes including:

- Feasibility of management's plan to indefinitely reinvest undistributed earnings in foreign operations and the appropriateness of applying the indefinite reversal criterion to recording deferred tax liabilities on taxable outside basis differences related to foreign operations;
- Expectations that an entity will ultimately recover a taxable outside basis difference in a more-than-50%-owned subsidiary in a tax-free manner;
- Risk of changes in the past interpretations and administrative practices followed by a taxing authority for purposes of evaluating recognition, derecognition, and measurement of tax uncertainties, and in imposing interest and penalties; and
- Effect of changing levels of operations and profitability in different jurisdictions on apportionment of income for state and local income taxes and the estimated tax rate used in calculating interim tax expense.

**3.080 Tax Professional Fees.** Fees paid to advisors by an entity for advice on the tax treatment of transactions, preparation of income tax returns, and other professional services are not part of income tax expense.

**3.081 Operating Loss and Tax Credit Carryforwards.** Current U.S. tax law provides that an entity's net operating losses or unused tax credits may be used to settle future taxes due (referred to as carryforwards). Accordingly, an entity recognizes deferred tax assets for these net operating losses (NOLs) in the period they are generated. Using the NOLs on the tax return for which deferred tax assets have been recognized with no

valuation allowance generally would not change total income tax expense. For example, using a pre-2017 operating loss carryforward (post-2017 net operating loss carryforwards may only offset 80% of taxable income in a given year after the expiration of the CARES Act provisions - see Paragraphs 4.016a and 4.016aa for additional discussion) to settle all taxes due in the current year will cause current tax expense to be zero as no income taxes are currently due. However, using the operating loss carryforward decreases the amount of deferred tax assets and thus results in deferred tax expense.

**3.082** The deferred tax asset recognized for operating losses and tax credit carryforwards is measured using the enacted tax rate for the year in which the benefit is expected to be realized (i.e., when the entity expects to generate taxable income or offset reversing taxable temporary difference). Accordingly, management's expectations for how these carryforwards will be used may affect the measurement of the deferred tax asset and ultimately tax expense. See the discussion beginning in Paragraph 9.016 for additional guidance on the effect of unrecognized tax benefits on the presentation of net operating loss carryforwards.

**3.083** In some tax jurisdictions, net operating losses may be carried back to recover previous taxes paid (post-2017 U.S. net operating losses generally cannot be carried back, see Paragraph 4.016a for additional discussion). In those situations, an entity that generates an operating loss typically would first consider whether the loss could be carried back to reduce taxes paid in previous years to obtain a tax refund. If the benefit from an operating loss is carried back to recover taxes paid in a prior period, a current tax benefit, equal to the amount of recovered taxes, is recognized in the year the operating loss is generated (i.e., such benefit would be recognized based on the rate applicable to the prior period for which the refund is being claimed). If an entity is not able to carry back a net operating loss or tax credit, or chooses not to, and the entity may carry forward the remaining benefit, it would recognize a deferred tax asset and measure that deferred tax asset based on the currently enacted rate applicable to the future period in which it expects to use the carryforward.

**3.084 Discounting Not Permitted.** Deferred tax assets and liabilities should be measured as the future tax consequence of temporary differences. Discounting deferred tax assets and liabilities (reporting deferred tax assets and liabilities at their net present value) is not permitted under ASC Topic 740. Although many deferred tax assets and liabilities relate to basis differences and net operating loss carryforwards that may not be realized until many years in the future, the FASB determined that ASC Topic 740 would not permit discounting due to the complexity of the implementation issues associated with discounting (e.g., selection of the discount rate and determination of the future years in which deferred tax assets and liabilities will reverse). A U.S. taxpayer also is not permitted to discount (a) its transition tax liability, or (b) its refundable AMT credit carryforward, both of which resulted from the U.S. tax reform provisions enacted in 2017. See Paragraph 7.024d for additional discussion. ASC paragraph 740-10-30-8

**3.085 Measurement of Deferred Taxes on the Outside Basis Difference Arising on Equity Method Investments and Investments in Subsidiaries.** An investor recognizes its proportionate share of the earnings of equity method investees and subsidiaries

(referred to herein as the *investee*) in income for financial reporting purposes. In some tax jurisdictions, the investor's share of the investee's earnings is not included in taxable income until those earnings are remitted to the investor. Undistributed earnings increase the financial statement carrying amount of the investor's investment; however, undistributed earnings generally do not change the tax basis of the investor's investment. The resulting basis difference may become taxable when dividends are received from the investee, upon liquidation of the investee, or upon sale of the investment. Generally, the resulting deferred tax liability should be recognized based on enacted tax law applicable to the expected type of future taxable income that would result from the reversal of the taxable temporary difference. In other words, the rate used for measuring the deferred tax liability for an equity method investment or for an investment in a subsidiary (assuming the exceptions provided for in ASC paragraph 740-30-25-17 (*Accounting Principles Board Opinion No. 23, Accounting for Income Taxes – Special Areas (APB 23)*) or ASC paragraphs 740-30-25-7 and 25-8 have not been applied – see Section 7, *Foreign Operations*, and Section 2, *Temporary Differences*, respectively) should be based on whether the investor/parent expects the difference to reverse through dividends, liquidation, the sale of the investment, or a combination of methods. It generally would not be appropriate for an investor in an equity method investment to assume it would acquire the remaining interest in an investment in a business combination and recover the investment through tax rates only available to subsidiaries. If the taxable temporary difference, or a portion thereof, is expected to reverse through dividends, the calculation of the related deferred tax liability should reflect any available dividends-received deductions, foreign tax credits, and any withholding taxes that would be withheld from the dividend. If the taxable temporary difference, or a portion thereof, is expected to reverse through sale, capital gains rates or withholding taxes may apply.

**3.086** In determining to what extent dividends-received deductions and other special rates applicable to dividends affect the measurement of the deferred tax liability, the investor should consider the level of control it has over the dividend policy of the investee. For example, consideration of the dividends-received deduction generally would be appropriate for investments in subsidiaries where the parent intends to recover the outside basis difference through dividends because the parent generally controls the dividend policy. Alternatively, it may be inappropriate to assume that the entire basis difference will reverse through future dividends for an equity method investment because the investor generally does not control the dividend policy. Additionally, for the basis difference to reverse through future dividends, future dividends paid by the investee must exceed the investee's income earned in the future period in which the dividend is assumed to be paid (i.e., the dividend would include distribution of amounts accumulated in retained earnings). This is unlikely to be a reasonable assumption over the life of the investment; however, in cases where future dividends are expected to exceed future earnings for a limited period of time, it may be appropriate to assume a portion of the temporary difference will be recovered through receipt of dividends and the remainder upon sale of the investment. Regardless of how the parent expects the outside basis difference to reverse, it should base the measurement of such outside basis differences on currently enacted tax rates applicable to the relevant character of income (e.g., capital versus ordinary). ASC paragraph 740-10-55-24

**3.087 Differences between the Undistributed and Distributed Rate.** In certain foreign tax jurisdictions, different rates may apply to income earned based upon whether such income will be distributed to shareholders. In other jurisdictions, an entity may receive a tax credit when earnings are distributed (i.e., when dividends are paid). Still other jurisdictions may assess an incremental tax on an entity when earnings are distributed that may, in some cases, be akin to a withholding tax. These situations may affect the measurement of deferred tax assets and liabilities in the entity's financial statements as well as the consolidated financial statements of the entity's parent.

**3.087a** For example, Country A may impose a tax of 40% on undistributed corporate profits and then provide a tax credit of 5% upon payment of dividends, resulting in the foreign entity being taxed at 35% on that distributed income. ASC paragraphs 740-10-25-39, 25-40, and 30-14 address the accounting by a foreign entity for the tax credits it receives when its earnings are distributed. ASC Topic 740 requires the entity to measure its current and deferred taxes using the undistributed rate and recognize the tax benefit of the credit as a reduction of income tax expense in the period the credit is included in its tax return. ASC paragraphs 740-10-25-39 and 25-40 and 30-14

**3.087b** While a foreign entity may not anticipate receiving a tax credit on a distribution when measuring its taxes in its stand-alone financial statements, ASC paragraph 740-10-25-41 indicates a parent entity that consolidates a foreign subsidiary that receives a tax credit for dividends paid should reflect the subsidiary's current and deferred taxes at the distributed rate in the consolidated financial statements if the parent entity has not applied the ASC paragraph 740-30-25-17 (indefinite reversal) exception. However, if the parent entity has applied the ASC paragraph 740-30-25-17 exception, and therefore has not recognized a deferred tax liability on the unremitted earnings, the tax calculations are performed using the undistributed tax rate. We believe the guidance in this paragraph also applies when an entity determines how changes in an equity method investee's deferred taxes affect its equity in earnings when the investee is a foreign entity. ASC paragraph 740-10-25-41

**3.087c** Some jurisdictions may tax distributed earnings at a higher rate than undistributed earnings, resulting in additional taxes when dividends are paid to shareholders. For example, before April 1, 2012, resident entities in the Republic of South Africa were subject to a dual corporate tax system: a corporate income tax and a Secondary Tax on Companies, or STC, that is assessed on cash dividends declared. The effect of the STC was to effectively increase an entity's rate from the 28% corporate income tax rate to 34.55% on distributed earnings. Entities were able to avoid current period STC on dividends declared if those dividends were in the form of stock; however, the STC would become payable by the entity at some point during its life when accumulated earnings were paid to shareholders; for example, through merger, liquidation, or through a stock buy-back. In 2002, the AICPA's International Practices Task Force and the SEC staff discussed the matter of what rate should be used to record deferred taxes for entities subject to the STC. The Task Force and the SEC staff concluded that providing taxes at the distributed rate (an effective rate of 34.55%) was preferable, but that because the existing literature was not conclusive, it would not object to entities recording deferred taxes at the undistributed rate (an effective rate of 28%) provided the following

disclosures were made in one section of the financial statements to facilitate a reader's understanding of the implications:

- A statement that if dividends are distributed that the entity will have to pay additional taxes at a rate of X% on all distributions, and that this amount will be recorded as an income tax expense in the period the entity declares the dividends;
- A statement of when the additional taxes will be owed to the government;
- The amount of retained earnings that if distributed would be subject to the tax;
- The amount of tax that would be owed if the entity distributed all of the retained earnings that would be subject to the tax; and
- If dividends were declared and additional tax provision recorded during the year an income statement is presented, this item would need to be separately presented in the effective rate reconciliation. That is, the materiality criteria in Rule 4-08(h) of Regulation S-X would not be applied to justify combining with other items. If the registrant is not providing an effective rate reconciliation on U.S. GAAP basis (disclosure of the effective rate reconciliation is presented in the primary financial statements) the effect on the income tax provision would need to be separately disclosed.

The Task Force and SEC staff further stated that all entities subject to the STC should disclose the basis on which tax liabilities had been computed and, to the extent provision for the STC was made, the amount of undistributed earnings on which the provision has been made. While not addressed by the Task Force, an entity with a subsidiary subject to the STC for which the entity does not apply the exception to recording deferred tax liabilities when the temporary difference on the outside basis is indefinitely postponed, would need to include the STC in the determination of the deferred tax liability on the outside basis difference, if not recognized by the subsidiary. AICPA IPTF November 25, 2002 Meeting Minutes

The STC was replaced by a Dividends Tax, effective April 1, 2012. This tax on individuals and non-residents is levied at a rate of 15%. Entities with STC credits as of April 1, 2012 were able to use the credits for a period of three years from the effective date of the Dividends Tax to reduce the dividends withholding tax on dividends payable to individuals and non-residents and were able to pass on credits to shareholders who were resident entities.

On July 31, 2012, the French Parliament passed the second Amended Finance Act for 2012 (AFA) that enacted a new 3% tax on certain dividend distributions similar to the STC. We believe the accounting for the incremental French distribution tax should be consistent with the accounting for the STC.

**3.088 Real Estate Investment Trusts (REITs).** REITs obtain deductions for distributions to shareholders and, therefore, are not taxed on such distributed income. To qualify as a REIT, the entity must distribute 90% of its ordinary income. Because the



REIT will not pay tax on distributions of ordinary income to shareholders, basis differences which are expected to be part of the distribution of earnings will have no future tax consequences and therefore are not temporary differences for which deferred taxes should be provided. While REITs need not distribute capital gains to obtain the tax deduction for ordinary income, they must distribute those gains to obtain a capital gains tax deduction. Income tax paid by a REIT on retained capital gains is a component of the current tax expense for the REIT in the period the capital gains are realized. Deferred taxes should be recognized on differences between the tax basis and financial statement carrying amount of the assets and liabilities of the REIT if the reversal of those differences would result in capital gains that are expected to be retained and subject to taxes.

**3.089** In some cases, REITs can elect to pass retained capital gains and the related taxes paid by the entity to its shareholders. Under the election, the retained capital gains are treated as having been distributed and are therefore included in the shareholders' taxable income and any tax paid by the REIT is treated as having been paid on behalf of the shareholders. While this election may appear to convert the tax paid by the REIT into a withholding tax, similar to the situation discussed in ASC paragraphs 740-10-55-73 and 55-74 (see Paragraph 7.025 for additional discussion), we believe the tax liability and related tax expense remains with the REIT because the REIT will be required to pay the tax even if distributions are not made, the tax is based on capital gains of the REIT as opposed to the amount of an actual distribution, and the tax is assessed at the REIT's tax rate. Accordingly, income tax expense should be provided at the REIT level on retained capital gains whether or not the election has been made. A similar situation may arise with retained capital gains of registered investments companies. ASC paragraph 740-10-15-4

**3.090 Tax Holidays.** An entity should not recognize a deferred tax asset for the expected future benefit from a tax holiday that reduces taxes payable on future income. The benefit from the tax holiday (not being subject to the tax) is reflected when income is earned in the holiday period. For example, an entity that is granted a tax holiday in 20X7 for income generated through 20X9 should not recognize a deferred tax asset in 20X7 for the future benefit of not being subject to tax in 20X8 and 20X9. This prohibition against recognizing an asset for the future benefit applies to all tax holidays, regardless of whether the entity must qualify to obtain the holiday by fulfilling specific legal requirements or the tax holiday is available without qualifying requirements. ASC paragraphs 740-10-25-35 through 25-36

**3.091** As expressed in the Basis for Conclusions of FASB Statement No. 109 (paragraphs 183 to 184), in evaluating whether a deferred tax asset should be recorded for the expected future reduction in taxes payable during a tax holiday, the Board viewed a tax holiday *generally available* to any entity in a class of entities as creating a nontaxable status analogous to S-corporations under U.S. federal tax law. Further, the Board treated entities in jurisdictions where there may be a *unique* type of tax holiday that is controlled by the entity that qualifies for the tax holiday consistently with the treatment of generally available tax holidays, due to the practical problems in distinguishing between unique and generally available tax holidays.

**3.092** We believe the granting of a tax holiday is analogous to a voluntary change in tax status. As discussed in Paragraph 5.020, the effect of recognizing or eliminating deferred tax assets or liabilities as a result of a change in tax status is charged or credited to income tax expense from continuing operations on the taxing authority's approval date of the change in status or on the date the election is made if approval is not necessary. The change is recognized in income from continuing operations even if the deferred tax balances relate to a prior year or prior interim period gain or loss that was reported as a discontinued operation or an item of other comprehensive income. Similarly, the effects on current taxes payable or receivable of the retroactive provisions in a tax holiday result in a catch-up adjustment recorded in continuing operations.

**3.093** A tax holiday may reduce the enacted tax rate expected to apply to temporary differences that reverse during the holiday period. The effect of a tax holiday on measuring deferred tax assets and liabilities for existing temporary differences should be based on the period deferred tax assets and liabilities are expected to reverse. For example, if a net operating loss carryforward is scheduled to be used during a tax holiday, no deferred tax asset would be recognized. See Section 4 for guidance on selecting a scheduling method.

### Example 3.8: Measuring the Effect of a Tax Holiday

ABC Corp. is granted a tax holiday by a foreign government. Under the tax holiday arrangement, ABC is not required to pay income tax on taxable income generated during 20X6 through 20Y0. In addition:

- ABC acquires an asset for FC 600 on January 1, 20X6.
- The acquired asset is depreciated on a straight-line basis over six years for financial statement purposes (FC 100 per year).
- The acquired asset is depreciated on a straight-line basis over three years for tax purposes (FC 200 per year).
- The tax rate on taxable income after the five-year holiday is 40%.

December 31		Financial Statement Carrying Amount	Tax Basis	Basis Difference
20X6	FC	500	FC 400	FC 100
20X7		400	200	200
20X8		300	—	300
20X9		200	—	200
20Y0		100	—	100
20Y1		—	—	—

ABC should schedule the reversal of existing temporary differences at each balance sheet date and should recognize deferred taxes only for those differences that will reverse in periods after the tax holiday has expired and tax effected. ABC could use either of the

following acceptable scheduling methods in determining the timing of the reversal of existing temporary differences. See the Appendix A.

#### **Method 1: Last-in First-out**

ABC should record a deferred tax liability and a deferred tax expense of \$40 in 20X6, which does not reverse until year 20Y1. There would be no tax expense in years 20X7, 20X8, 20X9, and 20Y0 and the deferred tax liability would remain at FC 40 during those years because there is no net increase in the deferred tax liability as a result of scheduling the temporary differences to reverse on a LIFO basis.

#### **Method 2: First-in First-out**

This alternative would not consider future originating differences in the scheduling process. Therefore, ABC would ignore the future originating differences and schedule the existing difference when they originate and reverse on a FIFO basis. Under this alternative:

- The FC 100 temporary difference at the end of 20X6 will reverse in 20X9. Because the tax holiday does not expire until after 20Y0, no deferred tax liability or deferred tax expense is recognized in 20X6.
- At the end of 20X7, the temporary difference of FC 200 is scheduled to reverse in 20X9 and 20Y0, which is still within the holiday period so no deferred taxes would be recorded in 20X7.
- In 20X8, the temporary difference of FC 300 will be scheduled to reverse in 20X9, 20Y0, and 20Y1. A FC 40 (FC 100 × 40%) deferred tax liability should be recognized in 20X8 for the FC 100 temporary difference reversing in 20Y1.
- There would be no change in that deferred tax liability in 20X9 and 20Y0. The deferred tax liability reverses in 20Y1 when the entity is subject to tax.

**3.094** If the tax holiday exempts only a portion of taxable income from taxation each period, the guidance discussed in Paragraphs 3.053 and 3.054 for graduated tax rates generally would apply.

**3.095 Deferred Effects of Intra-entity Sales of Inventory.** As discussed in Section 2 (see the discussion beginning in Paragraph 2.063), income taxes paid in the seller's jurisdiction and the reversal of existing temporary differences in the seller's jurisdiction related to intra-entity sales of inventory are deferred and recognized in income when the inventory is transferred (sold) outside the consolidated group. These deferred tax effects are not temporary differences for which the seller recognizes deferred tax assets or liabilities under ASC Topic 740. Accordingly, these deferred tax effects are not adjusted for changes in tax rates but are simply measured based on the balances existing at the transaction date (subject to impairment).

**3.096 Tax Deduction on Qualified Production Activities before 2017 U.S. Tax Reform.** Before tax reform was enacted in 2017, U.S. tax law provided a tax deduction of up to 9% of the lesser of (a) *qualified production activities income*, as defined in the Act, or (b) taxable income (after the deduction for the use of any NOL carryforwards). This tax deduction was limited to 50% of W-2 wages paid by the taxpayer. ASC paragraphs 740-10-55-27 through 55-30 address the accounting for the deduction on qualified production activities. ASC paragraph 740-10-55-29 indicates that the deduction should be accounted for as a special deduction under ASC paragraph 740-10-25-37, not as a rate reduction, because the deduction is contingent on performing activities specified in the new tax law, including the future level of wages. While this guidance is no longer directly applicable in the United States because of the repeal of the deduction effective for tax years beginning after December 31, 2017 for C corporations, its concepts may still be relevant when evaluating whether certain tax law provisions are more akin to special deductions or tax rate adjustments.

**3.096a Patent Box Regimes.** Patent box regimes generally allow entities a deduction that has similar economic effect as a reduced corporate tax rate applied to profits attributed to qualifying intellectual property (IP) (e.g., patents, licenses) as long as the entity performs a specified amount of qualifying activities during the accounting period. The computation of the profit base (i.e., the eligible patent box income) to which the incentive applies and the amount of the deduction may be complex and often includes some (or all) of the following:

- Limiting the deduction to a fixed percentage of the total profit from the IP;
- Reducing the gross IP income for routine and marketing asset returns; and
- Multiplying the IP income by a nexus (or R&D) fraction, which generally is intended to capture the proportion of the value of the qualifying IP that is attributable to the research and development undertaken by the taxpayer.

Depending on the facts and circumstances of how an individual jurisdiction enacts its patent box regime, the benefit of the incentive related to eligible patent box income might be accounted for like (a) a special deduction, which is recognized in current tax expense or benefit no earlier than the period in which the deduction is available on the tax return (see Paragraph 3.074), or (b) a separate statutory tax rate to apply to temporary differences that are expected to reverse into eligible patent box income (see Paragraph 3.057). Although concluding on which approach is appropriate depends on the details of the individual jurisdiction's tax law, special deduction characterization has more often been appropriate in recent patent box regimes, particularly in consideration of the mechanics associated with the nexus fraction.

**3.097 Reenactment of Entire Tax System.** In certain foreign jurisdictions, the entire income tax structure may have a specified life, necessitating reenactment for the income tax system to continue. Deferred tax assets and liabilities in such jurisdictions generally should be recognized and measured based on the presumption that the currently enacted tax laws and rates will be reenacted for future years. Changes in those tax laws and rates, other than reenactment, should not be anticipated. See additional discussion in Paragraph 5.011.

**3.098 Tax-Exempt Status under ASC Subtopic 740-10 (FIN 48).** The ASC Subtopic 740-10 Sections addressing uncertainty in income taxes apply to not-for-profit organizations, pass-through entities, REITs, RICs, and other entities that are potentially subject to income taxes if conditions specified by the tax law are not met. A tax-exempt or pass-through entity's assertion that it is not subject to tax is a tax position (e.g., the entity qualifies as a REIT) that should be evaluated under ASC Subtopic 740-10 for recognition and measurement of uncertainty in income taxes in the same manner as other tax positions. In certain of these situations it may be appropriate to consider, among other things, how the taxing authority may apply its administrative practices and precedents to the entity's particular facts and circumstances. See Paragraph 3.023 for additional discussion of administrative practices and precedents. In addition, if a tax-exempt entity is required to consolidate a taxable entity, the consolidated entity should include the assets, liabilities, income, and expenses, as well as the disclosures, related to tax positions for the taxable subsidiary under ASC Subtopic 740-10 (FIN 48). ASC paragraphs 740-10-15-2AA, 55-229

**3.099 Nexus under ASC Subtopic 740-10 (FIN 48).** Similar to the discussion about tax-exempt status, the ASC Subtopic 740-10 Sections addressing uncertainty in income taxes apply in evaluating whether an entity is taxable in a particular jurisdiction. An entity should evaluate nexus for all jurisdictions where it might be subject to income taxes. Each of these evaluations is a separate tax position that is subject to the recognition, measurement, and disclosure requirements of ASC Subtopic 740-10. In certain situations related to nexus or tax-exempt status, it may be appropriate to consider, among other things, the administrative practices and precedents of the relevant taxing authority. For example, in some state jurisdictions, the taxing authority may have an administrative practice of limiting its assessment of income taxes to a certain number of previous years when it determines that an entity is taxable in that jurisdiction. In those circumstances, it may be appropriate to consider each year for which nexus is uncertain as a separate unit of account. An entity should also consider the application of the administrative practice to its particular facts and circumstances (e.g., would the taxing authority apply the same administrative practice when nexus was identified in an exam versus through self-reporting). See Paragraph 3.023 for additional discussion of administrative practices and precedents. ASC paragraph 740-10-55-223

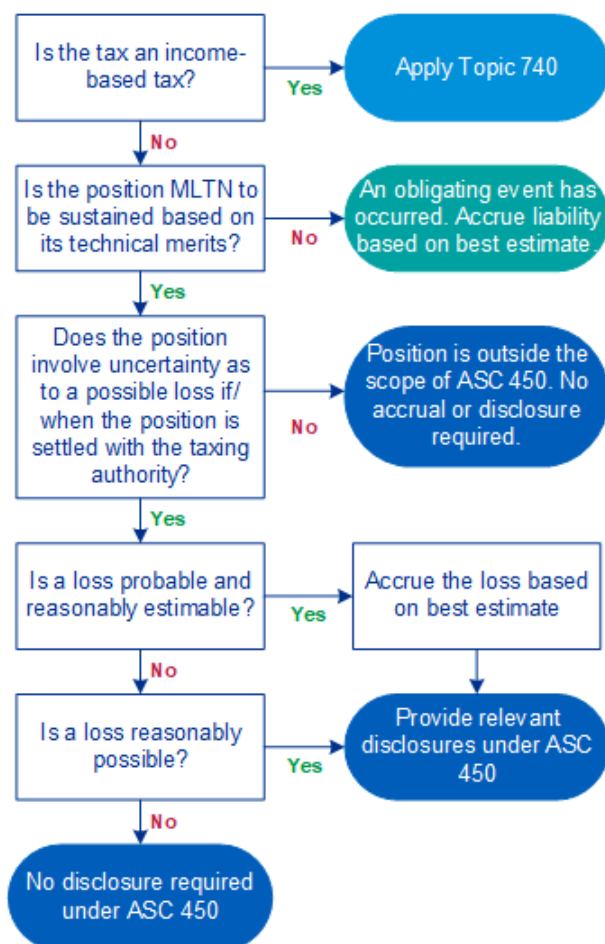
**3.100 Uncertainty in Non-Income-Based Taxes.** The guidance on accounting for uncertainty in income taxes does not apply to taxes that are not subject to ASC Topic 740. ASC Topic 450, *Contingencies*, provides guidance on the accounting for contingencies, including contingencies associated with non-income-based taxes. However, because not all uncertainties create a *contingency*, we believe an entity should first evaluate the technical merits of a non-income-based tax position to see if (a) an obligating event has occurred (i.e., the entity has (or will have) an obligation to remit amounts to the taxing authority when a taxable event occurs), or (b) a ASC Topic 450 contingency exists (i.e., there is uncertainty about whether the entity has (or will have) that obligation). When considering the technical merits, we believe an entity should assume the relevant taxing authority has full knowledge of the position (i.e., detection risk should not be considered).

**3.100a Non-Income-Based Taxes - Obligating Event Has Occurred.** We believe that if it is more likely than not (based on a technical analysis, assuming the taxing authority has full knowledge of the position) that the taxing authority will require the entity to pay the tax, then an obligating event has occurred. In that case, an entity should accrue that obligation based on its best estimate of the liability.

**3.100b Non-Income-Based Taxes - Contingency Exists.** If it is not more likely than not that the taxing authority will require the entity to pay the tax, we believe the entity should analyze and account for its exposure as a loss contingency under ASC Subtopic 450-20, *Loss Contingencies*. An entity recognizes a liability for a loss contingency only if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure is required if there is a reasonable possibility that a loss may have been incurred.

**3.100c** When assessing the probability that a liability has been incurred for an unasserted claim, the entity should consider the likelihood that (a) the claim will be asserted, and (b) that there will be an unfavorable outcome. This guidance differs from accounting for income tax uncertainties because ASC Topic 740 requires entities to assume the taxing authority has full knowledge of the position. ASC paragraphs 450-20-55-14 and 55-15

The following flowchart illustrates this guidance:



**3.101** For example, consider a situation in which ABC Corp., a retailer, operates in 10 states primarily in the Northeast. While it has sold goods in the state of New York for the past two years, ABC has never reported or remitted sales and use tax. ABC believes that if audited by the state, it would have a liability for its failure to collect and remit sales and use taxes, but also believes that there is a low likelihood that it will be audited.

**3.101a** As discussed in Paragraph 3.100, the guidance in ASC Topic 450, including the guidance about considering detection risk associated with unasserted claims, applies only to uncertainties that are considered *contingencies*. In this case, because there is no uncertainty that the obligating event has occurred, we do not believe the exposure associated with the failure to collect and remit the sales and use taxes is an unasserted claim under ASC Topic 450. Thus, no consideration should be given to the fact that the taxing authority has not discovered this omission. Rather, ABC should make its best estimate of the obligation assuming the taxing authority is fully aware of its position.

**3.101b Wayfair Decision.** On June 21, 2018, the Supreme Court overturned its previous decision<sup>1,2</sup> that a state cannot require a business to collect sales and use taxes from customers in states where the business has no physical presence. While the Court did not say that the South Dakota law is permissible in every circumstance, it paves the way for states that have adopted an economic nexus law to begin requiring the collection of sales and use taxes if the law does not otherwise violate constitutional principles. While the Court did not resolve all of the issues in its decision, it is clear that businesses that do not collect and remit sales and use taxes cannot continue to rely on not having a physical presence when doing business in states with economic nexus laws as support for that practice.

**3.101c** Entities affected by the Wayfair decision evaluated its impacts as discussed beginning in Paragraph 3.100. The first step was for an entity to evaluate the technical merits of its sales and use tax positions (assuming full knowledge by the state taxing authorities) to see if an obligating event had occurred or an ASC Subtopic 450-20 loss contingency existed. An entity may also have evaluated the accounting and reporting for its other non-income-based tax positions that could have been affected.

**3.101d** An entity that concluded that it was more likely than not that the state taxing authority would require it to collect and remit sales and use taxes generally began accounting for those obligations as they arose on and after June 21, 2018 (or, on and after the effective date of the particular state's tax law, if later). Entities also generally reevaluated their exposures before June 21, but it was considerably less likely that the state tax laws could have been applied retroactively.

**3.101e** An entity that concluded that it was not more likely than not that the state taxing authority would require it to collect and remit sales and use taxes, generally analyzed its exposure under ASC Subtopic 450-20 and recognized a liability for a loss contingency only if it was probable that a liability had been incurred and the amount of the loss was reasonably estimable.

**3.101f** While the Court case was specific to whether a state can require entities that do not have a physical presence in the state to collect sales and use taxes, many entities considered whether the decision affected their conclusions about state nexus for *income tax* purposes. We understand that some states may have applied by analogy the sales and use tax physical presence standard for asserting state nexus for income taxes. Affected entities may need to consider how the Court's decision affects the accounting for those positions on an ongoing basis. Entities are required to reevaluate recognition and measurement of income tax positions in the period in which new information is available.

**3.102 Application of ASC Topic 450 to Tax Uncertainties.** Uncertainties related to income taxes are not accounted for under ASC Topic 450. While some entities may have historically applied the predecessor of ASC Topic 450 to income tax contingencies in the past (i.e., before the adoption of FIN 48), ASC Topic 450 specifically excludes income tax uncertainties from its scope. Income tax uncertainties must be accounted for under the recognition and measurement principles of ASC Subtopic 740-10 (FIN 48). Under ASC Subtopic 740-10, some uncertainties are addressed in the recognition step (e.g., uncertainties surrounding the validity of a deduction) and others are addressed in the measurement step (e.g., uncertainties surrounding the settlement amount of a deduction). ASC subparagraph 450-20-15-2(c)

**3.103 Accounting for the Abatement or Refund of Non-Income-Based Taxes.** In some situations, an entity may be entitled to an abatement or refund of a non-income-based tax (e.g., sales tax or property tax) as long as it meets certain criteria (e.g., presence, minimum employment levels, or pollution control). We believe that an abatement or refund of non-income-based taxes (or a reduction in the amount of the payable) should be evaluated in the same manner used to evaluate an indemnification or recovery of losses or expenses; see Paragraph 6.045 for application of this guidance to indemnifications related to income tax uncertainties in business combinations.

**3.103a** Accordingly, before recognizing any benefit, the entity must meet the requirements to qualify for the abatement or refund and it should be probable, as that term is used in ASC Topic 450, that the contingent recovery will be both sustained upon examination by the taxing authority and realizable by the entity. A *probable* threshold for initial recognition is supported by the guidance in ASC paragraphs 410-30-35-8 through 35-10 (ASC Subtopic 410-30, *Asset Retirement and Environmental Obligations - Environmental Obligations*). That guidance generally requires that an asset related to the recovery of a loss be recognized only when realization of the recovery is probable (as that term is used in ASC Topic 450).

**3.104** If an entity is unable to conclude that the abatement or refund of the tax is probable of being sustained and realized, it should not recognize the benefit but should recognize an obligation for the tax as provided by statute or contract. The entity should also consider the disclosure requirements in ASC Topic 450 and ASC Topic 275, *Risks and Uncertainties*.

**3.105** Beginning in the period that the entity concludes that the tax abatement or refund is probable of being sustained and realized, we believe that the entity should generally



recognize the benefit in the period(s) that the benefit relates to. For example, if the benefit is intended to *compensate* the entity for maintaining minimum employment levels, it may be appropriate to recognize the benefit over the specified term. In many instances this will be the same as recognizing the benefit in the period that the benefit becomes available similar to the accounting for income tax holidays (see Paragraph 3.090 for further discussion). However, if the tax is related to the use of property, we believe that it is preferable in many instances that the benefit be recognized over the life of the related property (the deferral method in ASC paragraphs 740-10-25-45 and 25-46 – see additional discussion in Paragraph 10.128).

**3.106** Finally, if the entity were to subsequently determine that it is probable that the tax abatement or refund will be not sustained or realized (i.e., it is probable that a loss has been incurred), any benefit previously recognized should be reversed through the income statement in the current period.

**3.106a Non-Income-Based Tax Credits.** There may be situations in which a government provides a taxpayer with a credit against its non-income-based tax rather than an abatement or refund as discussed beginning in Paragraph 3.103. Depending on the facts and circumstances, that credit may be accounted for separately as a government grant, rather than a tax credit under the recovery model applied to a non-income-based tax abatement or refund. For example, the CARES Act granted eligible entities an employee retention credit against applicable payroll taxes for each calendar quarter in an amount equal to 50% of qualified wages. Eligible amounts that exceed an entity's applicable payroll tax liability are refundable to the entity. Therefore, the credit is determined to be a grant in its entirety. In accounting for this credit, the entity applies:

- ASC Subtopic 958-605 if it is a not-for-profit entity; or
- If it is a for-profit entity, one of the following by analogy:
  - IAS Standards 20, *Accounting for Government Grants and Disclosure of Government Assistance*,
  - ASC Subtopic 958-605, *Not-for-profit entities – revenue recognition*, or
  - ASC Subtopic 450-30, *Gain Contingencies*.

Additional guidance is provided in KPMG Hot Topic, [Financial reporting implications of the CARES Act](#). See also chapter 3 of KPMG handbook: *Tax Credits* for additional guidance on the accounting for refundable tax credits.

**3.107 Unit of Account – Examples.** The unit of account used to identify an individual tax position is a matter of judgment that should consider the manner in which an entity prepares and supports its income tax returns and the approach expected to be taken by the taxing authority during an examination. It generally is appropriate to define the unit of account at the lowest level necessary to ensure that benefits with widely varying levels of uncertainty or issues that may be treated differently under the tax law are not included in the same unit of account, assuming such disaggregation is consistent with the manner in which an entity prepares and supports its income tax returns and the approach expected to

be taken by the taxing authority during an examination. This issue often arises in analyzing research and experimentation expenditures. ASC paragraphs 740-10-55-81 through 55-86

**3.108** For example, an entity may claim a tax benefit for a qualifying research project that contains both expenditures that are highly certain to result in a benefit and expenditures that are likely to be disallowed but may ultimately yield some level of benefit if challenged and negotiated with the taxing authority. If the unit of account is the research project rather than each class of expenditure within the project, the entity would likely conclude that the more-likely-than-not recognition threshold has been met because it is more likely than not that the entity is entitled to some level of credit related to the research project as a whole. In that circumstance, the measurement of the benefit may include amounts associated with classes of expenditures that would not have met the recognition threshold had those classes of expenditures been evaluated as individual tax positions (i.e., the unit of account defined by project *and* class of expenditure) as a result of the consideration of negotiations with the taxing authority in the measurement step of ASC paragraph 740-10-30-7. While identifying the unit of account is a matter of judgment depending on the facts and circumstances, the entity is required to consider the approach expected to be taken by the taxing authority during an examination and, thus, if the taxing authority is likely to examine the research and experimentation benefits by project *and* by class of expenditure, it may be more appropriate to identify the unit of account as the benefit for specified expenditures rather than the project in its totality.

**3.109** Similar issues may arise in cost-sharing arrangements between related parties in which individual elements of the cost-share pool may be evaluated independently if examined by the taxing authority. For example, if a single cost sharing arrangement involves deductions for reimbursements of ordinary expenditures that are highly certain to be allowed by the taxing authority and costs that are less certain to be allowed, it may be more appropriate to conclude that there are two distinct tax positions associated with the cost-sharing arrangement; one related to the highly certain expenditures and one related to the costs for which the tax treatment is uncertain. A similar analysis may be appropriate in the jurisdiction that is reporting the reimbursement as taxable income. Unit of account should be analyzed separately in each jurisdiction in which related tax positions are taken if taxing authorities in different jurisdictions follow different laws or practices, or if those taxing authorities are likely to approach the tax position in a different manner. See additional discussion of cost-sharing arrangements beginning in Paragraph 8.025.

**3.110 Aggregating Multiple Tax Positions.** An entity can evaluate tax positions on an aggregate basis only when an aggregate analysis is expected to yield similar results to separate analyses by individual tax position. Accordingly, those positions should be similar in nature and subject to similar underlying risks of disallowance such that the recognition and measurement conclusions if the analysis were performed in the aggregate would be consistent with the conclusions if the analysis were performed separately as ASC paragraph 740-10-25-7 requires that each tax position be evaluated without considering offsetting positions. For example, it would not be appropriate if, as a result of

aggregating multiple tax positions, some level of benefit was recognized for a tax position that, if analyzed individually, would not meet the more-likely-than-not threshold.

#### **Example 3.9: Evaluating Uncertainty in State Tax Positions in the Aggregate**

ABC Corp. is evaluating the deductibility of current-period interest payments made between several wholly owned subsidiaries. All of the intra-entity interest payments are eliminated for financial reporting and federal income tax purposes but are deductible under similar tax laws in several states in which separate company returns are required. The reduction of taxes payable in any one state does not constitute a significant item for financial reporting purposes; however, the reduction to taxes payable for all states in the aggregate does constitute a significant item for financial reporting purposes.

Although ABC prepares separate tax returns for each state reflecting the intra-entity interest deduction, it may be acceptable to evaluate the tax positions for recognition in the aggregate if it calculates the deductions in a consistent manner and each state is likely to apply a similar standard in determining whether the deductions are valid. However, an aggregate analysis would not be appropriate if ABC expects different states to approach the issue differently.

#### **Example 3.10: Evaluating Uncertainty in Foreign Tax Positions in the Aggregate**

ABC Corp. is headquartered in the United States and has several foreign subsidiaries from which it collects royalties equal to 10% of the subsidiaries' sales to customers. ABC believes the IRS will analyze the royalty rate charged to all the foreign subsidiaries on the same basis because there are no international tax treaties applicable to any of the foreign tax jurisdictions in which the subsidiaries operate.

Despite the fact that the individual royalty arrangements have unique non-U.S. counterparties in various foreign tax jurisdictions, it may be acceptable to evaluate the U.S. tax positions in the aggregate if ABC expects to defend and settle these tax positions with the IRS in the aggregate. It generally would not be appropriate to aggregate the U.S. positions if ABC expected the IRS to approach each royalty arrangement in a different manner. In addition, it generally would not be appropriate to aggregate the comparable tax positions in each of the foreign tax jurisdictions due to the differences in tax law and regulations as well as the administrative practices of those taxing authorities.

See Paragraphs 3.018 for additional discussion of unit of account and 3.118 for additional considerations associated with transfer pricing.

**3.111 Economic Substance Doctrine.** The economic substance doctrine was developed as a common-law doctrine applied by courts to deny tax benefits resulting from transactions that do not meaningfully affect a taxpayer's economic position other than providing a tax benefit. This common law doctrine was codified and effective for transactions entered into after March 30, 2010. While the code does not provide guidance about when the economic substance doctrine should apply, it does provide a definition of economic substance that should be used to evaluate transactions to which a court determines the doctrine should apply. Under the economic substance doctrine, a transaction is treated as having economic substance if:

- The transaction changes the taxpayer's economic position in a meaningful way (apart from federal income tax effects), *and*
- The taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

**3.112** Entities should consider whether they meet both criteria in Paragraph 3.111 when evaluating tax positions where the economic substance doctrine may apply. If a tax position is determined not to have economic substance, the reasonable cause and good faith exception to the penalty does not apply and a 20% penalty would apply to the tax understatement. Therefore, even if an entity has an opinion from a tax advisor and reasonably believes a transaction meets the criteria, the 20% penalty would apply if the court determined the transaction did not have economic substance. The penalty increases to 40% for undisclosed noneconomic substance transactions. Penalties should be considered when determining the amount of penalties that should be accrued related to a tax position.

**3.113** The codification of the economic substance doctrine is not intended to disallow tax benefits that are consistent with congressional intent or alter the tax treatment of certain basic business transactions that are permitted under longstanding judicial and administrative practice just because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. These basic transactions include, among other things, choices between using:

- (1) Debt or equity to capitalize a business enterprise;
- (2) A foreign corporation or a domestic corporation to make a foreign investment (for a U.S. citizen);
- (3) A transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C of the Internal Revenue Code; and
- (4) A related-party entity in a transaction if the arm's-length standard of section 482 and other applicable concepts are satisfied.

**3.114 Valuation Uncertainties.** For tax positions that involve valuation uncertainty (for example, a deduction based on a nonmonetary transaction or a related-party transaction), if the tax position is considered more likely than not of being sustained in a tax authority examination (that is, it is more likely than not that the entity is entitled to some level of

tax benefit related to the transaction) then the valuation uncertainty should be addressed in measurement, even if it is more likely than not that the entity will not receive the entire benefit claimed on the tax return.

### **Example 3.11: Evaluating ASC Subtopic 740-10's Recognition Threshold for a Nonmonetary Transaction**

ABC Corp., a private company, issues common stock to a nonemployee as compensation for goods and services and takes a \$1 million deduction related to the share-based payment in its 20X7 tax return. Based on the tax law, management concludes that it is more likely than not that some level of deduction will be sustained in the 20X7 tax return if taken to the court of last resort, but the probability of the entire \$1 million being sustained is not more likely than not to be sustained. ABC believes that the largest amount that is greater than 50% likely of being sustained is \$600,000.

ABC would conclude that the tax position (deductibility of share-based compensation to the nonemployee) meets the more-likely-than-not recognition threshold and would measure the current tax benefit at a tax effect of \$600,000. ABC (assuming it had no net operating loss carryforwards or other credits to offset the unrecognized tax benefit if it were to be ultimately disallowed) would record a tax liability related to the unrecognized tax deduction of \$400,000 as well as any applicable interest and penalties.

**3.115 Timing Uncertainties.** If it is more likely than not that the entity is entitled to the benefit of a tax position (i.e., it is more likely than not that the benefit will be sustained in the current year or in a future year), that tax position generally meets the recognition threshold and should be measured under ASC paragraph 740-10-30-7. The entity would measure a current benefit equal to the largest amount that is greater than 50% likely of being realized for the current year, if any, and increase income taxes payable (which represents the unrecognized tax benefit) for the excess of the amount actually deducted on the tax return over the largest benefit that is greater than 50% likely of being realized. In addition to the measured current benefit and the related increase to taxes payable, it may be appropriate to recognize a deferred tax asset (or a reduction of a deferred tax liability) for the implied tax basis based on the largest amount of tax benefit that is greater than 50% likely of realization in a future year. The effect of potential interest and penalty assessments should also be addressed. ASC paragraphs 740-10-55-111 and 55-112

### **Example 3.12: Evaluating a Timing Uncertainty When Some Amount of Current Benefit Is Greater Than 50% Likely of Being Realized**

ABC Corp. incurs costs of \$1 million to repair major equipment in its manufacturing plant on January 1, 20X8 recognizing the expenditure as a current-year expense in the financial statements and intends to take the related deduction in its 20X8 tax return.

Management believes it is highly certain that the \$1 million will ultimately be deductible; accordingly, the more-likely-than-not recognition test is met. Management then assesses the largest amount that is greater than 50% likely of realization tax position, which is to capitalize the expenditure and amortize it over four years resulting in the following deductions (by tax year):

20X8	\$ 250,000
20X9	250,000
20Y0	250,000
20Y1	250,000

Because it is more likely than not that ABC will ultimately sustain the deduction, the position has met the recognition threshold and should be measured. ABC should record the current benefit of a \$250,000 deduction (i.e., recognize an increase in taxes payable for the benefit of the additional deduction of \$750,000) because the largest amount of benefit that is greater than 50% likely of being realized in the current period is for a \$250,000 deduction. Additionally, because it is more likely than not that ABC is entitled to future benefits (i.e., tax basis), it should also recognize a deferred tax asset related to the future deductible amounts of \$750,000 because there is no corresponding asset for financial reporting purposes. Assume ABC has a 21% tax rate and does not anticipate settling its unrecognized tax benefit via payment of cash within one year (the length of its operating cycle). ABC would make the following entries at December 31, 20X8 to reflect the application of ASC Subtopic 740-10 (FIN 48) to amounts expected to be reported in its tax return.

	Debit	Credit
Current tax expense	157,500	
Deferred tax asset	157,500	
Deferred tax benefit		157,500
Noncurrent income taxes payable		157,500

ABC would also be required to assess recognition of applicable interest and penalties on its unrecognized tax benefit (noncurrent taxes payable) of \$157,500. ABC should record interest beginning in the first period the interest would begin accruing according to the provisions of the relevant tax law. The \$157,500 unrecognized tax benefit should be included in the rollforward disclosure of unrecognized tax benefits discussed in Paragraph 9.097.

**3.116** If no level of deduction is greater than 50% likely of realization in the current year, no current benefit would be recognized and an increase to income taxes payable would be required for the entire amount actually deducted on the tax return. However, as discussed above, if the benefits are more likely than not of being sustained if taken in future years, then a deferred tax asset (or a reduction of a deferred tax liability) would be established that offsets the increase to income taxes payable. The effect of potential interest and penalties assessments should also be addressed.

### Example 3.13: Evaluating a Timing Uncertainty When No Amount of Current Benefit Is Greater Than 50% Likely of Being Realized

In 20X8, DEF Corp. accrues a \$1 million financial statement liability related to an environmental remediation contingency, which it expects to pay in 20Y2. DEF also intends to take a \$1 million deduction in its 20X8 tax return. Management believes it is highly certain that the \$1 million will ultimately be deductible; accordingly, the more-likely-than-not tax recognition test is met. Management then assesses the largest amount that is greater than 50% likely of realization tax position, which is that it will become deductible in 20Y2 when cash payment is expected to be made.

Because no amount of benefit is greater than 50% likely of being realized in the current year, DEF would recognize an increase in taxes payable for the tax effect of the entire \$1 million deduction, but also recognize a corresponding deferred tax asset for the future deductions of \$1 million because there is no corresponding liability for tax purposes. Assume DEF has a 21% tax rate and does not anticipate settling its unrecognized tax position via payment of cash within one year (the length of its operating cycle). DEF would make the following entries at December 31, 20X8:

	Debit	Credit
Current tax expense	210,000	
Deferred tax asset	210,000	
Deferred tax benefit		210,000
Noncurrent income taxes payable		210,000

DEF would also be required to assess recognition of applicable penalties and interest on its unrecognized tax benefit (noncurrent taxes payable) of \$210,000. DEF should record interest beginning in the first period the interest would begin accruing according the provisions of the relevant tax law. The \$210,000 unrecognized tax benefit should be included in the rollforward disclosure of unrecognized tax benefits discussed in Paragraph 9.097.

**3.116a Evaluating Uncertainties Associated with Unintended Benefits or Detriments in Enacted Tax Law.** As discussed beginning in Paragraph 3.066, the accounting for income taxes, including evaluating uncertainties, should be based on existing tax law, including existing interpretive guidance, as of the reporting date, even if an entity anticipates a future change in tax law. There may be provisions in the current tax law that an entity believes may provide unintended benefits or detriments to taxpayers. The entity also may believe that the law will be changed through future regulations or law changes. While these future changes may ultimately affect the analysis of a position's technical merits, an entity should account for its positions based on the tax law as currently enacted at the reporting date.

When evaluating whether to recognize a tax position, entities are reminded that:

- changes in tax law must be accounted for in the period of enactment and cannot be anticipated.
- when evaluating the more-likely-than-not recognition threshold, neither a notice of intent by the Treasury to issue a regulation, nor a proposed regulation, generally change the assessment of the taxpayer's ability to sustain the benefit if the taxpayer takes the dispute to the court of last resort. However, such notices may influence an entity's assessment of the effect of the taxing authority's administrative practices (such as a practice of not challenging positions consistent with its own proposed rulemaking). Entities may want to consult with their tax specialists as to the effect of such notices.
- there is a presumption that beneficial tax positions (based on currently enacted tax law) will be claimed even if they are not claimed (or expected to be claimed) in the original filing of a tax return.
- not recognizing benefits in the first period in which an expected filing position meets the more-likely-than-not recognition threshold may later result in an error for financial reporting purposes if (or when) that benefit is subsequently recognized.

When evaluating how to measure the benefit of a recognized tax position, entities are reminded that:

- while the amount of recognized financial statement benefit is not based solely on the probability of sustaining the position on its technical merits, measurement of a tax benefit at less than 50 percent may raise questions as to whether the tax position meets the more-likely-than-not recognition threshold; however,
- measurement of less than 50% may be appropriate in some circumstances. For example, an entity may believe that it is more likely than not that it would sustain a position under currently enacted tax law if it took the dispute to the court of last resort, but it is unlikely to realize the benefit. This may be the case because other information (e.g., interactions with the taxing authority, proposed regulations) suggests that if examined, the entity would be unsuccessful in negotiations with the taxing authority, and it is not willing to pursue the position to the court of last resort.

If an entity is recognizing the benefit of a tax position that would be reversed if regulations were finalized as proposed, we believe it should consider disclosing the nature and amount of any potential adjustment.

**3.117 Use of Probability Tables in Applying ASC Subtopic 740-10 (FIN 48).** ASC Subtopic 740-10 (FIN 48) does not require an entity to analyze recognition or measurement of uncertainty in income taxes in a specific manner. Further, because the nature and level of uncertainty of individual tax positions will vary, the extent of the



analyses required to conclude on measurement will also vary. For example, extensive analysis generally will not be required to support the measurement of highly certain tax positions that are not likely to be questioned by the taxing authorities when it is clear that the full amount of the benefit is highly likely of being realized. In these situations, documentation may be focused on the processes and procedures used to identify the uncertainty in the entity's tax positions. Similarly, if an entity has recently reached agreement on the current and future treatment for a particular class of tax positions in discussions with the taxing authority, the entity would likely be highly certain of the amount of benefit that it will realize assuming no change in the relevant tax law, assumptions, or other information that would affect its assessment. In those circumstances, management may not need to evaluate other possible outcomes. For tax positions with multiple (and sometimes indeterminate) possible settlement outcomes, management should consider all available relevant information in determining the largest amount of benefit that is greater than 50% likely of being realized upon settlement. Management is not required to identify every possible outcome, identify a particular number of possible outcomes, or document its considerations in a table (although a table may be an appropriate method for analysis in some circumstances). In many instances, management may be able to determine the largest amount of benefit that is greater than 50% likely of realization without constructing a cumulative probability table. ASC paragraphs 740-10-55-100 and 55-101, 55-109

### **3.118 Consideration of Tax Treaties in Measurement under ASC Subtopic 740-10.**

An entity should consider tax treaties and other agreements between taxing authorities in measuring the benefits it expects to realize on settlement when an intra-entity transaction results in offsetting tax positions in two or more tax jurisdictions. However, when performing the analysis of the uncertainty in its income tax positions, the entity should evaluate each of the individual tax positions generally on a tax position by tax position basis considering the effect of the treaty on the settlement result with each individual taxing authority. These considerations include whether the treaty applies to the particular tax position and, if so, how the treaty would affect the negotiation and settlement with each individual taxing authority. The consideration of tax treaties between jurisdictions is illustrated in Example 3.14.

#### **Example 3.14: Measurement of the Uncertainty in an Intra-entity Transaction under ASC Subtopic 740-10 (FIN 48)**

ABC Corp., a public business entity as defined in ASC Topic 740, is headquartered in the United States and has a subsidiary in Canada. ABC-Canada pays a royalty of 10% of sales to ABC-US for the use of ABC-US intangible property. In the year in question, ABC-Canada sales were \$1 billion and therefore the royalty payment was \$100 million. ABC-Canada faces a marginal tax rate of 15%, while ABC-US faces a marginal tax rate of 21%. ABC-Canada deducted the \$100 million payment from taxable income, lowering taxes payable in Canada by \$15 million, and ABC-US included the \$100 million payment in taxable income, increasing taxes payable in the United States by \$21 million.

ABC has determined that there are two tax positions associated with the royalty transaction, one for the tax position in Canada deducting the royalty, and one for the tax position in the United States including the royalty in income. ABC has identified two units of account even though the transaction is supported by one transfer pricing study because the transaction results in two separate taxpayers within the consolidated group reporting to two different taxing authorities. The tax position in Canada relates to the risk that the taxing authority in Canada (the *CRA*) will disallow some or all of the deduction. The tax position in the United States relates to the risk that the IRS will assert that the royalty rate was too low such that reported taxable income is understated.

ABC has concluded that it is more likely than not that some amount of royalty is deductible in Canada, and further that there is taxable royalty income in the United States and therefore the royalty transaction passes the recognition test with respect to both units of account.

With respect to the royalty income recorded in the United States, ABC has determined that, if examined by the IRS, the IRS would likely assert that the royalty rate should have been higher. Absent any consideration of relief through international tax treaty, ABC has determined in measuring the tax benefit under ASC paragraph 740-10-30-7 that the lowest royalty rate that is greater than 50% likely of being accepted by the IRS is 15%. This adjustment would increase U.S. taxable income by \$50 million and U.S. taxes payable by \$10.5 million. However, this outcome would mean double-taxation of the \$50 million, because the United States would be levying taxes on that amount of royalty income in excess of the deduction received in Canada. The United States and Canada have a tax treaty that provides an administrative process (competent authority, or *CA*) between the IRS and the *CRA* to attempt to resolve double-tax issues. Should the IRS adjust the royalty rate, ABC expects to apply for relief of the double taxation through competent authority. If accepted for the process, the U.S. and Canadian competent authorities would seek to agree on a royalty rate acceptable to both tax authorities. If those negotiations were successful, final taxable income and taxes in both the United States and Canada would be adjusted to reflect the agreed royalty rate and the double-taxation would be eliminated.

ABC, in consultation with its tax advisors, has considered its eligibility for competent authority and the likelihood of various outcomes of the *CA* process based on knowledge of similar cases, and believes that it is highly likely this tax position would be successfully resolved through the *CA* process if examined. Considering the likelihood of a successful *CA* process and the likelihood of various outcomes of that process, ABC has determined that lowest royalty rate that is greater than 50% likely of being accepted by the IRS (through agreement of the U.S. and Canadian competent authorities) is 12.5%. At that outcome, ABC would have additional taxable income in the United States (relative to filing position) of \$25 million and additional taxes of \$5.25 million.

ABC has determined that if the Canadian tax position were examined by the *CRA* in the absence of the competent authority process, the highest royalty rate that is greater than 50% likely of being accepted is 10% (the as-filed tax position). However, considering the *CA* process (which is considered to apply to this position, as described above), the largest

benefit that is greater than 50% likely of being sustained (i.e., 12.5%) exceeds the as-filed benefit. Assuming both the Canadian tax position and the related U.S. tax position are settled through the CA process, settlement of the Canadian tax position is likely to result in a further reduction of taxable income in Canada (relative to the filing position) of \$25 million and an adjustment to taxes of \$3.75 million. In this particular case, the measurement of the largest benefit with a greater than 50% chance of being sustained is symmetrical between the U.S. tax position and the Canadian tax position because of the high likelihood of settlement through the CA process. These measures may not always align, even if an international treaty exists, depending on the probability of various settlement outcomes for each tax position. In each case, an entity must assume that all tax positions will be examined, and consider the effect of all relevant facts and circumstances on the probability of various settlement outcomes assuming the entity's tax positions are examined by the taxing authorities with full knowledge of the relevant facts.

The net exposure of ABC to the risk of its transfer pricing position in the United States, considering the likelihood of competent authority relief and its effect on the measurement of the royalty tax positions in the United States and Canada, is therefore \$1.5 million. However, ABC would need to establish a liability of \$5.25 million for the additional taxes payable in the United States and a tax asset of \$3.75 million for the related refund in Canada. The Canadian tax asset may represent an income tax receivable or a deferred tax asset depending on the relationship of eligibility for the benefit with the ultimate payment of taxes in the United States and whether the asset represents a possible refund related to a previously filed tax return or would instead represent a deduction to be reported in a tax return for a future period. In some cases, the benefit may represent an increase in an NOL carryforward. All facts and circumstances should be considered. If the asset is considered a receivable, it should be classified as current or noncurrent based on the expected timing of receipt. If the asset is a deferred tax asset (e.g., an increase in an NOL carryforward), it should be evaluated for recoverability in the same manner as other deferred tax assets existing in the tax jurisdiction where the future benefit arises.

Because ASC Section 740-10-50 requires public entities (public business entities after the adoption of ASU 2023-09) to disclose the gross unrecognized tax benefit (exclusive of indirect effects), ABC would disclose a \$5.25 million unrecognized tax benefit in its tabular rollforward (under ASC subparagraph 740-10-50-15A(a)). In addition, ABC would disclose a \$1.5 million unrecognized tax benefit (\$5.25 million less \$3.75 million) that if recognized would affect the effective tax rate (under ASC subparagraph 740-10-50-15A(b)). ABC must also consider interest and penalties, if applicable, for each tax position.

See additional discussion of the general disclosure requirements in Paragraphs 9.077 - 9.114, as well as Paragraph 9.123 for additional discussion of those disclosure requirements in the context of indirect effects.

**3.118a Evaluating Offsetting Positions Without a Treaty.** As discussed in Paragraph 3.118, an entity should consider how offsetting tax positions in two or more tax jurisdictions affect its measurement. However, when performing the analysis of the

uncertainty in its income tax positions in jurisdictions without a treaty (or other agreement), the entity should evaluate in isolation each of the individual tax positions in each individual tax jurisdiction. Without a treaty (or other agreement), an entity cannot simply assume offset between jurisdictions.

### **Example 3.14a: Evaluating Uncertainty in State Tax Positions in Multiple Jurisdictions**

ABC Corp. sold a business that had assets in two states and generated taxable income in 20X7. ABC determined that it is more likely than not required to apportion 100% of the gain on the sale of the business to one of the state jurisdictions (State X) and intends to file its State X tax return in that manner. ABC also determined that it was not more likely than not to sustain its filing position of apportioning no amount of the gain to the other state jurisdiction (State Y). Accordingly, ABC recognized a liability for the position associated with the State Y tax return. If State Y challenges the position and requires ABC to pay tax on a re-apportioned gain, ABC intends to file an amendment to the 20X7 return in State X to request a refund for the overpayment in State X based on the re-apportioned gain. ABC has not concluded that it is more likely than not that State X will grant the refund.

We believe it would be inappropriate for ABC to net its exposure in State Y with the offsetting effect that it may sustain on an amended State X tax return when measuring the tax effects of the sale. We do not believe ABC's facts and circumstances support a conclusion that the result of an amended State X tax return is an indirect effect of the State Y exposure (see Paragraph 3.059) that is more likely than not to be sustained.

As a result, ABC would not record a current tax receivable from State X, because:

- The tax return filed with State X is based on ABC owing 100% of the tax in State X; and
- ABC has not concluded that it is more likely than not that State X will grant the refund.

**3.119 Consideration of Litigation Costs in Measurement under ASC Topic 740 (FIN 48).** Costs to defend a tax position are not accounted for under ASC Topic 740 and thus should not be included in an entity's measurement of a tax position. Such legal costs generally should be accounted for under an entity's existing policy as discussed in ASC paragraph 450-20-S99-2 and should not be included in income tax expense. While legal costs should not be included in the measurement of a tax position, an entity's expectations as to how far it plans to litigate a position that meets the more-likely-than-not recognition threshold should be considered in evaluating the possible settlement outcomes for purposes of determining the largest amount of tax benefit that is greater than 50% likely to be realized (see Paragraph 3.048). That is, the expectation that an entity will settle with the examiner or at specific points in the litigation process rather

than litigate a position to the court of last resort should be considered in determining the probability of possible settlement outcomes.

**3.120 Interest and Penalties Related to Income Taxes.** ASC paragraph 740-10-25-56 requires entities to accrue interest expense on the underpayment of income taxes if the full benefit of a tax position is not recognized in the financial statements and interest would be required to be paid on underpayments of income tax under the tax laws. An entity would calculate interest based on the difference between the tax position recognized in the financial statements and the amount claimed on the tax return. That is, if the more likely than not recognition threshold is not met (see Paragraph 3.019 for additional discussion), interest should be accrued on the entire amount of the claimed benefit and if the recognition threshold is met, interest should be calculated based on the difference between the benefit recognized in the financial statements and the as filed benefit.

**3.121** Interest accrual computations under the provisions of the tax law can be complex. For instance, the rate at which interest is accrued may depend on the amount of underpayment and the effect of offsetting overpayments of tax (or prepayment of tax obligations) if certain elections are made. Further, the interest rate on overpayments of income tax may be different than the rate assessed on underpayments of income tax. Therefore, an entity may not be able to simply assume that offsetting tax positions will result in a net amount of zero interest. In some cases, there may be uncertainty as to how the taxing authority would apply the interest netting rules to an entity's particular facts and circumstances. Nevertheless, entities must make a reasonable effort to identify the relevant provisions of the tax law in estimating the amount of interest that they would be assessed assuming their unrecognized tax benefits are challenged and ultimately disallowed by the taxing authority. That analysis should consider when the tax positions would begin to accrue interest and what rate would apply to each position (considering the rules for interest rates that apply to offsetting positions, if applicable).

**3.122** The accrual of interest begins in the first reporting period that interest would begin to accrue under the tax law. Under U.S. tax law, interest is accrued on underpayments of income tax beginning on the last date prescribed for payment of the tax. Therefore, in the financial statements, interest may not necessarily begin to accrue when the entity initially recognizes a liability for unrecognized tax benefits. If the tax position does not meet the minimum statutory threshold to avoid penalties, penalties should be recognized in the financial reporting period for the tax year the tax position would give rise to the penalty. For interest income on overpayments of income taxes, the SEC staff has indicated that it will continue to accept registrant interest income attribution policies consistently applied as either a gain contingency recognized when resolved or recognized in a manner consistent with accruing interest income over time. Because of complex netting provisions in the tax law as discussed above and a desire for symmetrical accounting, we believe many entities will accrue interest income the same way they accrue interest expense under ASC Subtopic 740-10 (FIN 48). Classification of interest and penalties on the income statement represents an accounting policy decision that an entity should consistently apply. See Paragraph 9.120 for additional discussion.

**3.123 Consideration of Administrative Practices in the Assessment of Interest and Penalties.** In some foreign jurisdictions, the taxing authority may have an administrative practice of not assessing interest and/or penalties in certain circumstances. To the extent that such practices are widely known and consistently applied in the entity's specific circumstances such that it is more likely than not that interest and/or penalties will not be assessed even if the related tax position is disallowed, those administrative practices would be considered in determining whether the position would be subject to interest and/or penalties under the tax law.

**3.124 Capitalization of Interest Cost Accrued on Underpayment of Tax.** Interest expense on unrecognized tax benefits may not be capitalized under ASC Subtopic 835-20, *Interest - Capitalization of Interest*. For purposes of capitalization under ASC Subtopic 835-20, *interest cost* includes interest recognized on debt and other borrowings and interest related to capital leases determined under ASC Topic 842, *Leases*. Even if interest on unrecognized tax benefits is classified in interest expense (see Paragraph 9.120 for additional discussion), we do not believe those expenses qualify as interest cost as that term is contemplated in ASC Subtopic 835-20 because unrecognized tax benefits and other income tax liabilities are subject to ASC Topic 740 (i.e., income tax accounting) rather than ASC Subtopic 835-30, *Interest - Imputation of Interest*, or ASC Topic 840 (i.e., debt and lease accounting).

**3.125 Effect of a Projected Change in the Timing of Income Tax Cash Flows on the Accounting for a Leveraged Lease.** Lessors are required to recalculate the rate of return and periodic income allocation for leveraged-lease transactions when there is a change or projected change in the timing of income tax cash flows related to the lease. However, recalculation is required only for changes or projected changes in the timing of income tax cash flows that relate directly to the leveraged-leasing transaction (e.g., changes related to interpretations of tax law or the expected outcome of tax audit). Changes in the anticipated timing of tax benefits related solely to the effect of the lessor's tax credits or projected tax losses generally do not trigger a required recalculation of a leveraged lease. In addition, a change in the projected timing of income tax cash flows does not trigger a reassessment of lease classification. Similar recalculation requirements exist for changes in income tax cash flows due to a change in tax law. See Paragraph 5.051.

**3.126** The timing and amount of expected tax cash flows in leveraged-lease calculations and recalculations discussed above should be determined using the principles of ASC Subtopic 740-10 (FIN 48) for income tax uncertainties (see Paragraph 3.015 for additional discussion). Any projected interest and penalties that relate to settlement or potential settlement of a tax position related to the lease should not be included in the calculation of cash flows from a leveraged lease. Similarly, advance payments and deposits to taxing authorities toward potential settlement of a leveraged-lease tax position are not considered cash flows to be included in the leveraged-lease recalculation. ASC paragraphs 840-30-35-40 through 35-47

**3.127** In February 2016, the FASB issued ASU 2016-02, *Leases*. The standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective

date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date.

**3.128 Effect of Ongoing Appeals and Administrative Reviews on Effective Settlement.** An entity should evaluate on a position by position basis whether the criteria for effective settlement have been met. Accordingly, not all unrecognized tax benefits taken in a single tax return may be effectively settled at the same time. In some cases, the taxing authority will have completed its required examination procedures and communicated the results of the examination, but certain individual tax positions will remain subject to review by an oversight committee (e.g., Joint Committee of the United States Congress). Similar situations may arise when an entity is only appealing certain individual tax positions within a particular tax return. In such cases, an entity may be able to conclude that positions not subject to oversight committee review (or ongoing appeals, if applicable) have been effectively settled (assuming the entity does not intend to appeal or litigate any aspect of the positions and it is remote that the taxing authority would examine or reexamine any aspect of the positions) before those positions that are subject to the review. Entities should, however, consider what, if any, effect ongoing Joint Committee review of certain positions (or ongoing appeals, if applicable) has on its assertion that it is remote that the taxing authority will examine or reexamine other positions. Example 3.15 illustrates this guidance.

**Example 3.15: Effect of Administrative Review on Effective Settlement under ASC paragraph 740-10-25-10 (FIN 48)**

The taxing authority has examined ABC Corp. for the 20X4 tax year. Three positions (positions X, Y, and Z) did not meet the recognition criteria before the examination. The taxing authority specifically reviewed Positions X and Y during the examination. Position Z was not specifically reviewed by the taxing authority but was subject to the examination of the 20X4 tax year. ABC obtained new information during the examination that would result in a change of its evaluation of the technical merits for Position Y. In 20X7 the taxing authority completed the examination for the 20X4 tax year and communicated the results of the examination to ABC. The taxing authority's policy is to not reopen an examination once it is completed unless specific conditions exist; ABC believes that even if the taxing authority had full knowledge of Position Z, it is remote that it would examine the position. ABC does not intend to appeal any of the tax positions. Further, based on the tax code, an oversight committee of the taxing authority is required to review Position X. That review is expected to occur in 20X8. The oversight committee's practice is to evaluate only Position X. The statute of limitations expires in 20X9.

ABC determines based on new information that Position Y meets the more-likely-than-not recognition threshold in ASC paragraph 740-10-25-8. ABC also determines that Position Z has been effectively settled in 20X7 because it has satisfied the criteria in ASC paragraphs 740-10-25-10 and 25-11. The determination that Position Z has been effectively settled is based on the fact that the taxing authority has completed its examination of the tax position, ABC does not intend to appeal any aspect of the tax

position, and its evaluation is that it is remote that the tax position would be examined or reexamined based on the taxing authority's policies. ABC should not recognize Position X until the oversight committee has completed its evaluation of the tax position.

**3.129 Indemnification of Income Tax Uncertainties.** Entities may enter into indemnification arrangements whereby third parties will contractually agree to reimburse the entity if a tax position is resolved unfavorably with the taxing authority. In these situations, the entity should account for and disclose the income tax uncertainty under ASC Subtopic 740-10 (FIN 48) and any rights related to indemnification would be considered separately. In certain cases, a third party may agree to indemnify the entity for the tax effects of a transaction or activity. This arrangement would not be considered in accounting for the tax uncertainty under ASC Subtopic 740-10. Those rights related to indemnification from a third party should be accounted for separately under other applicable literature (see Paragraph 6.045) and should not be offset with the accounting for or disclosure of tax uncertainties under ASC Subtopic 740-10. Refer also to Paragraph 10.053 for discussion of parent/subsidiary relationships, Paragraph 10.156 for discussion of indemnifications in a spin-off, and Paragraphs 9.097 and 9.129 for additional discussion of the disclosures required for income tax uncertainties.

**3.130 Accounting for Income Tax Amnesty Programs.** From time to time, the taxing authority in a particular jurisdiction may institute an amnesty program in which unpaid tax liabilities and/or interest and penalties are forgiven if certain criteria are met. While the accounting for such programs will largely depend on its specific terms, the principles of ASC Subtopic 740-10 (FIN 48) will generally apply in determining whether a benefit for a tax position would be recognized based on the terms of the program and, if a benefit is recognized, the timing of the recognition.

### Example 3.16: 2007 Mexico Tax Amnesty

In December 2006, Mexico's Federal Congress approved its 2007 tax reform bill that, among other things, authorized the Tax Administration Service (SAT) to provide amnesty to taxpayers for certain unpaid tax liabilities. Guidance on the specific procedures and requirements to petition for the amnesty was issued in April 2007. The program allowed taxpayers to petition the SAT for abatement of 80% of specified unpaid tax liabilities (and 100% of the related interest and penalties) related to tax periods before January 1, 2003, and for interest and penalties related to tax periods January 1, 2003 through December 31, 2005 provided the taxpayer met certain criteria and filed its petition before December 31, 2007.

ABC Corp. believed that it had tax positions that may have qualified for the amnesty program. However, as of ABC's fiscal year-end on December 31, 2006, ABC did not have enough information about the amnesty program to determine whether any positions met the more-likely-than-not threshold. Because ASC paragraphs 740-10-25-6 and 30-7 require an entity to consider only information that is available at the reporting date in the



recognition and measurement analysis (see discussion beginning in Paragraph 3.026), ABC did not recognize these tax positions as of December 31, 2006.

After the release of the clarifying guidance in April 2007, ABC concluded it had both the intent to petition for relief and had met all the requirements making it eligible for relief because approval by the SAT on these tax positions was generally believed to be perfunctory. Based on this information ABC recognized the tax benefits for those tax positions that met the more-likely-than-not threshold under ASC paragraph 740-10-25-6. ABC recognized these tax positions as discrete items in the period and it concluded that it had both the intent to petition for relief and had met all the requirements making it eligible for relief.

For tax positions that did not meet the more-likely-than-not threshold, ABC recognized tax benefits when the position was effectively settled under ASC paragraph 740-10-25-10. When evaluating effective settlement in these circumstances, we believed that the taxing authority completed its examination procedures when the SAT approved ABC's petition. Further, we believed that generally after the petition was approved, it was remote that the SAT would reexamine the position because all positions subject to the amnesty were required to be fully disclosed on the petition. However, if ABC had a position in which it could not conclude that it was remote that the taxing authority would reexamine the position due to the petition's specific facts and circumstances, it would not have been considered effectively settled and no tax benefit would have been recognized.

**3.131 Nonmonetary Exchanges Accounted for at Fair Value.** Nonmonetary exchanges are generally accounted for at fair value resulting in financial statement gain or loss. However, often such transactions involving real property will be considered like-kind exchanges under IRC section 1031 resulting in no current taxes payable upon transfer. Because the exchange generates financial statement gain or loss, it should be accounted for first as a sale (including the related tax consequences) and second as a purchase (including the related tax consequences, if any).

**3.132** For example, assume ABC Corp. transfers Land A in exchange for Land B in a like-kind exchange that qualifies as a fair value exchange under ASC paragraph 845-10-30-1. Assume ABC's financial statement carrying amount and the tax basis of Land A is \$400, the fair value of Land B is \$1,000, and the tax rate is 21%. ABC would first recognize a gain on the sale of Land A of \$600 (\$1,000 fair value of Land B less the \$400 financial statement carrying amount of Land A) and at the same time recognize the related tax consequence via a charge to income expense for \$126. Because the transaction does not result in current taxes payable but rather a deferred tax consequence due to the taxable temporary difference arising in the purchase of Land B, ABC would establish a corresponding deferred tax liability for \$126 (\$1,000 financial statement carrying amount of Land B less the carryover tax basis of \$400 times the tax rate). The \$126 of tax expense should be recognized in earnings as the tax effect of the financial statement gain recognized on the sale of Land A. ABC's entries at the date of transfer would be as follows:

	Debit	Credit
Land B	1,000	
Deferred tax expense	126	
Land A		400
Deferred tax liability		126
Gain on exchange		600

See the discussion beginning in Paragraph 9.077 for further information about income tax disclosures.

**3.133 Deferred tax assets associated with the Impairment of a Subsidiary Held for Sale.** A parent may reach a conclusion that a subsidiary to be disposed qualifies for held-for-sale presentation under ASC Subtopic 360-10, *Property, Plant, and Equipment – Overall*, and should be measured at the lower of its carrying amount or fair value less cost to sell. We believe an inside deferred tax asset or reduction of a deferred tax liability measured at the subsidiary’s tax rate arises from the impairment because the carrying amount of the subsidiary’s assets have effectively been reduced. Any potential deferred tax asset for the impairment that relates to costs to sell that would be incurred by the parent should consider the deductibility of such costs by the parent and the parent’s tax rate. Any deferred tax asset recognized would need to be analyzed for realizability and may necessitate the use of the simultaneous equation. See Section 4 of KPMG Handbook, *Discontinued operations and held-for-sale disposal groups*.

## ENDNOTES

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<sup>1</sup> South Dakota v. Wayfair, Inc. No. 17-494 (S.Ct. June 21, 2018)

<sup>2</sup> Quill Corp. v. North Dakota, 504 U.S. 298 (1992) and National Bellas Hess, Inc. v. Department of Revenue of Ill. 368 U.S. 753 (1967)

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**4.000** This section explains when to recognize a *valuation allowance* for deferred tax assets. The judgments and analysis necessary to reach these conclusions are essential to the accounting for income taxes.

## FUNDAMENTALS FOR RECOGNIZING A VALUATION ALLOWANCE

**4.001** As discussed in Section 2, *Temporary Differences*, deferred tax assets are recognized for all deductible temporary differences and operating loss and tax credit carryforwards. A valuation allowance is required for deferred tax assets if, based on available evidence, it is *more likely than not* that all or some portion of the asset will not be realized due to the inability to generate sufficient taxable income in the period and/or of the character necessary to use the benefit of the deferred tax asset. After reducing deferred tax assets by the valuation allowance, the net deferred tax assets represent the tax benefits that are more likely than not of being realized. The requirements for recognizing a valuation allowance are the same for deductible temporary differences and for carryforwards. Deferred taxes, including valuation allowances, are determined separately for each tax-paying component in each jurisdiction.

**4.002** A valuation allowance is not used to (a) derecognize the benefits of tax positions that do not meet the more-likely-than-not threshold or (b) reduce the benefits of tax positions to the largest amount that is greater than 50% likely of being realized upon settlement with the taxing authority. Those circumstances result in unrecognized tax benefits rather than valuation allowances. A valuation allowance is only relevant for reducing a deferred tax asset recognized and measured under the provisions of ASC Subtopic 740-10, *Income Taxes - Overall* (i.e., a future benefit that is more likely than not of being sustained by the taxing authority on its technical merits and represents the largest amount that is greater than 50% likely of being realized) to an amount that is more likely than not of being realized by generating sufficient taxable income. While the more-likely-than-not threshold is used both to determine whether a deferred tax asset is *recognized* under ASC Subtopic 740-10 when there is uncertainty in an entity's tax positions (i.e., it is more likely than not that the entity will sustain the position assuming challenge by the taxing authority) and *realizable* pursuant to ASC paragraph 740-10-30-5(e) (i.e., it is more likely than not that the entity will generate sufficient taxable income to realize the benefit), the threshold is used in different contexts. See Section 3, *Tax Calculation*, for additional discussion of the recognition and measurement principles relevant in accounting for the uncertainty in income taxes. ASC subparagraph 740-10-30-5(e)

**4.003 More-Likely-Than-Not Criterion.** The more-likely-than-not criterion means the likelihood of realization is greater than 50%. When evaluating whether it is more likely than not that all or some portion of the deferred tax asset will not be realized, all available evidence, both positive and negative, that may affect the realizability of deferred tax assets should be identified and considered in determining the appropriate amount of the valuation allowance. Accordingly, evidence other than what is cited in this section may need to be considered. ASC paragraph 740-10-30-17

**4.004** Consideration of all positive and negative evidence when determining how much of a valuation allowance to recognize is mandatory. That is, a valuation allowance is recognized when it is more likely than not that all or a portion of the deferred tax asset will not be realized, and a valuation allowance is not recognized whenever it is more likely than not that the benefits from the deferred tax asset will be realized. Changes in the valuation allowance caused by changes in circumstances that result in a change in judgment about the realizability of deferred tax assets generally are reflected in income from continuing operations. See Paragraph 9.065 for additional discussion.

**4.005 Sources of Taxable Income.** Deferred tax assets are realized by an entity by having sufficient taxable income to allow the related tax benefits to reduce taxes otherwise payable. Accordingly, the taxable income must be both of an appropriate character (e.g., capital versus ordinary) and within the carryback and carryforward periods permitted by law. For example, capital loss carryforwards may only be used in offsetting capital gains. Similarly, if an operating loss can be carried forward 10 more years as of the balance sheet date, but no carryback is available, the entity would need to generate sufficient taxable ordinary income during the 10-year period following the balance sheet date to benefit from the carryforward, because that benefit is not available to offset taxes paid in prior periods. ASC paragraph 740-10-30-18

**4.006** The following possible sources of taxable income may be available to realize the benefit of deferred tax assets: ASC paragraph 740-10-30-18

- (1) **Future Reversals of Existing Taxable Temporary Differences.** Deferred tax assets are realizable if the future deductible amounts would reduce, under the existing provisions of the tax law, taxes that would be paid on future taxable income generated by existing taxable temporary differences. See Paragraph 4.034.
- (2) **Future Taxable Income Exclusive of Reversing Temporary Differences and Carryforwards.** Deferred tax assets are realizable if the future deductible amounts would reduce, under the existing provisions of the tax law, taxes that would be paid on future taxable income excluding the reversal of existing temporary differences and carryforwards. See Paragraph 4.039.
- (3) **Taxable Income in Carryback Years if Carryback Is Permitted by the Tax Law.** Deferred tax assets are realizable if the future deductible amounts would, under the existing provisions of the tax law, result in future tax losses that can be carried back to recover taxes paid for the current year or prior years. While post-2017 U.S. net operating losses generally cannot be carried back after tax reform was enacted in 2017 (see Paragraph 4.016a for additional discussion), other tax jurisdictions may allow carryback of net operating losses. In addition, U.S. entities can still carryback capital losses for three years. See Paragraph 4.052.
- (4) **Tax-Planning Strategies.** Tax-planning strategies may be available to accelerate or delay taxable income or deductions, change the character of taxable income or deductions, or switch from tax-exempt to taxable investments so that there would be sufficient taxable income of the

appropriate character and in the appropriate periods to allow for realization of the tax benefits of deductible temporary differences or carryforwards. Tax-planning strategies are actions that the entity might not take, but would take in order to realize the tax benefits. See Paragraph 4.057.

**4.007** While consideration of all positive and negative evidence is required, if one or more sources of taxable income is sufficient to support a conclusion that it is more likely than not that all of an entity's deferred tax assets will be realized, the entity generally does not consider the effects of the other sources. For example, if a valuation allowance is not needed because an existing taxable temporary difference will reverse in the same carryforward period as an existing deductible temporary difference, the entity does not estimate future taxable income exclusive of reversing temporary differences and carryforwards. While a projection of future taxable income may provide an additional source of taxable income to support more of an entity's deferred tax assets, it would not reduce the amount of deferred tax assets supported by the reversals of existing taxable temporary differences. ASC paragraphs 740-10-55-16 and 55-17, and 55-120 through 55-123

**4.007a** If an entity is evaluating more than one source of taxable income to determine the amount of deferred tax assets that are realizable, questions may arise as to how to evaluate the interaction between those sources. We believe an entity should evaluate multiple sources of taxable income in combination with each other. Alternatively, we also believe it would be acceptable to evaluate the amount of deferred tax assets supported by one source of income in isolation, then evaluate how much of the remaining deferred tax assets are supported by another source of income in isolation and add the amount of deferred tax assets supported by the multiple sources of income. We believe that under either approach, the amount of deferred tax assets supported by multiple sources of income should not be less than the amount supported by any one source of taxable income. See Example 4.26 for an illustration using both the combination approach and an additive approach where reversing taxable temporary differences are evaluated first, and the remaining deferred tax assets are then evaluated by considering future taxable income exclusive of reversing items. ASC paragraphs 740-10-55-8 and 55-9

**4.008 Dependence on Tax-Planning Strategies.** Tax-planning strategies generally do not represent a source of taxable income by themselves but instead, if executed successfully, increase the amount of taxable income from the three sources of taxable income discussed above. For example, tax-planning strategies may accelerate the recovery of a deferred tax asset so the tax benefit of the deferred tax asset can be used to offset a reversing deferred tax liability. See Paragraph 4.057 for additional discussion of tax-planning strategies.

### SCHEDULING

**4.009 Scheduling the Reversal of Existing Temporary Differences.** While ASC Topic 740, *Income Taxes*, does not require an entity to perform detailed scheduling of its temporary differences, it may be necessary to estimate the pattern and timing of the reversal of existing temporary differences to determine the need for a valuation

allowance. For example, when determining whether the reversal of an existing taxable temporary difference provides sufficient taxable income to support realization of a deferred tax asset, it may be necessary to schedule the reversal of such temporary differences to determine whether the benefit of the deferred tax asset will be available in the period in which taxable income is generated as result of the reversal of the deferred tax liability.

**4.010** The extent of scheduling required is a matter of judgment and depends on the facts and circumstances of each situation including the pattern and timing of the reversal of existing temporary differences, the magnitude of temporary differences, relevant tax law, and the level of taxable income expected to be generated by future operations. As a practical matter, scheduling the reversal of existing temporary differences is more commonly required when evaluating future reversals of existing taxable temporary differences and the ability to access taxable income in prior carryback years.

**4.011 Selecting a Scheduling Method.** Scheduling methods, such as the loan amortization method or the present value method, are discussed in Appendix A. ASC Topic 740 provides the following guidance on selecting a scheduling method:

- Minimizing complexity is an appropriate objective in selecting a method for determining reversal patterns.
- The method used should be systematic and logical.
- The same method should be used for all temporary differences within a particular category of temporary differences (such as liabilities for deferred compensation arrangements or investments in direct financing and sales type leases) for a particular tax jurisdiction.
- The same method should be used for the same category of temporary difference regardless of tax jurisdiction.
- Different methods may be used for different categories of temporary differences.

The same method for a particular category of temporary differences should be used consistently from year to year. A change in the method of determining reversal patterns of temporary differences is a change in accounting principle under ASC Topic 250, *Accounting Changes and Error Corrections*. ASC paragraph 740-10-55-22

**4.012 Determining the Period in Which Temporary Differences Reverse.** The timing of the reversal of temporary differences is a function of tax law and generally coincides with the period in which the underlying assets are recovered or liabilities are settled. ASC Topic 740 does not specify when temporary differences reverse. ASC paragraph 740-10-55-12

**4.013** The extent of scheduling the reversal of temporary differences when determining the amount of the valuation allowance related to the deferred tax asset is dependent on the pattern and timing of the reversal of temporary differences, the magnitude of those differences, relevant tax law, and the level of future taxable income expected to be



generated by future operations. Generally, scheduling temporary differences would not be required in assessing the need for a valuation allowance if evidence about the sources of taxable income other than reversing taxable temporary differences and carryforwards is sufficient to support a conclusion that a valuation allowance is not necessary. For instance, assuming no significant negative evidence exists, an entity may be able to conclude that it is more likely than not that future taxable income, exclusive of reversals of existing temporary differences, will be adequate to realize the entity's deferred tax assets. ASC paragraph 740-10-55-16

**4.014** When an entity considers the reversal of existing taxable temporary differences as a source of taxable income in determining the need for a valuation allowance, it may be possible to limit the extent of the scheduling process by using time spans of several years, to exclude certain temporary differences from the scheduling exercise, or to limit scheduling to only certain temporary differences. For instance, if a future deductible amount is expected to reverse in a period which clearly precludes carryback or carryforward to offset future taxable amounts under relevant tax law, a source of taxable income other than the reversal of taxable temporary differences would need to be considered in determining whether it is more likely than not that the tax benefit related to that asset will be realized.

**4.015** The extent of scheduling performed under ASC Topic 740 is a matter of judgment and should be determined based on the facts and circumstances in each situation. It is appropriate for an entity to consider ways to meet the requirements of ASC Topic 740 while minimizing the extent of scheduling performed.

**4.016** Determining the period in which a temporary difference will result in a taxable or deductible amount may be straightforward when the recovery of the related asset or the settlement of the related liability is governed by a contract. Scheduling is also straightforward for temporary differences associated with depreciable assets if the financial reporting and tax lives and methods are known. In other cases, determining the period of reversal may require estimates and judgments. Entities estimating reversal patterns to assess the need for a valuation allowance should consider the following:

- The general pattern and time period in which temporary differences are expected to reverse;
- Remaining carryforward periods for existing operating loss and tax credit carryforwards;
- The length of the carryback and carryforward period permitted by law;
- Limitations on the use of certain deductions, tax credits, carrybacks, or carryforwards;
- The character (such as ordinary or capital) of taxable and deductible amounts that will occur upon the reversal of temporary differences;
- The extent to which future reversals of taxable and deductible temporary differences clearly offset each other within the carryback and carryforward periods;

- The availability of tax-planning strategies that could accelerate or delay taxable or deductible amounts to allow deferred tax benefits to be realized;
- Taxable or deductible temporary differences for which the period of reversal is indefinite; and
- The scheduled reversal of existing temporary differences should exclude future originating temporary differences and their subsequent reversals (see Paragraph A.000b for further considerations when future originating temporary differences are expected).

**4.016a Net Operating Loss Carryforwards in the United States after Enactment of 2017 Tax Reform and the 2020 CARES Act.** Before tax reform was enacted in 2017, net operating losses could be carried back two years and carried forward 20 years. The 2017 tax reforms repealed the pre-enactment carryback provisions for net operating losses (except for certain farming losses and net operating losses of property and casualty companies) and provides for the indefinite carryforward for net operating losses arising in tax years ending after December 31, 2017. Those net operating loss carryforwards may offset only 80% of taxable income in any given year. Net operating losses arising in tax years ending on or before December 31, 2017 are not affected by the changes to the carryback and carryforward provisions and are not subject to the 80% limitation.

**4.016aa** On March 27, 2020, the CARES Act was signed into law. The CARES Act allowed a five-year carryback of net operating losses (NOLs) arising in tax years beginning after December 31, 2017 and before January 1, 2021. The legislation also allowed full carryback for these NOLs. As a result, an entity:

- Was able to offset all of its taxable income with these NOLs – it was not limited to offsetting 80% of its taxable income; and
- Generally realized a 35% benefit from these NOLs if it carried them back to a tax year in which 35% was the enacted tax rate. Off-calendar year-end taxpayers also realized a benefit higher than 21% if they carried the NOLs back to a tax year in which the enacted rate was 35% or a blended rate applied to the tax year.

**4.016ab** The CARES Act also allows an off-calendar year-end taxpayer to carry back two years but restricts the carryforward to 20 years for NOLs that arose in the tax year that straddled December 31, 2017. This change corrected an apparent error in the 2017 tax reforms, which were enacted in December 2017.

If an entity applied the carryback provisions under the CARES Act, it:

- Converted to income tax receivables the deferred tax assets related to those NOLs; and
- Reduced the total amount of existing deferred tax assets.

**4.016a** Although ASC Topic 740 does not require an entity to prepare a detailed schedule of the reversal of its temporary differences, it may need to schedule to determine how much of the new total of deferred tax assets are more likely than not to be realized – i.e., after the total has been reduced by the carryback amount. Further, off-calendar year-end taxpayers may be able to conclude that deferred tax assets scheduled to reverse in tax years beginning before January 1, 2021 are more likely than not to be realized because they also will be available for carryback.

**4.016b** As discussed in Paragraph 4.027 and illustrated in Example 4.9 and Example 4.26, limitations under the tax law should be considered when determining whether it is more likely than not that deferred tax assets will be realized. Because post-2017 net operating losses in the U.S. may only offset 80% of taxable income in a given year (except for those affected by the CARES Act, see Paragraph 4.016aa), even if an entity had a taxable temporary difference equal to its post-2017 net operating loss carryforward, other future taxable income would have to exist to support realization of NOL carryforwards that remain after applying the limitation and must continue to be carried forward. In addition, if an entity's deductible temporary differences are expected to reverse in a loss year, the annual benefits of those deferred tax assets will similarly be limited. This will require some entities to perform detailed scheduling to evaluate the realizability of their deferred tax assets.

**4.016c Disallowed Interest Carryforwards in the United States after Enactment of 2017 Tax Reform.** The 2017 tax reforms in the United States also changed the deductibility of net business interest expense. The law amended section 163(j) to generally disallow a deduction for net business interest expense in excess of 30% of the taxpayer's adjusted taxable income for the year. Disallowed interest deductions are carried forward indefinitely. However, on March 27, 2020, the CARES Act was signed into law. The CARES Act temporarily increased the deductibility of interest expense from 30% to 50% of adjusted taxable income for tax years beginning in 2019 and 2020. As discussed in Paragraph 4.027 and illustrated in Example 4.26, limitations under the tax law should be considered when determining whether it is more likely than not that deferred tax assets will be realized.

**4.016d SRLY and Section 382 Limitations on the Use of Net Operating Loss Carryforwards.** Two other provisions of current U.S. tax law may limit the availability of net operating loss carryforwards – the SRLY limitation and the section 382 limitation. SRLY (separate return limitation year) is a year when a subsidiary that was not a member of the consolidated tax group generates a tax loss. The SRLY limitation (1) arises when that subsidiary becomes a member of the consolidated group and (2) limits the availability of the net operating loss carryforwards generated in the SRLY. Separately, section 382 limits the availability of net operating loss carryforwards when there is a change in the control of the entity, such as an entity's issuance of stock or the sale of shares by an entity's owners.

**4.016e** As discussed in Paragraph 4.027, limitations under the tax law should be considered when determining whether it is more likely than not that deferred tax assets will be realized. However, limitations resulting from future activity are generally not

anticipated when determining any necessary valuation allowance. Paragraph 4.031 discusses future events that are not anticipated when determining a valuation allowance, some of which may cause SRLY or section 382 limitations.

**4.017 Reversal in the Indefinite Period.** The timing of the reversal of a temporary difference or carryforward may be indefinite. For example, an entity may have a temporary difference related to land that is not expected to be sold in the foreseeable future, an indefinite-lived intangible asset, or goodwill. In those cases, it generally would be inappropriate to assume that the reversal of those taxable temporary differences will be available to support deferred tax assets with limited carryforward periods. For example, if an entity had a net operating loss carryforward with a 15-year remaining carryforward period, it generally would not be able to support the conclusion (absent any other source of future taxable income) that it is more likely than not to be realized as a result of the reversal of a deferred tax liability associated with goodwill that is not being amortized for financial reporting purposes (see Section 6, *The Tax Effects of Business Combinations*, for additional discussion of deferred taxes related to goodwill) or an indefinite-lived intangible asset, for example, a trade name, because the deferred tax liability would typically not be scheduled to reverse within the 15-year carryforward period. In some cases, the reversal period of a deferred tax liability related to an indefinite-lived intangible asset, such as in-process research and development can be determined with sufficient reliability to be considered in assessing the realizability of deferred tax assets. See additional discussion at Paragraphs 6.123 and A.014.

**4.017a** Alternatively, if an entity has deferred tax assets that have unlimited carryforward periods (e.g., net operating loss carryforwards in certain foreign jurisdictions and post-2017 net operating loss carryforwards in the United States), it generally would be able to consider the reversal of a deferred tax liability associated with an indefinite lived asset (see Paragraph 6.123 for considerations specific to acquired IPR&D) when evaluating whether those deferred tax assets are more likely than not of being realized, as long as the temporary differences are expected to result in income of the appropriate character. For example, the reversal of a deferred tax liability for an indefinite-lived intangible asset or goodwill would generally be assumed to result in ordinary income (see Paragraph 6.016), so it would provide a source of taxable income to support realization of deferred tax assets associated with net operating loss or disallowed interest carryforwards that would reduce ordinary income in an indefinite future period. While the entity would benefit from the matching of the reversal periods in these circumstances, it should also consider whether limitations on the use of the indefinite-lived carryforwards apply. For example, the 80% limitation associated with post-2017 net operating loss carryforwards in the United States (see Paragraph 4.016a for additional discussion) may result in an inability to realize all of the benefits of the carryforwards even though they have unlimited carryforward periods.

**4.018** The following example demonstrates the analysis of reversal patterns to determine the need for a valuation allowance.

**Example 4.1: Analysis of Reversal Patterns**

ABC Corp. has no taxable income available under the tax law through carryback and has no operating loss carryforwards. The carryback and carryforward periods permitted by law in ABC's tax jurisdiction are 1 year and 20 years, respectively. The enacted tax rate is 35%. ABC has the following temporary differences at December 31, 20X6.

		<b>Financial Statement Carrying Amount</b>		<b>Tax Basis</b>		<b>(Taxable) Deductible Temporary Difference</b>
Equipment	FC	4,000	FC	3,000	FC	(1,000)
Building		11,100		10,800		(300)
Available-for-sale debt securities		1,500		2,000		500
Inventories		3,200		4,000		800
Deferred gain		1,000		—		1,000
Warranty liability		300		—		300
Deferred compensation liability		2,000		—		2,000
						<u>3,300</u>
Total taxable temporary differences						<u>(1,300)</u>
Total deductible temporary differences						<u>4,600</u>

ABC has a deferred tax liability of FC 455 ( $FC 1,300 \times 35\%$ ) and a deferred tax asset, before consideration of the need for a valuation allowance, of FC 1,610 ( $FC 4,600 \times 35\%$ ) relating to the temporary differences summarized above.

ABC obtains the following information about the timing and pattern of reversals of its temporary differences:

- The remaining lives of equipment for both financial reporting and tax purposes range from three to five years.
- The building has a remaining life of 30 years for tax purposes and financial reporting purposes. The method of depreciation used is straight-line for both tax and financial reporting purposes. The FC 300 difference will not reverse until the building becomes fully depreciated for tax purposes.
- Available-for-sale debt securities are carried at cost for tax purposes and fair value for financial reporting purposes. Management expects the securities will be sold in 20X8.
- The inventory temporary difference will reverse in 20X7.

- Warranty liabilities accrued for financial reporting purposes are expected to be paid over the next three years.
- Deferred compensation will reverse over the next 25 years as ABC is contractually obligated to make payments.
- The deferred gain is expected to reverse in 20X7.

Given only the information provided above, the management of ABC concludes that FC 1,000 of the deductible temporary differences related to the available-for-sale debt securities, inventories, deferred gains, and warranty liability will offset the FC 1,000 of reversing taxable temporary differences relating to equipment during the carryforward period. Further, FC 300 of the deductible temporary difference related to deferred compensation will offset the taxable temporary difference relating to the building (FC 300 of the deductible temporary difference could be carried forward to offset the taxable temporary difference). Accordingly, no valuation allowance is necessary for FC 455 of the FC 1,610 deferred tax asset, because FC 1,300 of the deductible amounts will offset taxable amounts resulting from the reversal of taxable temporary differences.

Realization of the remaining tax benefits depends on other sources of taxable income.

#### **Example 4.2: Analysis of Reversal Patterns - Indefinite/Unlimited Reversal**

DEF Corp. operates in a jurisdiction with an unlimited carryforward period for net operating losses. At December 31, 20X6, DEF has a deferred tax asset (DTA) recognized for its net operating losses and a deferred tax liability (DTL) recognized for an indefinite-lived intangible asset.

Management is assessing whether it is more likely than not that the DTA will be realized. The taxable temporary difference for the indefinite-lived intangible asset is the only source of income available to support realization of the DTA. Both the DTA and DTL are in the same jurisdiction and are of the same character for tax purposes. However, under the tax law, net operating losses are available to offset only 80% of taxable income in a given year.

Management concludes that 80% of the taxable temporary difference for the indefinite-lived intangible asset provides a source of taxable income to support the realization of the net operating loss with an unlimited carryforward period because the DTA would not expire before the reversal of the DTL. If DEF had remaining net operating loss carryforwards after using some to offset 80% of the taxable income generated by the reversal of the DTL, it would need to support realization of those carryforwards with another source of taxable income.

**4.019** Appendix A describes a number of typical temporary differences and provides general guidance for determining the periods in which those differences will result in taxable or deductible amounts.

## EVALUATING SOURCES OF TAXABLE INCOME

**4.020 Evidence about the Sources of Taxable Income.** All available evidence, both positive and negative, should be identified and considered when determining whether it is more likely than not that all or some portion of deferred tax assets will not be realized. In order to support a conclusion that a valuation allowance is not needed, positive evidence of sufficient quantity and quality (objective compared to subjective) is necessary to overcome negative evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which the strength of the evidence can be objectively verified. ASC paragraph 740-10-30-23

**4.021** If sufficient positive evidence from one source of taxable income supports a conclusion that a valuation allowance is not necessary, the other sources of taxable income generally need not be considered. Otherwise, evidence about each of the sources of taxable income should be considered in arriving at a conclusion about the need for and amount of a valuation allowance. ASC paragraphs 740-10-30-17 and 30-18

**4.022** As discussed above, the relative weight given to evidence accumulated for the valuation allowance assessment should be commensurate with its level of objectivity. Accordingly, while there is no requirement for one of the sources of taxable income to be considered before any other source, a practical approach is to consider the sources of taxable income in order of the least subjective to the most subjective. For example, taxable income in carryback years and reversals of existing taxable temporary differences provide significant objective positive evidence that will support the realization of deferred tax assets if the amounts offset under the tax law. As a practical matter, evaluating future taxable income exclusive of the reversal of temporary differences and carryforwards will be the area that typically requires a judgmental weighing of positive and negative evidence. ASC paragraphs 740-10-30-23 and 55-16 and 55-17

### Example 4.3: Consideration of Sources of Taxable Income

ABC Corp. has a net deferred tax liability position at December 31, 20X6 (that is, deferred tax liabilities are greater than deferred tax assets). Based on the expected patterns of reversal of all existing temporary differences, ABC has concluded that it is more likely than not that the deferred tax assets will be realized. That is, the first source of taxable income evaluated by ABC, future reversal of existing taxable temporary differences, provides sufficient evidence to conclude that no valuation allowance is necessary.

If one of the sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources do not need to be considered and the deferred tax asset should be recognized without a valuation allowance.

**4.023 Examples of Negative and Positive Evidence.** The following lists include examples of negative and positive evidence that should be considered when determining whether a valuation allowance is needed. The existence of negative evidence does not

necessarily require a valuation allowance to be recognized. Likewise, positive evidence does not preclude the recognition of a valuation allowance. This list is not all-inclusive; each situation must be evaluated based on all of the specific facts and circumstances. ASC paragraphs 740-10-30-21 and 30-22

<b>Positive</b>	<b>Negative</b>
Cumulative earnings in recent years	Cumulative losses in recent years
Income of the appropriate character expected to be available in future years or available through carryback (e.g., capital gains expected in future years when capital loss carryforward exists)	Income of appropriate character is not expected to be available in future years or through carryback
Timing of reversal of taxable amounts would offset deductible amounts in the permitted carryback/carryforward period	Timing of reversal of taxable amounts does not offset deductible amounts in the permitted carryback/ carryforward period
Long carryback/carryforward periods	Brief carryback/ carryforward periods
Taxes paid in the current year and prior years that could be recovered by carryback to prior years	Taxes have not been paid in the current and prior years and, therefore, carryback is not available
Prudent and feasible tax-planning strategies are available to accelerate or delay taxable or deductible amounts or convert tax-exempt investments to taxable investments	Prudent and feasible tax-planning strategies are not available
An excess of appreciated value over the tax basis of net assets (net built-in gains)	Net asset values are below tax basis (net built-in losses)
Trends support earnings expected in future years, such as current or recent period pretax income	Trends indicate losses expected in future years, such as current or recent period pretax loss
History of using all operating loss and tax credit carryforwards before they expire	History of operating loss and tax credit carryforwards expiring unused
Entity has demonstrated ability in prior years to reasonably project future results of operations	Entity has no significant experience projecting future operating results (e.g., a start-up entity) or past experience indicates that projected results of operations are not reasonable
Significant existing contracts or firm sales backlog are expected to produce taxable income	Existing contracts or backlog are insignificant or are not expected to produce taxable income
No known loss contingencies or unsettled circumstances	Loss contingencies and other unsettled circumstances that could adversely affect future operations and taxable income in future years, such as significant litigation, labor disputes, default on credit agreements, noncompliance with statutory



	capital requirements or other regulatory requirements, etc.
Obtained significant new customer or customers, favorable settlement of litigation or labor disputes, etc.	Loss of a significant customer or customers, loss of a patent or franchise, uninsured losses and unfavorable long-term commitments
Entity operates in a stable industry or, if in a cyclical industry, negative cycles are not expected to have significant long-term effect on profitability	Entity operates in a cyclical industry and the timing of cycles and effect of positive and negative cycles on profitability is difficult to reasonably predict
Entity operates in an industry in a growth stage and with a low rate of business failures	Entity operates in a declining industry that is experiencing negative trends or a high rate of business failures
Entity is a leader in its industry and has significantly greater resources than its competitors	Entity is in a highly competitive industry and its competitors have greater resources
Entity has a proven record of developing significant and successful new products	Entity does not have a proven record of developing significant and successful new products
Positive financial ratios, not highly sensitive to external economic factors, and long-term trends are expected to be positive	Adverse financial ratios, highly sensitive to external economic factors, long-term trends are expected to be negative, deficit in stockholders' equity, uncertainty about the entity's ability to continue as a going concern

**4.024 Cumulative Losses in Recent Years.** A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome. In situations where a cumulative loss in recent years exists, it may be difficult to overcome a conclusion that the deferred tax asset, net of the valuation allowance, should not exceed the amounts supported by carryback availability, if any, and offsetting taxable temporary differences. That is, it may be difficult to support a conclusion in that situation that expected taxable income from future operations (excluding reversal of existing temporary differences) justifies recognition of deferred tax assets. ASC paragraph 740-10-30-23

**4.025** ASC Topic 740 does not prescribe a methodology to determine whether *cumulative losses in recent years* exist. In practice, recent years generally has been interpreted to mean the current year and prior two years, and earnings/losses have been measured based on pretax book income/loss, including results of discontinued operations but excluding the cumulative effects of accounting changes. Further, we believe an entity also should consider the effects of permanent differences and amounts in other comprehensive income when evaluating its cumulative profile.

**4.026** Although the FASB concluded not to specifically define cumulative losses in recent years, we believe the methodology described above generally will result in a reasonable approach. To support a conclusion that a valuation allowance is not needed, positive evidence of sufficient quantity and quality is necessary to overcome negative

evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which the strength of the evidence can be objectively verified. Expected increases in future taxable income from (a) restructuring activities such as cost cutting measures, (b) changes in future operations, (c) changes in management, and (d) potential industry or political climates may not be sufficient to overcome the objective negative evidence of cumulative losses in recent years. Taxable income from other more objective sources (such as taxable income in carryback years and future reversals of existing taxable temporary differences) may be needed to overcome the presumption that a valuation allowance is needed when an entity has cumulative losses in recent years. However, all specific facts and circumstances, both positive and negative, must be considered. In certain circumstances, other factors, such as what caused the losses, when the losses occurred in the three-year period, significant new product development, or other factors may overcome the negative evidence of the cumulative losses. An entity should not rely solely on the timing of when it will have or no longer have cumulative losses in recent years to determine when a valuation allowance on deferred tax assets is required or an existing valuation allowance may be released. While having three-years of cumulative losses is significant negative evidence, it is not a bright-line for either establishing or, in the absence of cumulative losses, releasing a valuation allowance. See Paragraph 4.031 for discussion of events not considered when determining a valuation allowance. ASC paragraph 740-10-30-23

#### **Example 4.4: Cumulative Three-Year Losses with Proven Reserves**

ABC Corp. is in a three-year cumulative loss position at the end of its fiscal year. When considering what caused the losses, ABC identified that the three-year cumulative loss was driven solely by the ceiling test write-down of its oil and gas reserves as a result of a decline in oil and gas market prices. The ceiling test is a point-in-time impairment calculation that uses current market prices. Once an impairment charge is recorded as a result of the ceiling test calculation, no recovery is recorded regardless of the subsequent movement in the market prices.

ASC paragraph 740-10-30-22 indicates that 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 provides positive evidence that may support a conclusion that a valuation allowance is not needed when there is negative evidence. Similar to sales backlog, projections of future taxable income based on proven reserves and existing prices may provide evidence to support a conclusion that a valuation allowance is not needed assuming that ABC has sufficient liquidity to develop the reserves. However, all positive and negative evidence needs to be evaluated when assessing the level of evidence supporting a conclusion that no valuation allowance is necessary when a significant piece of negative evidence, such as a cumulative loss, exists.

Although probable or possible reserves would not provide as much support as proven reserves, in certain circumstances the value of probable and possible reserves could be

assessed as a positive attribute in a manner similar to other appreciated assets as contemplated by the provisions of ASC subparagraph 740-10-30-22(b).

#### **Example 4.4a: Cumulative Three-Year Losses in Interim Periods**

**Question.** Can an entity use a rolling 12-quarter period to determine whether it has cumulative losses and ignore the forecast of losses for future quarters in the current year?

**Answer.** No. While there is no prescribed methodology for determining cumulative losses in recent years at an interim date, we do not believe an entity can use an approach based on a rolling 36-month or 12-quarter period and ignore the fact that losses are forecast for future quarters in the current year.

We believe an entity's expectation to be in a three-year cumulative loss position in the near-term (e.g., because it is forecasting near-term losses) is significant negative evidence that is difficult to overcome.

**4.027 Provisions of the Tax Law.** The provisions of the applicable tax law may have a significant effect on whether the tax benefits of deductible temporary differences and carryforwards can be realized. Provisions of the tax law that may affect the ability to realize the tax benefits of deductible temporary differences and carryforwards include, but are not limited to, (1) the carryback and carryforward periods; (2) limitations on the use of carrybacks or carryforwards; (3) special treatment of certain types of income or deductions, such as capital losses; (4) limitations on the amount of certain deductions or tax credits that can be used in a period; and (5) limitations on transfers of tax benefits between entities under common control (see Example 9.15 for additional discussion). Accordingly, all applicable provisions of enacted tax law must be considered in determining the amount of the valuation allowance that should be recognized. Expected changes to the tax law or tax rates should not be considered before the enactment date. (As previously discussed, the United States enacted tax reforms in 2017 that changed many of the provisions of U.S. tax law applicable to net operating loss and disallowed interest carryforwards - see Paragraphs 4.016a, 4.016c and 4.017a for additional discussion.) ASC paragraphs 740-10-35-4, 55-12, 55-35 and 55-36

**4.028** For example, if a deductible temporary difference will result in a capital loss, and the tax law provides that capital losses are deductible only to the extent of capital gains, a valuation allowance should be recognized to offset the deferred tax asset related to the capital character temporary difference, unless (1) taxes paid on capital gains for the current year or prior years could be recovered by carryback of the capital loss that will result from reversal of the capital character temporary difference, (2) there are taxable temporary differences that will result in sufficient amounts of capital gains within the capital loss carryback and carryforward period, or (3) future capital gains are expected to occur within the carryback and carryforward period.

**4.029 More-Likely-Than-Not Tax Treatment.** Even though an entity may have a basis under the tax law for claiming certain deductions on its income tax returns, the calculation of current and deferred taxes should be based on the more-likely-than-not tax treatment for recognition and measurement under ASC Subtopic 740-10 (FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48)) as further discussed in Section 3. In addition, a tax-planning strategy that is not more likely than not of being sustained should not be considered in assessing the need for a valuation allowance (see Paragraph 4.062 for additional discussion of accounting for tax uncertainties in the context of tax-planning strategies). Furthermore, scheduling the reversal of temporary differences should be based on the more-likely-than-not tax treatment. ASC paragraphs 740-10-25-6, 30-7 and 30-20

**4.030 Consistency with Other Information and Analyses.** When determining the appropriate valuation allowance, management should consider the relationship between the assessment and related information from other analyses that require forecasts of future operations. For example, assumptions made when assessing the need for a valuation allowance should not be inconsistent with the analysis of the potential impairment of long-lived assets or goodwill and other relevant statements by management, such as statements included in Management Discussion and Analysis for public entities.

**4.031 Events Not Considered When Assessing the Need for a Valuation Allowance.** The effects of the following events are precluded from being considered when estimating future taxable income to determine whether deferred tax assets are realizable.

- **Future Business Combinations.** The tax effects of business combinations, including recognition or derecognition of a valuation allowance, generally are recognized and measured at the combination date. ASC paragraph 805-740-30-3 requires reductions in the acquiring entity's valuation allowance as a result of a business combination be recognized as an income tax benefit (or a credit directly to contributed capital under ASC paragraph 740-10-45-20). See Paragraph 6.035 for additional discussion.
- **Future Transactions among or with Shareholders.** Transactions among or with shareholders should not be anticipated when determining the need for a valuation allowance. Although ASC Topic 740 requires an entity to consider all available evidence when determining the need for a valuation allowance, events among or with shareholders generally are not within an entity's control and, therefore, should not be considered. See Example 4.5 and Paragraph 10.153 for additional discussion.
- **Anticipated Changes in Tax Laws and Rates.** ASC paragraph 740-10-35-4 requires changes in tax law and rates to be recognized in the period of the enactment date of the change. Accordingly, releasing (or not recognizing) a valuation allowance in anticipation of future changes in laws or rates is inconsistent with ASC paragraph 740-10-35-4. See Section 5, *Changes in Tax Laws, Rates, or Status*, about changes in laws and rates.

- **Anticipated Changes in Tax Status.** ASC paragraphs 740-10-25-32 and 25-33 require changes in tax status to be recognized on the approval or filing date of the change in tax status. Accordingly, releasing (or not recognizing) a valuation allowance in anticipation of future changes in tax status is inconsistent with ASC paragraphs 740-10-25-32 and 25-33. See Section 5 on changes in status.
- **Sales of Held-to-Maturity Debt Securities.** A sale of held-to-maturity securities should not be anticipated, because the sale of held-to-maturity securities is not consistent with management's intent as indicated by the classification of the securities using the provisions of ASC Subtopic 320-10, *Investments—Debt Securities - Overall*.
- **Sales of Indefinite-Life Intangible Assets.** A sale of an indefinite-lived intangible asset to a third party should not be anticipated, because the sale would not be consistent with the asset's indefinite useful life that was determined using the provisions of ASC Topic 350, *Intangibles—Goodwill and Other*. See Paragraph 4.075.
- **Expected Forgiveness of Debt.** An entity should not anticipate future taxable income from the forgiveness of debt when reducing an otherwise required valuation allowance. Taxable income from the forgiveness of debt is contingent on future actions of other parties that are beyond the entity's control. The tax effects of these future actions and events generally should be recognized when incurred. However, forgiveness of debt with a parent entity may be anticipated as a tax-planning strategy if the parent entity commits to such actions. See Example 4.6 and the effects of bankruptcy below.
- **Changes in Fair Value of Assets and Liabilities.** Future changes in the fair value of assets and liabilities are generally dependent on future market conditions or factors beyond the entity's control. Accordingly, gains or losses from the sale of assets or settlement of a liability resulting from future changes in their fair value should not be anticipated. ASC subparagraph 855-10-55-2(f)
- **Events Dependent on Future Market Conditions.** Events dependent on future market conditions, such as a sale of significant core operations, an initial public offering (or other similar transactions with shareholders), or bankruptcy settlements, generally should not be anticipated. As these events are beyond the entity's control, an entity cannot reasonably predict when, if ever, these events will occur. Accordingly, events that cannot be reasonably forecasted should not be anticipated. See Example 4.7.
- **Effects of bankruptcy.** ASC Subtopic 852-10 explicitly states that the effects of an entity's plan of reorganization are recognized as of the date the plan is confirmed or as of a later date if there are material unsatisfied conditions precedent to the plan becoming binding on all parties. As a result, an entity does not anticipate changes resulting from emergence from bankruptcy in its valuation allowance assessment. See ASC paragraph 852-10-45-18.

**4.032** Certain of the events discussed above are specifically required by ASC Topic 740 to be accounted for in the period of the event, for example, changes in tax law or status. In those circumstances, even if the events occur after the balance sheet date but before the financial statements are issued, the effect should not be considered in the valuation allowance assessment as of the balance sheet date. However, in many other circumstances (i.e., those that are not precluded from consideration under the guidance in Topic 740), it may be appropriate to consider transactions that have occurred during the subsequent event period because an entity generally is required to consider *all* available evidence in evaluating a need for a valuation allowance at each balance sheet date, including in interim periods. Regarding the consideration of an anticipated transaction (i.e., a transaction that is expected to occur after the financial statements are issued), if the transaction is not precluded from consideration under the guidance in Topic 740, the specific facts and circumstances surrounding the transaction must be analyzed to determine whether there is a sufficient level of certainty that it will occur before including its effects in assessing the need for a valuation allowance. Additionally, the weight of the evidence provided by the transaction will depend on the likelihood of the transaction closing. We would not expect any weight to be given to a transaction that is not at least more likely than not of being completed. See Paragraph 10.078 for additional information on the income statement effect of a change in valuation allowance during an interim period.

### **Example 4.5: Future Transactions with Shareholders That May Limit Availability of Operating Loss Carryforwards**

ABC Corp. has a \$50,000 deferred tax asset for pre-2018 net operating loss carryforwards at December 31, 20X6, and no other deferred tax assets or liabilities. For the past three years ABC has had taxable income and it currently forecasts using the remaining net operating loss carryforwards by the end of 20X8, 2 years before the losses expire. ABC concludes that it is more likely than not that it will benefit from the net operating loss carryforwards and has not recognized a valuation allowance.

Before December 31, 20X6, ABC files its first registration statement with the SEC to issue registered equity securities in an initial public offering. If the offering is successful, it will trigger a change of control under the tax law thereby severely limiting the availability of net operating loss carryforwards. ABC estimates that \$30,000 of the losses will expire without being used if the offering is successful. ABC completes its IPO on February 14, 20X7, which is before it issues its 20X6 financial statements.

Generally a valuation allowance should not be established in anticipation of the limitation on the use of the net operating loss carryforwards. The financial statement effect of the need for a valuation allowance or the write-off of a deferred tax asset generally should be recognized when the stock is issued. As a result, ABC should not adjust its valuation allowance for its 20X6 financial statements, but rather should adjust its financial statements in the financial reporting period that includes February 14, 20X7. However, ABC should disclose the effect of the limitation as a subsequent event.

**Example 4.6: Forgiveness of Debt after the Balance Sheet Date**

ABC Corp. is a calendar year-end entity. At December 31, 20X8, ABC has incurred cumulative losses in the current and prior two years. In addition, after considering all available positive and negative evidence, other than the debt forgiveness discussed below, in determining whether a valuation allowance is needed, ABC concludes that the deferred tax assets at December 31, 20X8 are not more likely than not of being realized.

On February 15, 20X9, prior to the issuance of its December 31, 20X8 financial statements, ABC completed an agreement with its lender whereby a portion of ABC's debt was forgiven by the lender. The amount of debt forgiven is sufficient to generate income in 20X9 to such an extent that the deferred tax asset at December 31, 20X8 is more likely than not to be realized.

We believe in this circumstance, ABC's analysis should consider the income generated from the debt forgiveness in evaluating the need for a deferred tax asset valuation allowance at December 31, 20X8. Because the forgiveness of debt was agreed to by the lender and finalized before the issuance of the December 31, 20X8 financial statements, considering the income generated from the debt forgiveness in determining the amount of the deferred tax asset valuation allowance would not be an *anticipation* of an event not primarily within the control of the entity, rather, it is a completed transaction that would be factored into estimates of future taxable income similar to sales of assets. Further, we believe that the forgiveness of debt is a subsequent event that should be considered as part of all available evidence, as discussed in Paragraph 4.032. This scenario differs from the consideration of a business combination completed after the balance sheet date but before the financial statements are issued because the guidance on business combinations requires an acquirer to release the valuation allowance in the period of the acquisition. See additional discussion beginning in Paragraph 6.035.

**Example 4.7: Forecasted Gains on Sale of a Business**

On October 17, 20X1, ABC Corp. entered into a transaction to sell assets constituting a business to DEF Corp. The transaction was approved by the Board of Directors of both ABC and DEF and a contract was signed before issuance of the financial statements for the quarter ended September 30, 20X1. The transaction does not require shareholder approval and will result in a significant taxable gain for ABC on closing. However, the final closing of the transaction is conditional on receipt of regulatory approval and is anticipated to close in early 20X2. The assets to be sold continued to be classified as held-and-used in the September 30, 20X1 financial statements as the held-for-sale criteria were not met until October. ABC previously recorded a full valuation allowance against its deferred tax assets (DTAs) because it was believed they were not more likely than not of being realized due to the inability to generate sufficient future taxable income.

ABC's attorneys with a background in the regulatory approval process assess the probability of obtaining regulatory approval within 30 days as 70% - 90% likely and assess the likelihood of the transaction dissolving if approval stretches beyond 75 days as low.

In this scenario, the expected transaction is a subsequent event that is not specifically precluded from consideration per the guidance in ASC Topic 740. However, to consider the transaction as part of the available evidence in evaluating the need for a valuation allowance at quarter-end, there must be a sufficient level of likelihood that the transaction will be consummated.

While the transaction was signed and announced prior to the issuance of ABC's financial statements for the quarter ended September 30, 20X1, final closing of the transaction is conditional on regulatory approval. ABC's probability assessment indicates a sufficient level of likelihood that the transaction will be approved and close. Therefore, in this fact pattern, because the agreement was signed and announced before the issuance of the financial statements and there is a high probability the transaction will be consummated, we believe ABC should consider the forecasted gain in its future projections when assessing the need for a valuation allowance at September 30, 20X1.

The income statement effect of the change in the valuation allowance should be recognized in the reporting period as described in Paragraph 10.078.

The sale of a business differs from the consideration of a business combination completed after the balance sheet date but before the financial statements are issued because the guidance about business combinations requires an acquirer to release the valuation allowance in the period of the acquisition. See additional discussion beginning in Paragraph 6.035.

#### **Alternative Scenario**

Conversely, if the contract was not signed and announced before the financial statement issuance or if there was more than insignificant uncertainty about regulatory approval, ABC would exclude this transaction from its valuation allowance assessment because there is not a sufficient level of certainty that the transaction will occur.

In this circumstance, the anticipated gain on the asset sale would be included as a component of the overall projection of taxable income or loss after the contract was signed and the regulatory uncertainty was resolved. If other anticipated losses offset the anticipated gain in the year of the sale, the anticipated gain would not support a reduction in the valuation allowance.

**4.033 A Practical Approach to Determining the Valuation Allowance.** The procedures described below provide a practical approach that may be useful in many situations in determining the amount of the valuation allowance necessary for deferred tax assets. In certain instances, it will not be necessary to perform all of the procedures or to perform them in the order shown below. Generally, the procedures should be performed for each



separate tax jurisdiction and for each separate tax-paying component within the tax jurisdictions where combined tax returns (or their equivalent) are not permitted. See Paragraph 3.006.

Step 1: Determine the amount of deferred tax assets and liabilities.

Deferred tax assets are recognized for deductible temporary differences and carryforwards. Deferred tax liabilities are recognized for taxable temporary differences.

Step 2: Determine the amount of taxes paid during the carryback period available under the tax law.

Taxable income in the current year and prior years that can be offset to recover taxes paid is an objectively verifiable source of income that can be used to justify recognition of deferred tax assets.

Step 3: Obtain a general understanding of the pattern and timing of the reversals of temporary differences, any limitations under the tax law, and the length of carryback and carryforward periods available under the tax law.

Because the tax law determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years, understanding the general pattern and timing of reversals and any limitations under the tax law are necessary to determine to what extent the tax benefits of deductible temporary differences and carryforwards can be realized through offsetting taxable temporary differences.

Step 4: Determine whether it is more likely than not that the tax benefits of deductible temporary differences and carryforwards could be realized by either the carryback availability determined in Step 2 or by offsetting taxable temporary differences based on the general understanding of the reversal patterns obtained in Step 3 or both.

If an entity can support a conclusion that it is more likely than not that the realization of deferred tax assets can be supported by (1) carryback to recover taxes paid in the current year or prior years and/or (2) offsetting taxable amounts related to taxable temporary differences within the carryback or carryforward period for which deferred tax liabilities are recognized, it is generally appropriate to conclude that no valuation allowance is necessary for that portion of the deferred tax assets. If an entity can conclude at this point that no valuation allowance is necessary for the deferred tax assets, it generally will not be necessary to perform other procedures.

**Step 5:** Determine the amount and timing of future taxable income exclusive of reversing temporary differences and carryforwards that is needed to support a conclusion that it is more likely than not that the deferred tax assets are realizable.

This step should be based on either the amount of deferred tax assets remaining after reducing the deferred tax assets by offsetting taxable temporary differences and those supported by carryback availability (Step 4) or in combination with those sources (see Paragraph 4.007a).

**Step 6:** Based on the amount of future taxable income needed to realize the remaining deferred tax assets as determined in Step 5, assess (a) whether there is positive evidence that the related tax benefits will be realized and (b) the strength of that positive evidence. That evidence may relate to historical earnings patterns, substantial appreciation in the value of the entity's net assets, or other facts and circumstances. The assumptions used to determine the amount and timing of future taxable income used in this analysis should not be inconsistent with other management forecasts.

Given historical earnings patterns, there may be situations in which the amount of remaining deferred tax assets is relatively insignificant in relation to the amount of future taxes that the entity expects to pay on future taxable income if the earnings pattern remains stable.

In considering whether the deferred tax benefits will be realized as a result of appreciated net assets, an entity should consider the degree to which the appreciated values can be objectively determined. It is important to note that the substantial appreciation as discussed here is with respect to the entity's *net* assets (i.e., equity).

**Step 7:** If an entity is not able to support a conclusion that it is more likely than not that the remaining deferred assets are realizable after performing the procedures enumerated above, the entity should consider tax-planning strategies that may be available.

Tax-planning strategies are actions that are prudent and feasible which an entity ordinarily might not take, but would take to prevent a tax benefit from expiring unused. See Paragraph 4.057 for additional discussion.

**Step 8:** Based on the procedures performed in the steps discussed above, an entity should reach a conclusion about the amount of deferred tax assets that will more likely than not be realized and record a valuation allowance for the remaining deferred tax assets, if any.

## FUTURE REVERSALS OF EXISTING TAXABLE TEMPORARY DIFFERENCES

**4.034** Future reversals of existing taxable temporary differences will support the realization of deferred tax assets if the amounts offset under the tax law. This principle holds true whether the taxable temporary differences arose through prior operating activity or were established from another event, such as a business combination. This principle also holds true in the consolidated financial statements whether the taxable temporary differences are tracked centrally or are pushed down to the entity that has recognized the related assets and liabilities. As previously discussed, some form of scheduling may be necessary to determine whether the future settlement of deferred tax liabilities will enable an entity to realize existing deferred tax assets. ASC 740-10-55-12

**4.035 Scheduling the Reversal of Existing Temporary Differences.** Detailed scheduling may be unnecessary, particularly if all future deductible amounts and carryforwards, after consideration of any limitations under the tax law, clearly offset reversing taxable temporary differences in future years during the permitted carryback or carryforward period. Similarly, in some instances, scheduling may not be necessary because the temporary differences clearly do not reverse within the same carryforward or carryback period or the character (i.e., ordinary income vs. capital gain) of the items are different.

**4.036** The following example illustrates a deferred tax asset that can offset the tax effect of an existing taxable temporary difference.

### Example 4.8: Determination That a Valuation Allowance Is Not Necessary Solely as a Result of Reversing Taxable Temporary Differences

ABC Corp. had tax loss of FC 2,000 in 20X6 and has FC 1,000 of deductible temporary differences and FC 5,000 of taxable temporary differences at the end of 20X6. ABC had no temporary differences or carryforwards at the beginning year, had no taxable income in the past three years and does not anticipate taxable income exclusive of reversal of existing taxable temporary differences in the future. A summary of the temporary differences follows:

	Financial Statement		Tax		Taxable (Deductible) Temporary Difference
	Carrying Amount		Basis		
Depreciable assets	FC 28,000	FC 23,000	FC	5,000	
Deferred compensation	1,000	—		(1,000)	
Net operating loss carryforward	—	2,000		(2,000)	
Net temporary differences			FC	<u>2,000</u>	

The estimated useful lives of existing depreciable assets range from one to five years. The deferred compensation will be paid in 20X8 based on the terms of the related employment contracts.

The tax law in ABC's tax jurisdiction permits a 20-year carryforward period for operating losses.

In this situation, because the reversal of the taxable temporary differences over the next five years would result in FC 5,000 of taxable income within the 20-year NOL carryforward period under applicable tax law, ABC would conclude that it is more likely than not that the entire amount of the deferred tax assets will be realized. ABC needs no additional information about the pattern of the reversals of temporary differences, future taxable income exclusive of reversing temporary differences, or tax-planning strategies.

**4.037 Anticipating Future Tax Losses.** Future tax losses should not be anticipated when assessing the need for a valuation allowance based on the reversal of existing taxable temporary differences. For example, if existing deferred tax liabilities are expected to reverse within the carryforward period of existing net operating loss carryforwards and the taxable income generated from those reversals would be sufficient to use those carryforwards after considering limitations (see Paragraph 4.016a for additional discussion of the 80% limitation associated with post-2017 U.S. net operating loss carryforwards), a valuation allowance is not appropriate even if the operating loss carryforwards are not actually expected to be used because future tax losses are expected to be in excess of the reversing existing deferred tax liabilities. However, if future tax losses are expected, it may be unlikely the entity could support realization of its deferred tax assets *beyond* the amount of the reversing deferred tax liabilities (e.g., through future taxable income exclusive of reversing taxable temporary differences). ASC paragraph 740-10-25-38

**4.037a** Similarly, if existing deferred tax liabilities are expected to reverse within the carryforward period of existing disallowed interest carryforwards, including consideration of the annual limitations (see Paragraph 4.016c for additional discussion of the interest limitation), a valuation allowance is not appropriate even if the disallowed interest deductions are not expected to be used because the future interest incurred will exceed the amount that is expected to be deductible. This position is consistent with the AICPA's Q&A Section 3300.02, *Evaluation of the Realizability of a Section 163(j) Carryforward*.

#### **Example 4.9: Anticipating Tax Losses**

ABC Corp. has net operating loss carryforwards at December 31, 20X1 of FC 500,000, had no taxable income in its five-year history, and does not expect to generate taxable income within the next three years. ABC has a FC 105,000 deferred tax asset for the

net operating loss carryforwards and a FC 110,000 deferred tax liability related to intangible assets with a three-year useful life. The net operating losses do not expire.

If there are no provisions under the tax law that restrict the use of the operating loss carryforwards, ABC should not establish a valuation allowance even if forecasted losses in future periods are expected to exceed the reversing taxable temporary differences. The deferred tax liabilities reverse within the carryforward period of the net operating loss carryforwards; accordingly, a valuation allowance in this example is not permitted. Other sources of taxable income and other positive and negative evidence need not be considered.

If ABC's deferred tax liability had been only FC 100,000, those expected future (and past) tax losses would result in a FC 5,000 valuation allowance on the remaining deferred tax asset (assuming no other sources of taxable income).

If the provisions under the tax law did restrict the use of the operating loss carryforward, ABC should consider those restrictions in the analysis. If the tax law limited the use of the net operating loss carryforward to 80% of taxable income for the year (e.g., post-2017 U.S. net operating loss carryforwards), the taxable temporary difference would support realization of only FC 88,000 (FC 110,000 × 80%) of the deferred tax asset and would result in a FC 17,000 valuation allowance on the remaining deferred tax asset (assuming no other sources of taxable income).

**4.038 Valuation Allowances That Result in Net Deferred Tax Liabilities.** In some cases, if an entity has deferred tax liabilities that equal or exceed its deferred tax assets, a valuation allowance will not be necessary when the deferred tax assets and liabilities are expected to reverse in the appropriate periods to allow them to offset. However, deferred tax assets and liabilities may not always offset and a valuation allowance may be necessary even if deferred tax liabilities exist. These situations may occur, for example as a result of:

- Limitations or other tax law provisions that prevent all or a portion of the deferred tax assets from being realized (such as the limitations under U.S. tax law for post-2017 net operating losses, SRLY, section 382 limitations). See discussion beginning in Paragraph 4.016a.
- Deferred tax assets and liabilities are sourced in separate tax jurisdictions.
- Mismatch in the reversal periods of the deferred tax assets and deferred tax liabilities.
- Mismatch in the character of the deferred tax assets and deferred tax liabilities.

**4.038a Deferred Tax Liabilities in a Subsidiary to be Disposed.** Existing taxable temporary differences associated with a subsidiary to be disposed of remain objectively verifiable sources of income that support the consolidated group's deferred tax assets until the date of the disposal (regardless of whether the subsidiary's deferred tax assets

and liabilities are classified as held-for-sale; see Paragraph 9.169a). However, because some, or all, of those deferred tax liabilities may be expected to reverse earlier than previously scheduled (i.e., because of an expected taxable sale) or may be expected to reverse after leaving the consolidated group (i.e., because of an expected carryover basis disposition), a valuation allowance may be necessary before the period of the sale as they may not generate future taxable income in the period necessary to realize the consolidated group's deferred tax assets. When the subsidiary is ultimately sold, the pretax gain or loss on sale includes the reversal of its deferred tax assets and liabilities (see Paragraph 9.169b).

### **FUTURE TAXABLE INCOME EXCLUSIVE OF REVERSING TEMPORARY DIFFERENCES AND CARRYFORWARDS**

**4.039** Future taxable income exclusive of reversing temporary differences and carryforwards is the second source of taxable income that may support recognition of a deferred tax asset. Due to the judgment and estimation involved in forecasting future taxable income exclusive of reversing temporary differences and carryforwards, this source of taxable income is generally considered to be the least objective when evaluating the weight of available positive and negative evidence.

**4.040 Estimating Future Taxable Income.** Analyses of future taxable income may include forecasts, projections, or any other process used by management to estimate whether future taxable income is sufficient to realize a deferred tax asset. The level of detail necessary in preparing such analyses is a matter of judgment and will depend on the specific facts and circumstances and the extent of positive and negative evidence. The forecast or projection prepared to assess the need for a valuation allowance does not need to meet the requirements of a financial forecast or financial projection as defined in the professional standards on prospective information. However, the level of evidence that a forecast, projection, or any other form of analysis provides becomes increasingly important in the presence of significant negative evidence. ASC paragraphs 740-10-55-8, and 55-9

**4.041** The assumptions and projections used for the purpose of evaluating the need for a valuation allowance should not be inconsistent with those used in other similar analyses required by GAAP (e.g., goodwill impairment analyses) as well as public disclosures such as MD&A and press releases.

**4.042** In certain cases, detailed forecasts, projections, or other types of analyses are not necessary to conclude that a valuation allowance is not needed because future taxable income is expected to significantly exceed the amount sufficient to realize the deferred tax asset. For example, it may be acceptable for a profitable entity to assume that future taxable income will at least equal the level of taxable income generated in recent years, assuming there is no negative evidence that suggests the entity will not be able to sustain that level of earnings. However, a recent history of earnings should not be the sole source of evidence used to support a conclusion that deferred tax benefits will be realized. For example, an entity with a recent strong history of earnings may face significant

uncertainties about future operations, such as significant loss contingencies or declining demand for the entity's products or services. That negative evidence and any other available evidence must be weighed in assessing the need for a valuation allowance.

**4.043 Ability to Estimate Future Taxable Income.** When an entity is relying on estimates of future taxable income, it is critical to assess its ability to produce reliable future income forecasts. Recent history of the entity meeting or missing its forecasts is a key factor in evaluating the ability to estimate future income. If there is a significant change in the economic environment, it may become increasingly difficult and subjective for an entity to demonstrate the ability to reliably project future operations. In addition, new products and production processes, new management, and the nature of operations are a few factors that affect an entity's ability to estimate. For example, an entity that has been operating in the same line of business for many years may be able to accurately forecast future taxable income better than an entity whose income depends on unproven production processes.

**4.044** Significant judgment and estimation goes into forecasting future taxable income, which is considered to be the least objective when evaluating the weight of available positive and negative evidence. In circumstances where estimates are more subjective, it may be appropriate to reduce the weight given to projections of future income in the assessment of the need for a valuation allowance. See Paragraph 4.050 for additional discussion.

**4.045 Future Originating Temporary Differences and Estimates of Future Taxable Income.** Estimates of future taxable income exclusive of reversing items generally should consider the effect of both taxable and deductible temporary differences that originate in the future (future originating temporary differences) and their reversals. As stated in ASC paragraph 740-10-55-16, "future originating temporary differences and their subsequent reversals are implicit in estimates of future taxable income." However, we believe it is acceptable to exclude future originating *deductible* temporary differences and their subsequent reversals from estimates of future taxable income. See Paragraph 4.048b for additional discussion. ASC paragraph 740-10-55-16

**4.046** In some cases, it may be unnecessary to schedule the origination and reversal of temporary differences that do not exist at the current balance sheet date and estimated pretax book income adjusted for permanent differences may be used as an estimate of future taxable income. However, because the actual timing of tax deductions and taxable income may be a critical factor in evaluating whether the benefit of an existing deferred tax asset will be realized, judgment is required in determining the extent to which the origination and reversal of future temporary differences is considered in an analysis of future taxable income. The following example illustrates a situation where it is not appropriate to recognize the benefit of a tax loss carryforward despite the existence of sufficient pretax book income.

**Example 4.10: Deferred Tax Assets with Limited Life**

At December 31, 20X6, DEF Corp. has no temporary differences except for a pre-2018 U.S. net operating loss carryforward of \$100. That carryforward expires in 20X7. DEF estimates \$100 of pretax financial statement income in 20X7. In addition, DEF expects to have an originating taxable temporary difference of \$100 in 20X7 and no other originating temporary differences.

Given the simple fact pattern provided above, DEF will have taxable income (before net operating loss carryforward) of \$0 in 20X7 (pretax financial statement income of \$100 less the originating taxable temporary difference of \$100). Accordingly, the tax operating loss carryforward will expire unused in 20X7, and it is inappropriate to recognize the benefit of the carryforward at December 31, 20X6. Unless DEF is able to identify a qualifying tax-planning strategy to keep the carryforward from expiring unused, a full valuation allowance would be necessary at December 31, 20X6.

**4.047 Effect of Excess Share-Based Payment Deductions on the Assessment of Future Taxable Income.** Projections of future taxable income should include consideration of future excess tax deductions associated with share-based payment awards, including disqualifying dispositions of incentive stock options, for which no deferred tax asset is recognized in the financial statements. Estimates of such future deductions should be based on the entity's best estimate of the future excess deductions. This will generally consider existing options, turnover, and other subjective factors, and will be based on the fair value of the entity's shares as of the balance sheet date. ASC subparagraph 855-10-55-2(f)

**4.048 Future Originating Deductible Temporary Differences and Carryforwards.** When future temporary differences and their pattern of origination and reversal are considered, careful evaluation is necessary to determine whether there is a rollover of existing deferred tax assets into newly originated deferred tax assets that are not more likely than not of being realized when those newly originated deferred tax assets reverse. For example, if the reversal of an existing deferred tax asset is replaced by an originating deferred tax asset with equal or greater value, the reversal of the existing deferred tax asset may not constitute *realization*. Determining how much, if any, of the existing deferred tax asset has been realized is a matter of judgment. Two acceptable approaches are the with-and-without approach and the replacement approach (see below). The tax-law ordering approach may also be acceptable in certain circumstances (see Paragraph 4.124d).

**4.048a** The *with-and-without approach* is one acceptable method for determining how much benefit is expected to be realized on reversal of a deferred tax asset. When applying the with-and-without approach, the entity forecasts its future taxable income and tax credits generated excluding reversing items and including future originating taxable and deductible temporary differences and compares (a) what it expects cash income taxes to be with the existing deferred tax asset, and (b) what cash income taxes would have been



without the existing deferred tax asset. The difference is the amount of the existing deferred tax asset that is realizable. Under this approach, the need for a valuation allowance for any deferred tax assets that originate in the future would be considered as the deferred tax asset originates. ASC paragraph 740-10-55-16

**4.048b** Another acceptable approach is the *replacement approach*. ASC paragraph 740-10-55-37 indicates the reduction in taxes payable from the utilization of a carryforward against taxable income generated by an originating deductible temporary difference gives no cause for recognition of a tax benefit because, in effect, the carryforward has been replaced by the temporary difference. Accordingly, when applying the replacement approach, the entity forecasts its future taxable income *exclusive of replacement effects*. To compute future taxable income exclusive of replacement effects, an entity determines how much future taxable income and tax credits generated are expected to be available excluding the future reversal of existing temporary differences and carryforwards and excluding originating *deductible* temporary differences or carryforwards. However, future originating *taxable* temporary differences and their subsequent reversals would be included. In other words, this approach looks to whether the future operations of the tax-paying component as a whole will generate more income tax attributes than it can use. Under this approach, existing deferred tax assets are only considered realized to the extent future operations have the capacity to use more attributes than generated. The deductible temporary differences and carryforwards that are expected to originate in the future are excluded under this approach because these originating deferred tax assets replace the existing deferred tax assets and will require future taxable income to be realized. The amount of the existing deferred tax asset that is more likely than not to be realized is the amount supported by future taxable income exclusive of replacement effects.

The following example illustrates these approaches.

#### Example 4.11: Future Originating Deferred Tax Assets

ABC Corp.'s only deferred tax balance at December 31, 20X6 is a \$105 deferred tax asset for a \$500 deductible temporary difference. That deferred tax asset is expected to be recovered in approximately equal amounts over the next three years. ABC has no carryback availability and is estimating future taxable income for 20X7, 20X8, and 20X9 to determine whether it is more likely than not that the benefit of the deferred tax asset will be realized. Assume also that ABC has no other sources of taxable income and expects no permanent differences in future years. The enacted tax rate is 21%.

	20X7	20X8	20X9
Expected pretax book income	\$ 20	\$ 30	\$ 30
Future originating deductible temporary differences	190	160	150
Future taxable income exclusive of reversing items	<u>\$ 210</u>	<u>\$ 190</u>	<u>\$ 180</u>

The originating deductible temporary differences all reverse after 20X9 when ABC cannot rely on estimates of future taxable income.

### With-and-without Approach

Under the with-and-without approach, ABC forecasts its future taxable income and compares (a) what it expects its cash income taxes to be with its \$105 existing deferred tax asset, and (b) what its cash income taxes would have been without it.

The following table shows what ABC expects its cash income taxes to be with the existing \$105 deferred tax asset.

	20X7	20X8	20X9
Future taxable income exclusive of reversing items	\$ 210	\$ 190	\$ 180
Reversal of existing deductible temporary difference	<u>(167)</u>	<u>(167)</u>	<u>(166)</u>
Taxable income	43	23	14
Tax rate	<u>21%</u>	<u>21%</u>	<u>21%</u>
Current income taxes payable	<u>\$ 9</u>	<u>\$ 5</u>	<u>\$ 3</u>

The following table shows what ABC's cash income taxes would have been without the existing \$105 deferred tax asset.

	20X7	20X8	20X9
Future taxable income	\$ 210	\$ 190	\$ 180
Tax rate	<u>21%</u>	<u>21%</u>	<u>21%</u>
Current income taxes payable	<u>\$ 44</u>	<u>\$ 40</u>	<u>\$ 38</u>

Under the with-and-without approach, ABC concludes that it is more likely than not to realize the entire \$105 deferred tax asset. This is because over the three-year period, the existing deferred tax asset saves ABC \$105 in cash income taxes – i.e., it is expected to pay \$17 in cash income taxes over the three-year period when considering the effects of the existing deductible temporary difference and would be expected to pay \$122 without it.

### Replacement Approach

When applying the replacement approach, ABC determines how much of its \$105 existing deferred tax asset is more likely than not to be realized by computing the amount that is supported by future taxable income exclusive of replacement effects.

	20X7 - 20X9
Future taxable income exclusive of reversing items	\$ 580
Future originating deductible temporary difference	<u>(500)</u>
Future taxable income exclusive of replacement effects	80
Tax rate	<u>21%</u>
Current income taxes payable	<u><u>\$ 17</u></u>

A valuation allowance is not needed for \$17 of the existing \$105 deferred tax asset. This is the amount of the deferred tax asset that would reduce current income taxes payable in future years if ABC excludes the originating deductible temporary differences when forecasting future taxable income.

**4.049 Scheduling the Reversal of Existing and Future Originating Temporary Differences.** Although pretax book income adjusted for permanent differences may serve as a surrogate of future taxable income in many cases, it is important to consider the actual timing of deductions under the tax law and the periods in which taxable income will be available to realize the benefit of existing carryforwards or deductible temporary differences. Judgment is required in determining the extent of the analysis performed in arriving at estimates of future taxable income, including decisions made about the number of future years that will be included in the analysis of future taxable income. The following example schedules the reversal of existing temporary differences and the origination and reversal of future originating temporary differences to estimate future taxable income. (This example is not intended to provide guidance on or benchmarks for the number of years that should be included in an analysis of future taxable income.)

#### Example 4.12: Calculation of Future Taxable Income Exclusive of Reversing Temporary Differences and Carryforwards

As of December 20X6, ABC Corp. has deferred tax assets and liabilities resulting from the following temporary differences and tax carryforwards:

	Financial Statement Carrying Amount	Tax Basis	(Taxable) Deductible Temporary Difference
Depreciable assets	\$ 21,000	\$ 12,000	\$ (9,000)
Deferred compensation	1,000	—	1,000
Warranty liability	2,000	—	2,000
Net operating loss carryforwards (pre-2018)			<u>20,000</u>
Total future net deductible amount			<u><u>\$ 14,000</u></u>

The net operating loss carryforwards will expire at the end of 20Y0.

ABC is preparing an estimate of future taxable income, exclusive of reversing temporary differences and carryforwards, through 20Y0. The depreciable assets were originally purchased for \$30,000 three years ago and are being depreciated straight-line over 10 years for book purposes and five years for tax purposes. The deferred compensation deferred tax asset is the result of a continuing plan where \$1,000 is paid six months after the fiscal year-end in which certain performance targets were met. The warranty accrual is calculated as a percentage of sales for the five-month warranty given on product sales. The warranty liability is not expected to change in the next five years, primarily because sales are relatively flat and warranty costs are not expected to increase.

ABC has projected \$10,000 in pretax income in years 20X7 through 20Y1 as part of the preparation of their annual five-year operation plan. Furthermore, ABC plans to acquire \$10,000 of computer equipment in 20X8. The new computer equipment will be amortized over two years for financial statement purposes and four years for tax purposes.

ABC uses the with-and-without approach for determining the amount of future taxable income exclusive of reversing items (see Paragraph 4.048a).

The following table shows the calculation of future taxable income exclusive of the reversal of existing temporary differences and carryforwards:

	20X7	20X8	20X9	20Y0	20Y1
Projected book net income before taxes	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
Projected change in temporary differences:					
Depreciable assets <sup>1</sup>	(3,000)	(3,000)	3,000	3,000	3,000
Deferred compensation	—	—	—	—	—
Warranty liability	—	—	—	—	—
New computer assets <sup>2</sup>	—	2,500	2,500	(2,500)	(2,500)
Taxable income	<u>7,000</u>	<u>9,500</u>	<u>15,500</u>	<u>10,500</u>	<u>10,500</u>
Less reversing existing temporary differences:					
Depreciable assets	—	—	(3,000)	(3,000)	(3,000)
Deferred compensation <sup>3</sup>	1,000	—	—	—	—
Warranty liability <sup>4</sup>	2,000	—	—	—	—
New computer assets	—	—	—	—	—
Taxable income for valuation allowance assessment	<u>\$ 10,000</u>	<u>\$ 9,500</u>	<u>\$ 12,500</u>	<u>\$ 7,500</u>	<u>\$ 7,500</u>

<sup>1</sup> The depreciable assets will continue to be depreciated for tax purposes at twice the book rate of depreciation through 20X8. The difference begins to reverse in 20X9.

<sup>2</sup> The new computer assets will be depreciated twice as fast for book purposes than for tax purposes resulting in an originating temporary difference beginning in 20X8. The annual difference represents  $[(\$10,000 \div 2) - (\$10,000 \div 4)]$ .

<sup>3</sup> In year 20X7, a \$1,000 future deductible for deferred compensation is created and a separate \$1,000 is used. The newly created component is a future originating temporary difference and is included in future taxable income. Because this deferred tax asset relates to a continuing deferred compensation plan, its reversal is replaced by a newly originating deferred tax asset resulting in no net reversal in 20X8-20Y1.

<sup>4</sup> In year 20X7, a \$2,000 future deductible amount for warranty is created, and a separate \$2,000 is used. The newly created component is a future originating temporary difference and is included in future taxable income. Because this deferred tax asset relates to a warranty liability that is expected to remain consistent over the next five years, its reversal is replaced by a newly originating deferred tax asset resulting in no net reversal in 20X8-20Y1.

**4.050 Number of Years to Include in the Estimate of Future Taxable Income.** In preparing its best estimate of future taxable income, entities should consider as many years as are reliably estimable, recognizing the fact that the subjectivity of an estimate generally increases as the number of years increases. Factors to consider in evaluating the reliability of the estimate for each of the future periods being relied upon include whether the entity has demonstrated the ability to reliably project historically for the relevant number of periods into the future based on a comparison of prior projections to actual operating results, the existence of a strong and stable earnings history, the state and stability of the industry in which the entity operates, projected budget and operating cycles based on the current business plan, etc.

**4.051** An entity generally should not limit the evaluation of future taxable income to a set number of years based on a corporate policy (for example, one, three, or five years) or other similar directive. Limiting the estimate of future taxable income to a set number of years may inadvertently smooth the effect of changes in the valuation allowance (i.e., release an existing valuation allowance in increments equal to one-year of taxable income). For example, a start-up entity that had historically maintained a valuation allowance for existing deferred tax assets that has since established a strong earnings history and demonstrated its ability to project future taxable income generally should not continually limit the amount of recognized deferred tax assets to the amount of taxable income in the next three years. While incremental release of the valuation allowance may be appropriate for a period of time based on the specific facts and circumstances, entities are required to release some or all of the valuation allowance at the point in time when, based on all the available evidence, it is more likely than not that the related deferred tax asset will be realized. Limiting future taxable income to three years over multiple profitable periods may inappropriately delay release of some or all of a valuation allowance related to a deferred tax asset that is more likely than not of being realized to the period beyond the third year in circumstances when the entity has established a strong and stable earnings history and no evidence suggests that current earnings levels adequate to recover the deferred tax asset will not continue.

**4.051a Taxable Losses in a Subsidiary to be Disposed.** When an entity has sufficient future taxable income to conclude that it is more likely than not to realize its deferred tax assets, it does not recognize a valuation allowance. In some cases, a parent may file a consolidated tax return that includes a subsidiary that would be unable to realize its

deferred tax assets if it were to file a separate tax return. Although no valuation allowance is necessary (or appropriate) in the consolidated financial statements, a question arises as to whether a valuation allowance is necessary when the parent expects to sell that subsidiary. We believe the parent in that situation should not recognize a valuation allowance for the deferred tax assets of the subsidiary if the future taxable income of the consolidated group (or parent alone) would be sufficient to realize the benefits of the subsidiary's deferred tax assets. The acquirer of the subsidiary will perform its own assessment of whether a valuation allowance is needed for the deferred tax assets of the subsidiary depending on the facts and circumstances after the acquisition.

**4.051b Future Taxable Income in a Subsidiary to be Disposed.** If a consolidated tax group (or parent alone) supports realization of its deferred tax assets based on the future taxable income exclusive of reversing items generated by a subsidiary that is held-for-sale, it should recognize a valuation allowance in the period in which management concludes the sale is expected to occur. If the parent no longer expects to have income from the subsidiary, it would no longer consider that income in its projections of future taxable income for periods after the disposal date. See Paragraph 4.076 for additional guidance on considering the sale of a subsidiary as a tax-planning strategy.

### **TAXABLE INCOME IN PRIOR CARRYBACK YEARS IF CARRYBACK IS PERMITTED BY THE TAX LAW**

**4.052** Taxable income in prior carryback years, if carryback is permitted by the tax law, is the third source of taxable income that will support recognition of a deferred tax asset if the amounts offset under the tax law. The elimination of the carryback period for post-2017 U.S. federal net operating losses generally prevented this source of taxable income from supporting U.S. federal ordinary deferred tax assets (see Paragraph 4.016a for additional information). U.S. entities can still carryback federal capital losses, foreign tax credits and certain state operating losses. The following example demonstrates how this source of taxable income is determined when supporting the recognition of deferred tax assets.

#### **Example 4.13: Taxable Income in Prior Carryback Years**

At December 31, 20X6, ABC Corp. has FC 10,000 of deductible temporary differences arising from amortizable intangible assets. The tax amortization has historically been less than book amortization, and the deductible temporary difference will reverse ratably over the next five years. In 20X5 and 20X6 ABC had taxable income of FC 3,000 and FC 1,000, respectively. Current tax law in ABC's tax jurisdiction permits losses to be carried back for one year.

Without considering other sources of taxable income, the deferred tax asset, with respect to FC 1,000 of the deductible temporary difference, is supportable by taxable income in carryback years. The temporary difference will reverse FC 2,000 a year for five years, generating FC 2,000 of tax deductions in 20X7 through 20Y1. Assuming no other taxable income in 20X7, the taxable loss in 20X7 could be carried back to

recover the taxes paid on the FC 1,000 of taxable income in 20X6. The tax paid on the FC 3,000 in 20X5 is not available to be recovered with the reversal of existing deferred tax assets because of the one-year limitation on the ability to carryback.

**4.053 Interaction with Income Tax Law.** The fundamental assumption in calculating taxable income in prior carryback years as a source of taxable income is that in the future period in which the deferred tax asset reverses, the related tax loss becomes available for carryback - i.e., excluding the tax loss arising from the reversal of the deferred tax asset, taxable income is zero. If that tax loss, caused solely by the reversal of the existing deferred tax asset, can, under the tax law in the relevant jurisdiction, be carried back to recover the taxes paid in prior years, then no valuation allowance for that portion of the deferred tax asset is needed or permitted. However, we would also accept a view that a deferred tax asset is only supported by carryback availability to the extent a taxable loss is expected. ASC subparagraph 740-10-55-12(c) and paragraph 55-122

#### **Example 4.14: Anticipating Future Losses in the Carryback Years**

At December 31, 20X6, ABC Corp. has a FC 10,000 deferred tax asset. Assets and liabilities that gave rise to this deferred tax asset will be settled ratably over the next four years such that FC 2,500 of the deferred tax asset will reverse in each of the next four years. ABC paid FC 20,000 of tax in 20X6, and tax law permits future tax losses to be carried back one year to recover taxes paid. FC 2,500 of the deferred tax asset that reverses in 20X7 can be carried back to 20X6 to recover taxes paid. Accordingly, a valuation allowance is not needed (or permitted) for FC 2,500 of the existing deferred tax asset.

The income tax law does not permit losses reported in 20X8, 20X9 or 20Y0 to be carried back to recover taxes paid in 20X6. Accordingly, a valuation allowance is needed for the remainder of the deferred tax asset that is not supported by other sources of taxable income. It would be inappropriate to assume the reversals of the deferred tax asset in 20X8, 20X9 and 20Y0 will be carried back to 20X6 because income tax law does not permit such a carryback.

**4.054 Dislodged Credits.** A carryback of future deductible amounts to prior years may result in reestablishing (freeing up or dislodging) tax credits used in prior years that reduced income taxes payable. The potential tax benefit of a carryback of a future deductible amount to a prior year includes (1) the difference between the amount of taxes paid in the carryback years and the amount of the tax liability after carryback, and (2) the tax benefit of the dislodged credits that can be carried back to recover taxes paid in prior years or carried forward to reduce taxes payable in future years.

**4.055** The effect of dislodged credits must be considered in determining whether a valuation allowance is necessary to reduce deferred tax assets when carryback availability is used to support recognition of the assets. If the carryback will dislodge

credits that are expected to expire unused, a valuation allowance should be established to reduce the net deferred tax asset to the amount of the refund that could be realized as a result of the carryback. No valuation allowance is necessary or permitted if the dislodged credits are more likely than not to be realized from other sources of taxable income. Paragraph 4.048 provides additional discussion of acceptable approaches for evaluating future taxable income exclusive of reversing items when considering a deferred tax asset that is the replacement of an item that was carried back.

**4.056 Accrued Liability for Unrecognized Tax Benefits.** The amount of taxes paid in prior years that may be recovered from the reversal of existing deferred tax assets when carryback is available under the tax law should be based on the more-likely-than-not tax treatment, which includes taxes paid and taxes that may be paid for tax positions for which there is uncertainty. As a result, in some situations, the amount of taxes available to support realization of deferred tax assets will be greater than the actual taxes paid. The amount of the taxes for prior years that may be available to support existing deferred tax assets includes taxes paid in the carryback periods and liabilities required under ASC Subtopic 740-10 (FIN 48) for tax positions that are not more likely than not of being sustained or are measured at less than 100% of the benefit. See Section 3 for additional discussion of the recognition and measurement principles of ASC Subtopic 740-10 for accounting for uncertainty in income taxes.

## THE ROLE OF TAX-PLANNING STRATEGIES

**4.057** *Tax-planning strategies* are actions (including elections for tax purposes) that management ordinarily might not take but would take if necessary to realize a tax benefit for a carryforward before it expires. Tax-planning strategies may include actions that could be taken by management to accelerate, delay, or offset the tax effects of reversing deductible or taxable temporary differences to realize tax benefits that would otherwise not be realized (change the timing of expected reversals so that future taxable and deductible amounts related to existing deferred tax assets and liabilities would offset). Other strategies may include actions that would affect estimates of future taxable income exclusive of reversing temporary differences and carryforwards. The effect (benefit) from tax-planning strategies reduce the amount of the valuation allowance for deferred tax assets that otherwise would be necessary. ASC paragraphs 740-10-30-19, 55-39

**4.058** ASC Topic 740 identifies tax-planning strategies as the fourth source of taxable income that may support recognition of a deferred tax asset. However, tax-planning strategies generally do not stand by themselves as a source of taxable income, but instead provide a means to facilitate the use of the other sources of taxable income during the period or of the character necessary for realization of the deferred tax asset. For example, a tax-planning strategy that accelerates a deduction (so that a deferred tax asset is recovered in the same period that a deferred tax liability is settled) increases the amount of taxable income from the reversal of existing taxable temporary differences, but does not generate a separate source of taxable income. ASC paragraph 740-10-30-18

**4.059** Under ASC Topic 740, tax-planning strategies are considered only when assessing the need for a valuation allowance for deferred tax assets. Tax-planning strategies are not



considered when identifying temporary differences or determining the existence of a deferred tax asset. Tax-planning strategies cannot be used to reduce deferred tax liabilities. Tax-planning strategies, as that term is used in ASC Topic 740, does not include actions that management takes in the normal course of business to minimize income taxes. ASC paragraph 740-10-55-39 includes as an example of an entity that has a practice of deferring taxable income whenever possible by structuring sales to qualify as installment sales. Because the entity has a practice of structuring its sales in that way, the action would not be considered a tax-planning strategy. ASC paragraphs 740-10-55-46, 55-39

**4.060 When to Consider Tax-Planning Strategies.** If it is more likely than not that all of the deferred tax asset will be realized because of sufficient taxable income provided through carryback, reversals of existing taxable temporary differences, and future taxable income exclusive of the reversal of existing temporary differences, tax-planning strategies do not need to be considered. However, whenever those other sources are not sufficient, management must make a reasonable effort to identify tax-planning strategies before concluding that a valuation allowance for a deferred tax asset is necessary. When there are multiple qualifying tax-planning strategies that may be used in combination, an entity should consider the combined effects of those strategies. ASC paragraphs 740-10-55-41, 55-163 and 55-164

**4.061 Qualifying Tax-Planning Strategy.** A qualifying tax-planning strategy is an action that (a) is prudent and feasible, (b) an entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward or other tax benefit from expiring unused, and (c) would result in realization of deferred tax assets. In determining whether a strategy is a qualifying tax-planning strategy, an entity should consider matters such as the following:

- It is not prudent to implement strategies with transaction costs in excess of the tax benefit or those that are economically detrimental to the entity overall.
- It may not be feasible to sell a major production facility that will significantly alter operations.
- It is not feasible to use a strategy that contradicts other accounting positions, such as the sale of held-to-maturity securities or the surrender of life insurance policies for the cash surrender value where management has asserted that the policies will be held until the death of the insured party (see additional discussion of life insurance policies beginning in Paragraph 2.023). ASC paragraph 740-10-55-39

**4.062** In addition to the considerations discussed above, entities are required to consider the provisions of ASC Subtopic 740-10 (FIN 48) related to accounting for uncertainties in income taxes when evaluating the effects of tax-planning strategies. In determining the amount of future taxable income that may result from implementing a tax-planning strategy and the related effect on the valuation allowance for deferred tax assets, an entity must consider whether it is more likely than not of sustaining the position in a tax examination and, if the position is more likely than not of being sustained, the amount of

benefit that would be allowed is based on the measurement criteria of ASC paragraph 740-10-30-7. ASC paragraph 740-10-30-20

**4.063** For example, if management has identified a tax-planning strategy that would result in accelerating the reversal of a deferred tax liability that would enable the realization of the tax benefits of an operating loss carryforward that would otherwise expire unused, the strategy would only be considered feasible if it is more likely than not that upon examination by the taxing authority, the use of the carryforward would be sustained. In other words, the strategy must meet the more-likely-than-not recognition threshold of ASC paragraph 740-10-25-6 to be an appropriate tax-planning strategy to consider in the valuation allowance determination. If the tax-planning strategy meets the more-likely-than-not recognition threshold, the amount of taxable income that would be considered a possible source of future income should be determined using the measurement guidance in ASC paragraph 740-10-30-7. See Section 3 for additional discussion of the recognition and measurement principles of ASC Subtopic 740-10 on accounting for uncertainty in income taxes.

**4.064 Entity's Control Over Tax-Planning Strategies.** An entity must have the ability to implement a tax-planning strategy for it to be feasible. Accordingly, an entity must be able to demonstrate that it controls the actions necessary to implement a strategy for it to be considered qualifying. ASC Topic 740 requires actions necessary to implement a strategy to be *primarily* within the control of management but does not require *unilateral* control. For example, transactions involving partnerships or joint ventures that require the entity to obtain approval from other partners or investors before implementing the strategy may not be within management's unilateral control. However, implementing the strategy may be primarily within the control of management when obtaining necessary approvals is largely a perfunctory exercise, the transaction contemplated by the strategy is not disadvantageous to the other party, and management has no evidence to indicate that approval could not be obtained. ASC paragraph 740-10-30-19

**4.065** Determining whether tax-planning strategies are primarily within the control of management involves judgment. Each potential strategy should be evaluated to determine whether it is feasible.

**4.065a Tax-Planning Strategies Used to Support Deferred Tax Assets with Indefinite Lives.** Like other deferred tax assets, we believe entities should evaluate whether prudent and feasible tax-planning strategies are available to generate future taxable income sufficient to realize the deferred tax assets associated with carryforwards that do not have an expiration date. As previously discussed, a tax-planning strategy by itself is not a separate source of taxable income; it is an action that an entity would take to generate additional future taxable income. In addition, the strategy must be more likely than not of being sustained if examined by the taxing authority, prudent, and feasible.

**4.065b** In addition, when a tax-planning strategy is intended to generate incremental taxable income to support deferred tax assets with indefinite lives, that income is not considered in isolation – it is just one additional component of the entity's overall estimate of future taxable income. If the income from the tax-planning strategy (e.g., a

gain from a sale of an asset when the entity has overall appreciated net assets) is expected to be offset by future operating losses, that potential income would not provide sufficient evidence to support realization of deferred tax assets.

**4.066 Measuring the Benefit of Tax-Planning Strategies.** As discussed in Paragraph 4.062 above, the recognized tax benefit of a qualifying tax-planning strategy (the reduction in the amount of the valuation allowance) should be measured in accordance with the provisions of ASC paragraph 740-10-30-7 for accounting for uncertainties in income taxes. Accordingly, the reduction of the valuation allowance will be limited to the amount that is greater than 50% likely of being realized as a result of the tax-planning strategy as opposed to the actual benefit that may be reflected on the tax return. (See Section 3 for additional discussion of accounting for tax uncertainties under ASC Subtopic 740-10 (FIN 48)). Further, the tax benefit recognized as a result of a tax-planning strategy should be reduced by the expenses or any losses (net-of-tax) that would be recognized if the strategy were implemented. ASC paragraphs 740-10-30-19 and 30-20

#### **Example 4.15: Effect of Tax-Planning Strategy's Costs on Valuation Allowance**

Assumptions:

- A pre-2018 U.S. net operating loss carryforward of \$900 will expire on December 31, 20X7.
- Due to the existence of cumulative losses in recent years and the weight of other available evidence, ABC Corp. concludes that it is not more likely than not that there will be taxable income in 20X8, excluding the reversal of existing temporary differences.
- Total taxable temporary differences at December 31, 20X6 are \$1,200 and are expected to result in taxable amounts of \$400 in each of the next three years.
- The tax rate is 21%.

#### **Without a Tax-Planning Strategy:**

Deferred tax liability ( $\$1,200 \times 21\%$ )	\$	<u>(252)</u>
Deferred tax assets:		
Deferred tax asset ( $\$900 \times 21\%$ )		189
Valuation allowance ( $\$500 \times 21\%$ )		<u>(105)</u>
Net asset	\$	<u>84</u>

Without a tax-planning strategy, ABC must recognize a valuation allowance at December 31, 20X6 for the portion of the operating loss carryforward that is expected

to expire unused (\$500, which is the \$900 loss carryforward less \$400 of taxable temporary differences expected to reverse in 20X7).

#### With a Tax-Planning Strategy:

Assume that there is a qualifying tax-planning strategy to accelerate the reversal of the entire amount of the \$1,200 of taxable temporary differences next year. Under the provisions of the tax law, the operating loss carryforward could be used to offset taxable income resulting from the reversal of the taxable temporary differences. Estimated legal and other expenses, which would be deductible for tax purposes, to implement the strategy are \$100.

Deferred tax liability ( $\$1,200 \times 21\%$ )	\$	<u>(252)</u>
Deferred tax assets:		
Deferred tax asset ( $\$900 \times 21\%$ )		189
Valuation allowance (net-of-tax cost)		<u>(79)</u>
Net asset	\$	<u>110</u>

If the strategy is implemented, there will be sufficient taxable income (\$1,200) resulting from the reversal of the taxable temporary differences to use the \$900 operating loss carryforward. The tax benefit of the strategy is \$105 (the tax effect of the \$500 operating loss carryforward that otherwise would expire unused multiplied by the 21% tax rate). However, to implement the strategy, ABC will incur costs of \$100 that have not been recognized in the entity's financial statements. Therefore, the tax benefit of the strategy (\$105) must be reduced by the net-of-tax cost of the strategy, calculated as follows:

Legal and other expenses to implement strategy	\$	100
Tax benefit ( $\$100 \times 21\%$ )		<u>(21)</u>
Net-of-tax cost	\$	<u>79</u>

Accordingly, a valuation allowance of \$79 is recognized to reflect the net-of-tax cost of the strategy. The net benefit of the strategy is \$26 (the \$105 tax benefit less the \$79 net-of-tax cost of the strategy), which is the difference between the valuation allowance without the strategy (\$105) and with the strategy (\$79).

**4.067 Tax Benefit of the Cost of Tax-Planning Strategies.** In the example above, the tax benefit recognized (the reduction of the valuation allowance) was reduced by the after-tax effects of the cost of the implementing the strategy. Accordingly, while the total costs were \$100, the overall tax benefit of the strategy was only reduced by \$79, based on a 21% tax rate. If the tax benefit associated with the cost incurred to implement the strategy is not expected to be realized (i.e., \$21 in the example above), the valuation allowance should not be reduced by that tax benefit. This may be the case because the tax

benefit associated with the cost of implementing the tax-planning strategy (i.e., the deduction for the cost of the strategy) does not meet the recognition threshold under ASC paragraph 740-10-25-6 (FIN 48) (the overall benefit realizable as a result of implementing the tax-planning strategy must meet the recognition threshold under ASC paragraph 740-10-25-6 in order to be considered in the analysis of the valuation allowance) or because that benefit is simply replacing the existing deferred tax asset and it is not more likely than not that there will be sufficient taxable income to realize *both* benefits (see Paragraphs 4.048 and 4.055). For example, if the total taxable temporary differences in the previous example were only \$900 instead of \$1,200, there would not be sufficient taxable income to realize the tax benefits of the entire amount of the operating loss carryforward plus the costs of the strategy. In that case, the valuation allowance assuming use of the strategy would be \$100 (the amount of the costs of the strategy with no reduction for the tax benefit). The valuation allowance in that case also could be characterized as including the net-of-tax cost of the strategy of \$79 plus the \$21 tax benefit of \$100 of the operating loss carryforward that would expire unused.

**4.068** If a tax-planning strategy, such as a sale of assets with appreciated values, will, net of its costs, result in anticipated financial statement income that creates sufficient taxable income to realize the deferred tax assets, the costs of the tax-planning strategy do not affect the determination of a valuation allowance. In those situations, the income from the tax-planning strategy may be viewed as a portion of the future taxable income exclusive of reversing temporary differences. See Paragraph 4.069 for additional discussion of asset sales.

#### **Example 4.16: Considering the Cost of a Tax-Planning Strategy**

At December 31, 20X6, ABC Corp. has a deductible temporary difference of \$4,000. The cost of each of the tax-planning strategies below is \$1,000.

##### **Scenario 1:**

The tax-planning strategy will result in both financial statement income and a taxable gain of \$6,000. In this scenario, the \$5,000 anticipated net gain (\$6,000 - \$1,000), exceeds the amount of the deductible temporary difference; therefore, the costs of implementing the tax-planning strategy would not be retained in the valuation allowance (i.e., the full valuation allowance would be released). The income from the tax-planning strategy may be viewed as part of the estimate of future taxable income.

##### **Scenario 2:**

The tax-planning strategy will result in no financial statement income and a taxable gain of \$6,000 (the tax-planning strategy accelerates the reversal of a taxable temporary difference). A valuation allowance for the tax effect of the net-of-tax costs of \$790 ( $(1-21\%) \times \$1,000$ ) is needed.

**4.069 Asset Sales.** A sale of assets qualifies as a tax-planning strategy only when an entity has appreciated value in its total net assets. The sales may create future taxable income that results in realization of deferred tax assets. However, ASC Topic 740 limits the amount of the anticipated gains from asset sales that is included in the estimate of future taxable income, exclusive of the reversal of existing temporary differences, to the appreciation in the value of the entity's total net assets. Accordingly, an asset sale is not an appropriate tax-planning strategy if the value of the entity's total net assets is less than the financial statement carrying amount of the total net assets. An asset sale also is not an appropriate tax-planning strategy if the character of the taxable income generated by the sale does not allow the entity to realize its deferred tax assets. ASC paragraph 740-10-30-22

**4.070** The sale of assets that are essential to an entity's revenue producing activities to a third party generally may not be considered feasible, and therefore would not be considered a qualifying tax-planning strategy. See Paragraph 4.081 for discussion on the use of a sale-leaseback as a potential qualifying tax-planning strategy.

**4.071** The taxable income accelerated by the sale of an asset as part of a qualifying tax-planning strategy generally should equal the difference between the anticipated sales price of the asset (net of any disposal costs) and its tax basis. If the expected sales price of the asset (net of disposal costs) is less than its financial statement carrying amount (but greater than the tax basis), the anticipated financial statement loss on the sale is a cost of the strategy that, along with any expenses of the strategy as discussed above, should be considered when determining the amount of the valuation allowance (see additional discussion beginning in Paragraph 4.066).

**4.072** If the expected sales price is greater than the financial statement carrying amount of the asset, the taxable amounts resulting from the assumed sale of the asset may be viewed in two components: (1) the reversal of an existing taxable temporary difference, if any, and (2) the anticipated gain (net of any disposal costs) for financial reporting purposes (sales price in excess of the financial statement carrying amount). Only the anticipated gain (net of any disposal costs) for financial reporting purposes would be included in the estimate of future taxable income, exclusive of the reversal of existing temporary differences, assuming that the anticipated gain is not offset by declines in the value of the entity's other assets or other losses. The anticipated gain, net of costs, for financial reporting is only one component of the estimate of future taxable income. Accordingly, if that gain is expected to be offset by future operating losses, that potential gain from the tax-planning strategy would not provide sufficient evidence that a valuation allowance is not necessary. If the anticipated gain (net of any disposal costs) would result in sufficient taxable income to realize the deferred tax asset, it is not necessary to include the net-of-tax cost in the determination of the valuation allowance. See the discussion beginning in Paragraph 4.066.

**4.073** The following example illustrates the use of an asset sale as a tax-planning strategy to accelerate future taxable income.

### Example 4.17: Sale of Assets as a Tax-Planning Strategy

At December 31, 20X6, ABC Corp. has a capital loss carryforward of \$10,000 that expires in 20Y1. ABC has no temporary differences at December 31, 20X6.

At December 31, 20X6, the appraised fair value (and estimated selling price) of ABC's investment in land exceeded the financial statement carrying amount by \$30,000. ABC does not currently use the land and management concludes that it is prudent and feasible to sell the land to enable it to use the capital loss carryforward. Costs that would be incurred in the sale are estimated to be \$2,000.

ABC is in the process of assessing the need for a valuation allowance for the deferred tax asset of \$2,100 resulting from applying the enacted tax rate of 21% to its capital loss carryforward. Management of ABC concludes no valuation allowance is necessary for the \$2,100 deferred tax asset, because (1) the sale of the land qualifies as a tax-planning strategy and (2) the anticipated gain on the sale, net of costs, of \$28,000 provides sufficient taxable income of an appropriate character to realize the tax benefits of the capital loss carryforward. However, if the value of ABC's total net assets do not exceed the carrying amount, or the gain would be offset by other future projected losses, the asset sale would not be considered a viable tax-planning strategy and a valuation allowance would still be required.

**4.074** An entity may also have a tax-planning strategy to settle liabilities at an amount less than the financial statement carrying amount. This strategy may result in a taxable gain on settlement of the liabilities. While this type of strategy often may not meet the tax-planning-strategy criteria of being prudent, feasible, primarily in management's control, and not contrary to other financial statement assertions, there may be situations where such a strategy exists. Settling liabilities at amounts less than their carrying amounts generally would not qualify as a tax-planning strategy because it generally would not be within management's control. Assuming that the strategy constitutes a valid tax-planning strategy in accordance with ASC paragraph 740-10-30-19, we believe a strategy for the settlement of liabilities at a gain is analogous to selling an appreciated asset and that the same limitations would apply. Therefore, for the settlement of liabilities at a gain to qualify as a tax-planning strategy there must be appreciated value in total net assets. After applying the tax-planning strategy, the value of the entity's total net assets should equal or exceed the financial statement carrying amount of the total net assets.

**4.075 Sales of Indefinite-Lived Intangible Assets.** It generally would be inappropriate to consider the sale of an indefinite-lived intangible asset to a third party as a tax-planning strategy as the strategy would be inconsistent with management's assertion with respect to its intended use for the asset. The accounting for a recognized intangible asset is based on its useful life to the entity under ASC paragraphs 350-30-35-1 through 35-5. To conclude that an intangible asset has an indefinite life, an entity generally must have both the intent and the ability to continue use of the asset indefinitely. It would be inconsistent for the entity to consider the sale of the asset in connection with a tax-

planning strategy if that would be inconsistent with the determination that the asset has an indefinite useful life. An entity may, however, consider an intra-entity transfer of an indefinite-lived intangible as a qualifying tax-planning strategy under limited circumstances. The expected taxable gain resulting from the sale of an indefinite-lived intangible asset (i.e., in a transaction treated as a sale of assets for tax purposes) may also be considered if the indefinite-lived intangible asset is part of a disposal group classified as held for sale because the entity no longer has the intent and ability to use the asset indefinitely. See Paragraph 4.102 for additional discussion.

**4.076 Sale of a Subsidiary.** The assessment of a sale of a subsidiary as a potential tax-planning strategy should consider the effect the sale will have on future income projections. As with the sale of assets, the benefit from the sale of a subsidiary is limited to the amount of the appreciation in the entity's net assets. Furthermore, the sale of a subsidiary may not qualify as a tax-planning strategy because such a sale generally is subject to economic conditions outside management's control. See Paragraph 4.031.

**4.077** The effect of a future sale of a subsidiary may, however, affect the valuation allowance assessment even if the sale is not considered a qualifying tax-planning strategy. For example, the effect of a pending sale of a subsidiary may affect the estimate of future taxable income as an entity generally is required to consider all available evidence in evaluating the need for a valuation allowance (see Paragraph 4.051b).

**4.078** Certain taxable temporary differences are not recognized for the excess of an entity's book investment in a subsidiary over the investment's tax basis (taxable outside basis difference). For example, a deferred tax liability is not recognized for a taxable outside basis difference related to an entity's investment in a domestic subsidiary if the tax law provides a means for the difference to be settled tax-free and management intends to use that means. In addition, a deferred tax liability is not recognized for a taxable outside basis difference related to an entity's investment in a foreign subsidiary if management is able to demonstrate that it has a plan to indefinitely reinvest the undistributed earnings of the subsidiary (indefinite reversal criterion of ASC paragraph 740-30-25-17 (Accounting Principles Board Opinion No. 23, *Accounting for Income Taxes – Special Areas* (APB 23))). The conclusion that an entity will sell a subsidiary if necessary to realize deferred tax assets generally contradicts a conclusion that a deferred tax liability does not need to be recognized for an investment in a subsidiary because of the available exceptions discussed above. See Paragraphs 2.038 and 7.003 for additional discussion of these exceptions.

**4.079** Because of the inherent contradiction in these two assertions, an entity generally cannot meet the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) and have a tax-planning strategy that contemplates the sale of the foreign subsidiary. In addition, an entity cannot have a tax-planning strategy to sell a domestic subsidiary if the sale will result in a tax liability related to the taxable outside basis difference, which has not been recognized. Accordingly, if the sale of a subsidiary (foreign or domestic) is determined to qualify as tax-planning strategy, a deferred tax liability generally will need to be recognized for the outside taxable temporary difference. Furthermore, the deferred tax liability should be recognized when management concludes that it will, if necessary,



sell the subsidiary to realize deferred tax assets, rather than if and when the tax-planning strategy is actually implemented. Deductible outside basis differences should not be recognized unless the temporary difference is apparent to reverse within the foreseeable future. ASC paragraph 740-30-25-10

**4.080** Another consideration is whether the sale of a subsidiary is primarily within management's control for it to qualify as a tax-planning strategy. It may be difficult to conclude a sale of a subsidiary is primarily within management's control if the subsidiary does not meet the recognition criteria detailed in ASC paragraph 360-10-45-9 to be classified as held for sale.

**4.081 Sale and Leaseback of Plant and Equipment.** In many situations, the financial statement carrying amount of plant and equipment will exceed the tax basis, because accelerated depreciation methods are used for tax purposes. This taxable temporary difference typically reverses over the depreciable life of the plant and equipment. The reversal of the taxable amounts could be accelerated through a sale and leaseback transaction. In certain situations, an assumed sale and leaseback under an operating lease would qualify as a tax-planning strategy. As a result of this strategy, a future taxable amount equal to the remaining balance of the taxable temporary difference should be scheduled to reverse in the year of the assumed sale and leaseback transaction.

**4.082 Consolidated Tax Return.** A subsidiary may file a separate tax return even when that subsidiary could be included in a consolidated tax return with its parent, if an election were made under the provisions of the tax law. If the deferred tax calculation is based on the subsidiary's filing a separate return, the tax benefits of net operating loss or tax credit carryforwards or deductible temporary differences of the subsidiary may not be recognizable. The parent may determine that it can reduce the consolidated group's taxes by filing a consolidated return in the future. An assumption that the parent will elect to file a consolidated tax return, including the subsidiary, may be a qualifying tax-planning strategy for the consolidated financial statements if such an election is permitted under the tax law and if it would allow for realization of existing deferred tax assets. For U.S. federal tax purposes, this election is generally limited to subsidiaries owned 80% or greater. If the subsidiary actually files a separate return, such strategy would have no effect on the subsidiary's stand-alone financial statements. See Paragraph 10.043 for additional discussion of intercorporate tax allocation.

**4.083 Changing the Character of Taxable Amounts.** An entity may have capital loss carryforwards that are not more likely than not to be realized when future capital gains are expected to occur beyond the carryforward period or when future taxable income within the carryforward period is expected to result in ordinary income rather than capital gains. A sale of assets to accelerate future taxable income and/or change the nature of the income from ordinary to capital could be a qualifying tax-planning strategy. The taxable income generated by the planned sale (assuming the tax basis is less than the fair value) would be equal to the difference between the assumed sales price and the remaining tax basis of the assets less any costs of the sale. If the expected sales price is greater than the financial statement carrying amount of the asset, the taxable amount that would result from the sale includes two components – the reversal of the existing taxable temporary

difference and the anticipated gain for financial reporting purposes. See Paragraph 4.072 for additional discussion.

**4.084 Switches to Taxable from Tax-Exempt Investments.** An entity may generate future taxable income by increasing its holdings of investments that generate taxable income and decreasing the amount of its tax-exempt investments. For instance, an entity may have an investment portfolio with an aggregate market value of \$10,000,000, which is comprised of tax-exempt municipal bonds with a market value of \$8,000,000 and corporate bonds with a market value of \$2,000,000. Selling some portion or all of the municipal bonds and reinvesting the proceeds in taxable securities could generate future taxable income and, accordingly, may be a qualifying tax-planning strategy. The net-of-tax effects of commissions and other costs and any realized loss that might be recognized related to the sale of the tax-exempt securities and purchase of taxable securities should be considered in determining the valuation allowance. However, the future effect of a differential in the interest rates on the securities is not considered a cost of the strategy. Note that this strategy would not be appropriate where the investments are accounted for as held-to-maturity under ASC Subtopic 320-10 (see Paragraph 4.031 for additional discussion). It also would not be appropriate to anticipate discretionary (versus contractual) distributions from such investments or other proceeds based on anticipated changes in the fair value of those investments as those items are primarily outside the control of management.

**4.085 Sale of Receivables.** Gains recognized at the time of sale for financial reporting purposes may have been deferred for tax purposes under the installment method. This taxable temporary difference would be scheduled to reverse in the future based on the payment terms of the installment sale contract and the tax law. In certain situations, a tax-planning strategy to sell the installment receivable and accelerate the taxable income may meet the criteria for a qualifying tax-planning strategy. An entity should consider the costs associated with the sale of the receivable (net of any tax benefits expected to be realized for those costs) when determining of the amount of the valuation allowance. Costs of the strategy would not include the future effects of any differential in interest rates on the receivables as compared to rates that would be earned on alternative investments if the receivables were sold. ASC paragraph 740-10-55-44

**4.086 Obsolete Inventory.** Write-downs of obsolete and excess inventory to the lower of cost or net realizable value (or market for LIFO or retail inventory methods) for financial reporting purposes generally will not be deductible until disposition of the inventory. A tax-planning strategy could accelerate or delay the timing of the future tax deduction relating to the ultimate disposal of the inventory.

**4.087 Extinguishing Liabilities.** Certain liabilities may have carrying amounts for financial reporting purposes in excess of their tax bases. The timing of the future tax deduction related to such temporary differences could be accelerated by implementing a tax-planning strategy to extinguish the liability before the scheduled payment date, assuming the extinguishment results in an allowable deduction under the tax law. If there is a cost associated with extinguishing the liability, such as a prepayment penalty, the net-of-tax cost of the strategy should be considered in determining the valuation allowance.

See Paragraph 4.074 for additional discussion of tax-planning strategies to settle liabilities.

**4.088 Annual Payments to Reduce Pension Obligation.** If an entity has a deductible temporary difference related to a long-term pension obligation recognized for financial reporting purposes, the entity may be able to accelerate future tax deductions by making larger annual payments to reduce the pension obligation. A strategy that assumes making larger payments may be a qualifying tax-planning strategy if the payments would accelerate the tax deductions under the tax law.

**4.089 Available-for-Sale Debt Securities.** A portfolio of debt securities classified as available-for-sale by an entity results in an unrealized holding loss if the fair value is less than its amortized cost. This unrealized holding loss represents a future deductible amount and gives rise to a deferred tax asset.

**4.090** Because the fair value of the debt securities will eventually return to their par value at maturity, absent credit deterioration of the issuer, the ability and intent to hold the available-for-sale securities to maturity may be a qualifying tax-planning strategy because an investor can control its exposure to incurring a realized loss for tax purposes attributable to changes in interest rates by holding the security to maturity and collecting all of the contractual cash flows.

**4.091** For an entity to recognize a deferred tax asset without a valuation allowance, it must be able to conclude that it is more likely than not that it will generate sufficient future taxable income of the appropriate character (ordinary vs. capital) to allow those benefits to be recovered. Because a qualifying tax-planning strategy must be primarily within an entity's control, it generally cannot anticipate recovery of the portion of the fair value of the security that is dependent on a change in market conditions (see Paragraph 4.031). Thus, assuming no other sources of future taxable income of the appropriate character, an entity would need to evaluate, based on current market conditions, the likelihood of recovering its investment via collection of the contractual cash flows of the debt security (thus avoiding a realized loss on the investment for tax purposes).

**4.092** Where the fair value of a debt security has declined solely as a result of a change in interest rates (i.e., there are no credit concerns), the likelihood of collecting the contractual cash flows generally is high provided the entity holds the debt security to maturity. In other situations, there may be other-than-temporary impairments with both *credit losses* (taken through earnings) and a remaining portion of the impairment loss (taken through other comprehensive income). In the deferred tax asset valuation allowance assessment, an intent to hold a debt security to maturity and an assumption that the credit loss portion of the impairment would be recovered would not qualify as a tax-planning strategy because it would not be appropriate to assume recovery of the credit losses.

**4.093** The portion of the impairment loss recognized through other comprehensive income that is not attributable to credit losses for (i) held-to-maturity securities will be amortized prospectively through other comprehensive income and (ii) available-for-sale

debt securities will be adjusted for fair value changes consistent with the accounting for securities without other-than-temporary impairments. An intent to hold a debt security to recovery may be an appropriate qualifying tax-planning strategy for the non-credit portion of the impairment loss that is recognized in other comprehensive income because the fair value of the debt securities would be expected to recover to the expected cash flows, absent credit deterioration of the issuer. That recovery of the non-credit portion of the unrealized loss would result in taxable income supporting the deferred tax asset associated with this portion of impairment losses.

**4.094** This strategy is not applicable for the credit loss portion of impairments. However, there may be other sources of taxable income of the appropriate character to support the deferred tax asset associated with the credit loss portion of the impairment. For example, the reversal of existing taxable temporary differences associated with other securities or future taxable income (exclusive of reversing temporary differences) that may be generated as a result of selling appreciated assets through a qualifying tax-planning strategy (assuming the entity has an appreciated total net asset value).

#### **Example 4.18: Portfolio of Available-For-Sale (AFS) Debt Securities with a Net Unrealized Loss**

ABC Corp. recognized the following deferred tax amounts as of December 31, 20X8 in earnings and other comprehensive income related to gains and losses on available for sale debt securities:

##### Deferred tax assets

Recognized losses resulting from other-than-temporary impairment (20X8 Income Statement)	\$ 1,000
Unrealized losses on AFS debt securities (OCI)	<u>2,000</u>
Total deferred tax assets	3,000

##### Deferred tax liabilities

Unrealized gains on AFS debt securities (OCI)	<u>(1,200)</u>
Net deferred tax assets	<u><u>\$ 1,800</u></u>

In addition, ABC has \$2,380 (\$500 of taxes paid at a 21% tax rate) of capital gains reported within the carryback period. The only sources of taxable income supporting the December 31, 20X8 deferred tax assets (\$3,000) that are capital in nature include:

- (a) The reversal of the deferred tax liability (\$1,200) associated with unrealized gain on AFS debt securities - Reversals of such temporary differences are generally scheduled in the period management expects to sell the securities (see Paragraph A.003). Management has the intent and ability to trigger the reversal of the deferred tax liability via sale of appreciated debt securities in

the period in which the deferred tax assets reverse if the action is necessary to preserve its tax benefits.

(b) Taxes paid on capital gains within the carryback period (\$500).

Accordingly, only \$1,700 of the tax benefit of the deferred tax assets is more likely than not to be realized. ABC cannot rely solely on its intent and ability to hold its AFS debt securities to recovery to support realization of the deferred tax assets associated with unrealized losses recognized in other comprehensive income (\$2,000) (see Paragraph 4.095).

**4.095** Because the fair value of the debt securities will eventually return to their par value at maturity, absent credit deterioration of the issuer, the ability and intent to hold the available-for-sale securities to maturity may be a qualifying tax-planning strategy because an investor can control its exposure to incurring a realized loss for tax purposes attributable to changes in interest rates by holding the security to maturity and collecting all of the contractual cash flows. However, whether that strategy provides sufficient future taxable income must be evaluated in light of all other considerations related to future taxable income. In order for an entity to recognize a deferred tax asset without a valuation allowance, it must be able to conclude that it is more likely than not that it will generate sufficient future taxable income of the appropriate character (e.g., ordinary vs. capital, depending on how the tax law would characterize the current deduction if the issuer of the debt security were to default resulting in reversal of the deferred tax asset) to allow those benefits to be recovered. All positive and negative evidence should be considered when evaluating the need for a valuation allowance. Negative evidence would include projections of future losses. In addition, as further described in Paragraph 4.008, tax-planning strategies generally do not represent a source of taxable income by themselves but instead, if executed successfully, increase the amount of taxable income from the other three sources.

**4.095a** In circumstances where an entity expects future losses or is unable to reliably forecast future taxable income, the future taxable income generated by holding the securities to maturity and collecting all of the contractual cash flows may only offset future losses, rather than support the realization of existing deferred tax assets. A valuation allowance should be recorded unless there is evidence that the benefit from the deferred tax asset will be realized as a result of future taxable income (from one of the other potential sources identified in ASC paragraph 740-10-30-18 as described in Paragraph 4.006).

**4.096** Not used.

#### **Example 4.19: Evaluating the Need for a Valuation Allowance on Deferred Tax Assets Related to Debt Securities**

ABC Corp. recognized the following deferred tax assets at December 31, 20X7:

- Unrealized losses on available-for-sale debt securities (recognized in other comprehensive income) – \$2,000.
- Net operating loss carryforwards – \$3,500.

The available-for-sale debt securities mature in three years, and the unrealized losses are due to an increase in general interest rates (not the issuers' credit concerns). ABC has the intent and the ability to hold these debt securities to maturity and collect all the contractual cash flows.

ABC does not have taxable temporary differences. Further, it is in a cumulative loss position (it has been losing money for the last few years) and expects losses to continue for the next two or three years.

ABC evaluates the need for a valuation allowance for deferred tax assets related to available-for-sale debt securities together with all of its other deferred tax assets.

The cumulative loss in recent years provides significant negative evidence regarding the existence of sufficient future taxable income to support a conclusion that it is more likely than not that all or some portion of the deferred tax assets of ABC will be realized. This negative evidence is difficult to overcome even if ABC were to support its expectations of future taxable income with forecasts, including the expected reversal of unrealized losses on its available-for-sale debt securities that it has both the intent and the ability to hold to maturity.

ABC is unable to overcome the significant negative evidence with sufficient positive evidence, and therefore records a valuation allowance against all of its deferred tax asset.

**4.097 Equity Securities.** The ability and intent to hold equity securities cannot be a qualifying tax-planning strategy because an investor cannot control its exposure to incurring a realized loss for tax purposes attributable to changes in interest rates by holding the security to maturity and collecting all of the contractual cash flows. Rather, the recovery of the fair value (i.e., the ability to generate an unrealized gain on the security to offset the current unrealized loss) of an equity security is dependent on market conditions, which are not primarily within the entity's control (see Paragraphs 4.031 and 4.064). While the fair value of a debt security is also sensitive to market conditions, absent credit deterioration of the issuer, an investor can control recovery of the par amount by simply holding the security to maturity. ASC paragraph 740-10-30-19

**4.098** However, there may be other sources of taxable income of the appropriate character to support the deferred tax asset such as the reversal of existing taxable temporary differences associated with other securities or future taxable income (exclusive of existing taxable temporary differences) that may be generated as a result of selling appreciated assets via a qualifying tax-planning strategy (assuming the entity has an appreciated total net asset value). Additionally, the appropriate character (capital vs.

ordinary) of the future taxable income from reversal of taxable temporary differences or a qualifying tax-planning strategy needs to be considered in the analysis.

**4.099** Not used.

**4.100 Intra-entity Transfers of Assets.** A planned intra-entity transaction may qualify as a tax-planning strategy if the entity can demonstrate that as a result of the transaction, it will realize the benefit from the deferred tax assets.

**4.101** Such circumstances generally will be limited to situations in which the intra-entity transfer of the asset extends the life of carryforwards that were scheduled to expire or delays the reversal of deductible temporary differences through converting those benefits into tax basis in the buyer's jurisdiction. Accordingly, the amount of the benefit is limited to the actual reduction in future taxes payable for the consolidated entity, which will be affected by the transfer pricing associated with the transaction and the enacted tax rates in the seller's and buyer's jurisdiction.

**4.101a** Further, if the strategy involves the intra-entity transfer of an investment (whereby the entity converts a loss carryforward into a deductible outside basis difference), we believe that to support that the strategy is feasible, the buyer must be able to recognize the deferred tax asset for its deductible outside basis difference if the strategy were to be executed. Under ASC paragraph 740-30-25-9, an entity recognizes a deferred tax asset for a deductible outside basis difference only if it is apparent to reverse in the foreseeable future.

**4.102** Paragraph 4.069 discusses how the sale of assets qualifies as a tax-planning strategy only when an entity has appreciated value in its total net assets. Because the intra-entity transfer of assets such as intellectual property does not result in selling the assets outside the consolidated group, the concept of appreciated value in total net assets does not apply to the intra-entity transfer of assets. In this circumstance, the transaction results in shifting income between jurisdictions creating a gain in one jurisdiction and amortization deductions from the intellectual property in the receiving jurisdiction. Therefore, while the sale of assets to a third party may not qualify as a tax-planning strategy for an entity that does not have a net appreciated value in its total net assets, an intra-entity transfer of assets may be a qualifying tax-planning strategy provided it is prudent, feasible and successful in realizing a tax benefit for the consolidated entity.

**4.103** Not used.

### **Example 4.20: Intra-entity Transfer of Assets as a Tax-Planning Strategy**

ABC Corp. is evaluating whether it needs a valuation allowance for its pre-2018 net operating loss carryforwards of \$100 in the U.S. tax jurisdiction. ABC is unable to rely on future taxable income in the United States because it has a history of losses.

However, the consolidated worldwide group and its wholly owned foreign subsidiary (XYZ Corp.) have a history of taxable income and predictable future taxable income.

*Assumptions:*

- ABC could sell an intangible asset to XYZ for \$100, its current fair value.
- The financial statement carrying amount and tax basis of the asset is \$0.
- The transfer of the intangible assets from ABC to XYZ would trigger \$100 of taxable income in the United States, which would be offset by the NOL carryforward and a step-up in tax basis of the asset to \$100 in XYZ's tax jurisdiction.
- ABC's enacted tax rate is 21%, and XYZ's enacted tax rate is 10%.

Because the asset would have a tax basis of \$100 in XYZ's jurisdiction, the tax amortization will result in a reduction to the consolidated group's tax expense of \$10 over the life of the asset (\$100 tax basis  $\times$  10% tax rate for XYZ). The transfer of the asset to XYZ allows ABC to use \$10 of \$21 deferred tax asset for the NOL carryforward. This transaction essentially extends the life of a portion of the deferred tax asset (the NOL that would otherwise expire) and transfers the deduction to a jurisdiction that can realize a benefit by converting the NOL in the United States into a future tax deduction in the foreign jurisdiction. Based on this tax-planning strategy, ABC should release \$10 of its valuation allowance (and retain \$11) on the \$21 deferred tax asset for the NOL carryforward.

When the transaction occurs, ABC recognizes the tax effects of the intra-entity sale. This results in consolidated tax expense of \$0:

- Deferred tax expense of \$21 for the reversal of the ABC's deferred tax asset
- Deferred tax benefit of \$11 for the reversal of ABC's valuation allowance
- Deferred tax benefit of \$10 for the deferred tax asset resulting in XYZ's jurisdiction (\$100 deductible basis difference  $\times$  10%)

As XYZ amortizes the tax basis of the asset in its tax jurisdiction, the related deferred tax asset will reverse to offset the reduction in its current taxes payable, resulting in no net consolidated income tax expense or benefit in future periods.

### **Example 4.21: Intra-entity Sale of Stock to a Foreign Subsidiary as a Tax-Planning Strategy**

During the current fiscal year ABC Corp. generated capital losses which are realizable only to the extent ABC generates capital gains during the applicable carryforward period. To prevent capital losses from expiring unused, ABC is considering various



tax-planning strategies. One of the strategies would be an intra-entity sale of a portion of the stock of DEF, a domestic wholly owned subsidiary, to one of the entity's foreign subsidiaries, XYZ. The tax rate is zero in XYZ's foreign tax jurisdiction. ABC's outside tax basis of its investment in DEF is in excess of the book basis and the fair value of DEF is greater than the tax basis. ABC has not recognized a deferred tax asset on this excess outside basis difference based on ASC paragraph 740-30-25-9 because it is not apparent that the basis difference will reverse in the foreseeable future.

If ABC were to implement this strategy, ABC would generate capital gains sufficient to use the capital loss carryforwards and XYZ's tax basis in the portion of DEF that it acquired would be the fair value. XYZ would have a tax basis in its investment in DEF that is greater than its book basis (carryover basis from a consolidated financial statement perspective due to the intra-entity nature of the transaction); however, because XYZ's tax rate is zero there would be no income taxes paid on an eventual disposition of the investment outside the group and, therefore, no actual reduction in future taxes payable by the consolidated group. Accordingly, this strategy does not result in the realization of a net tax benefit for the group, and therefore does not qualify as a tax-planning strategy.

While this example illustrates a scenario in which the consolidated group realizes no net benefit because XYZ's tax rate is zero, it still may not be appropriate to consider this strategy even if XYZ's tax rate was not zero. When evaluating a strategy that converts a capital loss carryforward into an outside excess tax basis, an entity must be able to demonstrate that the benefit of that excess tax basis is realizable and that it is prudent and feasible for XYZ to sell the investment outside of the consolidated group. We believe ABC can assert the strategy is feasible only if on execution of the strategy, XYZ would recognize a deferred tax asset for the deductible outside basis difference (i.e., only if the basis difference is apparent to reverse in the foreseeable future under ASC paragraph 740-30-25-9).

#### **Example 4.22: Intra-entity Income as a Tax-Planning Strategy**

As part of a tax-planning strategy, a U.S. parent entity, ABC Corp., would license certain manufacturing-related intellectual property to its subsidiary in Bermuda, DEF, in return for an annual royalty payment. The royalty amount is evaluated each year and adjusted as deemed appropriate and in accordance with transfer pricing methodology. Bermuda has a 0% tax rate.

The arrangement between ABC and DEF would be structured for both book and tax purposes as a time-based license of the intellectual property with an ongoing royalty payment rather than an outright sale of the intellectual property.

ABC has tax net operating loss carryforwards. The royalty payments would be included in U.S. taxable income that is expected to be fairly predictable for several years. ABC has deferred tax assets related to tax net operating loss carryforwards and

absent the royalty arrangement, future taxable income would not be sufficient to support the realization of the deferred tax assets.

However, the royalty income created by this intra-entity transaction as a result of the tax-planning strategy does not ultimately result in the entity realizing any benefit from the deferred tax assets (NOLs). It is simply moving income from a jurisdiction that is not paying taxes to a nontaxable jurisdiction. Once the NOLs are fully used, all else being equal, the consolidated entity will have higher income tax expense as a result of this royalty arrangement.

Accordingly, we believe it would not be appropriate to include the forecasted intra-entity royalty income that would result from the strategy in evaluating whether ABC's deferred tax assets are more likely than not realizable. Absent other sources of income that support the realization of deferred tax assets, the tax-planning strategy would simply reduce the existing deferred tax assets without yielding an ultimate benefit to the organization (without the intra-entity transaction the consolidated group would pay no taxes in the United States and Bermuda, and with the transaction they would pay no taxes as long as the NOLs remain).

Note: If the foreign jurisdiction had a statutory tax rate, further consideration should be given to this tax-planning strategy because it is possible that the consolidated entity may realize a benefit for the amount of future taxes payable in the foreign jurisdiction that would not be paid as the result of the intra-entity transaction. In that situation, the benefits may be limited to the extent the foreign tax rate is lower than the U.S. tax rate. (Also see discussion beginning in Paragraph 4.100).

**4.104 Transfers of Indefinite-Lived Intangible Assets.** As discussed in Paragraph 4.075, it generally would be inappropriate to consider the sale of an indefinite-lived intangible asset as a tax-planning strategy as such strategy would be inconsistent with management's assertion of its intended use for the asset. However, an intra-entity transfer that results in incremental tax benefits for the consolidated entity may be an appropriate tax-planning strategy as the asset will continue to be used by the consolidated group. For example, if a parent entity transferred an indefinite-lived intangible asset to a profitable jurisdiction where the asset is amortizable for tax purposes (i.e., the transferee will be able to use the current tax amortization deductions), incremental tax benefit for the consolidated entity would arise because, in substance, the benefit has been transferred to a jurisdiction with sufficient taxable income to use that benefit. Other transfers, such as those that transfer the asset to a loss jurisdiction that ultimately will not be able to use the future net operating loss carryforward that will arise as a result of the future tax amortization deductions of the intangible asset, may not generate incremental tax benefits for the consolidated entity.

**4.105 Changes in Tax Methods.** A change in tax method, such as a change in inventory method from LIFO to FIFO, may affect the period when a temporary difference reverses. All relevant provisions of the tax law governing changes in tax method should be evaluated when determining whether a change in tax accounting method is for tax

purposes prudent and feasible. For example, an unfavorable change in a tax accounting method generally results in a cumulative catch-up adjustment (section 481 adjustment) that is recognized in taxable income over a period of time. Additionally, the LIFO conformity requirement which requires the basis of accounting for inventory to be consistent between financial reporting and income tax purposes if LIFO is used for income taxes, should be considered. To use a change in inventory methods that would affect financial statement accounting policies as a valid tax-planning strategy, an entity may need to consider whether the proposed method is preferable for financial reporting.

**4.106 Change in Tax Status.** A change in tax status generally is not a qualifying tax-planning strategy as ASC paragraphs 740-10-25-32 and 25-33 and 740-10-40-6 require changes in tax status to be recognized on the approval or filing date of the change in tax status. See Paragraph 4.031. ASC paragraph 740-10-55-48

### **VALUATION OF DEFERRED TAX ASSETS – SPECIFIC APPLICATION MATTERS**

**4.107** This subsection discusses other matters that should be considered when evaluating the need for a valuation allowance and matters that may arise in specific circumstances.

**4.108 Deferred Tax Assets Related to Share Options or Awards.** A deferred tax asset is recognized for temporary differences related to share options or awards that ordinarily would result in future tax deductions based on the compensation recognized for financial statement purposes. Generally, a decline in stock price that would cause a reduction in the potential future tax deduction does not affect the temporary difference or the related deferred tax asset. Furthermore, the reduction in the potential future tax deduction should not affect the determination of a valuation allowance. For example, if a temporary difference is recognized for compensation expense recognized for share options and the stock price decreases to the degree that it is unlikely the related share options will be exercised (or even if the options expire unexercised after the balance sheet date but before the financial statements are issued), it would be improper to recognize a valuation allowance for the deferred tax asset unless the entity's future taxable income is expected to be insufficient to recover the deferred tax assets in the period the deduction would otherwise be recognized or carried to for income tax purposes. The current fair value of an entity's stock should not be considered when identifying temporary differences, measuring deferred tax assets, or determining the necessary valuation allowance for share-based compensation. An entity should, however, consider the effect of excess tax benefits on its future taxable income when assessing the need for a valuation allowance. See Paragraph 4.047 for additional information. ASC paragraph 718-740-30-2

**4.109 Liabilities for Unrecognized Tax Benefits as a Source of Taxable Income.** A liability established under the provisions of ASC paragraph 740-10-25-16 generally represents additional income taxes payable in the event that a tax position is ultimately disallowed by the taxing authority. Accordingly, the associated taxable income provides a source of taxable income that should be considered in evaluating the need for a valuation allowance. Consideration should be given to the period in and for which the liability is

expected to result in taxable income and which deferred tax assets, if any, will be available for use. For example, under U.S. federal income tax law, if the IRS increases a taxpayer's taxable income upon examination, it generally attributes that taxable income to the tax year the taxpayer took the position on its tax return (versus the year in which it is discovered). In that situation, if and when there is a settlement that results in reporting additional taxable income, a taxpayer would consider that additional taxable income in evaluating any deferred tax asset for which the related deduction could be carried to the year of the taxable income from the examination. ASC paragraph 740-10-55-21

**4.110-4.112** Not used.

**4.113 Effect of Ongoing Alternative Minimum Tax (AMT) Status on the Realization of AMT Credit Carryforwards.** Alternative minimum tax rates and laws are a factor in considering the need for a valuation allowance for a deferred tax asset for AMT credit carryforwards. ASC subparagraph 740-10-55-15(c)

**4.114** In many situations, it may be appropriate to conclude that it is more likely than not that the tax benefits of AMT credit carryforwards will be realized to the extent that the net deferred tax liability for temporary differences and carryforwards (exclusive of the AMT credit carryforwards) calculated using enacted rates under the *regular* tax system exceeds the tentative minimum tax on temporary differences and carryforwards calculated under the AMT system. The recognition of the tax benefits of the AMT credit carryforwards can be justified to the extent the AMT credits could offset the net deferred tax liability, but not below the minimum amount of tax an entity would pay on AMT temporary differences. ASC paragraphs 740-10-55-32 and 55-33

**4.115** If the deferred tax asset generated by AMT credit carryforwards is greater than the amount by which the net deferred tax liability under the regular tax system can be reduced, the entity would have to generate sufficient future taxable income (exclusive of reversing temporary differences) that will be taxed under the regular tax system to allow realization of the benefit of those remaining AMT credit carryforwards. The weight of all available evidence, both positive and negative, would need to indicate that the entity will become a regular taxpayer and that sufficient taxable income, exclusive of reversing temporary differences, will be generated to realize the benefit of the AMT credit carryforwards. Although the AMT credit carryforwards can be carried forward indefinitely, it will be difficult to conclude that it is more likely than not that all or some portion of the benefits of AMT credit carryforwards in excess of the amounts that can reduce a net deferred tax liability will be realized by an entity that anticipates always being an AMT taxpayer.

#### **Example 4.23: Recognition of Tax Benefits of an AMT Credit Carryforward**

ABC Corp. (ABC) has FC 100,000 of AMT credit carryforwards at December 31, 20X6 that can be carried forward indefinitely under the provisions of the tax law. ABC's only temporary difference is a FC 2,000,000 taxable temporary difference for depreciation on property and equipment that is the same under both the regular tax

system and the AMT system. This difference is expected to reverse over the next five years. ABC has no other carryforwards and taxable income is not available through carryback under the tax law. The enacted regular system tax rate is 21% and the AMT rate is 15%.

ABC should record a deferred tax asset of FC 100,000 for the AMT credit carryforwards. ABC assesses that it is more likely than not that the tax benefits of the AMT credit carryforwards will be realized by reducing taxes payable under the regular tax system on the taxable temporary differences. The taxable temporary difference of FC 2,000,000 will result in a deferred tax liability of FC 420,000 under the regular tax system. Under the AMT system, the taxable temporary differences will result in total minimum tax of FC 300,000. Because the amount of regular tax exceeds the total minimum tax by more than the amount of the AMT credit carryforwards, it is appropriate to conclude that it is more likely than not that the tax benefits of the AMT credit carryforwards are realizable. Accordingly, a valuation allowance related to that asset would not be necessary.

In this example, if the amount of the AMT credit carryforwards exceeded FC 120,000, ABC would be required to assess the likelihood that taxable income from future operations, exclusive of the reversal of the FC 2,000,000 taxable temporary difference, under the regular tax system, will be sufficient to allow realization of the tax benefits of the AMT credit carryforwards in excess of FC 120,000. If the AMT credit carryforward exceeded FC 120,000, the amount due under the AMT system would exceed the net amount due under the regular tax system when considering the use of the entire AMT credit carryforward. This situation would put ABC back into the AMT system without being able to realize the benefit of the AMT credit carryforward.

The likelihood assessment of generating taxable income from future operations exclusive of the reversal of the FC 2,000,000 taxable temporary difference would include consideration of the likelihood that the future income will be taxed under the regular tax system rather than AMT system as well as any available tax-planning strategies. If ABC anticipates that it will be subject to the AMT system indefinitely, future net deferred tax assets for AMT credit carryforwards (i.e., net of the valuation allowance), should not exceed FC 120,000—the amount that can be supported by offsetting the deferred tax liability under the regular tax system (without putting ABC back into the AMT system).

**4.116 Effect of AMT Systems on Tax Benefits Under the Regular Tax System.** ASC subparagraph 740-10-55-15(c) states, “alternative minimum tax (AMT) rates and laws are a factor only in considering the need for a valuation allowance for a deferred tax asset for AMT credit carryforwards.” See also ASC paragraphs 740-10-55-31 and 55-32.

**4.116a** AMT status may also affect an entity’s ability to realize the entire amount of tax benefits under the regular tax system. For example, an entity may have an operating loss carryforward for regular tax purposes but no AMT loss carryforward. That operating loss carryforward can be used in the future to reduce taxable income under the regular tax

system but will not reduce future taxable income under the AMT system. If the regular tax loss carryforward is used to reduce future taxable income in a period in which the entity is subject to the AMT, the tax benefit of the loss carryforward under the regular tax system is offset by the payment of the AMT. The payment of the AMT results in an AMT credit carryforward that will be available to reduce future regular tax. In this situation, the entity must use the resulting AMT credit carryforward to offset future regular tax to realize the full tax benefit of the operating loss carryforward. If the entity is unable to use any of the AMT credit carryforward resulting from the use of the regular tax loss carryforward, then the tax benefit realized for the loss carryforward is only the difference between the regular tax determined without the carryforward and the lower AMT. The remaining tax benefit would not be realized if the entity remains an alternative minimum taxpayer.

**4.116b** Notwithstanding the phenomenon described in Paragraph 4.116a, because ASC Topic 740 explicitly states that AMT rates and laws are relevant only when assessing the need for a valuation allowance on deferred tax assets for AMT credit carryforwards as discussed in Paragraph 4.116, we believe entities have a policy choice to consider or to disregard the effect of the AMT system in determining the valuation allowance for deferred tax assets under the regular tax system. An entity's policy choice must be consistently applied and disclosed, if material.

#### **Example 4.24: AMT Interaction with Valuation Allowance on Regular Tax Deferred Tax Assets I**

ABC Corp. is a mining entity that began operating in 20X1. In recent years ABC has established a stable business plan and customer base, been profitable, and demonstrated an ability to accurately project future income.

As of December 31, 20X6, ABC has regular tax net operating loss carryforwards of FC 500,000 and AMT credit carryforwards of FC 100,000, both with full valuation allowances as a result of the inability to project future taxable income historically. ABC's expected taxable income for 20X7-20Y0 (the period over which ABC is able to reliably project taxable income) under the regular tax system is FC 1,000,000, which includes expected percentage depletion deductions of FC 200,000 under the regular tax system and does not include any future originating deductible temporary differences.

As a result of the nature of its operations that produce increasing depletion deductions and its projections of future taxable income (note that ABC does not have other sources of taxable income), ABC believes that it will be a perpetual alternative minimum taxpayer. Accordingly, ABC has concluded that a full valuation allowance on 100% of its AMT credit carryforwards continues to be appropriate.

**Policy option #1: ABC does not consider AMT when evaluating realization of regular tax deferred tax assets**

If ABC's policy is not to consider its AMT status in assessing the need for a valuation allowance on regular tax deferred tax assets, it would eliminate its valuation allowance on its regular tax net operating loss carryforwards. This is the case because it is projecting sufficient taxable income under the regular tax system to realize all of its regular tax net operating loss carryforwards.

**Policy option #2: ABC considers AMT when evaluating realization of regular tax deferred tax assets**

If ABC's policy is to consider its AMT status in assessing the need for a valuation allowance on regular tax deferred tax assets, it prepares a with-and-without analysis. The following with-and-without analysis is used to determine how much, if any, valuation allowance should be released related to ABC's regular tax net operating loss carryforwards considering the interaction with the AMT system (assume a 21% regular tax rate and a 15% AMT rate):

	<b>Regular</b>	<b>Alt Min</b>
Pretax income	\$ 1,200,000	\$ 1,200,000
Percentage depletion	<u>(200,000)</u>	<u>—</u>
Taxable income before NOL (A)	\$ 1,000,000	\$ 1,200,000
NOL	<u>(500,000)</u>	<u>—</u>
Taxable income (B)	\$ 500,000	\$ 1,200,000
Tax rate (C)	21%	15%
Taxes due with NOL (B × C)	\$ 105,000	\$ 180,000
Greater of regular tax or AMT <sup>1</sup>	\$ 180,000	
Taxes due without NOL (A × C)	\$ 210,000	\$ 180,000
Greater of regular tax or AMT <sup>1</sup>	\$ 210,000	

<sup>1</sup> The amount of taxes due. The amount of taxes due is the greater of the taxes due under the regular tax or AMT system.

ABC is expected to realize FC 30,000 of benefit associated with its net operating loss carryforwards as a result of its effect in reducing ABC's taxes due from FC 210,000 (the amount due without the NOL) to FC 180,000 (the amount due with the NOL). Accordingly, ABC should release FC 30,000 of valuation allowance associated with its NOL.

ABC would maintain the remainder of the valuation allowance associated with the net operating loss carryforwards of FC 75,000 (FC 105,000 of deferred tax asset (FC 500,000 × 21%) less the FC 30,000 of benefit realized per the computation above) and

the \$100,000 valuation allowance for the \$100,000 deferred tax asset for the AMT carryforward.

Note that the valuation allowance associated with the net operating loss carryforwards would remain notwithstanding that the deferred tax asset associated with the net operating loss carryforwards will (upon reversal in 20X7-20Y0 under the regular tax system) be partially replaced by a new deferred tax asset in the form of an additional AMT credit carryforward. This is the case because ABC is expecting to be a perpetual alternative minimum taxpayer and thus has recognized a full valuation allowance on 100% of its AMT credit carryforwards. See Paragraph 4.123 for additional discussion of the consideration of future credits when evaluating the need for a valuation allowance.

#### **Example 4.25: AMT Interaction with Valuation Allowance on *Regular Tax* Deferred Tax Assets II**

ABC Corp. has a FC 1,000 pre-2018 NOL carryforward under the regular tax system (21% rate) but no NOL associated with the AMT system. ABC anticipates future book and taxable income of FC 1,000 and expects it will pay AMT indefinitely at a 15% rate. Because ABC anticipates paying AMT indefinitely, the payment of the AMT on the future income will create an AMT credit carryforward of FC 150. Assume no reversing temporary differences.

##### **Policy option #1: ABC does not consider AMT when evaluating realization of regular tax deferred tax assets**

If ABC's policy is not to consider its AMT status in assessing the need for a valuation allowance on regular tax deferred tax assets, it needs no valuation allowance on its regular tax NOL carryforward. This is the case because it is projecting sufficient taxable income under the regular system to realize the entire regular tax NOL carryforward.

##### **Policy option #2: ABC considers AMT when evaluating realization of regular tax deferred tax assets**

If ABC's policy is to consider its AMT status in assessing the need for a valuation allowance on regular tax deferred tax assets, it prepares a with-and-without analysis.

The NOL carryforward can be used in the future to reduce taxable income under the regular tax system but will not reduce future taxable income under the AMT system. *With* the NOL carryforward, ABC reduces its taxes payable under the regular tax system by FC 210 (FC 1,000 × 21%). If the future taxable income is assumed to be FC 1,000, the net payable under the regular tax system, after use of the pre-2018 NOL carryforward, would be zero. However, ABC would have to pay AMT in that situation. This is because the AMT payable, assuming the same FC 1,000 in taxable income,



would be greater at FC 150 ( $FC\ 1,000 \times 15\%$ ) than the FC 0 under the regular tax system.

*Without* the NOL carryforward, ABC would pay tax of FC 210 under the regular tax system ( $FC\ 1,000 \times 21\%$ , because that amount is greater than  $FC\ 150 = FC\ 1,000 \times 15\%$  under the AMT system).

Because the NOL is saving ABC FC 60 (the difference between the FC 150 taxes payable with the NOL and the FC 210 payable without the NOL), a valuation allowance of FC 150 should be established against the FC 210 NOL carryforward deferred tax asset.

The AMT payment also results in a FC 150 AMT credit carryforward that will be available to reduce future regular tax. Although AMT credit carryforwards can be carried forward indefinitely, it will be difficult in this fact pattern to conclude that it is more likely than not that ABC will realize all or some portion of the benefits of AMT credit carryforward because ABC expects to be an AMT taxpayer for an indefinite period.

**4.116c Realization of Corporate AMT Credit Carryforward.** The tax benefits of a Corporate AMT credit carryforward (as discussed in Paragraph 3.073) can be realized by:

- (1) using the AMT credit to reduce taxes payable under the regular tax system on reversing net taxable temporary differences, but not below the amount of tentative minimum tax (TMT) that would be payable on AMT temporary differences; or
- (2) using the AMT credit to reduce taxes payable under the regular tax system on future taxable income exclusive of reversing items, but not below the amount of TMT that would be payable on the future income.

Corporate AMT credits may be carried forward indefinitely. Therefore, the realization of Corporate AMT credit carryforwards needs to be assessed as discussed beginning in Paragraph 4.113.

**4.116d Effect of BEAT status on the Valuation Allowance.** As discussed in Paragraph 3.072b, the 2017 U.S. tax reform introduced a base erosion and anti-abuse tax (BEAT). The BEAT partially disallows deductions for certain related-party transactions, but applies a tax rate to a taxpayer's modified taxable income lower than the 21% corporate rate. BEAT functions like a minimum tax, but unlike the AMT (see additional discussion in Paragraph 3.069), there is no interaction through a credit mechanism with the regular tax system. As discussed in Paragraph 3.072d, entities should measure their deferred taxes using the statutory rate based on the regular tax system and account for the incremental tax owed under the BEAT system as it is incurred. In addition, entities do not need to evaluate the effect of potentially paying the BEAT in future years when assessing the realizability of its deferred tax assets under the regular tax system.

**4.116e** While the FASB's guidance indicates that an entity does not need to consider its BEAT status for valuation allowance assessments related to deferred tax assets under the regular tax system, we believe it can elect to do so as an accounting policy election that should be consistently applied.

**4.116f** An entity that considers its BEAT status in the valuation allowance assessment may recognize a higher valuation allowance than an entity that does not because if an entity expects to be a BEAT taxpayer, the benefits of its regular-system deferred tax assets or attributes may be limited or eliminated. For example, BEAT taxpayers may use net operating loss carryforwards arising under the regular tax system to reduce their BEAT liability, but may not have enough NOLs to fully offset BEAT taxable income. Additionally, this computation requires a taxpayer to add back to its taxable income a percentage (the base erosion percentage) of the NOL deduction. Consequently, if an entity expects to pay BEAT during the period it expects to use its NOL carryforward, the benefits of that carryforward may be limited. Similarly, certain credits (e.g., the research credit, the low-income housing credit, renewable energy production credit and energy credit) are eligible to reduce the BEAT liability but, for some of these credits, only to the extent of 80% of the lesser of the credit or the base erosion tax amount otherwise computed.

**4.116g** An entity that considers its BEAT status in the valuation allowance assessment may use a *with and without* approach to measure the economic benefit of its deferred tax assets when evaluating future taxable income exclusive of reversing items. Using that approach, the entity would measure the benefit of a deferred tax asset by taking the difference between (a) what an entity expects its cash income taxes to be with the asset, and (b) what its cash income taxes would be without the asset. This approach has been historically used by some taxpayers that were subject to pre-2018 AMT. See Paragraph 4.116 and Examples 4.24 and 4.25 for additional discussion and illustrations.

**4.117 Foreign Tax Credit Carryforwards.** Tax laws in the United States generally provide that a foreign tax credit (FTC) may be taken for taxes paid or deemed paid by U.S. corporations. FTC carryforwards generally result if foreign-source income is taxed in the foreign jurisdiction at a rate higher than the U.S. tax rates.

**4.117a** FTCs generally cannot be used to reduce U.S. sourced income and are subject to other limitations, including limits from applying the U.S. statutory rate to foreign-source income (see Paragraph 4.118 for additional discussion). In addition, unused deemed-paid foreign tax credits attributable to global intangible low-taxed income (GILTI) in the United States are not carried forward or back. As discussed in Paragraph 7.087f, for any amount of GILTI that is included in a U.S. shareholder's income, the U.S. tax law provides for a limited deemed paid credit of 80% of the foreign tax attributable to the tested income of the controlled foreign corporations (CFCs). The tax also requires a full (100%) inclusion for foreign taxes paid (the "section 78 gross-up"). See additional discussion of the impact of GILTI on the valuation allowance assessment beginning in Paragraph 4.124a.

**4.118** Foreign tax credits that cannot be used to reduce U.S. taxes payable in a specific tax year (other than deemed-paid foreign tax credits attributable to GILTI in the United States as discussed in Paragraph 4.117a) may be carried back to the preceding tax year and carried forward to the succeeding ten tax years. FTC carryforwards can be used only to the extent that taxes which would be paid on foreign-source income in a future year (within the carryforward period) using the U.S. statutory rates exceed the amount of taxes actually paid or deemed paid for that future year. To the extent that taxes in the applicable foreign jurisdictions in future years will exceed taxes which would be paid by applying the U.S. statutory rate to the foreign-source income, additional FTC carryforwards will be generated and existing FTC carryforwards will not be used.

**4.119** Because FTC carryforwards may be attributable to higher statutory tax rates in foreign tax jurisdictions relative to U.S. statutory rates, the conditions that generate those foreign tax credit carryforwards may persist in future years and the FTC carryforwards may expire unused. In addition, U.S. tax law generally allows a U.S. shareholder of a 10% foreign corporation a 100% dividends received deduction for the foreign-source portion of dividends received. Consequently, foreign dividend income may no longer provide a source of taxable income to support realizability of deferred tax assets related to foreign tax credit carryforwards.

**4.119a** A valuation allowance should be established to offset the deferred tax asset related to FTC carryforwards if it is more likely than not that those carryforwards will not be used (after considering qualified tax-planning strategies).

**4.120** If taxable temporary differences related to the undistributed earnings of foreign investees are expected to reverse through dividends to a non-U.S. parent entity, the calculation of the related deferred tax liability should consider the effect of FTCs that would be available in the parent entity's tax jurisdiction as well as withholding taxes. In that case, the FTCs generally result in a reduction of the calculated deferred tax liability. However, an entity should not double count the benefit from FTCs by (1) reducing the liability for undistributed earnings and (2) recognizing a separate deferred tax asset for available FTCs.

**4.121** A non-U.S. parent entity may consider whether repatriation of undistributed earnings of a foreign subsidiary will generate sufficient foreign-source income to realize its FTCs. However, a plan to indefinitely reinvest the earnings of a foreign subsidiary would be inconsistent with a plan to repatriate earnings. Accordingly, it would be inappropriate for an entity to consider future distributions of future earnings of the foreign subsidiary unless a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past. ASC paragraphs 740-10-55-24, 740-30-25-9, 25-11 through 25-13

**4.122** The discussion above provides only a brief overview of the complex tax laws pertaining to FTC. All applicable provisions of the tax law should be considered in determining whether a valuation allowance is necessary for deferred tax assets related to FTC carryforwards.

**4.123 Consideration of Future Credits.** As discussed above in the context of FTC carryforwards, a carryforward will provide no incremental tax benefit if tax credits generated in future years will be displaced by the carryforward and those new carryforwards will expire unused or are otherwise not realizable. The potential displacement of credits by carryforwards (or other similar displacement of one deferred tax asset by another deferred tax asset) should be considered in determining the valuation allowance on deferred tax assets when the recognition of the asset depends on the entity's ability to generate future taxable income exclusive of reversing items.

**4.123a** For example, assume a non-U.S. parent entity (as discussed in Paragraph 4.119, foreign dividend income generally no longer supports realizability of deferred tax assets related to foreign tax credit carryforwards in the United States because of the 100% dividends received deduction) with an effective tax rate of 30% has an NOL carryforward and an investment in a foreign subsidiary with an effective rate of 40% for which the ASC paragraph 740-30-25-17 (APB 23) exception was not applied. We believe the future earnings of the foreign subsidiary would generally not support the realization of the NOL carryforward because use of the NOL to offset taxes due in the non-U.S. parent's jurisdiction upon repatriation of foreign earnings will simply be replaced by the FTC carryforwards associated with the taxes paid on the same earnings in the foreign jurisdiction. Because the foreign tax rate exceeds the parent's tax rate, the parent entity will, on a net basis, generate excess FTC carryforwards and the NOL carryforward does not result in a reduction of cash income taxes paid. Absent excess foreign source income from other transactions or investments, this will result in the inability to use (a) the excess 10% of the foreign tax credit carryforwards and (b) the NOL (assuming the foreign tax credit equal to 30% is used first). See Paragraph 7.030 for additional discussion.

**4.123b** In another example, assume a profitable entity consistently generates a larger general business tax credit than it can use to offset its taxable income each year and those credits can fully offset pre-credit income tax. An existing net operating loss carryforward will provide no incremental tax benefit if the general business credits generated in future years will be displaced by the carryforward and the entity cannot demonstrate that those new carryforwards are more likely than not of being realized and the entity cannot demonstrate the existing net operating loss carryforward results in a reduction of cash income taxes paid. Refer also to Paragraph 4.048 for similar discussion of rolling deductible temporary differences.

**4.123c** Following the prior example, if the general business credits generated in future years will only offset 75% of future pre-credit income tax, an entity may realize some amount of economic benefit from the existing net operating loss carryforward. In this instance, we believe it would be acceptable to recognize a deferred tax asset without a valuation allowance to the extent of the reduction in taxes payable as a result of the net operating loss carryforwards determined under a *with-and-without* approach. Alternatively, it would also be acceptable to apply a *replacement approach*. Under that approach, the entity would reduce the deferred tax asset for the net operating loss carryforward by a valuation allowance to the extent a similar or greater amount of tax credit carryforward is expected to be generated in the future (see Paragraph 4.048 for additional discussion). ASC paragraph 740-10-55-37

**4.123d** The displacement of future credits would not need to be considered when future taxable income generated by the reversal of existing taxable temporary differences is the source of taxable income that supports recognition of the existing deferred tax asset.

### **4.124 Consideration of Forgone Foreign Tax Credits Related to a Foreign Branch.**

As discussed in Paragraph 7.069, the U.S. parent of a foreign branch recognizes U.S. deferred tax liabilities for forgone foreign tax credits on the foreign source earnings necessary to realize deferred tax assets in the foreign jurisdiction. The U.S. parent should evaluate whether those deferred tax liabilities support its deferred tax assets similar to how it evaluates other existing reversals of taxable temporary differences - e.g., by considering limitations under the tax law and mismatches in reversal periods and character (see Paragraph 4.038 for additional discussion).

**4.124a Effect of GILTI on the Valuation Allowance When GILTI is Accounted for as a Period Cost.** As discussed in Paragraph 7.087a for tax years of foreign corporations beginning after December 31, 2017, the U.S. 2017 tax reform Act provides that a U.S. shareholder of any CFC must include in taxable income its pro rata share of GILTI. GILTI is considered the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. Additionally, a U.S. shareholder can deduct 50% of its GILTI (referred to as the section 250(a) deduction) through 2025, with a reduction to 37.5% after that. The law also provides for a limited deemed paid credit of 80% of the foreign tax attributable to the tested income of the controlled foreign corporations but requires a full (100%) inclusion for foreign taxes paid (the "section 78 gross-up"). Unused deemed-paid foreign tax credits cannot be carried forward or back.

**4.124b** As previously discussed, ASC Topic 740 requires entities to consider all available evidence, both positive and negative, to determine whether based on the weight of that evidence, it has sufficient taxable income to realize its deferred tax assets. Some entities that are accounting for GILTI as a period cost will have non-GILTI taxable temporary differences that are sufficient to support the realizability of some or all of their non-GILTI deferred tax assets. Those entities do not need a valuation allowance on the portion of their deferred tax assets that is supported by that future taxable income source. However, if an entity does not have taxable temporary differences that are sufficient to support the realizability of all of its deferred tax assets, it also will need to estimate its future taxable income exclusive of reversing temporary differences and carryforwards as a second source. Because a U.S. shareholder must include in its taxable income its pro rata share of GILTI under the regular tax system, we believe the shareholder likewise should include it as a source of future taxable income when assessing the need for a valuation allowance on its deferred tax assets. In addition to the two acceptable approaches discussed in Paragraphs 4.048a and 4.048b, the tax-law ordering approach is also available for an entity that accounts for GILTI as a period cost to determine the GILTI effects on the valuation allowance assessment. We understand that the FASB and SEC staffs do not believe either of the below two approaches are inconsistent with the principles of ASC Topic 740. An entity should consistently apply its policy choice to either apply its general policy or the tax-law ordering approach and consider disclosure in the notes to financial statements.

**4.124c *With-and-Without Approach:*** When applying the with-and-without approach, entities with deferred tax assets that are not supported by taxable temporary differences would consider the potential displacement of one benefit by another when estimating future taxable income exclusive of those reversing temporary differences (see Paragraph 4.123 for additional discussion). For example, assume an entity has an NOL carryforward that is not supported by reversing taxable temporary differences, but it expects to generate enough future taxable income (including GILTI) to use that carryforward. However, if the entity does not have the carryforward, its expected GILTI would generate section 250(a) deductions, foreign tax credits or both, that would be sufficient to offset the U.S. tax on GILTI. If the section 250(a) deductions and foreign tax credits are sufficient to reduce taxable income absent the existing NOL carryforward, the entity would not fully benefit economically from its carryforward.

When applying the with-and-without method, the entity compares (a) what it expects its cash income taxes to be with the NOL carryforward, and (b) what its cash income taxes would have been without the NOL carryforward. The entity would include in both calculations the estimated effects of the section 250(a) (and other GILTI) deductions and foreign tax credits associated with its forecasted GILTI. The entity would measure the benefit from its deferred tax asset associated with the NOL carryforward by taking the difference between (a) and (b). See Example 4.24 for an illustration of the with-and-without method.

**4.124d *Tax-law Ordering Approach:*** Another acceptable approach is to consider in the valuation allowance assessment the anticipated section 250(a) deductions and foreign tax credits as analogous to the section 199 deduction. Analogy to the section 199 deduction is appropriate because like the section 199 deduction, the section 250(a) deduction and foreign tax credits can be utilized on the tax return only after existing NOL carryforwards are utilized. The example in paragraph 740-10-55-145 illustrates how an entity should consider the section 199 deduction in the valuation allowance assessment and focuses on how the tax law orders the utilization of the benefits. The example, when applied in the context of GILTI, would conclude that the NOL carryforwards are realized first because they offset the GILTI inclusion before taxable income can be reduced for the section 250(a) deduction and foreign tax credits.

Under this approach, if the NOL carryforward is expected to fully offset the GILTI inclusion (before consideration of future section 250(a) deductions and foreign tax credits), no valuation allowance would be necessary for the NOL deferred tax asset, but the ultimate write-off of that asset in the period the carryforward is used may result in an effective tax rate higher than 21%.

**4.124e *Effect of GILTI on the Valuation Allowance When Deferred Taxes Are Provided.*** An entity that provides GILTI deferred taxes may not necessarily have the same policy choice discussed beginning in Paragraph 4.124b. We believe that there may be situations in which an entity needs to use one of the methods because use of the other method would be inconsistent with its measurement of GILTI deferred taxes.

*Entities that measure GILTI deferred taxes at less than 21%*

Assume an entity has an NOL carryforward, non-GILTI net taxable temporary differences that will be taxed at 21% and net GILTI taxable temporary differences that it expects will be taxed at 10.5%. Inherent in the entity's measurement of GILTI deferred taxes is that it reasonably expects taxable income adequate to realize the full section 250(a) deduction in the periods the related temporary differences are expected to reverse (see additional discussion in Paragraph 3.075c). In many cases, the entity's analysis supporting that it is more likely than not to realize its deferred tax assets will be straightforward because it has already supported its assertion that it expects taxable income adequate to realize the full section 250(a) deduction, and the section 250(a) deduction can be realized only after the NOL carryforward has been utilized.

However, there may be some situations in which the entity has a deferred tax asset with a reversal pattern that requires a more detailed valuation allowance analysis. We believe that if an entity is measuring its deferred taxes for GILTI temporary differences at a rate that is reduced to the extent of expected section 250(a) deductions, it should use its general policy (i.e., the with-and-without approach or the replacement approach) to measure how much incremental benefit, if any, will be realized from the existence of its deferred tax asset that is not supported by reversing taxable temporary differences.

We believe it would be inconsistent in this circumstance to conclude concurrently that (a) the future taxable GILTI represented by a GILTI taxable temporary difference will generate pre-NOL income taxes payable based on a 10.5% rate, and (b) the estimated future taxable GILTI exclusive of reversing GILTI temporary differences will generate pre-NOL income taxes payable based on a 21% rate (which generally results from using the tax-law ordering approach).

*Entities that measure GILTI deferred taxes at 21%*

Assume an entity has an NOL carryforward, non-GILTI net taxable temporary differences that will be taxed at 21% and net GILTI taxable temporary differences that it expects will be taxed at 21%. Assume the entity measures its GILTI deferred tax assets and liabilities using a 21% tax rate because it is unable to make reliable estimates of taxable income or does not expect to have taxable income (see additional discussion in Paragraph 3.075c). In most cases, this entity would not be able to support that it is more likely than not to realize its deferred tax assets because it has already supported its assertion that it cannot make reliable estimates of future taxable income or it estimates no taxable income.

However, there may be rare situations in which the entity measures its GILTI deferred tax assets and liabilities at 21% only because it has (and is expected to have) NOL carryforwards sufficient to offset its GILTI inclusion, but otherwise it can reliably estimate its future taxable income. We believe that if an entity is measuring its deferred taxes for GILTI temporary differences at the full 21% rate, it should use the tax-law ordering approach to measure how much benefit will be realized from its deferred tax asset that is not supported by reversing taxable temporary differences.

We believe it would be inconsistent in this circumstance to conclude concurrently that (a) the future taxable GILTI represented by the GILTI taxable temporary difference will generate pre-NOL income taxes payable based on a 21% rate, and (b) the estimated future taxable GILTI exclusive of reversing GILTI temporary differences will generate pre-NOL income taxes payable based on a 10.5% rate (which generally results from using the with-and-without approach).

**4.124f Effect of U.S. Disallowed Interest Carryforwards in the Valuation Allowance Assessment.** As discussed in Paragraph 4.016c, the 2017 tax reforms in the United States amended section 163(j) to generally disallow a deduction for net business interest expense in excess of 30% of the taxpayer's adjusted taxable income for the year. When the CARES Act was enacted on March 27, 2020, the amount of deductible interest was increased from 30% to 50% for the 2019 and 2020 tax years. Disallowed interest deductions are carried forward indefinitely. In addition, as discussed in Paragraphs 4.016a and 4.016b, the 2017 law and CARES Act also provided for the indefinite carryforward for net operating losses arising in tax years beginning after December 31, 2017 and limited the utilization of net operating loss carryforwards arising in tax years beginning after December 31, 2017 to offset 80% of taxable income in a year beginning on or after January 1, 2021. As discussed in Paragraph 4.027 and illustrated in Example 4.26, the interaction of these tax law limitations should be considered when determining whether it is more likely than not that an entity's deferred tax assets will be realized.

**4.124g** When an entity expects to generate disallowed interest carryforwards in the future and utilize existing deferred tax assets other than interest carryforwards, a question arises as to whether the future disallowed interest carryforwards are merely a replacement for the existing deferred tax assets. When evaluating future taxable income exclusive of reversing items, we believe it would be acceptable to recognize a deferred tax asset without a valuation allowance to the extent of the reduction in taxes payable as a result of the existing deferred tax assets determined under a *with-and-without* approach. Alternatively, we also believe it would be acceptable to apply a *replacement approach* whereby an entity would view the future disallowed interest carryforwards as a replacement for the existing deferred tax assets and reduce the existing deferred tax asset by a valuation allowance to the extent a similar or greater amount of disallowed interest carryforwards are expected to be generated in the future. Refer also to Paragraphs 4.048 and 4.123c for similar discussion on replacement deferred tax assets. ASC paragraph 740-10-55-37

### Example 4.26: Valuation Allowance: Interest Limitation

#### Background

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

ABC Co. is a U.S. taxpayer with a \$1,260 NOL carryforward, a \$500 disallowed interest carryforward and an \$800 taxable temporary difference as of December 31, 2018. ABC expects to indefinitely (a) incur annual interest expense in excess of the



Act's annual limitation and (b) maintain (through annual reversal and origination) an \$800 taxable temporary difference at the end of each year. ABC evaluates future taxable income exclusive of reversing items as part of its assessment of the need for a valuation allowance on existing deferred tax assets using the *with-and-without* approach.

In evaluating the need for a valuation allowance as of December 31, 2018, ABC first analyzes whether the reversal of existing taxable temporary differences is adequate to realize its deferred tax assets. The following table summarizes ABC's forecasted taxable income for 2019, including only the reversal of its \$800 existing taxable temporary difference. Assume the NOL can offset only 80% of taxable income.

	2018	2019
Income statement:		
EBITDA		\$ 800
Depreciation		-
Interest		-
Pretax income		\$ 800
Interest incurred		-
Allowed interest		(240)
Taxable income before NOLs		\$ 560
NOLs		(448)
Taxable income		\$ 112
Ending temporary differences and carryforwards:		
NOL <sup>1</sup>	\$1,260	\$ 812
Disallowed interest	500	260
Total carryforward	\$1,760	\$1,072
Taxable temporary difference	(800)	-
Net	\$ 960	\$1,072

Note:

<sup>1</sup> As discussed in Paragraph 4.124f, NOL carryforwards may offset only 80% of taxable income in an annual period.

ABC concludes that of its \$1,760 in total carryforwards at December 31, 2018, \$688 (\$240 of disallowed interest carryforwards and \$448 of NOL carryforwards) will be realized through reversal of its existing taxable temporary difference (see Paragraph 4.123d for additional discussion).

Next, ABC analyzes whether it expects future taxable income exclusive of reversing temporary differences and carryforwards to be adequate to realize a greater amount of deferred tax assets. This example shows the results under both the additive approach and the combination approach (see Paragraph 4.007a).

### Additive Approach

Under the additive approach, ABC evaluates the ability of future taxable income exclusive of reversing temporary differences and carryforwards in isolation to realize the deferred tax assets that remain after evaluating the reversal of existing taxable temporary differences.

	Interest limitation based on 30% of EBITDA			Interest limitation based on 30% of EBIT			
	2019	2020	2021	2022	2023	2024	2025
Income statement:							
EBITDA	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
Depreciation	(400)	(400)	(400)	(400)	(400)	(400)	(400)
Interest	(800)	(800)	(800)	(800)	(800)	(800)	(800)
Pretax income	\$ (200)	\$ (200)	\$ (200)	\$ (200)	\$ (200)	\$ (200)	\$ (200)
Originating temporary difference	(800)	(800)	(800)	(800)	(800)	(800)	(800)
Reversing temporary difference	-	800	800	800	800	800	800
Interest incurred	800	800	800	800	800	800	800
Allowed interest	(60) <sup>2</sup>	(300)	(300)	(180)	(180)	(180)	(180)
Taxable income before NOL	\$ (260)	\$ 300	\$ 300	\$ 420	\$ 420	\$ 420	\$ 420
NOL <sup>1</sup>	260	(240)	(240)	(336)	(256)	-	-
Taxable income	\$ -	\$ 60	\$ 60	\$ 84	\$ 164	\$ 420	\$ 420
Ending temporary differences and carryforwards:							
NOL	\$1,072	\$ 832	\$ 592	\$ 256	\$ -	\$ -	\$ -
Disallowed interest	1,000	1,500	2,000	2,620	3,240	3,860	4,480
Total carryforwards	\$2,072	\$2,332	\$2,592	\$2,876	\$3,240	\$3,860	\$4,480

#### Notes:

<sup>1</sup> As discussed in Paragraph 4.124f, NOL carryforwards may offset only 80% of taxable income in an annual period.

<sup>2</sup> \$60 = 30% × [\$1,000 (EBITDA, as reported) - \$800 (originating taxable temporary difference)]

At December 31, 2018, ABC concludes that it is not more likely than not that it will realize a benefit from its remaining interest carryforwards from future taxable income exclusive of reversing items because it is not projecting enough adjusted taxable income to use those carryforwards – i.e., the conditions that generate the carryforwards are expected to persist indefinitely.

Even if the previous year's interest carryforward were to be used first (which it is not – i.e., the tax law ordering rules require that current year interest incurred be used first), it would simply be displaced by a newly originating interest carryforward (see Paragraph 4.123 for additional discussion).

However, it is still appropriate for ABC to consider the reversal of its taxable temporary difference to support realization of \$240 of its interest carryforwards (as illustrated in the first step) because entities should not consider displacement of future credits when future taxable income is generated by the reversal of existing taxable temporary differences (see Paragraph 4.123d for additional discussion).

As a result of projecting future taxable income exclusive of reversing items, ABC concludes that it is more likely than not that it will realize the benefit from all of its remaining \$812 in NOL carryforwards because, assuming it can reliably project future taxable income, those carryforwards will be fully realized by December 31, 2023.

In total, as of December 31, 2018, ABC concludes that it is more likely than not to realize \$1,500 of its carryforwards (\$240 of its interest carryforwards and \$1,260 of its NOL carryforwards). In this illustration, ABC evaluated two sources of taxable income in isolation. ABC considered the amount of deferred tax assets supported by future reversals of existing taxable temporary differences and it considered the amount supported by future taxable income exclusive of reversing items and added the results to determine the total amount realizable.

**Combination Approach**

Alternatively, ABC could have evaluated these sources in combination - i.e., it could have considered the amount of deferred tax assets supported by future taxable income inclusive of reversing taxable temporary differences.

	Interest limitation based on 30% of EBITDA			Interest limitation based on 30% of EBIT			
	2019	2020	2021	2022	2023	2024	2025
Income statement:							
EBITDA	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
Depreciation	(400)	(400)	(400)	(400)	(400)	(400)	(400)
Interest	(800)	(800)	(800)	(800)	(800)	(800)	(800)
Pretax income	\$ (200)	\$ (200)	\$ (200)	\$ (200)	\$ (200)	\$ (200)	\$ (200)
Originating temporary difference	(800)	(800)	(800)	(800)	(800)	(800)	(800)
Reversing temporary difference	800	800	800	800	800	800	800
Interest incurred	800	800	800	800	800	800	800
Allowed interest	(300)	(300)	(300)	(180)	(180)	(180)	(180)
Taxable income before NOL	\$ 300	\$ 300	\$ 300	\$ 420	\$ 420	\$ 420	\$ 420
NOL <sup>1</sup>	(240)	(240)	(240)	(336)	(204)	\$ -	\$ -
Taxable income	\$ 60	\$ 60	\$ 60	\$ 84	\$ 216	\$ 420	\$ 420
Ending carryforwards:							
NOL	\$1,020	\$ 780	\$ 540	\$ 204	\$ -	\$ -	\$ -
Disallowed interest	1,000	1,500	2,000	2,620	3,240	3,860	4,480
Total carryforwards	\$2,020	\$2,280	\$2,540	\$2,824	\$3,240	\$3,860	\$4,480

Note:

<sup>1</sup> As discussed in Paragraph 4.124f, NOL carryforwards may offset only 80% of taxable income in an annual period.

Under the combination approach, ABC would conclude that it is more likely than not that it will realize a total of \$1,260 of its carryforwards because this amount equals or exceeds the amount determined by considering reversals of existing taxable temporary differences and future taxable income exclusive of reversing items in isolation. If ABC’s forecasts are accurate, this approach will more closely approximate how it expects to file its tax return.

## Summary

We believe that under either approach, at least \$688 of carryforwards are realizable because they are objectively supported by the reversal of existing taxable temporary differences. As discussed in Paragraph 4.007, while consideration of all positive and negative evidence is required, if one or more sources of taxable income is sufficient to support a conclusion that it is more likely than not that the deferred tax assets will be realized (in this case, reversals of existing taxable temporary differences), the entity generally does not consider the effects of the other sources. While a projection of future taxable income may provide an additional source of taxable income to support more of an entity's deferred tax assets (and that additional source must be considered if reversals of existing taxable temporary differences are not adequate to support all of the entity's deferred tax assets), it would not reduce the amount of deferred tax assets supported by the reversals of existing taxable temporary differences.

**4.125 Defined Pension and Other Postretirement Benefits.** Under ASC Topic 715, *Compensation—Retirement Benefits*, employers are required to recognize on the balance sheet the net amount by which a defined benefit postretirement obligation is over- or underfunded. The funded-status amount will be measured as the difference between the fair value of plan assets and the benefit obligation. If the benefit obligation is larger than the fair value of plan assets, the plan would be underfunded, and a net liability would be reported. Conversely, if the fair value of the plan assets is larger, the plan would be overfunded, and a net asset would be reported on the balance sheet. The funded status amount under ASC Topic 715 includes the recognition of net periodic benefit cost (recognized in the income statement) as well as amounts such as actuarial gains and losses, prior service cost, and transition amounts (recognized in accumulated other comprehensive income – see Paragraph 9.045 for additional discussion of intraperiod tax allocation). A deferred tax asset may arise as a result of the recognition of these benefit obligations and the tax law may not permit deductions for those benefits until they are actually paid. In many situations, the tax deductions related to the postretirement benefit liability will not occur for an extended period of time, in some cases a period of over 40 years or more depending on the age of the employer's work force. Accordingly, realization of the deferred tax asset often will depend on the entity's ability to generate future taxable income exclusive of reversing existing temporary differences in each of the tax jurisdictions in which the future deductions will arise.

**4.126** An entity generally should be able to conclude that a valuation allowance on the deferred tax asset related to the postretirement benefits liability is not necessary if the following conditions are present: (1) the entity has a strong and stable earnings history; (2) continuation of the current earnings level in the future would clearly provide sufficient taxable income to realize the tax benefits of the postretirement benefits liability; (3) no evidence suggests that the current earnings level will not continue; (4) no valuation allowances are necessary on the deferred tax asset for the entity's other deductible temporary differences and carryforwards; and (5) no other negative evidence suggests that the tax benefits of the postretirement benefits liability will not be realized.

**4.127** However, in situations where (1) continuation of the current level of earnings would not provide sufficient taxable income to allow for realization of the tax benefits of the postretirement benefits liability, (2) valuation allowances are needed for the deferred tax assets for the entity's other deductible temporary differences and carryforwards, or (3) there is negative evidence that suggests that the tax benefits of the postretirement benefits liability will not be realized, there should be a presumption that a valuation allowance is needed for all or a portion of the deferred tax asset related to the postretirement benefits liability.

**4.128** The analysis of the need for a valuation allowance should be performed for each tax-paying component of an entity in each tax jurisdiction. Therefore, an entity with more than one plan may determine that deferred tax assets associated with certain plans are not realizable while others are realizable unless an appropriate tax-planning strategy is available to shift income between those components and jurisdictions. For example, a deferred tax asset associated with a postretirement benefit plan of an unprofitable foreign subsidiary may not be realizable, while a deferred tax asset associated with a similar plan at its profitable domestic parent entity may be realizable.

### **4.129 Deferred Tax Assets Related to Exceptions to Recognizing Deferred Taxes.**

Sections 2, *Temporary Differences*, and 7, *Foreign Operations*, discuss exceptions to the recognition of deferred taxes on temporary differences. The exceptions generally relate to ASC Subtopic 740-30, *Income Taxes - Other Considerations or Special Areas* (APB 23) differences and other temporary differences grandfathered under ASC Topic 740. For example, a deferred tax asset is recognized for an excess of the tax basis over the financial statement carrying amount of an investment in the stock of a subsidiary or corporate joint venture (domestic or foreign) only if it is apparent that the deductible temporary difference will reverse in the foreseeable future. If a deferred tax asset is recognized for these deductible temporary differences when it is apparent that it will reverse in the foreseeable future, the need for a valuation allowance for that deferred tax asset should be assessed under the more-likely-than-not criterion of ASC Topic 740 along with other deferred tax assets. See Paragraphs 2.047 and 7.021 for additional discussion.

**4.130** In assessing the need for a valuation allowance for a deferred tax asset, future taxable income relating to taxable temporary differences for which a deferred tax liability has not been recognized because of an exception in ASC Topic 740 should not be considered a source of future taxable income. Similarly, in assessing the need for a valuation allowance, future distributions of future earnings of a subsidiary or corporate joint venture are not sources of future taxable income when assessing the need for a valuation allowance if a deferred tax liability has not been recognized for existing undistributed earnings due to applying the exception related to outside basis differences or when earnings have not been remitted in the past. ASC paragraphs 740-30-25-3 and 25-4, 25-9, 25-11 through 25-13

**4.131** For example, taxable income that may arise from the reversal of a savings and loan association's base-year bad debt reserve or distributions related to a parent entity's investment in a foreign subsidiary cannot support a decision that a valuation allowance is

not necessary for deferred tax assets unless a deferred tax liability has been recognized for the taxable temporary differences.

**4.132 Taxable Income Resulting from Recovery of Net Investment in Leveraged Leases.** Future taxable amounts resulting from future recovery of the net investment in a leveraged lease can be considered in assessing the need for a valuation allowance, subject to some limitations. ASC paragraph 840-30-45-6 states “to the extent that the amount of deferred tax credits for a leveraged lease as determined under [ASC Topic 840, *Leases*] differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the guidance of this Topic 740, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards.” ASC paragraphs 840-30-55-39 through 55-46 include an example of the integration of the tax effects of leveraged leases with the deferred tax consequences of other temporary differences. The example illustrates the limitation on the amount of taxable income that may be assumed to be generated by an investment in a leveraged lease when determining the need for a valuation allowance. ASC paragraphs 740-10-25-3, 840-30-45-6, 55-39 through 55-46

**4.133** In February 2016, the FASB issued ASU 2016-02, *Leases*. The standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date.

**4.134 Going-Concern Uncertainties.** When there is substantial doubt about an entity's ability to continue as a going concern, it raises doubt about that entity's ability to generate taxable income. Therefore, substantial doubt disclosure and the accompanying going-concern audit opinion generally necessitate a valuation allowance for all deferred tax assets that are not realizable through the reversal of existing taxable temporary differences or taxable income in carryback years. However, the lack of substantial doubt disclosure and an accompanying going-concern audit opinion does not mean a valuation allowance is not required. ASC Subtopic 205-40

**4.134a Considerations for Negative Economic Conditions.** Negative economic conditions may have significant effects on the valuation allowance assessment including:

- Interaction between intraperiod tax allocation and changes in a valuation allowance;
- Determination of the tax effects on the carrying amount of a reporting unit when evaluating impairment of goodwill; and
- Disclosures in the financial statements of significant assumptions leading to a conclusion that deferred tax assets would be realized and therefore a valuation allowance is not required for all or a portion of the deferred tax assets and the potential for those assumptions changing, including:

- Minimum amount of future taxable income needed to realize the deferred tax assets and whether the existing levels of pretax earnings for financial statement reporting purposes are sufficient to generate that minimum amount of future taxable income.
- If existing levels of pretax earnings for financial reporting purposes are insufficient to generate the minimum amount of income to support the realization of deferred tax assets, a discussion of the extent of future increase in profitability needed to realize the deferred tax assets (quantified to the extent possible) and the significant assumptions relied on by management in concluding that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the deferred tax assets (e.g., anticipated improvements in profitability resulting from gross margins, additional store openings, cost reduction programs, and corporate restructurings).
- The historical relationship between pretax earnings for financial reporting purposes and taxable income including a discussion of the nature and amount of material differences between such amounts. A table reconciling pretax financial statement income to taxable income for each of the years for which financial statements are presented has been used to accomplish this objective.
- A discussion of tax-planning strategies that would be available to generate future taxable income if the registrant were unable to generate sufficient taxable income from ordinary and recurring operations.
- The annual amounts of net operating loss carryforwards for income tax purposes that expire each year.
- If significant objective negative evidence indicates uncertainty about realizing the deferred tax assets, the countervailing positive evidence relied on by management in its decision not to establish a full valuation allowance against deferred tax assets should be identified.

See Paragraph 3.079 for additional considerations.

**4.135** Not used.

**4.136 Write-off of Valuation Allowance and Deferred Tax Assets.** ASC Topic 740 does not address whether it is appropriate to write off existing deferred tax assets and a related valuation allowance. A deferred tax asset for existing tax attributes and related valuation allowance generally should not be written off even if it is expected that the attributes will expire unused. However, such write-offs may be appropriate if the deferred tax asset exceeds the amount permissible to be used under tax law; for example, if there are statutory limitations on the ability to use an NOL carryforward.

**4.137 Deferred Effects of Intra-entity Inventory Transactions.** The deferred effects of intra-entity inventory transactions (taxes paid by the seller and reversing temporary

differences in the seller's jurisdiction) are not temporary differences (see Paragraph 2.063). Accordingly, these deferred effects should not be considered when assessing the need for a valuation allowance. That is, deferred charges resulting from the taxes paid and the reversal of temporary differences in the seller's jurisdiction should not be included in the total of deferred tax assets subject to a valuation allowance.

**4.138 – 4.140** Not used.

**4.141 Intra-period Tax Allocation of Changes in Valuation Allowance.** The tax effects of changes in the valuation allowance caused by changes in circumstances that result in a change in judgment about an entity's ability to realize deferred tax assets in future years are usually charged to income tax expense as a component of income from continuing operations. The intra-period tax allocation section of this handbook discusses the financial statement presentation of a change in a valuation allowance. See the discussion beginning in Paragraph 9.065 for additional discussion.

**4.142 Effect of Special Deductions on the Need for a Valuation Allowance.** The tax benefit of special deductions in future years should not be anticipated when reducing the amount of deferred tax liabilities. Such tax benefits are recognizable in the year they become deductible on the tax return. However, future tax benefits from special deductions are implicitly recognized in determining the need for a valuation allowance for deferred tax assets because those future deductions are an element of estimated future taxable income. ASC paragraphs 740-10-25-37, 30-13, 932-740-30-1

**4.143 Statutory Depletion Carryforwards.** Many oil and gas entities have existing statutory depletion carryforwards related to the production and sale of oil in the current year and prior years. The provisions of ASC Topic 740 as it relates to special deductions do not apply to existing carryforwards; those provisions apply to future deductions that will result from the future production and sale of oil. Existing statutory depletion carryforwards represent unused deductions that may be available to reduce taxable income in future years. Accordingly, a deferred tax asset, reduced by any necessary valuation allowance, should be recognized for the tax effects of existing statutory depletion carryforwards. Factors to consider in assessing the need for a valuation allowance for deferred tax assets related to existing statutory depletion carryforwards include: (1) reversals of existing taxable temporary differences, (2) the likelihood that the entity will have taxable income in future years exclusive of the reversal of existing temporary differences, (3) limitations on the use of statutory depletion carryforwards under the tax law, (4) future statutory depletion deductions expected to be created from future production, and (5) the effect of the use of statutory depletion carryforwards on the tax basis of the properties. After consideration of these and all other relevant factors, it may be necessary to recognize a valuation allowance for deferred tax assets related to statutory depletion carryforwards in many cases.

**4.144** The following bulleted paragraphs discuss matters that may affect the need for a valuation allowance for deferred tax assets related to statutory depletion carryforwards:



- The need for a valuation allowance can depend on limitations under the tax law on the use of statutory depletion deductions and its accounting policies on the consideration of the AMT system. See Paragraph 4.116b.
- If realization of the tax benefits of an existing statutory depletion carryforward depends on the entity generating future taxable income exclusive of the reversal of existing temporary differences and the entity expects that it will generate additional statutory depletion carryforwards in the future equal to or in excess of the amount usable under the provision of the tax law, a valuation allowance should be established to offset the deferred tax asset related to the existing statutory depletion carryforward. In this situation, the tax benefit of the existing statutory depletion carryforward should not be recognized if it is likely that the carryforward will provide no incremental benefit because of future statutory depletion. See Paragraph 4.123 for additional discussion of displaced credits.
- If estimates of future taxable income exclusive of the reversal of existing temporary differences are considered in assessing the need for a valuation allowance, future originating differences, such as future intangible drilling and development costs, should also be considered in those estimates of future taxable income.
- The use of an existing statutory depletion carryforward may result in a decrease in the tax basis of the properties. That decrease in the tax basis will create an additional taxable temporary difference. It would not be appropriate to recognize the tax benefits of the statutory depletion carryforward when use of that carryforward would create a new taxable temporary difference.

### **4.144a Initial Recognition of a Valuation Allowance at Lease Commencement.**

Because the right-of-use asset and lease liability will often not have tax bases in many jurisdictions, the lessee also will need to recognize a deferred tax liability and deferred tax asset. The balance of the deferred tax liability for the right-of-use asset may be almost equal to, but opposite of, the balance of the deferred tax asset for the lease liability. However, when evaluating the need for a valuation allowance for the deferred tax asset, among other things, an entity should consider whether the tax law limits the amount of taxable income that is available to realize the deferred tax asset in the period (or periods) it reverses.

### **4.144b** Not used.

**4.144c** As discussed in Paragraph 4.016a, post-2017 federal net operating losses in the United States may offset only 80% of taxable income in a given year. Many other jurisdictions have similar limitations. As a result, even though the taxable temporary difference for the right-of-use asset may be nearly equal to the deductible temporary difference for the lease liability at lease commencement, if that deferred tax asset (or a portion of the deferred tax asset) is expected to reverse in a loss year (and thus convert into a post-2017 net operating loss carryforward), other future taxable income beyond the taxable temporary difference for the right-of-use asset would have to exist to support

realization of the deferred tax asset that would remain after applying the 80% limitation (which will continue to be carried forward).

**4.144d** We believe a valuation allowance necessary at lease commencement, if any, should be recognized with a charge to income tax expense. We do not believe the guidance about accounting for temporary differences acquired other than in a business combination (see discussion beginning in Paragraph 10.001) applies because the net deferred tax balance is driven by a recoverability matter (i.e., the valuation allowance) and not a basis difference matter.

**4.144e** There may be other reasons the deferred tax asset and deferred tax liability are not equal at lease commencement even though related temporary differences are equal, such as when there is a phased-in rate change and the temporary differences reverse in different periods. Similar to the above, we believe an income tax expense or benefit should be recognized for any difference between the deferred tax asset and the deferred tax liability when the temporary differences are equal at lease commencement.

#### **Example 4.27: Valuation Allowance on Initial Recognition of a Lease**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

ABC Corp. enters into a lease contract for the right to use equipment for a 10-year term that is classified as a finance lease.<sup>1</sup> At the lease commencement date, ABC recognizes a lease liability of \$100,000 (based on the present value of its lease payments) and a right-of-use (ROU) asset of \$105,000 (based on initial measurement of the lease liability plus \$5,000 of initial direct costs). Assume ABC's \$5,000 of initial direct costs are immediately deductible for income tax purposes, resulting in a \$5,000 net operating loss carryforward (NOL) that can be carried forward indefinitely. ABC's preliminary deferred inventory after considering the lease but before considering the need for a valuation allowance is:

Deferred tax asset – NOL ( $\$5,000 \times 21\%$ )	\$ 1,050
Deferred tax asset – Lease liability ( $\$100,000 \times 21\%$ )	\$21,000
Deferred tax liability – ROU asset ( $\$105,000 \times 21\%$ )	\$22,050

When evaluating the need for a valuation allowance, ABC:

- Schedules the reversal of the lease liability based on the loan amortization method (see Paragraphs 4.011 and A.045);
- Schedules the reversal of the ROU asset on a straight-line basis;
- Expects annual utilization of any NOL to be limited to 80% of its taxable income, with no carryback availability;

- Has a history of losses and cannot rely on future taxable income exclusive of reversing temporary differences;
- Has not identified any tax-planning strategies; and
- Considers only the reversal of taxable temporary differences as a source of taxable income.

As a result of the taxable temporary differences reversing prior to the deductible temporary differences and the 80% limitation on the ability of NOLs to offset the taxable income from the reversing taxable temporary differences, ABC determines, through a scheduling exercise, that a valuation allowance of \$3,214 is required at lease inception.

ABC initially recognizes the deferred taxes, including the valuation allowance, associated with the lease as follows:

	Debit	Credit
ROU asset	105,000	
Deferred tax asset – NOL	1,050	
Deferred tax asset – Lease liability	21,000	
Income tax expense	3,214	
Lease liability		100,000
Deferred tax liability – ROU asset		22,050
Valuation allowance		3,214
Cash		5,000

<sup>1</sup>This example assumes that the lease is a finance lease for illustrative purposes only. The views illustrated here would equally apply if the lease was an operating lease, but the ROU asset and lease liability reversal patterns would differ. See Paragraph 9.002 for additional guidance on presenting deferred tax assets and liabilities on the balance sheet and Paragraph 9.082a for additional guidance on related disclosures in the notes to financial statements.

**4.145 Asset Retirement Obligations.** ASC Subtopic 410-20 requires an entity to recognize a liability for legal obligations associated with the retirement of a tangible long-lived asset. These liabilities generally will not be deductible for income tax purposes when accrued for financial reporting. Accordingly, a deferred tax asset should be recognized for the difference between the financial statement carrying amount and the corresponding tax basis (which generally will be zero). The offset to the liability established will be an increase in the carrying amount of the respective asset. This additional asset amount will result in a separate temporary difference for which a deferred tax liability should be recognized.

**4.146** The deferred tax liability associated with the increase in the asset amount will reverse as the asset is depreciated for financial statement purposes. However, because many of the asset retirement liabilities will be long-term, an entity may not be able to estimate when the liability will be settled and when the corresponding deferred tax asset will reverse. Accordingly, a valuation allowance may be needed for the deferred tax asset

related to the asset retirement obligation. While the deferred tax liability associated with the incremental asset amount may not provide a source of taxable income (due to a mismatch in the periods in which the deferred effects reverse) to support the deferred tax asset, other sources of taxable income, such as a tax-planning strategy or future taxable income exclusive of reversing temporary differences and carryforwards, may enable an entity to demonstrate that it is more likely than not the deferred tax asset related to the asset retirement obligation will be realized. When evaluating the timing of the reversal of temporary differences for asset retirement obligations, entities may consider factors similar to the reversal of temporary differences related to defined pension and other postretirement benefits. See Paragraph 4.125.

**4.146a** Like the initial recognition of a valuation allowance at lease commencement, we believe a valuation allowance necessary when an entity incurs an asset retirement obligation, if any, should be recognized with a charge to income tax expense.

**4.147 Investments.** Impairment losses (both temporary and other-than-temporary) on investment securities generally will result in the recognition of a deferred tax asset that ultimately will be capital in nature upon reversal under the tax law unless the holder of the securities is a dealer in such securities or otherwise holds the securities for sale to customers in the ordinary course of business. Accordingly, entities should consider the likelihood of having offsetting capital gains (including the effects of qualifying tax-planning strategies) when determining whether a valuation allowance is necessary. This may be of particular concern for financial institutions that may have no or very limited amounts of available capital gains due to the unique tax rules governing financial institutions. Similar issues may arise in analyzing recognized deductible outside basis differences for investments in subsidiaries and equity method investees.

## Section 5 - Changes in Tax Laws, Rates, or Status

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#### Changes in Laws, Rates, or Status – Specific Application Matters

- Example 5.15: Valuation Allowance – Interpretive Guidance Issued after Year-End

**5.000** This section explains how changes in tax laws, rates, or status affect the recognition and measurement of current and deferred tax assets and liabilities and when the tax effect of those changes should be recognized in financial statements.

**5.001** This section's guidance on changes in rates from a change in law generally applies to changes in rates from other causes, unless specifically indicated otherwise. A change in rate that does not result from a change in law may occur, for example, when an asset is transferred from one state to another state in a carryover basis transaction that changes the *applicable enacted tax rate* used to measure the tax effect of an existing temporary difference.

**5.002** Similarly, this section's guidance on changes in tax laws generally applies to all changes in the tax laws in all jurisdictions, including those changes that cause a change in tax status. The guidance on changes in tax status generally applies to all changes in tax status except those caused by a change in tax law. This section first discusses changes in tax laws or rates, and then discusses changes in tax status.

**5.003** The basic principles of ASC Topic 740, *Income Taxes*, require (1) the tax effect of changes in tax law and rates to be recognized in the period that includes the *enactment date* of the changes, and (2) the tax effect of changes in status to be recognized on the *approval date* or on the *filing date* if approval is not necessary. The entire effect of changes in tax laws and tax status on current and deferred tax balances is recognized in income from continuing operations, even if the deferred tax balances relate to a prior year or prior interim period transaction that was reported as a discontinued operation, directly in shareholders' equity, or in other comprehensive income. Changes in applicable tax law, tax rates (a provision of tax law), or tax status (a designation defined by tax law) should not be anticipated when measuring current or deferred taxes or determining the appropriate amount of a valuation allowance. The following paragraphs discuss these general provisions in more detail. ASC paragraphs 740-10-25-32 and 25-33, 35-4, 40-6, 45-15, 45-19

### CHANGES IN LAWS OR RATES

**5.004** An entity is required to adjust current and deferred tax liabilities and assets for the effects of changes in tax laws or rates. The adjustment should be included in income from continuing operations in the interim period that includes the *enactment date*. Those adjustments are included in tax expense attributable to continuing operations even if the deferred tax balances relate to a prior year or prior interim period transaction that was reported as a discontinued operation, directly in shareholders' equity, or in other comprehensive income. Despite the fact that deferred taxes are often not calculated on a daily basis, it will be necessary to estimate such balances at the enactment date. In addition, an entity generally should disclose in the notes to the financial statements significant effects of changes in tax laws or rates that are not yet recognized in the financial statements when the enactment date is after the balance sheet date. ASC paragraphs 740-10-25-47 and 48, 30-26, 35-4; 45-15 through 18

### Example 5.1: Recognizing the Change in Tax Law on Enactment Date

A change in tax law occurs on April 8, 20X7 and is effective retroactively as of the beginning of the entity's 20X7 tax year, or January 1, 20X7. The entire effect of the change on existing deferred tax assets and liabilities, as well as any necessary change in a valuation allowance, should be determined as of April 8, 20X7, assuming the change in the valuation allowance is attributed solely to the change in tax law. Similarly, the entity should adjust its current tax payable in the interim period that includes April 8, 20X7. All such adjustments should be recognized in income from continuing operations in the period including April 8, 20X7.

**5.005 Determining the Enactment Date.** The enactment date for a change in law or rate is the date that the legislation becomes law, not the date the law is applicable or the periods for which it is applicable. For example, if the President of the United States signs a law on December 22, 20X7 to lower rates to 21% effective January 1, 20X8, the enactment date is December 22, 20X7, not January 1, 20X8. Determining the enactment date will depend on the tax laws in the particular jurisdiction because the laws governing enactment of tax laws may vary by taxing authority.

**5.006** In many jurisdictions, the final steps required to enact a law may be considered to be perfunctory. Under ASC Topic 740 an entity cannot, however, recognize the effect of the change in law before formal enactment, including any perfunctory steps. This differs from IFRS<sup>®</sup> Accounting Standards because IAS Standards 12, *Income Taxes*, requires entities to recognize a change in law or rate when the change is *substantively enacted*, that is, when the process is complete and any remaining steps will not change the outcome. In some jurisdictions, *substantive enactment* under IAS Standards 12 may occur before *enactment* under ASC Topic 740. In other jurisdictions, substantive enactment and enactment may occur at the same time, for example, in the United States. According to the United States Constitution, all legislation passed by both the U.S. Senate and House of Representatives must be presented to the President. The President can then approve the bill by signing it into law, or veto the bill by returning it to Congress within 10 days. If the legislation is not vetoed and returned to Congress and remains unsigned, after 10 days it will automatically become law, unless Congress adjourns in those 10 days at which point the bill will fail to become law. In addition, Congress can override a Presidential veto by a two-thirds majority vote in both the U.S. Senate and House of Representatives, at which point the legislation would become law. The ability to veto and the passage of time create alternatives in the legislative process that would change the outcome. Therefore, we believe that legislation is enacted and substantively enacted at the same point in time in the United States under any of the following scenarios:

- (1) The President of the United States signs the legislation into law;
- (2) Both the Senate and House of Representatives override a Presidential veto by a two-thirds majority vote; or
- (3) The legislation remains unsigned for 10 days while Congress is in session and it automatically becomes law.

In the FASB/International Accounting Standards Board (IASB) joint deliberations about the income taxes short-term convergence project, the IASB reached the same decision in February 2005 that in the United States, "substantive enactment occurs upon the signing of legislation by the President or upon a successful override vote by both houses of Congress." See additional discussion of enactment and substantive enactment in foreign jurisdictions beginning in Paragraph 7.070.

### **Example 5.2: Determining the Enactment Date**

Country A's legislature passes a tax bill on May 1, 20X7. The country's President must sign the bill for it to become enforceable law. The President is not authorized to formally veto a bill, but can withhold a signature. However, no President of Country A has ever withheld a signature. In this tax jurisdiction, the enactment date of the new law when applying the provisions of ASC Topic 740 is the date the President signs the bill.

**5.007 Measuring Deferred Tax Assets and Liabilities at the Enactment Date.** Future reversals of deductible and taxable temporary differences may need to be scheduled as of the enactment date to determine what law or rate should be used to remeasure existing deferred tax assets and liabilities. The law or rate to be used depends in part on when the temporary differences are expected to reverse when the effective date of the change is different from the enactment date. For example, assume a tax bill that lowers the tax rate to 20% from 40% for tax years beginning after December 31, 20X8 was signed into law on September 30, 20X7. The 40% rate should continue to be used to measure deferred taxes for those temporary differences scheduled to reverse on or before December 31, 20X8, while the 20% rate is applicable to all other temporary differences (i.e., those scheduled to reverse after December 31, 20X8). Where the newly enacted rates are phased in over a number of periods, the reversal pattern of temporary differences must be considered to determine the appropriate rate for remeasuring existing deferred tax assets and liabilities and any current effect of the rate change. See Paragraph 5.016 for additional discussion.

**5.007a Estimating Temporary Differences as of the Enactment Date.** As discussed in Paragraph 5.004, for purposes of intraperiod tax allocations, the provisions of a new tax law or rate should be applied to current and deferred taxes as of the date of enactment based on the temporary differences and carryforwards as of that date. In most cases, it will be necessary for an entity to estimate those balances at the enactment date. Adjustments expected to be made to those financial reporting balances after the enactment date are not anticipated. For example, the 2017 U.S. tax reforms were enacted on December 22, 2017 and many entities routinely remeasure their pension and other postretirement benefit liabilities as of December 31. Because nothing in the postretirement benefit accounting guidance requires the benefit obligation to be remeasured due to a tax rate change, entities remeasured the temporary difference that existed as of the December 22, 2017 enactment date through earnings as part of the effect of the Act. Then, the adjustment to the benefit obligation resulting from the December 31, 2017 actuarial valuation was recognized at the post-enactment 21% tax rate. Entities



that recognized the remeasurement of the benefit obligation in other comprehensive income recorded the related tax effects in other comprehensive income. Entities that recognized the remeasurement in earnings recorded the related tax effects in the income statement, but separately from the effects of changes in tax law.

**5.008 Subsequent Events Considerations – Measuring Deferred Tax Assets and Liabilities before the Enactment Date.** The provisions of a new tax law or rate should not be applied before the enactment date either to calculate current and deferred taxes or to determine whether a valuation allowance is necessary. Even if the financial statements for the prior financial reporting period are issued after the change is enacted or if the tax law or rate has a retroactive effective date, current taxes and deferred tax assets and liabilities should continue to be measured for all periods that end before the enactment date of the new law or rate using the tax law and rates as of the balance sheet date. For example, the income tax effect of a change in income tax law signed into law on July 1, 20X7 and effective as of January 1, 20X7 should be recognized on July 1, 20X7, and deferred tax assets and liabilities should continue to be measured using the former income tax law for all periods ending before July 1, 20X7. ASC paragraph 740-10-25-48

**5.009** If a particular provision of the tax law is set to expire or has expired, measurement of current taxes and deferred taxes that reverse after the expiration generally should not anticipate reenactment of such provision. Those current and deferred taxes should instead be measured using existing tax law, which reflects the expiration. If the provision is reinstated, remeasurement of current and deferred taxes would occur at the reenactment date and the effect of that measurement would be accounted for as a change in tax law.

**5.010** For example, assume Congress adjourned in December 20X7 without extending the production tax credit that expired December 31, 20X7 under a sunset provision in the tax law. It is expected that during calendar year 20X8, Congress will enact legislation to extend the production tax credit retroactively to January 1, 20X8, similar to the legislation that was passed as a result of the previous expiration of the production tax credit. Assume that on April 1, 20X8, Congress reinstates the production tax credit with retroactive application to January 1, 20X8. Therefore, production expenditures paid or incurred beginning January 1, 20X8 are eligible for the credit on the 20X8 tax return. Consistent with the guidance in Paragraphs 5.008 and 5.009, although the legislation is retroactive and was enacted prior to the issuance of the March 31, 20X8 financial statements, the change in the tax law should not be anticipated in the estimated annual effective tax rate when preparing the March 31, 20X8 financial statements. The effect of the change in tax law (which, in this case, includes the effect of eligible expenditures already incurred through April 1, 20X8) should be recognized in the period including the enactment date of April 1, 20X8 (i.e., the quarter ended June 30, 20X8 for calendar year-end entities).

**5.010a Subsequent Events Considerations – Measuring State Deferred Tax Assets and Liabilities before the Enactment Date.** As discussed in Paragraph 5.008, the provisions of a new tax law or rate should not be applied before the enactment date, even if there is a high likelihood that the new law will be enacted based on prior practices and precedent. While some states' income tax laws automatically conform entirely to the

federal tax code on enactment of the federal legislation, others do not. Those states that do not automatically conform may later enact some or all of the provisions through future state legislation. We believe entities should prepare their state and local income tax provisions based on currently enacted state and local tax law and account for future state legislation in the period of enactment. If there is uncertainty about what tax law is enacted at the reporting date, the guidance on accounting for uncertainty in income taxes is applied.

### Example 5.3: Retroactive Changes in State Tax Law

Assume the federal government enacts new legislation on January 1, 20X7. State A's tax legislation generally conforms the state requirements to the federal requirements. However, State A's legislature meets in March each year to conform the state law to the federal law. In March, 20X7 the state legislature passed a bill to conform the state tax law to the federal tax law. The Governor signed the conforming changes into law on April 1, 20X7, effective retroactive to January 1, 20X7. In this example, the enactment date with respect to federal law is January 1, 20X7, and enactment date with respect to state tax law is April 1, 20X7. For state tax purposes, the deferred tax assets and liabilities should be measured using the former state tax law for balance sheet periods ending before April 1, 20X7.

**5.011 Reenactment of Entire Tax System.** In certain foreign jurisdictions, the entire income tax structure may have a specified term, necessitating reenactment for the income tax system to continue. In these unusual circumstances, deferred tax assets and liabilities in these jurisdictions generally may be recognized and measured based on the presumption that the currently enacted tax laws and rates will be reenacted for future years. Changes in those tax laws and rates, other than reenactment of the current system in its totality, should not be anticipated.

**5.012** Similar situations may occur in state and local income tax regimes in the United States. For example, as of December 31, 2005, the sunset provisions of the NYS Article 32 Bank Tax Law expired without extension because new legislation intended to make permanent or extend the 2005 version of Article 32 had not yet been passed by New York State. This expiration effectively reverted the bank tax law to an earlier version of Article 32 that was in effect in 1984. Since 1984, Article 32 (which had been substantially revised in 1985) had been subject to numerous sunset provisions; however, the provisions were repeatedly extended every few years by the New York state legislature and signed into law by the New York state governor. A number of these previous extensions occurred after the sunset and were made with retroactive effective dates to the date of the previous sunset. The substantial revisions in 1985 (and other changes in later years) effectively changed the basic system of taxation for banking institutions, including lower tax rates, different alternative minimum taxes, and a different method for apportioning income applicable to New York State. For example, the 1984 version of Article 32 predated interstate banking and did not have an income apportionment formula; rather the law required separate accounting for banks to compute taxable income for New York tax

purposes. Due to the substantial changes in the tax system since 1984, it was unclear how the 1984 Article 32 would be applied in the 2006 regulatory environment. Without reference to the provisions of the 2005 Article 32, it was unclear how to calculate New York State taxes. Accordingly, in this unusual situation, the 2005 version of Article 32 generally was used to compute 2006 tax provisions until new legislation was finalized. Analogies to this situation are expected to be rare.

**5.013 Changes in Tax Rates Dependent on Future Events.** Some tax laws have transition provisions that change the applicable rate only on the occurrence of a future event, such as holding assets for a specified period of time. The entire tax effect of a change in applicable tax law or rate that is contingent on a future event should be recognized as a component of income from continuing operations at the enactment date if:

- Achieving the contingent future event is within the control of the entity, and
- The entity has the ability and intent to achieve the future event.

If the above conditions are not met, the entity should apply the enacted applicable tax rate assuming the contingent event will not occur. If, however, the conditions are met in a period after the enactment date, the entire tax effect of the change in rate should be recorded in that period.

### **Example 5.4: Change in Tax Rate Dependent on a Future Event**

On January 13, 2011, the Illinois governor signed into law tax legislation that increased the corporate income tax rate from 4.8% to 7.0% effective January 1, 2011, decreased the rate to 5.25% effective January 1, 2015, and decreased it to 4.8% effective January 1, 2025. The legislation allowed a taxpayer whose tax year overlaps the date on which a rate change occurs to use a weighted average of the two rates or to account specifically for income and expenses earned during each part of the tax year. Illinois continued to impose a personal property replacement tax of 2.5% in addition to the base corporate income tax rate, thereby making the combined rate as applied to corporations (for calendar year entities):

- 9.5% for tax years 2011-2014;
- 7.75% for tax years 2015-2024; and
- 7.3% for tax years 2025 and later.

Additionally, the law included a provision that established limitations for state spending in each fiscal year from 2012 through 2015. Should the Illinois Auditor General determine the state exceeded the limit, the Governor could declare a fiscal emergency and, subject to disapproval by the State Comptroller or State Treasurer, portions of the state spending would not be counted against the limitation for that year. In the event the state spending exceeded the limitation as ultimately determined by the Auditor General,

after considering any declared fiscal emergency, the tax rates reduced back to 4.8% (i.e., 7.3% including the personal property replacement tax) for the rest of that tax year and future tax years. Effectively, the law had provisions to ensure the additional taxes generated by the increased rates do not result in increased spending beyond that considered in the limitations for each year.

Under ASC Topic 740, the effects of changes in tax law on current and deferred taxes are accounted for in the period that includes the enactment date of the change. Accordingly, entities recognized the tax effects of the new Illinois law on existing current and deferred tax assets and liabilities, including related valuation allowances, as a component of income tax expense from continuing operations as of the January 13, 2011 enactment date.

As the newly enacted rates were phased in over a number of periods, the reversal pattern of temporary differences were considered to determine the appropriate rate for measuring deferred tax assets and liabilities and the effect of the rate change. The enacted rates used did not reflect the effects exceeding state spending limits.

The reduction of rates contemplated by exceeding the state spending limitations were contingent on future spending by the State, a determination by the Auditor General, and a possible fiscal emergency declared by the Governor, and were not within the control of the taxed entities; accordingly, that potential reduction was not factored into income tax provisions. Changes to the rates would be made if and when an ultimate determination was made by the Auditor General that the spending limits were exceeded and the enacted tax rates reverted to the pre-2011 level.

**5.014 Tax Elections.** Certain changes in tax laws or rates are applicable only if an entity makes an election to apply a certain provision. Deferred tax assets and liabilities generally should be measured at the enactment date based on the entity's expectations of elections that will be made in filing its tax return, similar to considering annual elections that an entity may make in computing income taxes for financial statement purposes each year. For example, assume a new income tax law allows an entity to choose between taking a deduction or a credit for an existing future deductible amount. Deferred taxes as of and subsequent to enactment and the effect of the change in tax law should be calculated based on management's expectations as to whether the entity will elect to take the deduction or the credit on its tax return.

**5.015 Calculating the Effect of a Change in Income Tax Law or Rate.** When measuring the effect of a change in income tax law or rate, temporary differences should be identified and deferred tax assets and liabilities should be calculated as of the day the income tax law (or change in rate) is enacted (i.e., the date the President signed the law in the United States, even if the changes may not be effective until future periods). The enactment date will generally be different from an entity's normal closing cycle. The effect of the remeasurement is reflected entirely in the interim period that includes the enactment date and allocated directly to income tax expense (benefit) from continuing operations. The effect on prior year income taxes payable (receivable), if any, is also

recognized as of the enactment date. Calculating the effect of a change in law or rate generally will require estimates of the temporary differences and taxable income at the date of the enactment.

### Example 5.5: Determining the Effect of a Change in Tax Rate

At December 31, 20X7, ABC Corp. had fixed assets that have a five-year financial statement useful life and a seven-year tax useful life; depreciation is recognized on a straight-line basis for both book and tax. The assets were purchased on April 17, 20X5. Six months of tax depreciation was taken in the first year. The original purchase price of the asset was \$100,000. Accordingly, the financial statement carrying amount and tax basis of the asset at December 31, 20X7 were \$45,863<sup>1</sup> and \$64,266,<sup>2</sup> respectively. As a result of a change in tax law enacted on January 31, 20X8, the corporate income tax rate for earnings after January 1, 20X8 will be taxed at 21%, a decrease from the historical 35%. The following is a summary of the deferred tax asset at applicable dates.

		Temporary Difference	Tax Rate		Deferred Tax Asset
December 31	\$	18,403 <sup>3</sup>	35	\$	6,441
January 31	\$	18,888	21	\$	3,966
March 31	\$	19,811	21	\$	4,160
December 31	\$	24,117	21	\$	5,065

The effect of the change in the tax law on deferred taxes is  $\$18,888 \times (35\% - 21\%)$ , or \$2,644. The change in tax law would also affect current taxes as of January 31, 20X8, as the lower rate would retroactively apply to taxable earnings after January 1, 20X8.

<sup>1</sup> $\$100,000 - (988 \text{ days} \div 1,825 \text{ days} \times \$100,000)$ . 988 days of depreciation represents 258 days in 20X5 and 365 days in both 20X6 and 20X7. 1,825 days is 5 years  $\times$  365 days.

<sup>2</sup> $\$100,000 - (913 \text{ days} \div 2,555 \text{ days} \times \$100,000)$ . 913 days of depreciation represents 183 days in 20X5 and 365 days in both 20X6 and 20X7. 2,555 days is 7 years  $\times$  365 days.

<sup>3</sup>The tax basis of \$64,266 minus the financial statement carrying amount of \$45,863. The other temporary differences have been calculated using the same methodology.

### Example 5.6: Calculation of Deferred Taxes When Enacted Tax Rates Change

ABC Corp. has taxable temporary differences of \$39,000 and deductible temporary differences of \$10,000 at December 31, 20X4. These temporary differences are expected to result in taxable amounts of \$18,000 in 20X5 and \$21,000 in 20X6, and deductible amounts of \$10,000 in 20X8. Assume that enacted tax rates are 35% for 20X4 through 20X6 and 21% for 20X7 and all future years.

Management of ABC expects to report taxable income in each of the next six years. Accordingly, deferred tax assets and liabilities are measured as follows using the enacted rate of 35% for the taxable temporary differences expected to reverse in 20X5 and 20X6 and 21% for the deductible temporary differences expected to reverse in 20X8.

Taxable temporary differences	\$	39,000
Applicable tax rate		<u>35%</u>
Deferred tax liability		<u><u>13,650</u></u>
Deductible temporary differences	\$	10,000
Applicable tax rate		<u>21%</u>
Deferred tax asset	\$	<u><u>2,100</u></u>

**5.016 Phased-in Tax Rate Changes.** When phased-in changes in tax rates are enacted, the reporting entity should determine when the temporary differences are expected to reverse to determine the applicable enacted tax rate to use for measuring deferred assets and liabilities and the effect of the rate change. It may be necessary to schedule the reversal of temporary differences. The effects of such changes during the phase-in period represent rate reductions and thus should be recognized in the period that includes the enactment date.

**5.016a** For example, the U.S. tax reforms enacted in the United States on December 22, 2017 lowered the corporate tax rate to 21% effective January 1, 2018. However, the law required non-calendar year-end taxpayers to use a blended rate for the fiscal 2018 tax year by applying a pro-rated percentage of the number of days before and after the January 1, 2018 effective date (see Paragraph 5.017c for additional discussion). As a result, those entities had to schedule the reversal of enactment date temporary differences and those that arise in fiscal year 2018 to determine which would reverse under the blended rate in fiscal 2018 and which would reverse once the 21% rate is fully effective. Those entities that expected to carry forward NOLs from fiscal 2018 into future fiscal years measured their carryforwards at 21%; this is because the fully effective rate was expected to apply in the period those NOL carryforwards reverse. Appendix A provides general guidance on scheduling the reversal of temporary differences, Example 3.8 illustrates scheduling both when the entity does and does not consider future originating differences, and Example 5.8 illustrates how an entity that will experience a phased-in rate change may account for the change in tax law in an interim period. ASC paragraphs 740-10-30-8 and 30-9, 55-15, 55-22 and 55-23, 55-129 and 55-130

### Example 5.7: Enactment of a Phased-In Tax Rate

A new tax law enacted on March 31, 20X8 lowers the withholding tax rate on earnings distributions from 20% to 4% beginning January 1, 20X9. ABC Corp. has foreign

subsidiaries with undistributed earnings and ABC has historically recognized a deferred tax liability for the withholding tax using the then-enacted rate of 20%. If ABC waits until January 1, 20X9, its foreign subsidiaries can make earnings distributions that will be taxed at the 4% rate. If the distributions are made before January 1, 20X9, they will be taxed at 20%.

As discussed in Paragraph 5.013, to recognize a change in applicable tax rate that is contingent on a future event (earnings distributions on or after January 1, 20X9), the event needs to be within the control of the entity. Because ABC controls the timing of the distributions and intends to delay distributions until the lower rate is in effect, ABC would adjust its withholding tax liability as of the date of enactment (March 31, 20X8), or the date it concludes it will delay distributions to use the reduced rate (if it makes that conclusion after the enactment date). If ABC does not control when the foreign subsidiaries make earnings distributions, ABC should consider the expected timing of the earnings distributions to determine the appropriate rates for measuring the withholding tax liability at the enactment date.

**5.017 Effect of Changes in Tax Laws or Rates in Interim Periods.** The effect of a change in laws or rates on existing deferred tax assets and liabilities is a discrete event and should be recorded in the interim period that includes the enactment date. The effect of a change in laws or rates on deferred assets or liabilities should not be apportioned to other interim periods. The effect of the change in tax law on changes in temporary differences that arise between the enactment date and the effective date that are expected to reverse after the effective date should be reflected in the estimated annual effective rate beginning in the interim period that includes the enactment date. ASC paragraphs 740-10-25-48, 30-26, 740-270-25-5, 55-46 through 55-50

**5.017a** To practically apply the guidance in Paragraph 5.017, entities generally will compute total income tax expense related to ordinary income for the period including the enactment date using one of two approaches:

### **Method A: Enactment Date Approach**

- (1) Remeasure enactment date deferred taxes associated with ordinary income at the new rate and recognize the adjustment as a discrete item in the period including the enactment date.
- (2) Adjust the estimated annual effective tax rate and apply the new rate to year-to-date ordinary income. The revised estimated annual effective tax rate would include the change in deferred taxes occurring both before and after the date of enactment, but excludes the remeasurement as of the date of enactment.

### **Method B: Beginning-of-Year Approach**

- (1) Remeasure beginning of the year deferred taxes at the new rate and recognize the adjustment as a discrete item in the period including the enactment date.

(2) Adjust the estimated annual effective tax rate and apply that new rate to year-to-date ordinary income. The revised estimated annual effective tax rate would include the change in deferred taxes from the remeasured beginning of the year amount through the end of the year.

We believe either approach is acceptable, but in either case, the entity is required to disclose the total effect on deferred taxes resulting from the rate change. If an entity applies Method B, the beginning-of-year approach, it will still need to determine the adjustment to deferred taxes as of the enactment date balance sheet to disclose the total effect of the rate change on deferred taxes. We believe an entity that applies Method B may compute the total effect on deferred taxes as the sum of (a) the adjustment arising from remeasuring beginning of year deferred taxes, and (b) the adjustment arising from revising the estimated annual effective tax rate being applied to the year-to-date change in temporary differences as of the enactment date. Example 5.8 illustrates Method B.

**5.017b** Entities recognize all of the effects of a change in tax law in the interim period that includes the enactment date. If a change in tax law is effective retroactively within the current annual period (i.e., the effective date is before the enactment date), the retroactive effect results in a catch-up adjustment for the current taxes payable or refundable recognized in earlier interim periods. If a change in tax law is effective retroactively to a prior annual period, the retroactive effect on current taxes payable or refundable for that prior annual period is recognized discretely in the period of enactment. See Paragraph 10.083 for additional discussion.

**5.017c** The U.S. tax reforms enacted in the United States on December 22, 2017 lowered the corporate tax rate to 21% effective January 1, 2018. However, the law required a non-calendar year-end taxpayer to use a blended rate for its fiscal 2018 tax year by applying a pro-rated percentage of the number of days before and after the January 1, 2018 effective date. In that circumstance, the change in the tax rate was factored into the estimated annual effective tax rate in the period that included the December 22, 2017 enactment date. For example, the rate change for a June 30, 2018 year-end taxpayer applied retrospectively as of July 1, 2017 and the estimated annual effective tax rate was adjusted in the interim period ended December 31, 2017. This meant statutory income tax rate used in the measurement of the estimated annual effective rate was adjusted to approximately 28%  $((184/365 \text{ days} \times 35\%) + (181/365 \text{ days} \times 21\%))$  as of December 31, 2017.

**5.017d - 5.017e** Not used.

### Example 5.8: Change in Tax Rate in an Interim Period

The U.S. tax reforms enacted in the United States on December 22, 2017 lowered the corporate tax rate from 35% to 21% effective January 1, 2018. However, the law required non-calendar year-end taxpayers to use a blended rate for the fiscal 2018 tax year by



applying a pro-rated percentage of the number of days before and after the January 1, 2018 effective date.

ABC Co. is a U.S. taxpayer with a September 30, 2018 year-end. ABC has (or is expected to have) the following taxable temporary differences as of October 1, 2017, December 22, 2017 and September 30, 2018.

	10/1/17	10/1/17 – 12/21/17		12/22/17	12/22/17 – 9/30/18		9/30/18
	Temporary difference	Reverse	Originate	Temporary difference	Reverse	Originate	Temporary difference
LT							
Temp 1	\$ 20,000	\$ (2,000)	\$ -	\$ 18,000	\$ (2,000)	\$ -	\$ 16,000
ST Temp 2	10,000	(10,000)	-	-	-	-	-
ST Temp 3	-	-	8,000	8,000	-	-	8,000
ST Temp 4	-	-	-	-	-	12,000	12,000
Total	\$ 30,000	\$ (12,000)	\$ 8,000	\$ 26,000	\$ (2,000)	\$ 12,000	\$ 36,000

Before the tax law change, ABC's statutory tax rate was 35%. After the tax law change, ABC's rates are:

- for its 2018 fiscal year, 24.5%:  $(92/365 \text{ days} \times 35\%) + (273/365 \text{ days} \times 21\%)$ ; and
- for its 2019 fiscal year and beyond, 21%.

ABC expects to earn \$100,000 in pre-tax income for FY 2018, earns \$25,000 in actual pre-tax book income through December 22, 2017 and \$26,000 in actual pre-tax book income through December 31, 2017.

ABC expects to incur \$2,000 in expenses during the period from January 1, 2018 to September 30, 2018 that, while deductible under the old law, will become nondeductible as of January 1, 2018. Accordingly, in its quarter ended December 31, 2017 (the period including the enactment date), ABC adjusts its expectation of taxable income for FY 2018.

ABC has an accounting policy to compute the effect of changes in tax laws or rates on deferred taxes in interim periods using the beginning-of-year approach as discussed under Method B in Paragraph 5.017a. This example shows the application of currently codified Subtopic 740-270 to the interim accounting for the facts described, rather than Codification that existed in 2017.

### Three-months ended December 31, 2017

ABC performs the following four steps to measure the effect of the tax change.

**Step 1 – Remeasure beginning of year deferred taxes**

Beginning of year deferred taxes at the old rate:

	<b>Temporary difference</b>	<b>BOY tax rate</b>	<b>DTL</b>
LT Temp 1	\$ 20,000	35%	\$ 7,000
ST Temp 2	10,000	35%	3,500
Total BOY DTL at old rate	<u>\$ 30,000</u>		<u>\$ 10,500</u>

Beginning of year deferred taxes at the new rate:

LT Temp 1—

	<b>Temporary difference</b>	<b>New rate</b>	<b>DTL</b>
Portion reversing in FY 2018	\$ 4,000	24.5%	\$ 980
Portion that reverses in FY 2019+	16,000	21%	3,360
Total LT Temp 1	<u>\$ 20,000</u>		<u>\$ 4,340</u>

ST Temp 2—

	<b>Temporary difference</b>	<b>New rate</b>	<b>DTL</b>
Portion reversing in FY 2018	\$ 10,000	24.5%	\$ 2,450
Portion that reverses in FY 2019+	—	21%	—
Total ST Temp 2	<u>\$ 10,000</u>		<u>\$ 2,450</u>
Total BOY DTL at new rate	<u>\$ 30,000</u>		<u>\$ 6,790<sup>1</sup></u>

Note:

<sup>1</sup>\$4,340 + \$2,450

Adjustment to beginning of year deferred taxes: \$3,710 (\$10,500 - \$6,790):

	<b>Debit</b>	<b>Credit</b>
Deferred tax liability	3,710	
Deferred tax benefit		3,710

**Step 2 – Compute the estimated annual effective tax rate for FY 2018**

	<b>FY 2018</b>	<b>New rate</b>	<b>Notes</b>
Pretax income	\$ 100,000		
LT Temp 1	4,000		
ST Temp 2	10,000		
ST Temp 3	(8,000)		
ST Temp 4	(12,000)		
Nondeductible expenses	<u>2,000</u>		
Taxable income	<u>\$ 96,000</u>		
Current tax expense/payable	\$ 23,520	23.5%	Current effect. rate
DTL – LT Temp 1	\$ (980)	24.5%	FY 2018 reversal
DTL – ST Temp 2	(2,450)	24.5%	FY 2018 reversal
DTL – ST Temp 3	1,680	21%	FY 2019+ reversal
DTL – ST Temp 4	<u>2,520</u>	21%	FY 2019+ reversal
Deferred tax expense (benefit)	<u>\$ 770</u>	0.8%	Deferred effect. rate
Total tax expense	<u><u>\$ 24,290</u></u>		
Annual effective tax rate		24.3%	\$23,800 / \$100,000

**Step 3 – Apply the estimated annual effective tax rate to pretax income through December 31, 2017 and true-up total tax expense (benefit)**

	<b>Pretax income through 12/31/17</b>	<b>AETR</b>	<b>YTD tax expense (benefit)</b>
Year-to-date operations 10/1–12/31	\$26,000	24.3%	\$6,315

Total tax expense for the quarter ended December 31, 2017:

	<b>New rate</b>
YTD total tax expense as of 12/31/2017 excluding remeasurement of deferred taxes as of Oct. 1, 2017	\$ 6,315
Deferred tax expense (benefit) – remeasurement of deferred taxes as of Oct. 1, 2017	<u>(3,710)</u>
YTD total tax expense as of 12/31/2017	<u><u>\$ 2,605</u></u>

Rate reconciliation through December 31, 2017:

Income tax expense (benefit) at the 24.5% statutory rate	\$ 6,370
Nondeductible expenses	127 <sup>1</sup>
Remeasurement of deferred taxes as of Oct. 1, 2017	(3,710)
Effect of phased-in tax rate (21% after FY 2018)	(182) <sup>2</sup>
YTD total tax expense as of 12/31/2017	<u>\$ 2,605</u>

Notes:

All reconciling items (including those that may be insignificant individually) are shown for illustrative purposes.

<sup>1</sup> Annual impact of nondeductible expenses of \$490  $(\$2,000 \times 24.5\%) \times$  portion of ordinary income recognized of 26%  $(\$26,000 / \$100,000)$ .

<sup>2</sup> Annual impact of phased-in tax rate of \$700  $[(\$8,000 + \$12,000) \times (24.5\% - 21\%)] \times$  portion of ordinary income recognized of 26%  $(\$26,000 / \$100,000)$

***Step 4 – Compute total effect of rate change on deferred taxes (required disclosure)***

Change in deferred taxes through December 22, 2017 at the old rate:

	10/1–12/22	Old rate	Notes
LT Temp 1	2,000		
ST Temp 2	10,000		
ST Temp 3	(8,000)		
ST Temp 4	—		
DTL – LT Temp 1	\$ (700)	35%	FY 2018 reversal
DTL – ST Temp 2	(3,500)	35%	FY 2018 reversal
DTL – ST Temp 3	2,800	35%	FY 2019+ reversal
DTL – ST Temp 4	—	35%	FY 2019+ reversal
Deferred tax expense (benefit)	<u>\$ (1,400)</u>		

Change in deferred taxes through December 22, 2017 at the new rate:

	10/1–12/22	New rate	Notes
LT Temp 1	2,000		
ST Temp 2	10,000		
ST Temp 3	(8,000)		
ST Temp 4			
DTL – LT Temp 1	\$ (490)	24.5%	FY 2018 reversal
DTL – ST Temp 2	(2,450)	24.5%	FY 2018 reversal
DTL – ST Temp 3	1,680	21%	FY 2019+ reversal
DTL – ST Temp 4	—	21%	FY 2019+ reversal
Deferred tax expense (benefit)	<u>\$ (1,260)</u>		

The adjustment arising from revising the estimated annual effective tax rate is:

Deferred tax expense (benefit) at new rate	\$(1,260)
Deferred tax expense (benefit) at old rate	(1,400)
Adjustment to deferred tax expense (benefit)	<u>\$140</u>

ABC would disclose in its September 30, 2018 annual financial statements a downward adjustment to deferred tax liabilities of \$3,570 as result of the change in tax law. This total is made up of a \$3,710 deferred tax benefit related to remeasuring beginning-of-year deferred taxes and \$140 deferred tax expense related to revising the estimated annual effective tax rate being applied to the year-to-date change in ABC's temporary differences as of the enactment date.

### Example 5.9: Change in Tax Rate in Interim Periods - Retroactive Effective Date

A tax law that reduces the applicable corporate tax rate from 35% to 21% is enacted on April 2, 20X7 and is effective retroactive to January 1, 20X7. The estimated annual effective tax rate used for the first quarter ending March 31, 20X7 (for a calendar year-end entity) would presume a 35% statutory rate because the rate change was not enacted until April 2, 20X7. The estimated annual effective tax rate for the subsequent quarters (beginning with the quarter ended June 30, 20X7) would presume a 21% statutory rate for all of the expected 20X7 taxable income because the rate change is retroactive to January 1, 20X7. The adjustment to the estimated annual effective tax rate to reflect the 14% rate reduction applicable to taxable income earned on and after January 1, 20X7 (i.e., the effect on current taxes payable) should be made in the second quarter of 20X7.

### Example 5.10: Change in Tax Law in Interim Periods - Retroactive Effective Date

ABC Corp. has a December 31, 20X3 year-end and routinely generates a tax credit that significantly affects its effective tax rate. The tax credit expired on December 31, 20X2 and therefore was not considered in ABC's estimated annual effective tax rate for the period January 1, 20X3 through June 30, 20X3. On August 19, 20X3, a retroactive extension of the tax credit was signed into law that allows entities to take advantage of the credit from January 1, 20X3 through December 31, 20X3. At the enactment date, ABC determined it earned approximately \$2 million in tax credits from January 1, 20X3 through June 30, 20X3. In addition, ABC expects to earn approximately \$3 million more in tax credits from July 1, 20X3 through December 31, 20X3. ABC would adjust its estimated annual effective tax rate in the period including the August 19 enactment date to reflect the \$5 million of tax credits expected to be earned in its 20X3 tax year.

**5.018 Effect of Changes in Law Affecting Non-Income Based Tax Items.** While changes in law affecting non-income based taxes are not specifically addressed in the accounting literature, we believe that similar to the accounting for income taxes, entities should recognize the effects of such law changes in the period that includes the enactment date, even when there are retroactive provisions. For example, the American Taxpayer Relief Act of 2012 (the Act), which was signed on January 2, 2013, contained provisions that were retroactively applied to periods beginning on January 1, 2012, for non-income based tax items that are excluded from the scope of ASC Topic 740 (e.g., alternative fuel excise tax credits and outlay payments for various alternative fuels such as propane and certain excise taxes). Because the Act was signed into law on January 2, 2013, the effects of the new law were recognized for financial reporting purposes as of January 2, 2013 (the first quarter of 2013 for entities with calendar year-ends). The January 2, 2013 effects included the catch-up adjustment, if any, to capture the retroactive changes that apply to the 2012 tax year. This treatment is consistent with ASC Topic 855, *Subsequent Events*, which limits recognized subsequent events to those that provide evidence about conditions that *existed at the date of the balance sheet*.

## CHANGES IN TAX STATUS

**5.019** The guidance below on changes in tax status generally applies to all changes in tax status except those caused by a change in tax law. See Paragraph 5.004 for additional discussion of accounting for changes in tax law.

**5.020** Deferred tax assets and liabilities are recognized for temporary differences when a nontaxable entity becomes a taxable entity. Deferred tax assets and liabilities are eliminated when a taxable entity becomes a nontaxable entity. The effect of recognizing or eliminating deferred tax assets or liabilities as a result of a change in tax status (e.g., from nontaxable to taxable or vice versa) is charged or credited to income tax expense from continuing operations on the IRS approval date of the change in status or on the date the election is filed if approval is not necessary. The change is recognized in income tax expense from continuing operations even if the deferred tax balances relate to a prior year or prior interim period transaction that was reported as a discontinued operation or an item of other comprehensive income. ASC paragraphs 740-10-25-32 to 25-34, 40-6, 45-19, 55-48

**5.021** An example of a change in tax status is for an eligible entity to change from being viewed as a partnership to a corporation and vice versa. A deferred tax liability or asset is recognized for temporary differences in accordance with the requirements of ASC Topic 740 at the date that a nontaxable entity becomes a taxable entity. A deferred tax liability or asset is eliminated at the date an entity ceases to be a taxable entity. In either case, the effect of (a) an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and (b) a change in tax status that results from a change in tax law is recognized on the enactment date. The effect of recognizing or eliminating the deferred tax liability or asset is included in income tax expense from continuing operations. ASC paragraphs 740-10-25-32 and 25-33, 40-6, 45-19

**5.022** In some situations when a parent entity changes its tax status, it also must (or can) change the taxation of some or all of its individual subsidiaries within the consolidated group. Alternatively, individual subsidiaries within the consolidated group may change their tax status without the parent entity changing its status. While we believe entities generally should apply the guidance in ASC Topic 740 about changes in tax status to each individual taxpayer, there may be some situations (e.g., when a parent makes a check the box election for a subsidiary) in which the change may be accounted for as a tax election.

**5.022a Check the Box Elections.** U.S. tax law allows certain eligible entities through which a U.S. entity operates to file a check the box election. This election generally allows an entity to choose its tax status (corporation or either partnership or disregarded entity, depending on the number of owners) for U.S. income tax reporting purposes. As discussed in Paragraph 5.028, we believe it is appropriate to account for these elections as a change in tax status in the period the change in status is filed. However, we understand there is diversity in practice with respect to check the box elections for subsidiaries within a consolidated set of financial statements. Some believe that if the effect of the election is limited to a change in the recognition or measurement of the parent's outside basis difference, it should be accounted for like any other election that an entity may make in computing its income taxes for financial statement purposes each year (see Paragraph 3.061). Under this view, the parent would account for the expected check the box election when it commits to making the election and making the election is within its control, similar to the election of REIT or RIC status (see Paragraph 5.027). We believe it is also acceptable to apply this view as long as the policy is consistently applied. See Paragraph 10.086b for additional discussion of elections made during the subsequent events period.

**5.023 Recognition Date for Change in Tax Status.** The effect of a change in tax status on deferred tax assets and liabilities should be recognized as of the date that the election is filed if approval from the taxing authority is not required. The effect of the change in tax status should be recognized as of the date that the taxing authority approves the change if approval from the taxing authority is required. Accordingly, an expectation that a taxable entity will become a nontaxable entity in the future does not eliminate the need to recognize deferred taxes in the current period.

**5.024 Changes in Tax Status if Approval from the Taxing Authority Is Not Required.** Generally, the IRS cannot reject certain changes in tax status, such as a change from a C Corporation to an S Corporation. Because IRS approval of these changes is automatic, the effect of the change in tax status on deferred tax assets and liabilities should be recognized as of the date that the election is filed. ASC paragraph 740-10-55-48

### Example 5.11: Recognition Date for Change in Tax Status

ABC Corp., incorporated as a C Corporation that has a December 31 year-end for financial reporting and tax purposes, filed an election on December 31, 20X7 to become

an S Corporation effective January 1, 20X8. ABC meets all of the requirements to become an S Corporation.

Under ASC Topic 740, ABC would recognize the effect of the change in tax status on the net deferred tax asset or liability as of December 31, 20X7 in its 20X7 financial statements. The effect of the change in tax status should be recognized in income from continuing operations in the 20X7 financial statements because ABC filed the change in tax status before the balance sheet date.

If ABC filed the election to become an S Corporation in 20X8 to be effective as of January 1, 20X8, the effect of the change in tax status on the net deferred tax asset or liability should be recognized in 20X8 financial statements even if ABC filed the election before its 20X7 financial statements were issued. In that case, the tax effect of the change should not be recognized in the 20X7 financial statements because ABC filed the election after December 31, 20X7. However, disclosure of the subsequent change in tax status would be appropriate in the 20X7 financial statements. ASC paragraphs 740-10-25-34, 50-4, 55-48

### **Example 5.11a: Recognition Date for Change in Tax Status During the Subsequent Events Period**

ABC Corp., a C Corporation, has a December 31 year-end for financial reporting and tax purposes. On December 12, 20X7, ABC commits to a plan to become an S Corporation and files its election on January 15, 20X8. ABC meets all of the requirements to become an S Corporation and the change in status will be effective as of January 1, 20X8. ABC issues its financial statements on February 28, 20X8.

The effect of the change in tax status on ABC's deferred tax assets and liabilities should be recognized in the 20X8 financial statements because ABC filed the election in January 20X8. Under ASC Topic 740, ABC recognizes the effect of the change in tax status on net deferred tax assets and liabilities as the date that the election is filed if approval from the taxing authority is not required. Generally, IRS approval for certain changes in tax status, such as a change from a C Corporation to an S Corporation, is automatic.

Although the change in status is accounted for in 20X8, subsequent event disclosure of the change in tax status would be appropriate in the 20X7 financial statements. ASC paragraphs 740-10-25-34, 50-4, 55-48

**5.025 Measuring the Effect of a Change in Tax Status.** The financial statement effect of a change in tax status generally is measured as the difference between the net deferred tax asset and liability just before the date the change in tax status is filed with or approved by the IRS and the net deferred tax asset or liability after the change in tax status is filed with or approved by the IRS. If the filing date or approval date of the election precedes the effective date of the change in tax status, scheduling the reversal of



existing temporary differences generally will be necessary to estimate what portion of deferred tax assets or liabilities is expected to reverse after the effective date of the change. Furthermore, during the period after the filing or approval date and before the effective date, deferred tax expense or benefit should be recognized only for those reversing existing temporary differences and future originating temporary differences that will result in a future tax consequence.

### **Example 5.11b: Recognition Date when Applying for Tax-Exempt Status**

ABC LLC was formed in July 20X4 as a taxable LLC with a December 31 year-end. In August 20X6, 25 months after formation, ABC submitted an application to the IRS applying for tax-exempt status. According to IRS Revenue Procedure 2018-5, Section 6, ABC has 27 months from inception to apply for tax-exempt status and have that tax-exempt status applied retroactively to its formation date.

Under IRS regulations, Form 990 is filed by tax-exempt entities in lieu of the standard tax return filed by taxable entities. According to IRS Revenue Procedure 2018-5, Section 6.05, “Organizations that claim exempt status under § 501(c) generally must file annual Form 990 series returns or notices, even if they have not yet received their determination letter recognizing exemption.” Accordingly, while ABC had not yet received its determination letter for its 2015 tax year, it proceeded to file its Form 990 for that tax year.

In February 20X7, ABC received its determination letter recognizing its tax-exempt status effective from its July 20X4 formation date.

Provided operating as a tax-exempt entity was entirely within ABC’s control and ABC was not required to perform additional non-perfunctory actions in 20X7 to obtain tax-exempt status, the effect of the change in tax status should be recognized on the application filing date in August 20X6.

### **Example 5.12: Change in Tax Status with Filing Date before the Effective Date**

DEF Corp. with a December 31 year-end and a net deferred tax liability files an election on September 30, 20X7 to become an S Corporation as of January 1, 20X8. The effect of the change in tax status should be recognized as of September 30, 20X7 assuming IRS approval is not necessary for the change in status to be effective. Estimates of the deferred tax liability as of September 30, 20X7, December 31, 20X7, and January 1, 20X8 would be required to determine the effect of the change.

As of September 30, 20X7 DEF should eliminate the portion of the deferred tax assets and liabilities related to temporary differences that will reverse after December 31, 20X7 and will not be taxable under the provisions of the tax law. At September 30, 20X7, after

recognition of the change in tax status, the remaining deferred tax asset or liability should represent the tax effects of existing temporary differences that will reverse from October 1, 20X7 through December 31, 20X7 plus the tax effects of any temporary differences that will reverse subsequent to December 31, 20X7 that will still result in a future tax consequence (such as a built-in gain tax). Net deferred tax expense or benefit would not be recognized during the period from October 1, 20X7 through December 31, 20X7 for temporary differences that originate during this period unless reversal of those temporary differences occur either before December 31, 20X7 or subsequent to December 31, 20X7 but will nevertheless result in a future taxable or deductible amounts under the tax law.

**5.026 Electing Real Estate Investment Trust (REIT) or Registered Investment Company (RIC) Status.** Corporations that meet certain criteria under the U.S. Internal Revenue Code may elect REIT or RIC status, which allows a tax deduction for dividends paid to shareholders. A tax deduction for dividend payments essentially provides an exemption from entity-level taxation. Accordingly, these entities do not recognize deferred taxes on temporary differences if the entity is appropriately structured to qualify as a REIT or RIC, the entity has met the appropriate qualification tests to be a REIT or RIC, the entity expects to distribute substantially all of its income that would otherwise be taxable, the entity intends to continue to meet the applicable tests, and there are no indications that the entity will fail to meet those requirements.

**5.027** An election to be taxed as a REIT or RIC does not require IRS approval or the filing of an election. To be taxed as a REIT or RIC, an entity needs only to meet the qualifications of a REIT or RIC and file its tax return by the normal due date indicating that it is to be taxed as a REIT or RIC. Because no formal filing is required for a corporation to be treated as a REIT or RIC and because the IRS does not approve REIT or RIC status, the tax effects of a change to REIT or RIC status (including recognition of deferred tax liabilities for built-in gains, if any) should be recognized no earlier than the period in which the entity expresses its intent to be taxed as a REIT or RIC for that period and (a) has met all tax law requirements to be a REIT or RIC (including making the necessary corporate resolutions, distributing cumulative earnings, notifying shareholders, etc.); (b) has not met all the requirements but can control meeting the requirements; or (c) has not met the all the requirements but the remaining requirements are perfunctory.

### **Example 5.13: Effective Date for a Change to a REIT**

ABC Corp. has historically been taxed as a C Corporation but intends to qualify for REIT status for its fiscal year ending December 31, 20X7. Accordingly, during 20X7, ABC obtains all necessary corporate and shareholder approvals to elect REIT status, however, does not make all required distributions of cumulative earnings until January 15, 20X8. If at December 31, 20X7 making the required distributions was entirely within management's control and management was not required to perform any additional non-perfunctory actions in 20X8, the effect of change in status could be recognized in 20X7. If making the required distributions was not entirely within management's control or required actions determined to be other than perfunctory were required in 20X8, then

deferred tax assets and liabilities existing at December 31, 20X7 would be reversed at January 15, 20X8 assuming all other criteria for electing REIT status have been met.

**5.027a Effective Date for a Change from REIT or RIC to C Corporation Status.** An election to be taxed as a RIC is irrevocable for such taxable year and all succeeding taxable years. However, a RIC can effectively terminate RIC status in a taxable year by failing to meet one or more of the requirements to be taxed as a RIC. An election to be taxed as a REIT continues until it is revoked by the entity filing a statement with the IRS or is terminated due to the entity failing to qualify as a REIT. When a REIT or RIC election is revoked or terminated due to a qualification failure, as applicable, the change to being taxed as a C Corporation does not require IRS approval or the filing of an election. A REIT or RIC that becomes subject to tax as a C Corporation, simply needs to file its tax return as a C Corporation. Similar to converting from a C Corporation to a REIT or RIC, because no formal election is required and the IRS does not approve the change in status, we believe an entity should recognize the tax effects of the status change in the period in which it no longer expects to be taxed as a REIT or RIC.

#### **Example 5.13a: Effective Date for a Change from REIT to C Corporation**

ABC Corp. has a fiscal year ending December 31 and has historically qualified for, and elected, REIT status. On July 1, 20X7, ABC acquires assets that will result in it no longer qualifying as a REIT for the fiscal year ending December 31, 20X7. ABC should recognize the change in tax status from REIT to C Corporation on July 1, 20X7.

**5.028 Conversion from a Partnership to a Corporation.** A U.S. business may change from being taxed as a pass-through entity to being taxed as a corporation through a variety of methods, including amending the legal entity's organizational documents, transferring the business assets to a new legal entity, or filing a check the box election (see Paragraph 5.022a). The effect of establishing deferred tax assets and liabilities for the pass-through entity's existing basis differences should be recognized in income tax expense from continuing operations in the period of the change. If the change is effected through a filing with the taxing authority, the income tax effect is recognized (a) in the period the change in status is filed, if approval from the taxing authority is not required, or (b) at the date it is approved by the taxing authorities, if approval is required. ASC paragraphs 740-10-25-32 and 25-33, 40-6, 45-19

**5.028a** In some conversions, the former partners or owners may be subject to an income tax *and* the bases of the assets and liabilities of the new corporation are stepped-up for tax purposes. This increase in tax basis generally is accounted for through continuing operations as part of the initial establishment of deferred taxes when the change in status occurs. However, we believe it is also acceptable for the new corporation to recognize the change to its deferred taxes resulting from the step-up as an adjustment to equity - i.e., consistent with the accounting for transactions among shareholders (see Paragraph 9.070). Any tax payments made by the former partners or owners should not be

recognized by the corporation, because the income tax is levied on the partners or owners and not the corporation.

**5.028b** There may be other transactions that can be viewed as either a change in tax status or a transaction among shareholders. For example, some operating non-taxable entities create Up-C structures to facilitate initial public offerings. In an Up-C structure, a new corporation is formed to raise cash in an IPO with the intent to acquire the ownership interests in an existing partnership or limited liability company. The newly formed corporation may acquire those interests for cash or through the issuance of shares. We understand that some of the newly formed corporations initially recognize deferred taxes related to the consolidated partnership's assets and liabilities with an adjustment to continuing operations (like a change in tax status) because the partnership has effectively been converted to a corporation, while others initially recognize them with an adjustment to equity (like a transaction among shareholders) because the partnership's tax status has not changed. Entities should carefully analyze the facts and circumstances of their transaction to determine which accounting is most appropriate.

### Example 5.13b: Change in Tax Status and Change in Tax Basis of Assets

ABC Corp. (a C Corporation) purchases DEF Corp. (an S Corporation) and immediately makes a section 338(h)(10) election. After the transaction, DEF continues to issue separate financial statements and does not apply push-down accounting.

As a result of the section 338(h)(10) election, DEF's former owners are subject to an income tax *and* the basis of the assets and liabilities of the corporation are stepped-up for tax purposes. The table below summarizes the financial statement carrying amounts of the assets and liabilities and their tax bases before and after the section 338(h)(10) election:

	Financial Statement Carrying Amount	Tax Basis before Election	Temporary Difference	Tax Basis after Election	Temporary Difference
Cash	\$ 5,000	\$ 5,000	—	\$ 5,000	—
Intangible asset	1,000	850	\$ (150)	1,200	\$ 200
Liabilities	(1,000)	(1,000)	—	(1,000)	—

#### Step 1: Change in tax status

DEF recognizes the effect of establishing deferred tax assets and liabilities as a result of the change in tax status for DEF's existing basis difference in income tax expense from continuing operations in the period of change. Assuming a 21% enacted tax rate, the entry would be as follows:

	Debit	Credit
Deferred tax expense <sup>1</sup>	32	
Deferred tax liability		32

<sup>1</sup> \$150 × 21%

**Step 2: Step-up in tax basis**

As discussed in Paragraph 5.028a, the increase in tax basis as a result of the step-up from the section 338(h)(10) election generally is accounted for through income tax expense from continuing operations as part of the initial establishment of deferred taxes when the change in status occurs (step 1). However, we believe it is also acceptable for DEF to recognize the change to its deferred taxes resulting from the step-up as an adjustment to equity - i.e., consistent with the accounting for transactions among shareholders.

DEF records the following entry to account for the total \$74 increase in tax basis ( $\$350 \times 21\%$ ):

	<b>Debit</b>	<b>Credit</b>
Deferred tax asset	42	
Deferred tax liability	32	
Deferred tax benefit [or equity]		74

**5.029** The SEC staff has indicated that a partnership, S Corporation, or similar tax-exempt entity converting to a C Corporation should report pro forma income tax expense and earnings per share data on the face of the filed financial statements at least for the latest year and interim period; however, presentation for all periods is encouraged if the necessary pro forma adjustments are limited to taxes. In filings subsequent to the change in status, the entity should continue to present pro forma information for earlier comparable periods presented and for the period of change if the entity elected to present more than the latest year and interim period in the filing for the period of change. Pro forma tax expense should be calculated based on the statutory rates in effect for the earlier period. Section 3410 of the SEC Financial Reporting Manual

**5.030 Unrealized Built-In Gains for C Corporations That Elect S Corporation (or REIT) Status.** C Corporations that elect S (or REIT) status may continue to be subject to corporate-level tax. As a result, those S Corporations may be required to continue to recognize related deferred tax liabilities. The deferred tax liabilities should be recognized in accordance with the enacted tax laws, such as the built-in gain tax laws. Those deferred tax liabilities, if any, represent the expected future tax consequence of recovering existing assets and settling existing liabilities at their financial statement carrying amounts.

**5.031** A *built-in gain* is the difference between the tax basis of net assets and liabilities and the fair value of those assets and liabilities at the date an entity changes its status to an S Corporation. When a corporation elects S (or REIT) status, the new entity continues to be subject to a tax for the built-in gain that (1) existed at the date of conversion and (2) is realized during the five-year period after conversion.

**5.032** Taxes will not be payable on a built-in gain if (1) assets are not disposed of in the five-year post-conversion period or (2) the taxes would not have been payable if the entity did not convert to an S Corporation or a REIT. That is, the built-in-gain tax is equal

to the lesser of (1) the tax on the realized built-in gain for the year or (2) the amount of tax that would have been paid if the corporation's taxable income were computed assuming it was a C Corporation. If the entity does not recover (through disposition) the assets within the five-year post-conversion periods, there will be no tax consequence to the entity of existing basis differences or the built-in gain. Recovery of the financial statement carrying amount of an asset through depreciation or amortization would not result in future taxable amounts under the built-in gain system. ASC paragraph 740-10-25-30

**5.033** An entity that does not expect to realize the built-in gain (i.e., management has the ability and intent to hold the assets for the five-year post-conversion period) or does not expect to pay the tax on the built-in gain (e.g., income limitations are expected to eliminate the tax on a realized built-in gain) should not recognize a deferred tax liability. Alternatively, deferred tax liabilities should continue to be recognized by the S Corporation (or REIT) if those deferred tax liabilities are expected to be settled as part of the tax paid on any realized built-in gain.

**5.034** The results of the tax calculations under the built-in gain system and the C Corporation system (which should consider all differences between the financial statement carrying amounts and tax basis of all assets and liabilities at the date of the calculation) should be compared to determine which amounts are expected to be payable based on the provisions of the tax law in the five-year post conversion period and deferred tax liabilities should be computed accordingly.

**5.035** For example, if the taxes payable under the built-in gain system (i.e., the excess of the fair value at conversion over the tax basis at conversion) for a particular year are expected to be less than the taxes payable under the C Corporation system (i.e., the amount of taxable income for the year considering the excess of the current financial statement carrying amounts of the entity's assets and liabilities over their current tax bases), deferred tax liabilities should be recognized on taxable temporary differences under the built-in gain system. Deferred tax assets should be recognized under the built-in gain system only for the tax benefits of deductible temporary differences and carryforwards that are expected to be realized by offsetting taxable amounts under the provisions of the tax law. It would not be appropriate to recognize deferred tax assets for deductible temporary differences or carryforwards if those deductions cannot be used to offset taxable amounts under the built-in gain provisions of the tax law.

**5.036** If it is expected that taxes will be payable under the C Corporation system for a particular year, deferred taxes would be recognized on those temporary differences that are expected to reverse and carryforwards that are expected to be used in that year. However, the determination as to whether it is expected that taxes will be payable under the built-in gain system or C Corporation should not consider future losses that are expected to occur. That is, if the entity expects to be subject to the C Corporation system because of future losses but absent those future losses the entity would be subject to built-in gain system, deferred taxes should be recognized under the built-in gain system.

**5.037** Because taxes payable in each year of the five-year post-conversion period may be based on either the built-in gain system or the C Corporation system, the reversal of temporary differences under both systems may need to be scheduled over the five-year post-conversion period. The deferred taxes recognized may include taxes under the built-in gain system for certain future years and taxes under the C Corporation system in other future years and those amounts may change throughout the five-year post-conversion period. Deferred tax expense or benefit should be recognized for any change in the deferred tax liability. ASC paragraphs 740-10-55-64 and 55-65, 55-168 and 55-169

**5.038** Realized built-in gains may not be taxed in the year the gain is realized, because of income limitations. The tax obligation on the realized gains is carried forward to future years and becomes payable to the extent future period income would have been taxed within the five-year period after conversion if the entity were still a C Corporation. A deferred tax liability should be recognized for tax expected to be paid on a realized gain.

#### Example 5.14: Built-In Gain System

On January 1, 20X7, ABC Corp. converts from a C Corporation to an S Corporation. At the date of the conversion, ABC's assets comprise the following:

	Carrying Amount	Fair Value	Tax Basis	Temporary Difference	Built-in gain (loss)
Marketable securities	\$ 900	\$ 900	\$ 1,020	\$ (120)	\$ (120)
Inventory	\$ 960	\$ 1,000	\$ 800	\$ 160	\$ 200
Depreciable fixed assets	\$ 1,000	\$ 1,100	\$ 850	\$ 150	\$ 250

ABC expects to hold its depreciable assets over the five-year conversion period; however, book and tax depreciation (if under the C Corporation system) are \$100 and \$150 per year, respectively. ABC also has no operating or capital loss carryforwards at January 1, 20X7. ABC expects to sell its inventory during 20X8 and its marketable securities in 20X9. This would result in taxes due in 20X8 of \$2  $[(\$160 - \$150) \times 21\%]$ , because the \$2 due under the C Corporation system (taxable gain of \$160 on the sale of inventory less \$150 of tax depreciation on fixed assets times 21%) is less than the tax on the built-in gain of \$42  $(\$200 \times 21\%)$  on the inventory for 20X8. ABC may not assume the deductible built-in loss on the marketable securities will offset the built-in gain on the inventory because the marketable securities are not expected to be sold until 20X9 while the inventory is expected to be sold in 20X8.

Assume at December 31, 20X7, ABC decides that it will sell its marketable securities in 20X8 such that its related built-in loss will partially offset the built-in gain on the inventory. The carrying amounts and tax bases of ABC's assets (if it were still a C Corporation) are as follows:

	Carrying Amount	Tax Basis	Temporary Difference
Marketable securities	\$ 2,000	\$ 1,020	\$ 980
Inventory	\$ 960	\$ 800	\$ 160
Depreciable fixed assets	\$ 900	\$ 700	\$ 200

ABC would recognize deferred tax expense of \$15 computed as the end of year deferred tax liability of \$17 [(\$200 - \$120) × 21%] less the beginning of year deferred tax liability of \$2. The end of year deferred tax liability is based on the built-in gain because \$17 is less than the amount that would have been due under the C Corporation system (taxable gains of \$980 and \$160 on the sales of the marketable securities and the inventory less \$150 of tax depreciation on fixed assets times 21% = \$208).

**5.039 Effect of Changes in Tax Status in Interim Periods.** The effect of a change in tax status on existing deferred tax assets and liabilities is a discrete event and should be recorded in the interim period that includes the date that the election is filed if approval from the taxing authority is not required. The effect of the change in tax status should be recognized as of the date that the taxing authority approves the change if approval from the taxing authority is required.

## CHANGES IN LAWS, RATES, OR STATUS – SPECIFIC APPLICATION MATTERS

**5.040** The following paragraphs discuss other matters that should be considered when evaluating the financial statement effect of changes in tax law, rates, or status and matters that arise in specific circumstances.

**5.041 Recognizing Tax Effects of Changes in Laws and Rates When Temporary Differences Were Initially Established in Acquisition Accounting.** The effect of recognizing or eliminating deferred tax assets or liabilities as a result of a change in tax laws or rates should be included in income tax expense from continuing operations even when the temporary differences arose from a prior business combination. This income statement treatment also applies in cases where the change in tax law or rate results in the increase or reduction of a valuation allowance or results in a change in an acquired tax position. ASC paragraph 740-10-45-15

**5.042** Tax benefits arising as a result of excess tax-deductible goodwill resulting from a retroactive change in tax law shall also be recorded as a component of income tax expense from continuing operations as a change in tax law as a result of the application of ASC paragraph 805-740-25-9. See Section 6, *The Tax Effects of Business Combinations*, for additional discussion of business combinations.

**5.042a Changes in Laws and Rates during the Acquisition Accounting Measurement Period.** Changes in deferred tax assets and liabilities as a result of a change in tax law



after the consummation of a business combination should be recognized as a component of income tax expense from continuing operations even if the measurement period for the business combination has not ended. See Paragraph 6.112a for additional discussion.

**5.043 Change in Tax Status Is Not a Tax-Planning Strategy.** Changing an entity's tax status (e.g., from a C Corporation to an S Corporation) generally is within management's control. Such a change may enable deferred tax assets to reverse in the same periods as deferred tax liabilities, a source of future taxable income when evaluating whether a valuation allowance is needed for existing deferred tax assets. However, a change in status is a discrete event that is governed by ASC paragraphs 740-10-25-32 and 25-33, 740-10-40-6, and 740-10-45-19. Accordingly, a change in tax status does not qualify as a tax-planning strategy. ASC paragraph 740-10-55-48

**5.044 Effect of Changes in Rates on Deferred Intra-entity Amounts.** The deferred tax effects of intra-entity inventory transactions, which include taxes paid on the transactions by the seller and the tax effects of the reversal of any temporary differences in the seller's tax jurisdiction, are not deferred tax consequences of temporary differences. Accordingly, the deferred effects of intra-entity inventory transactions should not be adjusted for subsequent changes in tax rates.

**5.045 Private Letter Rulings and Case Law.** Private letter rulings and case law provide additional interpretive guidance to existing tax law. Interpretive guidance on tax law should not be considered a change in tax law or rate. Changes in the estimate of deferred tax assets and liabilities as a result of interpretive guidance generally should be recognized as a change in estimate, not as a change in tax law. When additional interpretive guidance becomes available after the balance sheet date but before the financial statements are issued, judgment will be required to determine in which financial reporting period the change in estimate will be recognized. For example, because only information that is available at the reporting date is considered in the recognition and measurement analyses of uncertainty in income taxes under ASC Subtopic 740-10, *Income Taxes - Overall* (FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*), such changes in available facts should be recognized in the period in which the change in facts occurs, even if that new information provides a more precise estimate of the ultimate outcome of an uncertainty. Conversely, because an entity generally is required to consider all available evidence in evaluating a need for a valuation allowance, the additional interpretive guidance may need to be considered in those analyses, regardless of when the entity accounts for the change in estimate. See Paragraphs 3.026 and 4.003 for additional discussion.

### **Example 5.15: Valuation Allowance – Interpretive Guidance Issued after Year-End**

ABC Corp. is a C Corporation that has a December 31 year-end for financial reporting and tax purposes. ABC has a deductible temporary difference as of December 31, 20X4,

for which there is uncertainty as to whether the related deduction is of an ordinary or capital character.

At December 31, ABC concludes that taking a position that the related deduction is ordinary is more likely than not of being sustained and that 100% of the benefit is greater than 50% likely of being realized if examined by the taxing authority. ABC has a long history of generating positive ordinary income and significant positive evidence exists indicating it will continue to generate substantial ordinary income and thus no valuation allowance would be necessary on the deferred tax asset.

On February 24, 20X5, prior to the issuance of the 20X4 financial statements, the IRS issued interpretive guidance that a similar transaction resulted in a deduction of a capital character. As a result, ABC now believes that the IRS would likely challenge an ordinary treatment of the deduction and concludes that it is more likely than not that the deduction is capital in nature. ABC does not have a history of generating capital gain income and has no forecasts of generating future capital gains. As a result, ABC concludes that a valuation allowance is needed against the related deferred tax asset.

ABC recognizes the valuation allowance in its 20X4 financial statements. An entity is generally required to consider all available evidence in evaluating the need for a valuation allowance. Because private letter rulings and case law generally provide additional interpretive guidance about existing tax law, they are typically accounted for as a change in estimate and not as a change in tax law or rate. As a result, interpretive guidance may need to be considered in valuation allowance assessments at the reporting date even if it is issued after the balance sheet date.

**5.046 IRS Regulations.** New IRS regulations generally represent changes in currently enacted law. The financial statement effects of these regulations should be recognized entirely on the date the regulation is issued consistent with a change in tax law. There are some regulations that only interpret or clarify current law instead of enacting new law. The financial statement effects of those regulations should be recognized as a change in estimate in the financial statements in the same manner as discussed above in the context of private letter rulings. Judgment will be required to determine whether a new IRS regulation should be accounted for as a change in estimate or a change in law.

**5.046a Unintended Benefits or Detriments in Enacted Tax Law.** As discussed beginning in Paragraph 3.066, the accounting for income taxes, including evaluating uncertainties, should be based on existing tax law, including existing interpretive guidance, as of the reporting date, even if an entity anticipates a future change in tax law. There may be provisions in the current tax law that an entity believes may provide unintended benefits or detriments to taxpayers. The entity also may believe that the law will be changed through future regulations or law changes. While these future changes may ultimately affect the analysis of a position's technical merits, an entity should account for its positions based on the tax law as currently enacted at the reporting date. See additional discussion in Paragraph 3.116a.

**5.047 Change from S&L to Bank Charter.** Savings and loan associations may convert their charters to bank charters. The conversions may be voluntary, such as a reaction to changes in the business model, a common-control merger, or an acquisition, or they may be involuntary, such as when an S&L fails to meet savings and loan association requirements. A former S&L newly chartered as a bank may be required to recognize a deferred tax liability for differences between the financial statement carrying amount and the tax basis of the bad debt reserves. Generally the exception to recognizing a deferred tax liability for bad debt reserves that arose in tax years beginning before December 31, 1987 applies only to entities that currently operate as savings and loan associations and qualified thrifts, but may also apply to certain thrifts that changed their charters subsequent to December 31, 1995 as a result of the Small Business Job Protection Act of 1996 (the Bill). The Bill allowed certain thrifts that converted into *commercial banks* (as defined in IRC section 593(e)) via a change in charter, merger, liquidation (as well as other thrifts that lost qualification and reestablished qualification) to *freeze* their base year qualifying and nonqualifying reserves and the supplemental reserve so that amounts will not be subject to recapture under the tax law. Accordingly, the entities would not recognize the related deferred tax liability. ASC subparagraph 740-10-25-3(a)(3)

**5.048** A deferred tax liability should be recognized for a thrift changing its charter when the thrift can no longer meet the criterion of ASC paragraph 942-740-25-1. For example, the deferred tax liability should be recognized when circumstances indicate that the entity is likely to pay taxes, either currently or in later years, because of expected reductions in the bad debt reserve (e.g., the thrift converts to a credit union). This change is not a change in income tax status but rather an inability of the entity to avail itself of the ASC paragraph 942-740-25-1 election. For example, if the thrift determines that its base year and supplemental reserves are subject to recapture due to its impending conversion to a credit union, it is inappropriate to defer recognizing the deferred tax liability for bad debt reserves until the conversion is effective. (Bad debt reserves of thrifts are also discussed in Paragraph 2.086). ASC paragraph 942-740-25-1

**5.049 Interaction with Guidance on Special Deductions.** ASC Topic 740 requires that the tax benefits of special deductions be recognized no earlier than the year in which those deductions are available for deduction on the tax return. Accordingly, no deferred tax asset or reduction in a deferred tax liability would be recognized in the period in which a law is enacted providing for a special deduction, even if such deductions are expected to be taken when existing temporary differences reverse. In some circumstances, deductions provided under the tax law may be similar to rate reductions, which would require remeasurement of deferred tax assets and liabilities. Determining whether a deduction is a rate reduction or a special deduction requires judgment and depends on the specific facts and circumstances. For example, while the tax deduction on qualified production activities, provided for under the American Jobs Creation Act of 2004, effectively reduced an entity's tax rate as a result of permitting a deduction for up to 9% of qualifying taxable income, it was nonetheless characterized as a special deduction because the computation of the deduction was contingent upon future performance of specified activities similar to the computation required for the statutory depletion deduction in the extractive industries. See Paragraphs 3.074 and 3.096 for

additional discussion. ASC paragraphs 740-10-55-27 through 55-30 and 55-146 through 55-148

**5.050 Residual Tax Effects within Other Comprehensive Income.** The total effect of changes in tax laws and status on deferred tax assets and liabilities is recognized in income tax expense from continuing operations, even if such balances relate to transactions that were reported in other comprehensive income. Consequently, a residual tax effect may remain within accumulated other comprehensive income. The method for releasing such residual tax effects should be systematic, rational, and consistently applied. See Paragraph 9.031 for additional discussion.

**5.051 Effect of a Change in Tax Law on Investments in Leveraged Leases.** All components of a leveraged lease should be recalculated from inception of the lease based on the residual after-tax cash flows arising from a change in tax law, including revised tax rates and the effect on the investment tax credit, if any. The difference would be included in income of the period in which the tax law is enacted. ASC paragraph 840-30-S99-2

**5.052** In February 2016, the FASB issued ASU 2016-02, *Leases*. The standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date.

**5.053 Tax Indemnifications in Lease Agreements.** Some leases contain indemnification clauses that indemnify lessors, on an after-tax basis, for certain tax benefits that the lessor may lose if a change in tax law precludes realization of those tax benefits. Lessors receiving indemnification payments should allocate the payments into two parts: (1) amount resulting from any investment tax credit lost; and (2) amount relating to all other tax effects. The portion allocated to investment tax credits should be recognized in the income statement in the same period in which the lessor would have recognized the investment tax credit per its accounting policy. The remaining payment should be accounted for as an adjustment of the lessor's net investment in the lease if the lease is a sales-type lease or a direct financing lease or recognized ratably over the lease term if an operating lease. ASC paragraphs 840-10-25-10 and 25-11, and 25-53, or 842-10-55-38 and 55-39, and 842-30-55-16

**5.054 – 5.057** Not used.

**5.058 Enactment Date in Mexico.** In Mexico, a law is deemed to be enacted after it is passed by Congress, signed by the President and published in the *Diario Oficial*. All three steps must be completed before the law is considered enacted for purposes of applying ASC Topic 740.

## Section 6 - The Tax Effects of Business Combinations

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Endnotes

**6.000** This Section discusses the accounting for income taxes in business combinations under ASC Topic 740, *Income Taxes*, and ASC Topic 805, *Business Combinations*.

**6.001** The examples in this Section are based on the provisions of the U.S. federal tax law. The effects of taxes in other tax jurisdictions are not considered in the examples unless indicated. While this Section focuses on U.S. tax law, an acquirer should consider the tax laws in its jurisdiction (and the acquiree's jurisdiction) when accounting for the business combination.

### **PRINCIPLES OF ACCOUNTING FOR THE TAX EFFECTS OF BUSINESS COMBINATIONS AT THE ACQUISITION DATE**

**6.002** As a result of a business combination, temporary differences may arise due to differences between the tax bases of assets acquired and liabilities assumed (determined by tax law) and the values of those assets and liabilities recognized for financial statement purposes (determined based on the provisions of ASC Topic 805). ASC Topic 740 requires an entity to recognize deferred tax assets and liabilities for those temporary differences and acquired operating loss or other tax credit carryforwards that exist at the acquisition date or that arise as a result of a business combination. However, deferred taxes are not recognized for differences related to nondeductible goodwill, leveraged leases<sup>1</sup>, and certain other differences for which there are specific exceptions (see discussion of exceptions to recognizing deferred taxes in Section 2). A valuation allowance is established at the acquisition date if it is more likely than not that all or some portion of acquired deferred tax assets will not be realized in the future. ASC paragraphs 805-740-25-3 and 25-4

**6.003** Whether an acquisition is taxable or nontaxable may affect the differences that arise between the tax bases of assets and liabilities and the financial statement carrying amounts determined by ASC Topic 805. A taxable business combination refers to a business combination in which the acquirer gets a new tax basis in the individual assets acquired and liabilities assumed. A nontaxable business combination refers to a business combination in which the acquirer assumes the seller's tax bases of the assets acquired and the liabilities assumed. In all business combinations, the objective is to recognize, with certain limited exceptions, deferred tax assets and liabilities on differences between the recognized amounts for financial reporting purposes of the assets acquired and liabilities assumed and the tax bases of those assets and liabilities and acquired carryforwards.

**6.004 Nontaxable Business Combinations.** In a nontaxable business combination, there generally is no change in the tax bases of the assets and liabilities of the acquired entity, and the tax bases of the acquired assets and assumed liabilities are the acquiree's tax bases immediately before the acquisition (carryover tax bases). This includes, as discussed in Paragraph 6.119, the tax basis of an acquiree's existing tax-deductible goodwill from a prior acquisition. Almost all nontaxable business combinations give rise to temporary differences for which deferred taxes are recognized because the financial statement carrying amounts of the acquired assets and assumed liabilities generally are

their respective fair values at the date of the acquisition under ASC Topic 805, whereas the tax bases equal the acquiree's former tax bases.

**6.005 Taxable Business Combinations.** In a taxable business combination, the tax bases of the assets acquired and liabilities assumed are stepped up to the fair value at the date of the acquisition. In these situations, although the recognized amount for both financial statement purposes and tax purposes may be *stepped up*, the amounts assigned to the individual assets and liabilities may differ in certain circumstances. For example, this may occur when the tax law does not recognize a liability for a contingent obligation that is required to be recognized under ASC Topic 805. Deferred taxes generally should be recognized for these basis differences. ASC paragraph 805-740-25-6

**6.006 Determining Whether the Election to Treat a Nontaxable Business Combinations as Taxable Is Included in the Acquisition Accounting.** In some circumstances, the acquirer of the shares of an entity (generally a nontaxable transaction) may either unilaterally elect (e.g., under section 338(g) of the Internal Revenue Code), or, together with the seller of the entity, jointly elect (e.g., under section 338(h)(10) of the Internal Revenue Code), to have the transaction treated as a taxable transaction. This election results in a step-up in the acquirer's tax bases in the acquired entity's individual assets and liabilities based on their fair market values on the date of purchase. These elections also typically result in tax-deductible goodwill. Whether the tax consequences of an election are deemed to be a part of the business combination or a separate transaction accounted for outside of the acquisition is a facts and circumstances determination for each transaction.

**6.007** Not used.

**6.007a** ASC paragraph 740-10-25-53 states that transactions directly between a taxpayer and a government should be recorded directly in income tax expense. See Paragraph 10.008a for additional discussion about increasing the tax basis of tax-deductible goodwill in a transaction directly with the taxing authority and Paragraph 6.117 and Paragraph 10.154 for additional discussion about the accounting for the step-up in the stand-alone financial statements of the acquiree.

**6.007b** An entity that increases the tax basis of goodwill in a transaction with the taxing authority must determine if the step-up relates to the business combination in which the financial statement goodwill was originally recognized or if it is a separate transaction. ASC paragraph 740-10-25-54 includes factors (not all inclusive) that may indicate a step-up in tax basis relates to a separate transaction.

- (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 the 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 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 was not contemplated at the time of the business combination.

Although the scope of guidance is specific to transactions with governments, it may be appropriate to apply this guidance by analogy to other transactions that result in the step-up in the tax basis of goodwill or to determine whether a transaction is part of a business combination. ASU 2019-12.BC20

**6.007c** If the step-up is considered part of the business combination, the entity recognizes a deferred tax asset only to the extent that the newly deductible goodwill amount exceeds the remaining balance of financial statement goodwill. We believe that if a transaction is considered part of a business combination, its tax effects, including a liability for consideration to be paid to the taxing authority, is recognized in the acquisition accounting under ASC Topic 805.

**6.007d** If the step-up is considered a separate transaction, the entity recognizes a deferred tax asset for the newly created tax goodwill. If the consideration paid to the taxing authority differs from the amount of the deferred tax asset (if any), the entity recognizes that difference as part of income tax expense (as discussed in Paragraph 6.007a).

**6.007e** We believe an entity's analysis of whether the elections under section 338(g) and section 338(h)(10) are accounted for as part of the business combination or separate transactions will need to consider the facts and circumstances of its election relative to the factors in ASC paragraph 740-10-25-54.

### **Example 6.1: Domestic Section 338(g) Election Close to the Date of the Acquisition**

On January 1, 20X3, ABC Corp. acquired the stock of DEF Corp., a domestic entity, in a business combination. Immediately after the acquisition closed and as contemplated at the time of the acquisition, ABC filed a section 338(g) election to treat the acquisition as if it were a taxable transaction thereby obtaining a step-up in tax basis of the acquired assets and liabilities. ABC satisfied the taxes generated by the section 338(g) election by (1) paying \$3,000 cash to the taxing authority and (2) relinquishing \$4,000 in acquired net operating loss carryforwards. The consideration paid to the taxing authority resulted in \$16,000 of tax basis in goodwill. There was no financial statement goodwill recognized in the acquisition accounting and ABC's tax rate is 25%.

In this example, ABC would consider the factors listed in ASC paragraph 740-10-25-54.

ABC concludes that the step-up in goodwill should be accounted for as a separate transaction. In considering the factors, ABC notes that there was little lapse in time between the acquisition and the step-up, the step-up in tax basis was based on a valuation as of the date of the business combination, the step-up was accomplished by a simple tax election, and it contemplated the transaction at the time of the business combination. However, ABC paid consideration to the taxing authority for the benefit, suggesting that the increase in tax basis does not represent an asset acquired in the business combination.

Accordingly, ABC concludes that the tax effects of the section 338(g) election would be accounted for outside of acquisition accounting. Therefore, a \$1,000 deferred tax asset is recognized in acquisition accounting for the acquired net operating loss carryforward and is reversed as part of the accounting for the section 338(g) election below. A deferred tax asset for the tax basis in goodwill generated by the section 338(g) election is recognized as part of the accounting for the election regardless of whether financial statement goodwill exists. ASC paragraph 740-10-25-53 states that transactions directly between a taxpayer and a government should be recorded in income.

ABC records the following entries after acquisition accounting:

	<b>Debit</b>	<b>Credit</b>
Current tax expense	3,000	
Cash		3,000
Deferred tax asset – tax goodwill	4,000	
Deferred tax asset – net operating loss carryforward		1,000
Deferred tax benefit		3,000

### **Example 6.2: Foreign Section 338(g) Election Negotiated in the Business Combination**

On March 20, 20X3, ABC Corp. acquired the stock of DEF, a foreign entity, in a business combination. As part of the negotiations with the seller, the selling shareholders of DEF agreed to accept a portion of the purchase price in cash and the remainder in ABC stock, which makes the transaction a qualified stock purchase. The purchase price is directly affected by the negotiations to achieve a transaction structured as a qualified stock purchase. As a result of the transaction being a qualified stock purchase, ABC filed a section 338(g) election shortly after the acquisition.

ABC concludes that the effects (e.g., deferred taxes for Subpart F income or GILTI) of the step-up, if any, should be accounted for in acquisition accounting because:

- There was not a significant lapse in time between the acquisition and the step-up;
- The step-up was based on the fair value of DEF's assets and liabilities on the acquisition date;
- The step-up required only a simple tax election;
- There was no cash tax cost or sacrifice of existing tax attributes; and
- The transaction was contemplated at the time of the business combination.

### **Example 6.3: Reflecting in the Financial Statements a Section 338(h)(10) Election When the Timing of the Election Is Uncertain**

On December 1, 20X2, ABC Corp. acquires 100% of the shares of DEF. The transaction would be treated as a nontaxable transaction, if no election is made under section 338(h)(10). On the transaction date, ABC anticipates it will elect under section 338(h)(10) of the Internal Revenue Code to treat the transaction as an asset acquisition for tax purposes (thereby causing it to be treated as a taxable transaction) but only if the valuation of the corresponding assets acquired and liabilities assumed support this election. ABC negotiated a specific provision into the executed acquisition agreement stipulating that DEF has consented to a section 338(h)(10) election if ABC chooses to do so (joint election). This provision also quantified the additional consideration that would be provided by ABC to the sellers of DEF if such an election is made.

At the time of the transaction, ABC is not reasonably certain whether the valuation of the corresponding assets acquired and liabilities assumed support such an election. ABC finalizes its valuation and analysis after the balance sheet date but before issuance of the financial statements. ABC will make the section 338(h)(10) election as the final valuation evidences that it would be financially beneficial to ABC.

ABC considered the factors in ASC paragraph 740-10-25-54 and concluded that the election should be accounted for in the acquisition accounting because:

- There was not a significant lapse in time between the acquisition date and the election;
- The step-up in tax basis required only a simple election; and
- There was no cash tax cost or sacrifice of existing attributes.

As the section 338(h)(10) election was contemplated in the acquisition agreement through inclusion of provisions providing that (a) DEF would consent to the election, and (b) additional consideration would be transferred to the sellers of DEF, the election should be reflected in the acquisition accounting when ABC expects that the election will be made. This could be on the date of election if there is significant uncertainty until that date or could be before the date of the election if ABC expects that such

election will be made at that earlier date. For example, in the current fact set, ABC has contemplated the election at the time of the agreement and expects to make the election if the future benefits from the election exceed the additional consideration to be paid to the sellers of DEF on making the election. To the extent the valuation is finalized and ABC plans to make the election, reflecting the effects of the election on the date the valuation is finalized may be appropriate even though it may be some time before the election is actually filed.

As the section 338(h)(10) election is required to be made within 8½ months of the transaction, the adjustment to the provisional amounts recognized in the acquisition accounting resulting from the election generally will be within the measurement period available under ASC Topic 805. Consistent with ASC Topic 805, finalization of the fair value determinations and the resulting effect on the section 338(h)(10) election generally would represent new information obtained about facts and circumstances that existed as of the acquisition date. ASC Topic 805 requires measurement period adjustments that occur after the period of the acquisition to be recognized in the reporting period in which the adjustments to the provisional amounts are determined.

**6.008 Determining Whether Tax Benefits and Tax Uncertainties Are Included in the Acquisition Accounting.** As discussed in the previous paragraphs, tax benefits and tax uncertainties may arise as a consequence of the business combination. ASC paragraph 805-740-25-2 states "An acquirer shall recognize a deferred tax asset or deferred tax liability arising from the assets acquired and liabilities assumed in a business combination and shall account for the potential tax effects of temporary differences, carryforwards, and any income tax uncertainties of an acquiree that exist at the acquisition date, or that arise as a result of the acquisition, in accordance with the guidance in [ASC] Subtopic 740-10 . . ."

**6.009** In accordance with the guidance in the previous paragraph, an acquirer should determine whether tax benefits and tax uncertainties *arise* from the business combination. Consistent with the discussion in Paragraphs 6.006 to 6.007, we believe that tax effects that require agreement of both the buyer and the seller generally are deemed to arise from the business combination. Conversely, tax effects that are a consequence of actions taken unilaterally by the buyer after the business combination generally are deemed not to arise from the business combination and, accordingly, such tax effects are generally recognized in income tax expense rather than as a part of the acquisition accounting.

### **Example 6.4: Section 953(d) Election Treated as a Part of the Acquisition Accounting**

On December 1, 20X3 ABC Corp. acquires 100% of DEF Corp., a Bermuda Insurance Company. As part of the acquisition, ABC plans to elect under section 953(d) of the Internal Revenue Code to treat DEF as a U.S. corporation for tax purposes. Section 953(d) allows an entity to make this election if it is a controlled foreign corporation (CFC) engaged in the insurance business. While there are no other requirements to qualify for the IRC section 953(d) election, the IRS must approve it for it to be effective.

A CFC that so elects will be subject to tax in the United States on its worldwide income but will not be subject to certain branch profits tax, the branch-level interest tax, or the excise tax imposed on policies issued by foreign insurers. The planned election was discussed in joint statements of ABC and DEF and was filed with the IRS on December 2, 20X3, the day after the acquisition is consummated.

As a result of ABC's election of section 953(d), deferred taxes will be recognized on any inside basis differences of DEF based on U.S. tax laws treating DEF as a domestic entity. The section 953(d) election, once approved, will be effective as of the first day of the tax period. In this example the first day of the tax period will revert to December 1, 20X3, the acquisition date (a short period will exist for tax purposes from the acquisition date through December 31 of that year). No taxes were due in connection with the filing.

We believe the IRC section 953(d) election should be accounted for as part of acquisition accounting rather than in post-combination income tax expense. The statements before the acquisition and timing of the filing (i.e., the day after the acquisition closed) indicate that the election was contemplated as part of the plan of acquisition and not based on events related to the period after the acquisition date. Additionally, the effects of the election on approval will be retroactive to the acquisition date. While ABC must get IRS approval (which cannot be done until after the acquisition has been completed), it concluded that such approval was perfunctory because (i) the only criteria for approval of the election by the IRS are objectively determinable (i.e., whether the entity was a controlled foreign corporation and was eligible to file tax returns as an insurance company were tax positions that were highly certain of being sustained on examination), (ii) ABC was not aware of such an election ever being rejected, and (iii) the IRS Manual states that the election can be approved provided the election statement is complete and conforms to the guidelines prescribed in Rev. Proc. 2003-47.

### **Example 6.5: Tax Consequences Resulting from the Transfer of Intellectual Property to a Separate Jurisdiction**

ABC Corp is a non-U.S. entity that has a direct subsidiary, Company S, which is a U.S. entity. ABC acquires Company B (an unrelated U.S. entity that is a business) through the execution of two legal transactions that were negotiated together in contemplation of each other and will close contemporaneously. In step 1, ABC acquires the intellectual property from Company B. In step 2, immediately following step 1, Company S acquires the stock of Company B, which contains the operating assets of the business. The intellectual property is a key value-driver of the business such that the value of the ongoing operations without the intellectual property would be significantly less. After the transactions, ABC is the legal owner of the intellectual property and enters into a licensing agreement with Company S allowing Company S to continue to operate the business under the existing brand. Company S owns Company B as a wholly owned subsidiary.

Because the intellectual property is legally acquired by a non-U.S. entity (ABC Corp), Company S believes there is a significant likelihood that the IRS will challenge the valuation of the intellectual property that was purchased by the non-U.S. entity asserting that an artificially low value was placed on that transaction and will assert an additional tax liability based on a higher assessed value for the intellectual property. The additional tax liability would be legally imposed on Company B as the legal seller of the intellectual property.

In contrast to the current situation, if two unrelated parties entered into a transaction to sell intellectual property on an arms' length basis, it is highly unlikely that the IRS would assert that the sale of the intellectual property was for an amount less than fair value. As a consequence, the uncertainty in the tax position comes from the effective unilateral transfer by the buyer of the intellectual property from Company S to ABC. Because the effective unilateral transfer of the intellectual property is within ABC's control as Company S's parent, and is for the benefit of ABC (rather than for the benefit of the seller), the uncertainty in the tax position does not arise from the business combination and therefore is not accounted for as part of the business combination.

### **Example 6.6: Acquisition of Business in Foreign Jurisdiction Using a New Entity**

As described in Paragraph 6.009, generally the tax benefit from a post-combination legal restructuring is recognized in income tax expense as a post-combination event rather than as part of the acquisition accounting, because the subsequent restructuring is typically undertaken unilaterally by the buyer, and is for the buyer's benefit. However, it may be appropriate to reflect the tax consequences of the subsequent restructuring in the acquisition accounting based on the particular facts and circumstances of the transaction and the jurisdiction's tax laws. We believe it would be appropriate to reflect the tax effects of a post-combination statutory merger in the acquisition accounting when all of the following conditions are met:

- (1) The local tax law requires a post-acquisition statutory merger to establish the tax basis of goodwill (i.e., a direct acquisition of the target would not result in goodwill being taxable);
- (2) Both the buyer and seller are aware of this requirement and as such, this tax benefit is priced into the agreed sales price (evidence to support this might include observed differences in transaction prices for similar arrangements where the tax benefits will not become subsequently available or where the seller agrees to a taxable transaction thereby incurring additional taxes on the sale of the business);
- (3) There are no approvals required to effect the statutory merger;

- (4) There are no fees/taxes that are payable or other economic consideration (e.g., forgoing of tax benefits of existing NOLs) when the statutory merger is effected; and
- (5) The tax basis of the goodwill is established at the acquisition date and is not adjusted for subsequent transactions that occur between the acquisition date and the date the statutory merger is effected (i.e., the tax basis of goodwill exists on a notional basis at the acquisition date and that tax basis is confirmed by the subsequent statutory merger).

**6.009a Determining Whether a Voluntary Change in Tax Status of a Newly Acquired Subsidiary Is Included in the Acquisition Accounting.** As noted in Paragraphs 5.023 to 5.024, voluntary changes in tax status are usually recorded through income tax expense from continuing operations in accordance with ASC paragraphs 740-10-25-32 and 40-6. However, we believe that a voluntary change in tax status of a newly acquired subsidiary may be considered in the acquisition accounting when all of the following conditions are met:

- (1) The change was contemplated as part of pre-acquisition planning of the business combination;
- (2) The change was effective as of the acquisition date;
- (3) The change did not involve a cash tax cost or sacrifice of existing tax attributes (e.g., a net operating loss carryforward);
- (4) There were no significant costs incurred to execute the change; and
- (5) The change does not require more than a simple tax election or the approval of the change by the tax authority is either automatic or perfunctory.

### **Example 6.6a: Voluntary Change in Tax Status of a Newly Acquired Subsidiary Treated as a Part of the Acquisition Accounting**

Company Y acquired Company X on May 17, 20X3. Shortly after closing of the acquisition (June 6, 20X3), Company Y, an S corporation, filed an election to convert Company X from a C corporation to a qualified subchapter S subsidiary. The filing was made with the taxing authority and an acceptance letter is generally received in 60-90 days. Acceptance of such a change is considered perfunctory. On August 19, 20X3, Company Y received a confirmation from the taxing authority that its election was accepted with an effective date of May 17, 20X3.

Company Y concluded that the tax consequences of Company X's S corporation conversion would be reflected in the acquisition accounting because:

- (1) The change in tax status was contemplated as part of the pre-acquisition planning of the business combination;

- (2) The change in tax status was effective as of the acquisition date, therefore Company X will not file a C corporation return for any period subsequent to the close of the acquisition on May 17, 20X7;
- (3) The change in tax status did not involve any compensation paid to tax authorities;
- (4) As the only direct costs related to the conversion were the costs to file the election, there were no significant costs incurred to execute the conversion; and
- (5) The acceptance of the election to convert to an S corporation was perfunctory and was validated within the normal timelines.

**6.009b Involuntary Changes in Tax Status in a Business Combination.** Some business combinations result in an involuntary change in the tax status of the acquiree – e.g., in some acquisitions of an S Corporation by a C Corporation acquirer. In those situations, the acquirer generally recognizes in the consolidated financial statements the acquiree’s newly arising deferred tax assets and liabilities as part of its acquisition accounting. However, the acquiree would recognize in its separate financial statements the newly arising deferred tax assets and liabilities as an adjustment to income tax expense from continuing operations.

**6.009c** If the transaction also involves an increase to the tax basis of the acquired assets and liabilities – e.g., through a section 338(h)(10) election – the acquirer generally recognizes the effect on acquired deferred tax assets and liabilities as part of its acquisition accounting, provided the election was negotiated as part of the consideration transferred (see Paragraph 6.006). When push-down accounting has not been elected, the acquiree generally would recognize in its separate financial statements the changes in deferred tax assets and liabilities resulting from the step-up either in income tax expense from continuing operations or as an adjustment to equity (see Paragraphs 5.028a, 6.117 and 10.148).

## RECOGNIZING AND MEASURING DEFERRED TAXES ARISING IN A BUSINESS COMBINATION

**6.010** The accounting requirements for identifying temporary differences and for measuring deferred tax assets and liabilities are discussed in ASC Topic 740 and apply to acquired assets and assumed liabilities. This subsection discusses the application of those requirements to temporary differences arising from or acquired in a business combination.

**6.011 Applying the Acquisition Method.** The tax effects of acquired temporary differences generally are identified and recognized in the following manner, subject to the guidance and limitations in ASC paragraphs 805-740-25-3 through 25-4, 25-6, and 25-8 through 25-9, 30-1, 30-3, 05-01, 55-2 through 13, 35-2 and 35-3:



- (1) Recognize fair values (ignoring the tax bases) of identifiable assets acquired and liabilities assumed under ASC Topic 805.
- (2) Identify the tax bases of identifiable assets acquired and liabilities assumed based on applicable enacted tax laws and regulations (for nontaxable transactions the tax bases generally will be the carryover bases; for taxable transactions the tax bases will be the stepped-up bases).
- (3) Compare the recognized amounts of the identifiable assets acquired and liabilities assumed with the tax bases to determine temporary differences.
- (4) Recognize deferred tax assets and liabilities for the future tax consequences of the deductible and taxable temporary differences between the recognized amounts and the tax bases.
- (5) Recognize a deferred tax asset for the tax benefits of operating loss and tax credit carryforwards acquired in the combination.
- (6) Recognize a valuation allowance, to the extent necessary, to reduce the acquired deferred tax assets to an amount that more-likely-than-not will be realized in the future by the combined entity. Necessary changes in the acquirer's existing valuation allowances are also evaluated at this time but are not accounted for in applying the acquisition method. See Paragraph 6.039.
- (7) Recognize income taxes payable (receivable) and liabilities or other adjustments for unrecognized tax benefits.
- (8) Recognize initial goodwill as the residual difference between (a) the sum of (i) the consideration transferred, (ii) the fair value of any noncontrolling interest and (iii) the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree (for business combinations achieved in stages) and (b) the acquisition-date amounts of the identifiable assets acquired and liabilities assumed measured under ASC Topic 805, including the deferred tax assets, net of any valuation allowance, and deferred tax liabilities.
- (9) Recognize a deferred tax asset and an adjustment to goodwill for second component tax goodwill, if any. See Paragraph 6.014.

The above steps generally are calculated for each tax-paying component of the entity in each tax jurisdiction as if pushdown accounting is applied (regardless of whether pushdown accounting is actually applied in the separate financial statements of the acquired entity) because that is the basis on which total income tax expense will be calculated after the acquisition.

**Example 6.7: Business Combination Resulting in Recognition of Goodwill**

ABC Corp. acquires 100% of DEF Corp. on January 1, 20X9 for \$200,000 in a nontaxable transaction. ABC has no temporary differences or carryforwards before the acquisition of DEF. The applicable enacted tax rate is 21% for 20X9 and all future years. DEF has no operating loss or tax credit carryforwards. The identifiable assets acquired and liabilities assumed have the following fair values and tax bases:

	Fair Value	Tax Basis	Temporary Difference
Current assets	\$ 50,000	\$ 50,000	—
Property, plant, and equipment	150,000	100,000	\$ 50,000
Current liabilities, excluding deferred taxes	<u>(25,000)</u>	<u>(25,000)</u>	<u>—</u>
Identifiable net assets acquired	<u>\$ 175,000</u>	<u>\$ 125,000</u>	<u>\$ 50,000</u>

The assets acquired and liabilities assumed would be recognized as follows:

Current assets	\$ 50,000
Property, plant, and equipment	150,000
Current liabilities	(25,000)
Deferred tax liabilities	(10,500)
Goodwill	<u>35,500</u>
Consideration paid	<u>\$ 200,000</u>

The deferred tax liability of \$10,500 is the result of the \$50,000 taxable temporary difference between the recognized amount and tax basis of property, plant, and equipment multiplied by the applicable tax rate enacted for the years in which that temporary difference would reverse ( $\$50,000 \times 21\%$ ). Deferred taxes are not recognized on the basis difference related to goodwill in this case as goodwill for financial reporting purposes (\$35,500) exceeds goodwill for tax purposes (\$0). See Paragraph 6.012.

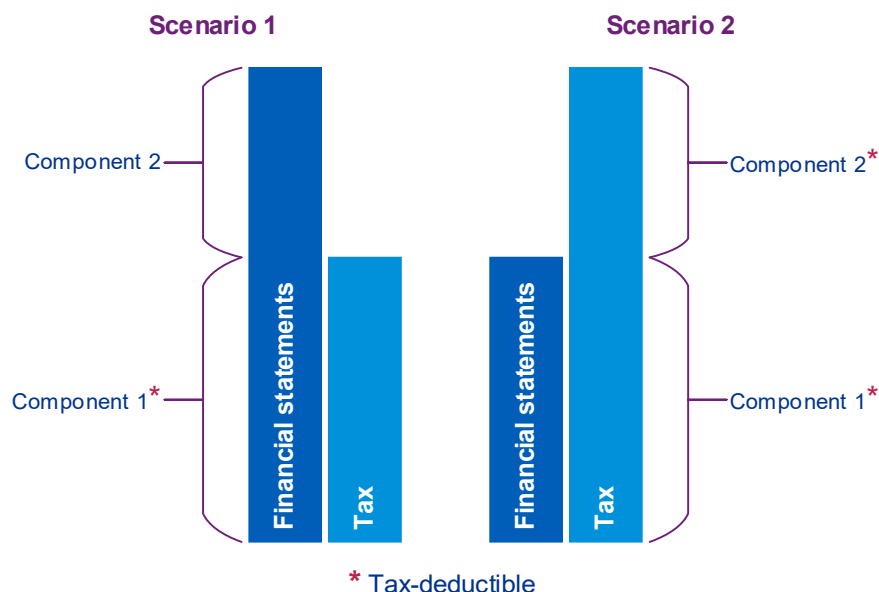
## ACCOUNTING FOR THE TAX EFFECTS OF GOODWILL AT ACQUISITION

**6.012 Accounting for Temporary Differences Related to Goodwill.** Deferred taxes are not recognized at the date of an acquisition for the differences between the tax basis of goodwill and the financial statement carrying amount of goodwill other than the portion of amortizable tax basis goodwill in excess of book basis goodwill (referred to as *second*

*component* goodwill, see Paragraph 6.013). However, even when deferred taxes are not recognized at the date of acquisition they may need to be recognized afterwards as a result of changes in the difference between the tax basis of goodwill and the financial statement carrying amount that arise after the acquisition. How and if those subsequent changes are recognized depends on whether (a) goodwill has a tax basis (i.e., whether goodwill is deductible for tax purposes) and (b) the financial statement carrying amount of the goodwill at the acquisition date is less than, equal to, or greater than the tax basis of goodwill at the acquisition date.

**6.013 First and Second Component Goodwill.** Goodwill is separated into two components to facilitate the accounting for basis differences associated with goodwill. This determination is made in the acquisition accounting and is not subsequently reevaluated. The *first component of goodwill* equals the lesser of goodwill for financial statement purposes and tax-deductible goodwill. In performing this calculation, tax-deductible goodwill includes any carryover basis of tax-deductible goodwill of the acquiree. The *second component of goodwill* is the remainder of any goodwill for financial statement purposes or tax purposes. This is frequently the full amount of the financial statement goodwill for nontaxable business combinations. If the second component of goodwill is ‘excess financial statement goodwill’, it is typically referred to as nondeductible goodwill. If the second component of goodwill is excess tax-deductible goodwill, it is typically referred to as second component tax goodwill. ASC paragraphs 805-740-25-8 through 25-9

**6.013a** The following diagram illustrates two scenarios. In Scenario 1, tax-deductible goodwill is less and is designated as first component goodwill; the excess of financial statement goodwill is second component goodwill. Only the first component is tax-deductible. In Scenario 2, financial statement goodwill is less and is designated as first component goodwill; the excess of tax-deductible goodwill is second component goodwill. Both components are tax-deductible. For nontaxable business combinations – i.e., when the acquiree’s tax bases of the individual assets acquired and liabilities assumed are carried over by the acquiring entity (see Paragraph 6.004) – the first component of goodwill is frequently zero.



**6.013b** In the following example, Situation A summarizes the two components of goodwill assuming total goodwill for financial statement purposes is \$800, but only \$600 of it is tax deductible. Situation B summarizes the two components of goodwill assuming total financial statement goodwill is \$600, but tax-deductible goodwill is \$800. In Situations C and D, all of the goodwill is excess goodwill. In Situation C, it is referred to as nondeductible goodwill whereas in Situation D, it is referred to as second component tax goodwill.

	Situation A		Situation B	
	Financial Statement Carrying Amount	Tax Basis	Financial Statement Carrying Amount	Tax Basis
First component	\$ 600	\$ 600	\$ 600	\$ 600
Second component	200	—	—	200
Total goodwill	<u>\$ 800</u>	<u>\$ 600</u>	<u>\$ 600</u>	<u>\$ 800</u>

	Situation C		Situation D	
	Financial Statement Carrying Amount	Tax Basis	Financial Statement Carrying Amount	Tax Basis
First component	\$ —	\$ —	\$ —	\$ —
Second component	800	—	—	800
Total goodwill	<u>\$ 800</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 800</u>

**6.014 Accounting for First and Second Component Goodwill at the Acquisition**

**Date.** At the acquisition date, no deferred taxes are provided on (a) the first component of goodwill (because by definition no basis difference will exist at the acquisition date), or (b) nondeductible goodwill (i.e., second component financial statement goodwill).

Accordingly, no deferred taxes would be provided at the acquisition date in Situations A and C above. However, deferred taxes should be recognized at the acquisition date for basis differences related to second component tax goodwill, resulting in a deferred tax asset at the acquisition date for Situations B and D above. That deferred tax asset and the reported amount of goodwill associated with the acquisition is determined using a simultaneous equation approach (see Paragraph 6.015 for additional discussion).

**Example 6.8: Financial Statement Goodwill Exceeds Tax Goodwill in a Taxable Business Combination**

ABC Corp. acquires 100% of DEF Corp. in a taxable business combination for \$10,000. Net assets acquired, including identified intangible assets, have a recognized amount of \$7,000 for financial reporting purposes. The tax basis of the net identifiable assets acquired is \$8,000, resulting in \$2,000 of tax-deductible goodwill. Applying ABC's 21% tax rate, a \$210 deferred tax asset is recognized for the \$1,000 basis difference of the identifiable assets acquired (assuming that it is more-likely-than-not that the deferred tax asset will be realized). Recording a \$210 ( $21\% \times [\$8,000 - \$7,000]$ ) deferred tax asset results in recognition of \$2,790 financial statement goodwill ( $\$10,000 - \$7,000 - \$210$ ).

The assets acquired and liabilities assumed are recognized as follows:

	<b>Financial Statements</b>	<b>Tax</b>
Net identifiable assets acquired	\$ 7,000	\$ 8,000
Deferred tax asset	210	—
Goodwill	<u>2,790</u>	<u>2,000</u>
Consideration paid	<u>\$ 10,000</u>	<u>\$ 10,000</u>

Total first component goodwill is \$2,000 (i.e., the lesser of tax-deductible goodwill (\$2,000) and the financial statement carrying amount of goodwill (\$2,790)). No deferred taxes are provided on the second component financial statement goodwill of \$790. Although no deferred taxes are recognized at the acquisition date related to the first component of goodwill because there is no related temporary difference at the acquisition date (first component of goodwill is the same for financial statement purposes and tax), deferred taxes will be recognized in future periods for any difference that arises between the financial statement carrying amount and the tax basis of the first component goodwill (see Paragraph 10.018a for additional discussion).

**6.015 Recognizing Deferred Taxes for Second Component Tax Goodwill at the Acquisition Date.** As described in Paragraph 6.014 a deferred tax asset for second component tax goodwill is recognized in the financial statements at the acquisition date as an acquired deferred tax asset. The recognition of that deferred tax asset for the second component of tax goodwill results in a reduction in the first component of financial statement goodwill. The reduction in the first component of financial statement goodwill increases the second component of tax goodwill (the excess of tax goodwill over financial statement goodwill). To resolve this continuous *loop* and determine the deferred tax consequences of goodwill when tax-deductible goodwill exceeds the financial statement goodwill, a simultaneous equation may be used as follows:

$$\begin{aligned} &\text{Adjustment to Goodwill and Deferred Tax Asset for the Second} \\ &\text{Component of Tax Goodwill} = \\ &\text{Preliminary Temporary Difference (the excess of tax goodwill over} \\ &\text{financial statement goodwill)} \times (\text{Tax Rate} \div (1 - \text{Tax Rate})) \end{aligned}$$

ASC paragraphs 805-740-55-9 through 55-13 illustrate the use of the simultaneous equation in these circumstances. If the adjustments result in goodwill being reduced to zero, it may result in a bargain purchase gain or an increase to the bargain purchase gain. ASC paragraphs 740-10-25-3, 805-740-25-6 and 25-8 through 25-9, 55-9 through 55-13

**6.016** The first step in solving the simultaneous equation is to calculate the last element of the equation ( $\text{Tax Rate} \div (1 - \text{Tax Rate})$ ). As discussed in Paragraph 3.057, if tax rates vary by source of income, an entity should measure deferred tax assets and liabilities by applying the appropriate enacted tax rate based on the expected manner of recovery. Because the accounting for goodwill assumes realization in an indefinite future period through operating the business of the reporting unit to which it relates, the ordinary income tax rate is generally used in measuring deferred taxes on indefinite-lived intangibles and goodwill. For example, assuming that the tax rate is 21% for all future years, the calculation is:

$$0.21 \div (1 - 0.21) = 0.2658227$$

**6.017** The second step to determine the appropriate amount of the final deferred tax asset and the corresponding adjustment to goodwill as originally calculated is done by multiplying the result from the first step (26.58227%) by the preliminary temporary difference (calculated as the excess of tax goodwill over financial statement goodwill, before considering the additional tax benefit associated with reducing the financial statement goodwill). See Example 6.9 for an illustration of the simultaneous equation applied when tax deductible goodwill exceeds goodwill for financial reporting purposes.

### **Example 6.9: Tax Goodwill Exceeds Financial Statement Goodwill in a Taxable Business Combination**

ABC Corp. completes a taxable business combination on January 1, 20X9 that results in tax-deductible goodwill exceeding the financial statement goodwill. At the

acquisition date, the goodwill for financial reporting purposes is \$6,000,000 before computing any deferred taxes related to second component goodwill. The tax basis of goodwill is \$9,000,000. ABC will amortize tax goodwill over three years. ABC's tax rate is 21%.

ABC should, as of the acquisition date, adjust goodwill for financial reporting purposes for the tax benefit associated with the second component tax goodwill by using the simultaneous equation as follows:

$$\text{Total tax benefit to reduce financial statement goodwill} = (\$9,000,000 - \$6,000,000) \times (21\% \div (1 - 21\%))$$

$$\text{Total tax benefit to reduce financial statement goodwill} = \$797,468$$

The goodwill for financial reporting purposes is adjusted as follows:

	Debit	Credit
Deferred tax asset	797,468	
Goodwill		797,468

The goodwill for financial reporting is established at the acquisition date at \$5,202,532 (\$6,000,000 less the \$797,468 adjustment).

A proof of this determination:  $(\$9,000,000 - \$5,202,532) \times 21\% = \$797,468$

Below is a summary of allocation of the first and second component goodwill:

<u>January 1, 20X9</u>			
	<b>Financial Statement Carrying Amount</b>		<b>Tax Basis</b>
First component	\$ 5,202,532	\$	5,202,532
Second component	—	\$	<u>3,797,468</u>
Total goodwill	<u>\$ 5,202,532</u>	\$	<u>9,000,000</u>

At the acquisition date, the deferred tax asset recognized for the second component tax goodwill is \$797,468.

**6.018** A simultaneous equation may need to be modified in certain situations – e.g., to accommodate multiple tax jurisdictions, valuation allowances for acquired deferred tax assets, or the interaction between the acquirer and the acquiree's tax positions. The final differences between the assigned financial statement amounts, excluding second component financial statement goodwill, and tax bases of assets acquired, including second component tax goodwill, and liabilities assumed multiplied by the applicable

enacted tax rate should be used to check the amount of deferred tax assets and liabilities recognized in the acquisition accounting.

**6.019 Recognizing Deferred Taxes for Second Component Tax Goodwill in Multiple Jurisdictions.** The unit of account for determining tax basis in goodwill may vary by jurisdiction. For example, some jurisdictions may assign tax basis in goodwill to legal entities or to trades or businesses. Under ASC paragraph 740-10-30-5, deferred taxes are determined separately for each tax-paying component (an individual entity, or group of entities, that is consolidated for tax purposes) in each tax jurisdiction. Accordingly, an entity also must determine its first and second component goodwill at that level, in consideration of the individual tax-paying entities that generate (or have generated) tax goodwill in their respective tax jurisdictions.

**6.019a** However, ASC Topic 350, *Intangibles—Goodwill and Other*, does not require an acquirer in a business combination to allocate financial statement goodwill on the same basis as ASC Topic 740. ASC Topic 350 requires that goodwill be allocated only to the reporting unit level. If the acquiree includes foreign entities, goodwill and other acquisition accounting adjustments must be attributed to those foreign entities and measured in their functional currencies because ASC paragraph 830-30-45-11 specifies that the foreign currency guidance in ASC Topic 830 applies to assets acquired and liabilities assumed in a business combination, including goodwill. Accordingly, we believe goodwill should be attributed to all the acquiree’s entities (both foreign and domestic) that contain one or more businesses. Conversely, we believe goodwill should not be attributed to an entity that does not contain a business (e.g., a holding company with no operations). This is the case even if the adjustments are not pushed down to the foreign entities’ financial statements (see Section 5 of KPMG Handbook, *Impairment of nonfinancial assets*).

**6.019b** Applying ASC Topics 350 and 830 could result in allocating financial statement goodwill at a different level than where tax goodwill exists. When an entity needs to allocate financial statement goodwill to a lower level than its reporting unit to compute its first and second component goodwill under ASC Topic 740, it should use a methodology that is consistent with the methodology that was used to determine the initial allocation of goodwill to the reporting units for financial statement purposes.

### Example 6.10: Tax Deductible Goodwill in Multiple Jurisdictions

ABC Corp. completes a nontaxable business combination of DEF Corp. on January 1, 20X9. DEF has one reporting unit with two subsidiaries in two different jurisdictions, Subsidiary 1 (U.S.) and Subsidiary 2 (Canada). Total financial statement goodwill for DEF is \$800, of which \$600 relates to the U.S. subsidiary and \$200 relates to the Canadian subsidiary. Additionally, there is \$600 of carryover tax-deductible goodwill, of which \$200 relates to the U.S. subsidiary and \$400 relates to the Canadian subsidiary. ABC determines the first and second components of goodwill as follows:



	U.S. Subsidiary		Canadian Subsidiary	
	Financial Statement Carrying Amount	Tax Basis	Financial Statement Carrying Amount	Tax Basis
First component	\$ 200	\$ 200	\$ 200	\$ 200
Second component	400	—	—	200
Total goodwill	<u>\$ 600</u>	<u>\$ 200</u>	<u>\$ 200</u>	<u>\$ 400</u>

In accounting for this acquisition, ABC recognizes a deferred tax asset for the second component tax goodwill in the Canadian subsidiary even though total financial statement goodwill exceeds tax goodwill.

### 6.020 Accounting for First and Second Component Goodwill after the Acquisition

**Date.** See discussion beginning in Paragraph 10.018a for information about the accounting for first and second component goodwill after the acquisition date.

**Examples 6.11 through 6.14:** Not used.

**6.021 – 6.030** Not used.

**6.031 Bargain Purchase.** A business combination in which the acquisition-date amounts of the identifiable assets acquired and liabilities assumed exceeds the consideration transferred (plus the fair value of the noncontrolling interests and the acquisition date fair value of the acquirer's previously held interests, if any) is referred to as a bargain purchase and results in a gain being recognized by the acquirer at the acquisition date. The bargain purchase gain is determined after the deferred taxes have already been established in acquisition accounting for temporary differences arising from differences in the assigned value for financial reporting purposes. The bargain purchase gain results in an outside basis difference. The tax effects of the resulting outside basis difference, if any, should be recognized outside of the acquisition accounting.

## INTERACTION OF ACQUIRING AND ACQUIRED ENTITIES' TAX POSITIONS

**6.032** Generally, the effects of the acquisition on the acquirer's deferred taxes (e.g., the release of an existing valuation allowance) are recognized as an adjustment to income tax expense or contributed capital under ASC paragraphs 740-10-45-20 and 740-20-45-4 as of the acquisition date while the effects of the acquisition on the acquiree's deferred taxes (e.g., the establishment/remeasurement of a deferred tax asset and related valuation allowance considerations) are recognized as part of acquisition accounting. If the combined entity files a consolidated tax return after the acquisition, deferred taxes should

be calculated on a consolidated tax return basis as of the acquisition date. In these circumstances, consideration should be given to the interaction of the acquirer's and acquired entities' tax attributes (e.g., temporary differences and tax carryforwards) as permitted under the tax law. These interactions may affect the deferred tax consequences recognized as part of acquisition accounting and may result in tax effects recognized in continuing operations. The acquirer may determine that as a result of the business combination it may be able to use the benefit of its tax operating loss carryforwards against the future taxable profit of the acquiree. The resulting reduction in the acquirer's valuation allowance is recognized as an income tax benefit in continuing operations (or credited directly to contributed capital). ASC paragraph 805-740-30-3

**6.033** When determining the total deferred tax consequence of an acquisition (including those effects recognized in acquisition accounting and those recognized in continuing operations at the acquisition date), the entity would likely consider, among other things:

- Will the acquired entity be included in the acquiring entity's consolidated tax return after the acquisition?
- Will the sources of taxable income that support realization of the acquirer's deferred tax assets continue to be available (such as the reversal of existing taxable temporary differences and tax-planning strategies)?
- Will the acquired entity's future taxable income or reversing taxable temporary differences provide sufficient future taxable income to allow the acquirer to reduce its valuation allowance?
- Will restrictions under the tax law limit the realization of the deferred tax assets?
- Will the applicable enacted tax rate used to measure the combined entity's deferred tax assets and liabilities change, if graduated rates are a significant factor in the acquirer's tax jurisdiction?

As discussed in Paragraph 4.020, when considering the sources of taxable income that support realization of the deferred tax assets, all available evidence, positive and negative, should be identified and considered as well as the quality of evidence (i.e., objective versus subjective). See additional discussion of objective evidence at Paragraph 4.026.

**6.034 Recognition of the Tax Consequences Resulting from the Interaction of the Acquiring and Acquired Entities' Tax Positions.** As discussed in Paragraph 6.032, the interaction of the acquiring and acquired entities' tax attributes may affect the deferred tax consequences recognized as part of acquisition accounting and also may result in tax effects recognized in continuing operations or contributed capital of the acquirer. Generally, the effects of the acquisition on the acquirer's existing deferred taxes are recognized as an adjustment to income tax expense or contributed capital under ASC paragraphs 740-10-45-20 and 740-20-45-4 as of the acquisition date. These effects may include a release of an existing valuation allowance, a change in applying the indefinite reversal criterion, a change in other assertions about the acquirer's expected manner of

recovery of its existing deferred tax assets and liabilities, etc. While the change in an existing valuation allowance on a deferred tax asset (see Paragraph 6.036 for additional discussion) is a common consequence when considering the interaction of the acquiring and acquired entities' tax attributes, other consequences may include the elimination of the acquiring entity's outside basis difference in a business combination achieved in stages (see discussion of these transactions beginning in Paragraph 6.065), the change in the applicable tax rate expected to apply when temporary differences are expected to reverse (see Paragraph 6.041 for additional discussion), and the effects of acquired foreign tax credits, particularly when acquiring a foreign branch (see Paragraph 6.129 for additional discussion).

**6.035 Release of Acquirer's Valuation Allowance for Acquisitions Closing before the Financial Statements Are Issued.** As discussed in Paragraph 6.034, the release of an acquirer's existing valuation allowance resulting from the acquisition is recognized as an adjustment to income tax expense or contributed capital under ASC paragraph 805-740-30-3 *as of the acquisition date*. Therefore, if the acquisition closes after the balance sheet date but before the financial statements are issued, the adjustment would not be reflected in those financial statements because the acquisition did not occur in that period (i.e., the closing of the acquisition during the subsequent event period does not permit the acquirer to release the valuation allowance as of the balance sheet date). This guidance is consistent with paragraph B283 in the Basis for Conclusions of legacy FASB Statement No. 141(R), *Business Combinations*, which states that adjustments to the acquirer's valuation allowance are recognized in the period of the business combination. While ASC Topic 740 requires an entity to consider all available evidence when determining the need for a valuation allowance, anticipated business combinations generally are outside an entity's control and, therefore, should not be considered at the balance sheet date even if the uncertainty of the transaction is resolved before the financial statements are issued. ASC paragraphs 855-10-55-2(b)

**6.036 Recognition of the Acquirer's Valuation Allowances at the Acquisition Date and Allocation of Changes.** As discussed in Paragraph 6.033, the determination of the valuation allowance of the acquirer's and acquiree's deferred tax assets on the acquisition date will be affected by whether the acquiree will be included in the entity's consolidated return after the acquisition, as well as the provisions of the tax law. For example, if tax law restricts acquired tax benefits from being recovered only through future taxable income of the acquired entity after the acquisition, only the acquired entity's expected future results of operations and reversal of deferred tax liabilities should be used in determining the need for a valuation allowance on the acquired entity's existing deferred tax assets. A similar situation arises when the combined entity is not permitted to file a consolidated tax return after the acquisition. In those circumstances, taxes payable resulting from the reversal of existing taxable temporary differences of the acquiring entity would not be reduced by reversing deductible temporary differences of the acquired entity if the combined entity is not permitted to file a consolidated tax return. Likewise, when a consolidated tax return is not filed, the acquiring entity would not consider the acquired entity's expected future results of operations in determining the continued need of a valuation allowance on the acquiring entity's existing deferred tax assets and the need for a valuation allowance for all or a portion of its deferred tax assets

existing as of the acquisition date. However, if an entity is permitted to file a consolidated tax return, the possibility of filing a consolidated return may need to be considered in the entity's evaluation of qualifying tax-planning strategies if permitted under the tax law. Limitations under the tax law should also be considered when determining whether it is more likely than not that a deferred tax asset will be realized and a valuation allowance is needed. See Paragraphs 6.100 and 6.100a for discussion about limitations on the use of net operating loss carryforwards.

**6.037** If use of the acquired deductible temporary differences is not restricted, the need for a valuation allowance for both the acquirer's existing deferred tax assets and the newly acquired deferred tax assets should be determined based on the combined entity's past and expected future results to the extent permitted under the tax law. For example, after considering the combined entity's past and expected future results, tax benefits of the acquiring or acquired entity may be recognizable at the acquisition date because of an increase in expected future taxable income. Tax benefits of the acquiring entity that become recognizable at the acquisition date generally are recognized as an adjustment to income tax expense or contributed capital under ASC paragraphs 740-10-45-20 and 740-20-45-4 and tax benefits of the acquired entity that are recognizable at the acquisition date are recognized in acquisition accounting. ASC paragraph 805-740-30-3

**6.038** In assessing the need for a valuation allowance for the combined entity, the acquiring entity considers qualifying tax-planning strategies that the combined entity would be willing to take if necessary to realize a tax benefit that may otherwise not be realized. Tax-planning strategies considered in the valuation allowance assessment at acquisition (and going forward) must comply with the guidance in ASC Subtopic 740-10, *Income Taxes - Overall*, about the accounting for uncertainty in income taxes.

**6.039 Measuring the Acquirer's Change in Valuation Allowance at the Acquisition Date.** The acquirer's deferred tax consequence of an acquisition is generally measured by applying the with-and-without approach (i.e., the difference between the acquiring entity's valuation allowance before the acquisition and the acquirer's valuation allowance after the acquisition). If the combined entity plans to file a consolidated tax return, deferred tax assets of the acquiring entity (e.g., those related to net operating loss carryforwards) that may not have previously been realizable may become realizable based on expectations of future taxable income of the combined entity. The recognition of those benefits (that were not more-likely-than-not of being realized absent the acquisition) generally are recognized as a decrease to income tax expense from continuing operations at the acquisition date under ASC paragraphs 740-10-45-20 and 740-20-45-4. The effects of changes in the valuation allowance for the *acquirer's* deferred tax assets are not included in the acquisition accounting.

**6.040 Reflecting a Change in the Acquirer's Valuation Allowance in Interim Periods.** As discussed in Paragraphs 6.035 and 6.039, changes to the acquirer's valuation allowance on its deferred tax assets that result from the acquisition generally are recognized as an increase or decrease to income tax expense or contributed capital in the period of the business combination. We believe there are two acceptable methods for

reflecting this change in interim period income tax calculations (the choice of which is an accounting policy election that should be consistently applied):

### Method #1

ASC Section 740-270-25 addresses how income tax expense is recorded in interim periods and distinguishes between elements that are considered in estimating the annual effective tax rate applied to year-to-date ordinary income versus those that are recognized as discrete items in the period of occurrence. Discrete items include tax affects arising from *significant unusual or infrequently occurring items*.

Because a business combination is a transaction that generally cannot be anticipated (and cannot be reliably incorporated into the estimated annual effective tax rate calculation), a business combination could be considered to be a significant unusual or infrequently occurring item. Consequently, the release of the valuation allowance as a result of a business combination may be recognized as a discrete item in the interim period of the acquisition.

### Method #2

ASC Section 740-270-30 addresses how a change in a valuation allowance should be recognized in interim periods and distinguishes between valuation allowance changes related to deductible temporary differences and carryforwards originating during the year (which are generally incorporated into the estimated annual effective tax rate), versus those related to judgments about the beginning of the year valuation allowance (which are recognized as discrete items).

Under this view, in the interim period that includes the business combination, the resulting change in the acquirer's valuation allowance may be considered in estimating the annual effective tax rate to the extent the change relates to deductible temporary differences and carryforwards originating during the year, with the remainder recognized as a discrete item in the interim period to the extent the change relates to a change in judgment about the beginning of the year valuation allowance.

See discussion beginning in Paragraph 10.065 for additional information about interim period tax calculations.

### **6.041 Changes in the Acquirer's Tax Rate that Results from a Business**

**Combination.** When considering the interaction of the tax positions of the acquiring and acquired entities, the acquirer may conclude that the estimated applicable tax rate may change due to changes in state apportionment factors or the level of combined income if the acquirer operates in a tax jurisdiction in which graduated tax rates are a significant factor. If so, the adjustment to the existing deferred taxes of the acquiring entity should be recorded at the new tax rate at the date of the acquisition. ASC Topic 740 requires that the effect of the change in tax rate should be recorded as an adjustment to income tax expense in the period of the change and cannot be anticipated (see Paragraph 6.112). As a result, the effect of a change on an acquiring entity's existing temporary differences and carryforwards should be recognized in the period of acquisition. The acquirer may also

need to make adjustments to the estimated annual effective tax rate for current and deferred taxes expected to arise after the change in rate. See Section 5 for additional discussion about the accounting for changes in tax laws and rates.

**6.042 Acquiree's Deferred Taxes.** At the acquisition date, deferred taxes should be recognized for the (a) acquired operating loss and tax credit carryforwards for tax purposes and (b) differences between the assigned amounts for financial reporting purposes and the tax bases of assets acquired and liabilities assumed (except for differences related to the portion of goodwill not deductible for tax purposes, leveraged leases<sup>2</sup>, and acquired differences in ASC Subtopic 740-30, *Income Taxes – Other Considerations or Special Areas*). With limited exceptions, ASC Topic 805 requires that assets acquired and liabilities assumed in a business combination be measured at fair value. A valuation allowance for acquired deferred tax assets is established at the acquisition date if it is more-likely-than-not that all or some portion of the acquired tax benefits will not be realized in the future. ASC paragraphs 805-740-25-3 and 25-4

**6.043** As discussed, on the acquisition date the acquirer considers the interaction of acquiring and acquired entities' tax positions. When determining the measurement of the acquiree's deferred taxes, the acquirer considers its attributes on the measurement of the deferred tax assets and liabilities. For example, an acquirer may not be able to assert the indefinite reversal criterion of ASC Subtopic 740-30 for its acquired subsidiary. Although the acquiree may have previously been able to make such an assertion, deferred taxes related to outside basis differences of acquired investments should be recorded as part of the acquisition accounting.

**6.043a Acquired GILTI When Acquirer Accounts for Related Taxes as a Period Cost.** As discussed in Paragraph 7.087a, under the GILTI regime, a U.S. shareholder has an inclusion in U.S. federal taxable income equal to the excess of the U.S. shareholder's net controlled foreign corporation (CFC) tested income over its net deemed tangible income return. Net CFC tested income is a U.S. shareholder-level calculation based on its CFC's tested income and tested loss. While the GILTI inclusion generally is calculated on an individual U.S. shareholder basis, the regulations require the inclusion to be determined on a consolidated basis for taxpayers that file a consolidated tax return. Under this approach, the tested losses attributable to CFCs owned by one consolidated group member offset tested income attributable to CFCs owned by another member of the group.

**6.043b** In certain situations in which a U.S. parented multinational group is acquired, a CFC's tax year does not terminate even though its U.S. shareholder files a short period return – i.e., while the target U.S. shareholder may join the consolidated U.S. federal income tax filing of the acquirer, the CFC's U.S. federal tax year is not deemed to end at the acquisition date. In such circumstances, the U.S. effects of foreign operations, including GILTI and Subpart F inclusions, are considered to occur on the last day of the CFC's year for U.S. tax purposes. As such, these items are excluded from the target U.S. shareholder's short period return and, instead, the full year of activity (including pre-acquisition period activity) is included in the acquiring consolidated group's U.S. federal income tax return. While the full year of activity will be included in the acquirer's tax

return in the year of acquisition (as if the acquiree had been owned all year), we believe an acquirer that accounts for taxes on GILTI as a period cost should include only the tax effect of post-acquisition GILTI in income tax expense; consequently, it should record the expected tax effect of pre-acquisition GILTI income, losses and credits as current taxes payable or receivable in acquisition accounting.

### Example 6.15: Acquiring a GILTI Tested Loss

ABC Corp., a U.S. entity, operates several domestic subsidiaries that are all included in a consolidated U.S. federal income tax return. ABC also owns CFC 1, which is incorporated in a foreign jurisdiction.

On July 1, 20X1, ABC acquires XYZ, Corp. in a stock acquisition. XYZ, a domestic corporation, operates CFC 2 in a foreign jurisdiction and continues to hold the investment through the acquisition. All entities have a December 31 year-end for both tax and financial reporting purposes, and CFC 2's tax year will not terminate for either U.S. federal or foreign purposes as a result of the acquisition. After the acquisition, XYZ will join the consolidated U.S. federal income tax return of ABC and its subsidiaries.

For 20X1, CFC 1 has tested income of \$1,000 and CFC 2 has a tested loss of \$400, \$250 of which relates to the pre-acquisition period. Assume no foreign tax credit or net deemed tangible return, and that ABC qualifies for a full section 250 deduction.

For the 20X1 U.S. tax year, the \$600 net tested income results in an increase to ABC's U.S. income tax expense of \$63 [ $\$600 \times 10.5\%$ ]. Before the acquisition, the \$1,000 of net tested income from CFC 1 was forecast to result in an increase to ABC's income tax expense of \$105 [ $\$1,000 \times 10.5\%$ ], which ABC included in its estimated annual effective tax rate during the first two quarters of 20X1. As a result, XYZ's 20X1 tested loss results in \$42 of total income tax benefit to ABC.

In its estimated annual effective tax rate for the first two quarters of 20X1, XYZ included a net zero impact to income tax expense (benefit) related to GILTI because a tested loss in isolation will not result in a GILTI inclusion. A tested loss results in a benefit only if tested income is available to offset it.

We believe ABC should record a \$26 ( $\$250$  pre-acquisition tested loss  $\times$  10.5%) current taxes receivable (or a reduction to current taxes payable) on XYZ's opening balance sheet as part of acquisition accounting. The pre-acquisition tested loss provides economic benefit to the combined entity by reducing total income taxes payable for the consolidated group. We believe it would be inappropriate to recognize the \$26 benefit in income tax expense because it arose in the pre-acquisition period and is unrelated to ABC's existing tax attributes and 20X1 pretax income (loss). In addition, because ABC has a policy to reflect the impact of GILTI as a period cost, the benefit should not be characterized as a deferred tax asset.

ABC recognizes the remaining \$16 (\$42 - \$26) of income tax benefit (related to XYZ's post-acquisition tested loss) in consolidated income tax expense (benefit).

**6.044 Uncertainties Related to Income Taxes in a Business Combination.** Tax uncertainties may be assumed from the seller or created by the transaction. The uncertainty in *acquired tax positions* may include questions about the (1) tax bases of the acquired assets and liabilities, (2) existence of acquired carryforwards, (3) sustainability of prior tax-return positions of the acquired entity and the primary obligor for those positions, and (4) tax treatment of acquisition costs. The tax bases used in the calculation of deferred tax assets and liabilities as well as current and noncurrent amounts due to or receivable from taxing authorities related to prior tax returns of the acquired entity are determined pursuant to the provisions of ASC Subtopic 740-10 rather than the amounts reported or expected to be reported on the tax return. Accordingly, deferred tax assets and liabilities should be calculated based on the differences between the assigned amounts for financial reporting purposes and the tax bases as determined using ASC Subtopic 740-10 recognition and measurement principles. ASC paragraph 805-740-25-5

**6.045 Tax Indemnifications.** An entity may enter into an indemnification arrangement whereby the seller of a business will contractually agree to reimburse the acquirer if a tax position taken before the sale is resolved unfavorably with the taxing authority. The acquirer should account for and disclose the income tax uncertainty under ASC Subtopic 740-10 and any rights related to indemnification would be considered separately as an indemnification asset in the acquisition accounting. Under ASC Topic 805, the entity measures the indemnification asset on the same basis as the indemnified item, subject to management's assessment of collectibility and contractual limitations. Subsequent changes to an indemnification asset, including write-off of the receivable due to changes in the seller's creditworthiness, would be recognized in earnings in the period when all or a part of the receivable is deemed uncollectible. See paragraph 10.156 for considerations of indemnifications after a business separation. ASC paragraphs 805-20-25-27 through 25-28, 805-20-30-18 through 30-19, and 805-20-35-4 and 40-3

**6.046** In situations where the indemnification is part of the business combination, it is deemed fully collectible, and the indemnification is not subject to contractual limitations, the amount of the asset is equal to the tax liability at each reporting date. This situation results in a *gross up* of the acquirer's balance sheet because the indemnification asset is recognized separately from the tax liability. Additionally, while any adjustments in the liability and related asset will be equal to one another when there is no adjustment for collectibility or contractual limitations, the adjustments are reported separately in the income statement. In situations in which the indemnification is not part of the business combination, such as an insurance policy purchased by the buyer separately from the business combination, we believe the amount of asset recognized should be limited such that a gain is not recognized. Any adjustment to the income tax liability is reflected in income tax expense for the period, whereas the related adjustment to the indemnification asset is reported as a pretax item.



**6.046a Acquired Tax Receivable Agreements.** As discussed in further detail beginning in Paragraph 9.054, tax receivable agreements (TRAs) are contractual arrangements used in IPO or other transactions in which the historic owners of a business receive the right to a payment for a portion of the benefits from certain tax attributes (e.g., net operating loss carryforwards, a step-up in tax basis). Under a typical TRA, the historic owners will be paid a percentage (commonly 85%) of the benefits realized by the new parent for the tax attributes associated with conditions that existed when control transferred. Because TRAs may remain outstanding for an extended period of time, it is not unusual for an acquiree to have an existing arrangement outstanding at the time it is acquired by another entity. When acquired in a business combination, we believe entities generally measure these obligations either at the undiscounted amount (see Paragraph 9.056a) or at fair value.

### SUBSEQUENT MEASUREMENT AND ACCOUNTING

**6.047 Measurement Period.** The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for the business combination. See discussion of measurement period in Section 10, *Measurement Period*, of KPMG Handbook, *Business combinations*. Provisional amounts are adjusted during the measurement period if new information is obtained about facts and circumstances that existed as of the acquisition date that if known, would have affected the measurement of the amounts recognized. The measurement period extends through the date on which the entity receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. The measurement period cannot exceed one year from the acquisition date.

**6.048** Adjustments to provisional amounts during the measurement period result in increases or decreases in goodwill or identifiable assets or liabilities. For example, an entity may receive additional information during the measurement period related to the fair value of an acquired building. The entity determines that the adjustment should be recorded as part of the acquisition accounting because the information reflects circumstances that existed at the acquisition date. The corresponding adjustment may change the temporary difference related to the building and therefore would change the related deferred taxes. The adjustment to both the provisional amount of the building and the related deferred taxes should be recognized as part of the acquisition accounting and results in an adjustment to goodwill. The adjustments are calculated as if they were known at the acquisition date, but they are recognized in the reporting period in which they were determined. If the adjustments result in goodwill being reduced to zero, it may result in a bargain purchase gain or an increase to the bargain purchase gain.

**6.049** The guidance in Paragraphs 6.047-6.048 also applies to changes in valuation allowances on acquired deferred tax assets and changes of acquired tax uncertainties resulting from new information obtained during the measurement period related to facts and circumstances that existed at the acquisition date. ASC paragraph 805-740-45-2

### Example 6.16: Change in Provisional Amounts Based on Information Received During the Measurement Period

ABC Corp. acquires DEF Corp. on January 1, 20X0 for \$120,000 in a nontaxable business combination. The independent appraisal report for the property, plant, and equipment was not received by the time ABC issued its financial statements for the 3 months ended March 31, 20X0. The provisional fair value amount recognized at the acquisition date included \$60,000 for acquired property, plant, and equipment and \$40,000 for acquired net current assets. For tax purposes, the tax basis of the property, plant, and equipment and the net current assets is \$50,000 and \$40,000, respectively. The applicable enacted tax rate for all future years is 21%.

ABC presents the provisional fair values recognized for financial reporting purposes and the tax bases of assets and liabilities acquired as follows.

	<b>Provisional Fair Values</b>	<b>Tax Basis</b>
Property, plant, and equipment	\$ 60,000	\$ 50,000
Net current assets	40,000	40,000
Goodwill	22,100	—
Deferred tax liability	<u>(2,100)</u>	<u>—</u>
Consideration transferred	<u>\$ 120,000</u>	<u>\$ 90,000</u>

For financial statement purposes, a deferred tax liability of \$2,100 ( $\$10,000 \times 21\%$ ) is recognized for the taxable temporary difference attributable to the excess of the fair value recognized for the property, plant, and equipment for financial statement purposes of \$10,000 ( $\$60,000 - \$50,000$ ) over the tax basis. The recognition of the deferred tax liability results in a corresponding increase in the amount assigned to goodwill.

The property, plant, and equipment is amortized straight-line over ten years for financial reporting purposes and straight-line over five years for tax purposes. There is no tax deductible goodwill.

On September 30, 20X0, during the measurement period, ABC receives the independent appraisal report for the property, plant, and equipment indicating that the fair value at January 1, 20X0, was \$70,000. The tax basis does not change. Additionally, the measurement period ends on September 30, 20X0, the date management determines it has received all the information it was seeking about circumstances that existed as of the acquisition date.

ABC presents the fair values as of the acquisition date for financial reporting purposes and for the tax basis determined at the end of the measurement period as follows.

## 6. The Tax Effects of Business Combinations

	Fair Values	Tax Basis
Property, plant, and equipment	\$ 70,000	\$ 50,000
Net current assets	40,000	40,000
Goodwill	14,200	—
Deferred tax liability	<u>(4,200)</u>	<u>—</u>
Consideration transferred	<u>\$ 120,000</u>	<u>\$ 90,000</u>

For financial reporting purposes, a deferred tax liability of \$4,200 ( $\$20,000 \times 21\%$ ) is recognized for the taxable temporary difference attributable to the excess of the fair value recognized for the property, plant, and equipment for financial reporting purposes of \$20,000 ( $\$70,000 - \$50,000$ ) over the tax basis at the acquisition date. The recognition of the deferred tax liability results in a corresponding increase in the amount assigned to goodwill. The following entries would be recorded during the period including September 30, 20X0 to adjust the provisional amounts.

	Debit	Credit
Property, plant, and equipment	10,000	
Goodwill		10,000
Goodwill	2,100	
Deferred tax liability		2,100
Depreciation expense	750 <sup>1</sup>	
Accumulated depreciation		750
Deferred tax liability	158	
Deferred tax benefit		158 <sup>2</sup>

<sup>1</sup> Additional depreciation expense for nine months  $[(\$70,000 - \$60,000) / 10 \text{ years}] \times 9/12$

<sup>2</sup>  $[(\$10,000 \text{ annual tax depreciation} - \$6,000 \text{ annual accounting depreciation based on provisional amount}) \times 21\%] - [(\$10,000 \text{ annual tax depreciation} - \$7,000 \text{ annual accounting depreciation based final amount}) \times 21\%] \times 9/12 = \$158$ . This amount may also be calculated as the sum of the deferred tax liability as of September 30, 20X0 before the adjustment (i.e., based on the amounts in the provisional purchase price allocation, or \$2,730) and the initial adjustment of \$2,100 to record the deferred tax liability on the \$10,000 adjustment to the fair value of the property, plant and equipment, less the deferred tax liability as of September 30, 20X0 after the adjustment (\$4,672).

**6.050 Changes in Deferred Taxes of the Acquiring Entity.** As discussed in Paragraph 6.034, all changes to an acquirer's deferred taxes as a result of a business combination are recognized outside of acquisition accounting. Therefore, any changes to the acquirer's deferred taxes occurring after the acquisition date are also recorded outside of acquisition accounting.

**6.051 Changes in the Deferred Tax Benefits of the Acquiree's Deductible Temporary Differences, Operating Losses, or Tax Credit Carryforwards Acquired in a Business Combination.** Subsequent recognition or derecognition of the acquired entity's tax benefits are generally reported as a reduction or increase of income tax expense (subject to intraperiod allocation rules, see Paragraph 9.065) if the adjustment is due to events that occurred after the acquisition date. For example, assume that an entity acquires another entity that has an operating loss carryforward. At the date of the acquisition, management concluded no valuation allowance was necessary for the deferred tax asset related to the acquired carryforward. If after the acquisition, management concludes that a valuation allowance is needed for the acquired carryforward, the valuation allowance is recognized as a charge to income tax expense in the period it is determined that the valuation allowance is required. ASC paragraph 805-740-45-2

**6.052** Even if the event that results in the change in a valuation allowance occurs during the measurement period, that change would be reported as a reduction or increase in income tax expense if it relates to events occurring after the acquisition date. For example, at the date of the acquisition, management concluded no valuation allowance was necessary for a deferred tax asset related to an acquired carryforward. However, during the measurement period the entity loses a significant customer which significantly decreases future taxable income that was originally estimated at the acquisition date. As a result, management concludes that the carryforward is not more-likely-than-not of being realized and records a corresponding valuation allowance. Because this change is the result of an event that occurred after the acquisition date, the entity records the adjustment as an increase to current period income tax expense.

**6.053 Other Adjustments during the Measurement Period.** The acquirer recognizes other measurement period adjustments to provisional amounts recorded at the acquisition date in the reporting period in which the adjustments are determined. ASC paragraph 805-10-25-17

**6.054** Adjustments to provisional amounts may directly affect an acquirer's assessment of the realizability of its deferred tax asset existing as of the acquisition date. For example, if adjustments to the fair value of depreciable or amortizable assets during the measurement period result in additional deferred tax liabilities that will support, or partially support, an acquirer's existing deferred tax assets that were previously not determined to be realizable at the acquisition date, an acquirer would reduce the related valuation allowance on its existing deferred tax assets. In the situation in which the acquirer concluded that it was appropriate to reduce the valuation allowance because of the deferred tax liabilities recognized in the acquisition accounting that would reverse before the expiration of the related tax benefits, we believe recognizing the additional deferred tax liabilities resulting from the adjustment to the provisional amounts of the depreciable or amortizable assets directly affects the amount of the adjustment to the acquirer's valuation allowance. Therefore, under ASC paragraph 805-10-25-17, it should recognize the reduction in the valuation allowance with a corresponding adjustment to income tax expense in the reporting period in which the adjustment was determined. In reassessing the realizability of a deferred tax asset that existed as of the acquisition date

as a result of a measurement period adjustment, the entity should only use information that would have existed as of the acquisition date. Subsequent adjustments to the valuation allowance that are not directly related to the measurement period adjustment should not be included in the measurement period adjustment.

**6.055 Changes in Acquired Tax Uncertainties.** The ongoing recognition and measurement of acquired tax uncertainties is subject to the requirements of ASC Subtopic 740-10. Accordingly, new information about the recognition and measurement of such positions should trigger a reevaluation after the acquisition date. The reevaluation could lead an entity to derecognize a previously recognized tax position, recognize a previously unrecognized tax position, or remeasure a previously recognized tax position. After the acquisition date, changes in current or noncurrent income taxes payable and/or deferred tax assets or liabilities that were recognized as of the acquisition date for acquired unrecognized tax benefits are recognized as an adjustment (increase or decrease) to income tax expense. Interest on acquired unrecognized tax benefits that is accrued after the acquisition should be recognized as a post-acquisition expense and classified under the acquirer's policy. ASC paragraph 805-740-45-4

**6.056 Changes in an Acquiring Entity's Valuation Allowance Initially Established on Emerging from Bankruptcy (or a Quasi-Reorganization).** ASC Subtopic 852-740, *Reorganizations – Income Taxes*, indicates that tax benefits realized, through the release of a valuation allowance that originated before fresh-start reporting (i.e., preconfirmation deferred tax assets) after a Chapter 11 Reorganization should be recognized as a reduction to income tax expense. We believe an entity should also apply this guidance when a valuation allowance on preconfirmation deferred tax assets is released in connection with a business combination after application of fresh start accounting. However, such benefits existing as of the date of *quasi-reorganization* should be reported as a direct addition to contributed capital. ASC paragraphs 852-740-45-1, 45-3, 220-10-45-10B

**6.057 Subsequent Changes in Valuation Allowance Caused by a Change in Tax Law.** Changes in the applicable enacted tax law may cause the initial recognition of a tax benefit for acquired deductible temporary differences (by elimination of a valuation allowance). The effect of a change in tax law that results in a change in a valuation allowance that was initially recorded as part of the acquisition accounting in a business combination should be included in income tax expense from continuing operations. Even if the change in tax law occurred during the measurement period, the effect of the change in tax law is included in income tax expense from continuing operations (see Paragraph 6.112a for additional discussion). ASC paragraphs 272-10-60-2, 740-10-25-32 through 25-33, 35-4, 40-6, 45-15, and 45-19

## ACCOUNTING FOR THE INCOME TAX EFFECTS OF REPLACEMENT AWARDS CLASSIFIED AS EQUITY ISSUED IN A BUSINESS COMBINATION

**6.058** When service is required to be rendered by the employees of the acquiree in connection with the acquirer issuing replacement awards, the acquirer determines the portion of the award to attribute to precombination service (and include in the measurement of the consideration transferred in the business combination) and the portion of the award to be attributed to postcombination service (and recognized as compensation cost in the postcombination financial statements). See Section 11, *Determining What Is Part of the Business Combination Transaction*, of KPMG Handbook, *Business combinations*, for additional discussion on the accounting for replacement share-based payment awards in a business combination.

**6.059 Tax Deductible Share-Based Replacement Awards.** If an acquirer issues an equity-classified replacement award that is deductible at the date of exercise (for share options) or at the vesting date (nonvested shares), a deferred tax asset is recognized for the deductible temporary difference that relates to the portion of the award attributed to precombination employee service. For portions of the award attributed to postcombination employee service, a deferred tax asset is recognized in the period that the compensation cost is recognized for financial reporting purposes under ASC Topic 718, *Compensation—Stock Compensation*. After the acquisition, any future tax deduction reported on the tax return for these awards may result in a related tax benefit that exceeds the deferred tax asset recognized for the replacement award for either precombination and postcombination service, or both (the excess tax benefit). This excess tax benefit should be recognized in income tax expense in the income statement in the period the tax deduction is taken on the tax return.

### Example 6.17: Tax Deductible Share-Based Replacement Awards

ABC Corp. acquires DEF Corp. on January 1, 20X8. ABC issues a replacement award of 100 share options with a fair value of \$10 per share option and an exercise price of \$2 to replace share options with a fair value on the acquisition date of \$10 per share option held by DEF employees. The share option replacement awards are nonqualified share options. The original vesting for DEF's awards is graded, with 25% vesting each year. Under the acquirer's existing policy for attributing graded-vesting awards (see discussion in Section 11 of KPMG Handbook, *Business combinations*), \$792 is attributed to precombination compensation cost and is computed as follows:

ABC Corp's Awards Vesting Schedule				
	20X6	20X7	20X8	20X9
Tranche 1	25%			
Tranche 2	12.5%	12.5%		
Tranche 3	8.33%	8.33%	8.33%	
Tranche 4	6.25%	6.25%	6.25%	6.25%
Total	52.08%	27.08%	14.58%	6.25%

Amount attributed to precombination service:

$$\$1,000^1 \times 79.16\%^2 (52.08\% + 27.08\%) = \$792$$

<sup>1</sup> Fair-value-based measure of DEF's award immediately before the acquisition.  
<sup>2</sup> Service rendered as of January 1, 20X8 based on ABC's attribution policy for graded-vesting awards.

At the acquisition date ABC records a deferred tax asset of \$166 ( $\$792 \times 21\%$ ).

ABC records an additional \$44 ( $\$208 \times 21\%$ ) of deferred tax asset in the two years following the acquisition as it recognizes the postcombination compensation cost.

Three years after the acquisition the share options are exercised when the market price of the shares is \$8. ABC receives a \$6 per share option tax deduction ( $\$8 - \$2$ ) and records a tax deduction of \$600 on its tax return that reduces its current taxes payable by \$126 ( $\$600 \times 21\%$ ).

ABC has a deferred tax asset of \$210, but only receives a \$126 tax benefit when employees exercise the award. This results in a deficiency of \$84, which is recognized as income tax expense. ABC records the following entry when the deduction is taken on the tax return:

	Debit	Credit
Current taxes payable	126	
Income tax expense	84	
Deferred tax asset		210

**6.060 – 6.062** Not used.

**6.063 Non-Tax Deductible Awards.** If an acquirer issues replacement awards in conjunction with a business combination that do not result in tax deductions under the current tax law, no deferred tax asset is recognized in the acquisition accounting for the portion of the award related to precombination services, because these awards do not create a future deductible temporary difference. This is the case, for example, for share options that qualify as incentive share options under the United States Internal Revenue Code. Although the acquirer may ultimately realize a tax benefit for these awards as a result of a disqualifying disposition, the acquirer should not anticipate that a disqualifying event will occur as the event is outside the entity's control. Tax benefits that arise because

employees do not comply with the requisite holding periods are recognized in the financial statements only when such events occur.

**6.064 Disqualifying Dispositions of Non-Tax Deductible Awards.** Tax benefits of non-tax deductible awards that subsequently become tax deductible due to an employee's disqualifying disposition should be recognized in income tax expense in the period the deduction is taken on the tax return.

#### **Example 6.18: Disqualifying Dispositions of Non-Tax Deductible Awards**

ABC Corp. acquires DEF Corp. on January 1, 20X8. ABC issues 100 share options with a fair value of \$10 per option and an exercise price of \$2 per option to replace share options with an aggregate fair value on the acquisition date of \$1,000 held by DEF employees. The share option replacement awards are incentive stock options (ISOs), and no deferred tax asset is recorded at the acquisition date for the amount attributed to precombination service. The original vesting for DEF's awards is graded, with 25% vesting each year. \$792 is attributed to precombination compensation cost under ABC's attribution policy for graded vesting awards (see Example 6.17 for computation).

Three years after the acquisition the share options are exercised when their market price reaches \$20 and there is a disqualifying disposition. ABC receives an \$18 tax deduction per share option (\$20 - \$2). ABC's tax rate is 21%.

ABC records the following entry when the deduction is taken on the tax return:

	<b>Debit</b>	<b>Credit</b>
Current taxes payable <sup>1</sup>	378	
Current tax benefit		378

<sup>1</sup>  $(\$18 \times 100) \times 21\%$

Paragraph 740-270-30-8 states that an entity should not include in its estimated annual effective tax rate the tax related to an employee share-based payment award when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes. Accordingly, we believe that \$168 ( $((\$18 - \$10) \times 100) \times 21\%$ ) of the total \$378 tax benefit should be considered a discrete item for interim reporting purposes. We also believe that the \$210 of remaining benefit generally should be considered a discrete item. Even though the \$210 remaining benefit relates to the \$1,000 of recognized compensation cost (\$792 through accrual at the acquisition date and \$208 in the statement of operations (\$208) in the post-combination period), it does not relate to current year operating income and therefore generally would not be considered in the estimated annual effective tax rate.



## A BUSINESS COMBINATION ACHIEVED IN STAGES

**6.065 Tax Consequences of Remeasuring an Existing Equity Investment.** A business combination that is achieved in stages requires the acquirer to remeasure to fair value its previously held equity interest at the acquisition date. Therefore, if an acquirer has an equity method investment and subsequently obtains control of that entity, then the equity investment is remeasured to fair value and any resulting gain or loss is recognized in earnings. That gain or loss calculation would also include reclassification of any amounts that the acquirer previously recognized in accumulated other comprehensive income before the acquisition date (e.g., the investor's share of an equity-method investee's accumulated other comprehensive income related to an unrealized gain or loss on an available-for-sale debt security, cumulative translation adjustment). ASC paragraphs 805-10-25-9 through 10

**6.066** The remeasurement of an existing investment upon obtaining control of the investee increases or decreases the financial statement carrying amount of the parent's previously held investment without a corresponding change in the tax basis. We believe the acquirer would recognize the deferred taxes related to the change in the outside basis of the previously held investment through income tax expense consistent with its recognition of the related gain or loss in earnings, not as part of the acquisition accounting.

**6.067** Similarly, an acquirer would recognize a gain or loss in earnings when it obtains control of an investee in which its previously held investment was accounted for as an available-for-sale debt security under ASC Topic 320, *Investments—Debt Securities*. In that situation, the recognized gain or loss would include a reclassification into earnings of the unrealized gain or loss that previously was recognized in accumulated other comprehensive income. We also believe, like the guidance in Paragraph 6.066, that the acquirer would reclassify the existing deferred taxes related to the unrealized gain or loss of the previously-held available-for-sale security from accumulated other comprehensive income to income tax expense consistent with its reclassification of the related gain or loss into earnings. These amounts would not be part of the acquisition accounting. ASC paragraphs 805-10-25-9 through 25-10

**6.068** Not used.

**6.069 Domestic Subsidiaries Acquired in a Business Combination Achieved in Stages.** The remeasurement of an equity method investment upon obtaining control is recorded in earnings, along with the deferred tax consequences of that remeasurement. The tax effects of the remeasurement thus are not recognized as part of the acquisition method of accounting. Additionally, if applicable, the derecognition of any deferred taxes related to the outside basis of the previously held equity method investment would be recognized outside of the acquisition and as part of income tax expense.

**6.070** ASC paragraphs 740-30-25-7 through 25-8 indicate that no taxable difference arises from an investment in a more-than-50%-owned domestic subsidiary if the tax law provides a means to recover the investment tax-free and the parent entity expects it will

use that means. If these criteria are met, an investor would derecognize a deferred tax liability associated with its investment in an equity method domestic investee if the investee becomes a more-than-50%-owned domestic subsidiary. The elimination of that deferred tax liability would be recorded in income tax expense outside of the acquisition accounting.

**6.071** ASC paragraphs 740-30-25-9 and 25-11 through 25-13 prohibit recognizing a deferred tax asset for a deductible outside basis difference unless it is apparent that the temporary difference will reverse in the foreseeable future. Accordingly, a deferred tax asset that had been recognized by an investor related to an investment in an equity method investee prior to the acquisition of the controlling interest generally would be eliminated when the investee becomes a subsidiary. The elimination of that deferred tax asset would be recorded in income tax expense outside of the acquisition accounting.

### **Example 6.19: Domestic Subsidiary Acquired in a Business Combination Achieved in Stages**

On January 1, 20X9, ABC Corp. purchases 25% of DEF Corp. for \$1,000, which is equal to the tax basis of its investment. The investment is accounted for under the equity method. ABC's income tax rate is 21%.

On January 1, 20X9, ABC records the investment in DEF:

	Debit	Credit
Investment in DEF	1,000	
Cash		1,000

At the end of 20X9, ABC calculates its share of income from its investment in DEF as \$100. On December 31, 20X9, ABC records the equity in earnings of the investee as:

Investment in DEF	100	
Equity earnings		100

ABC also recognizes a deferred tax liability associated with the outside basis difference created by the undistributed equity earnings based on its expected manner of recovery through a sale:

Deferred tax expense	21	
Deferred tax liability		21

On January 1, 20Y0, ABC purchases the remaining 75% of DEF for \$6,000. The fair value of the 25% equity investment is \$1,800. On January 1, 20Y0 ABC remeasures its equity investment to its fair value of \$1,800 and records a gain of \$700 (\$1,800 - \$1,100) as:

	Debit	Credit
Investment in DEF	700	
Gain on remeasurement		700

Assuming the exception in ASC paragraphs 740-30-25-7 through 25-8 does not apply, ABC would also recognize a deferred tax liability associated with the outside basis difference created by the gain on remeasurement:

Deferred tax expense	147	
Deferred tax liability		147

On January 1, 20Y0, after the remeasurement of the equity method investment, but before the application of the acquisition accounting, the book and tax basis of the investment in DEF is:

	Book	Tax
Initial investment in DEF	\$ 1,000	\$ 1,000
Equity earnings	100	—
Gain on remeasurement	700	—
Total	<u>\$ 1,800</u>	<u>\$ 1,000</u>

ABC recognizes a deferred tax liability of \$168 on the outside basis difference of its investment in DEF (\$1,800 - \$1,000) before the acquisition accounting.

If ABC had determined that DEF will be a more-than-50%-owned domestic subsidiary and the exception from recognizing deferred taxes on a taxable outside basis difference of a domestic subsidiary in ASC paragraphs 740-30-25-7 through 25-8 will apply upon the acquisition, the deferred tax on the gain would not be recorded and the existing deferred tax liability of \$21 would be eliminated with a corresponding tax benefit recorded in income.

### 6.072 Foreign Subsidiaries Acquired in a Business Combination Achieved in Stages.

As discussed, the remeasurement of an equity method investment on obtaining control is recorded in earnings, along with any deferred tax consequences of that remeasurement. The tax effects of the remeasurement, if applicable, are not recognized as part of the acquisition accounting.

**6.073** Deferred tax assets and liabilities are recognized for differences between the financial statement carrying amounts and tax basis of an investment in a foreign entity accounted for under the equity method if recovery of the investment will be deductible or taxable, respectively.

**6.074** Not used.

**6.074a**-An entity that has recognized a deferred tax liability for a taxable outside basis difference in its foreign equity method investment will eliminate that deferred tax liability with an adjustment to the income statement if the investee becomes a subsidiary and the investor expects to either apply the indefinite reversal criterion to its taxable outside basis difference under ASC paragraph 740-30-25-17 (APB 23) or expects to recover the investment in a tax-free manner.

**6.075 Inside Basis Difference.** When an entity obtains control of a previously held equity method investee, it accounts for the business combination by applying the acquisition method of accounting under ASC Topic 805. The acquisition method of accounting requires the entity to record and measure all of the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree. Additionally, the acquirer recognizes and measures a deferred tax asset or deferred tax liability arising from temporary differences in the assets acquired and liabilities assumed of the acquired equity method investee. The deferred taxes recognized on the inside basis differences of the assets acquired and the liabilities assumed should be recorded as part of the acquisition accounting. This includes the inside basis difference arising from the portion related to the previously held equity method investment that would not generally get a step-up in tax basis.

**6.076 Investee's Valuation Allowance When Entity Obtains Control of an Equity-Method Investee.** Acquiring an additional interest in an equity method investee such that the investor obtains control over the investee is a business combination achieved in stages. Upon obtaining control of the investee, any valuation allowance recognized in the consolidated financial statements of the investor for deferred tax assets recognized in the acquisition is accounted for subsequently as a valuation allowance recognized at the date of a business combination. Accordingly, the initial recognition of deferred tax assets (by reducing the valuation allowance) for which a valuation allowance was recognized at the date of the business combination (whether the valuation allowance originated before the acquisition of the equity method investment, during the period the investment was accounted for under the equity method, or recognized at the acquisition date of the additional interest causing the investee to be consolidated) should be recognized as a reduction to income tax expense (or a direct adjustment to contributed capital, if applicable) and not as part of the acquisition accounting.

## **BUSINESS COMBINATIONS – SPECIFIC APPLICATION MATTERS**

**6.077** The following paragraphs discuss other matters that should be considered when accounting for income taxes in a business combination and matters that arise in specific circumstances.

**6.078 Contingent Consideration.** A purchase agreement may require the acquiring entity to distribute additional consideration (either assets or equity interests) contingent

on specific events or transactions in the future. Contingent consideration may also be in the form of an acquirer's right to the return of previously transferred consideration if specified conditions are met. ASC Topic 805 requires contingent consideration to be recognized at fair value as part of the consideration transferred at the acquisition date. If contingent consideration is classified as an asset or liability, it is remeasured to fair value through profit and loss each reporting date until the contingency is resolved. Contingent consideration classified as equity is not remeasured and its subsequent settlement is accounted for within equity. See additional discussion on Contingent Consideration at Section 6, *Recognizing and Measuring the Consideration Transferred*, of KPMG Handbook, *Business combinations*. The income tax effects of contingent consideration recognized at the acquisition date will depend on whether the transaction is taxable and whether the contingent consideration is equity- or liability-classified.

**6.079 Acquisition Date Accounting for Tax Consequences of Contingent Consideration in a Taxable Business Combination.** In most circumstances, the amount paid (or a portion of the amount paid) as contingent consideration is not recognizable for income tax purposes until the amount is fixed and determinable (which is typically when paid), whereas the fair value of the contingent consideration at the acquisition date is included in the consideration paid for GAAP accounting purposes. While contingent consideration generally is not recognized for tax purposes until close to, or at, settlement, we believe the acquisition-date fair value of these payments generally should be characterized as tax-deductible goodwill when determining the amount of the first component of goodwill and the second component of goodwill at the acquisition date as discussed in Paragraph 6.013 (even if the amount ultimately is not characterized as goodwill for tax purposes upon resolution of the contingency). The determination of first component and second component goodwill at the acquisition date is not subsequently revised for changes in fair value of contingent consideration.

**6.080 Subsequent Decreases in Measurement of Contingent Consideration That Is Classified as an Asset or a Liability.** If contingent consideration is classified as an asset or liability, it is remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in earnings. In a taxable transaction, the contingent consideration recognized at the acquisition date is characterized as additional tax-deductible goodwill when determining the first and second components of goodwill. A subsequent decrease in the contingent consideration recognized as a credit (increase) in earnings is analogous to a reduction in the basis of tax goodwill resulting from amortization reported on the tax return because in both situations, income reported for financial reporting purposes exceeds income reported on the tax return. If a decrease in the contingent consideration reduces first component tax goodwill, a deferred tax liability is recognized with the related income tax expense reflected in earnings. If the contingent consideration resulted in second component tax goodwill at the acquisition date, a subsequent decrease in the measurement of that contingent consideration results in the reversal of the deferred tax asset first until it is reduced to zero and then a deferred tax liability is recognized. The reversal of the deferred tax asset (or the establishment of a deferred tax liability) is recognized through income tax expense.

**6.081 Liability-Classified Contingent Consideration Subsequent Increases in Measurement.** If the subsequent measurement of contingent consideration results in an increase in a liability-classified contingent consideration recognized in a taxable transaction, the related tax effect (e.g., a deferred tax asset if the increase in the contingent consideration liability is expected to result in future deductions for tax purposes) is recognized in earnings.

### Example 6.19a: Accounting for Contingent Consideration in a Taxable Business Combination

On January 1, 20X8, Company A acquires Company B in a taxable business combination. The terms of the acquisition agreement require Company A to pay additional purchase price to the seller based on Company B's performance relative to an EBITDA target for each of the two years ending December 31, 20X8 and 20X9. Company A appropriately identifies the arrangement as liability-classified contingent consideration and measures the initial liability at \$5,000, its fair value on January 1, 20X8. Company A will remeasure the liability to its current fair value at each reporting date until it is settled. Company A's tax rate is 21%.

Assume goodwill before taking into account any tax implications of the earn-out is as follows:

	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$75,000	\$75,000
Second component	-	25,000
Total goodwill	<u>\$75,000</u>	<u>\$100,000</u>

As discussed in Paragraph 6.079, Company A characterizes the fair value of the contingent consideration as additional tax goodwill to determine the amount of the related deferred tax asset. However, additional tax goodwill from contingent consideration is not recognized and amortized for tax purposes until the contingent consideration is settled.

Goodwill after taking into account future tax implications of the earn-out is as follows:

	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$75,000	\$75,000
Second component	-	30,000
Total goodwill	<u>\$75,000</u>	<u>\$105,000</u>

Company A records the following deferred tax asset for its \$30,000 (\$25,000 + \$5,000) second component tax goodwill, which includes the fair value of the contingent consideration. To measure the deferred tax asset (and corresponding reduction to financial statement goodwill), Company A uses the simultaneous equation (see Paragraph 6.015).

	Debit	Credit
Deferred tax asset	7,975*	
Goodwill		7,975

To recognize the deferred tax asset associated with second component tax goodwill.

$$*\$30,000 \times (21\% \div (1-21\%))$$

Company A's final goodwill after taking into account the tax implications of the contingent consideration and applying the simultaneous equation is as follows:

	Financial Statement Carrying Amount	Tax Basis
First component	\$67,025	\$ 67,025
Second component	-	37,975
Total goodwill	\$67,025	\$105,000

### Scenario 1: Subsequent increases in measurement and settlement of contingent consideration

Year ended December 31, 20X8

At December 31, 20X8, the fair value of the contingent consideration has increased to \$7,000. Company A:

- (1) remeasures the contingent consideration to fair value, and
- (2) establishes a separate deferred tax asset associated with the \$2,000 of tax basis that will be created when the contingent consideration liability is settled.

Company A records the following entry.

	Debit	Credit
Deferred tax asset	420*	
Expense	2,000	
Contingent consideration liability		2,000
Deferred tax benefit		420

To remeasure the contingent consideration liability and the related tax effect

$$*\$2,000 \times 21\%$$

Year ended December 31, 20X9

On December 31, 20X9, Company A settles the contingent consideration liability for \$9,000. Company A records the following (shown in two steps):

Step 1 – Remeasure the liability with the related tax effects

	Debit	Credit
Deferred tax asset	420	
Expense	2,000	
Deferred tax benefit		420
Contingent consideration liability		2,000

To record the increase in fair value of the contingent consideration liability and related tax effect

Step 2 – Recognize the settlement

Contingent consideration liability	9,000	
Cash		9,000

To record the settlement of the contingent consideration liability

When Company A settles the contingent consideration liability, it gets \$9,000 of tax basis that will be amortized as a reduction of taxable income over the remainder of the 15-year period from when the business was acquired. \$5,000 of this tax basis (the amount recognized as a contingent consideration liability in acquisition accounting on January 1, 20X8) has already been characterized as second component tax goodwill for financial reporting purposes. Company A's deferred tax asset for its second component tax goodwill will reverse over the remainder of the 15-year period as Company A takes amortization deductions. As discussed in Paragraph 10.018a, there are two methods Company A may use to recognize the deferred tax effects that arise as that tax goodwill is amortized.

\$4,000 of Company A's tax basis associated with the settlement of the contingent consideration liability (the amount of Company A's remeasurement during the earn-out period) is characterized as a tax-only intangible asset with no related financial statement carrying amount. Company A's related \$840 deferred tax asset ( $\$4,000 \times 21\%$ ) will reverse over the remainder of the 15-year period as Company A takes amortization deductions.

### Scenario 2: Subsequent decreases in measurement

At December 31, 20X8, the fair value of the contingent consideration decreases to \$3,000. Company A:



- (1) remeasures the contingent consideration to fair value, and
- (2) reduces the deferred tax asset associated with the second component tax goodwill that it established on January 1, 20X8. Company A records the following entry.

	Debit	Credit
Contingent consideration liability	2,000	
Deferred tax expense	420	
Income		2,000
Deferred tax asset		420*

To remeasure the contingent consideration liability and the related tax effect

\*\$2,000 × 21%

As described in Paragraph 6.080, the decrease in contingent consideration that results in a credit in earnings is analogous to a reduction in the basis of tax goodwill resulting from amortization.

As discussed in Paragraph 10.018a, there are two methods Company A may use to recognize the deferred tax effects that arise as the tax goodwill is amortized. Company A can either attribute the amortization first to second component tax goodwill (which reduces the deferred tax asset associated with second component tax goodwill that was recognized in acquisition accounting as illustrated above), or attribute the amortization on a pro rata basis between the first and second components of tax goodwill.

On December 31, 20X9, Company A settles the contingent consideration liability for \$3,000. Company A records the following:

Contingent consideration liability	3,000	
Cash		3,000

To record the settlement of the contingent consideration liability

On settlement of the contingent consideration liability, Company A gets \$3,000 of tax basis that will be amortized as a reduction of taxable income over the remainder of the 15-year period. This tax basis has already been (in acquisition accounting), and continues to be, characterized as second component tax goodwill for financial reporting purposes. Company A's related \$630 deferred tax asset ( $\$3,000 \times 21\%$ ) will reverse as Company A takes amortization deductions.

**6.082 Settlement of Equity-Classified Contingent Consideration.** Contingent consideration classified as equity is not remeasured to fair value at each reporting date and the subsequent settlement is accounted for within equity. In a taxable transaction, the equity-classified contingent consideration recognized at the acquisition date is characterized as additional tax-deductible goodwill when determining the first and second components of goodwill as described in Paragraph 6.079. Upon resolution of the

contingency, if the acquirer ultimately settles the arrangement for an amount greater than its acquisition-date fair value and this incremental amount is characterized as tax-deductible goodwill for tax purposes, a deferred tax asset would be recognized outside of the business combination accounting for that increment. If the ultimate settlement amount is less than the contingent consideration's carrying amount, a deferred tax liability should be recognized outside of the business combination accounting to the extent the amount reduces first component tax goodwill. Or, if the contingent consideration originally resulted in second component tax goodwill at the date of acquisition, a subsequent decrease in the amount of the contingent consideration as a result of the ultimate settlement would first reduce second component tax goodwill until it is reduced to zero and then reduce first component tax goodwill. As a consequence, there is a reversal of the deferred tax asset until second component tax goodwill is reduced to zero and then the recognition of a deferred tax liability as first component tax goodwill is reduced.

**6.083** Because equity-classified contingent consideration is recorded directly in equity at the acquisition date as part of the fair value of consideration transferred and is ultimately accounted for within equity on resolution of the contingency, the related tax effects of equity-classified contingent consideration should also be recorded directly in equity. ASC paragraph 740-20-45-11(c) states that the tax effects of "an increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock)" are charged or credited directly to other comprehensive income or to related components of shareholders' equity. As such, we believe that the tax effects of equity-classified contingent consideration arrangements at an amount greater or less than its acquisition-date fair value should be recorded directly in equity.

**6.084 Contingent Consideration in a Nontaxable Business Combination.** In a nontaxable transaction, the contingent consideration recognized at the acquisition date is generally not characterized as tax-deductible goodwill because it typically will not increase the tax basis of the assets acquired and liabilities assumed when settled. Rather, the settlement of the contingent consideration typically increases the outside tax basis of the investment in an amount generally equal to the contingent consideration paid. Therefore, at the acquisition date the acquirer should compute its outside basis difference assuming it will settle the contingent consideration liability at the recorded amount, with a corresponding adjustment to its tax basis. A difference between the actual amount of contingent consideration paid and the original fair value recorded in the acquisition accounting will result in a difference between the financial statement carrying amount and the tax basis of the acquirer's investment in the shares of the subsidiary (outside basis difference). That outside basis difference may be a temporary difference even though that investment account is eliminated in the consolidated financial statements. As part of the acquisition accounting, the acquirer should recognize deferred taxes on the outside basis difference, taking into account the effect of the contingent consideration originally recognized in the acquisition accounting on the outside basis difference, unless the exceptions to recognition of deferred taxes for investments in subsidiaries apply or the acquirer expects to recover the investment in a tax-free manner. In addition, subsequent changes in the fair value of a liability for contingent consideration may further affect the outside basis difference. Whether deferred taxes would be recognized on those changes

will depend on whether deferred taxes are recognized on the outside basis difference. When the subsequent change in fair value affects an outside basis difference for which no deferred taxes are provided, it is recorded in the income statement without a corresponding tax effect.

**6.085** There are certain exceptions to the recognition of deferred taxes for taxable outside basis differences related to investments in subsidiaries. The availability of these exceptions may depend on (1) whether the subsidiary is domestic or foreign, (2) the provisions of the applicable tax law, and (3) the parent entity's plans for reinvestment of undistributed earnings of the subsidiary. Furthermore, deferred tax assets are not recognized for deductible outside basis differences in investments in subsidiaries that are not apparent to reverse in the foreseeable future. ASC paragraphs 740-30-25-3, 740-30-25-5, 25-7 through 25-9, 25-11 through 25-13, 25-17 and 25-18

**6.086 Other Contingent or Nondeductible Liabilities Assumed.** In taxable business combinations, some liabilities of the acquired entity recognized for financial reporting purposes as of the acquisition date, such as liabilities for anticipated settlement of litigation and environmental matters, have no tax basis at the acquisition date. These liabilities may not result in an immediate deduction when they are settled, but instead may be characterized as additional tax goodwill that will provide amortization deductions. Because the tax bases of assets and liabilities should be determined using the provisions of ASC Topic 740, if it is more-likely-than-not that when the liability is paid it will be characterized as tax-deductible goodwill, then the deferred tax assets and liabilities as of the acquisition date should be determined on that basis. Accordingly, when determining the deferred tax effect of the business combination, the determination of the first and second components of goodwill would include the amount that would be added to tax deductible goodwill upon settlement of the liability as described in Paragraph 6.079. In a nontaxable transaction, if settling other assumed or contingent liabilities will result in an increase to the outside tax basis of the acquirer's investment, the acquirer accounts for the related deferred tax consequences similar to how it accounts for the deferred tax consequences of contingent consideration in a nontaxable business combination (see Paragraph 6.084). Otherwise, the acquirer will recognize deferred tax assets for those liabilities in the normal course.

**6.087 Acquirer Acquisition-Related Costs Deductible for Tax.** Under ASC Topic 805, acquisition-related costs are expensed as incurred or as services are received unless the costs are related to the issuance of debt or equity securities. Acquisition-related costs may include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. See Section 11 of KPMG Handbook, *Business combinations*, for additional discussion on acquisition-related costs. For tax purposes, these costs may be immediately deductible, capitalizable, included as part of tax-deductible goodwill, or included in the basis of the shares acquired. The ultimate tax treatment depends on whether the business combination is taxable, if the business combination is ultimately consummated, and various other factors.

**6.088** Generally, acquisition-related costs are tax deductible if the business combination is not consummated. If a business combination is taxable, acquisition-related costs generally will result in future deductions once the business combination is consummated. Acquisition-related costs in a nontaxable business combination often increase the outside tax basis in the investment once the business combination is consummated. When determining the tax effects of the acquisition-related costs, we believe that in the precombination period, an entity should consider the likelihood that the business combination will be consummated. The entity also would consider whether the business combination will be treated as taxable or nontaxable. Therefore, if the entity expected the business combination to be consummated would be taxable, then a deferred tax asset should be established for the acquisition-related costs incurred during the precombination period. Conversely, if the entity expected the business combination to be consummated would be nontaxable, then the acquisition-related costs would result in outside tax basis difference and thus the entity would not establish a deferred tax asset for the acquisition-related costs unless the deferred tax asset is expected to be recognized under ASC paragraphs 740-30-25-9 and 25-11 through 25-13. If a nontaxable business combination is consummated after the balance sheet date but before the financial statements are issued and the entity had initially expected it to be taxable, we believe it should write-off the previously-established deferred tax asset as of the balance sheet date because the subsequent consummation of the nontaxable transaction indicates that recognition of a deferred tax asset is no longer appropriate.

**6.089** Alternatively, an entity could take a position that it cannot assume a business combination will occur because it is not generally within the entity's control. Under that view, because acquisition-related costs generally are deductible if the business combination is not consummated, an entity may recognize a deferred tax asset for those costs because the consummation of a business combination is not anticipated. Subsequently, if a taxable business combination is consummated, the deferred tax asset would not be immediately written off if it will result in future deductions. Conversely, if the business combination is consummated as a nontaxable business combination, the deferred tax asset generally would be written off to earnings on consummation of the business combination (like changes in the acquirer's valuation allowance as described in Paragraph 6.035), unless the deferred tax asset is expected to be recognized under ASC paragraphs 740-30-25-9 and 25-11 through 25-13. The write-off of that deferred tax asset would not have a corresponding pre-tax income amount because the acquirer likely would have already expensed the transaction costs. If the business combination is consummated after the balance sheet date but before the financial statements are issued, we believe an entity applying this policy also may write-off the deferred tax asset as of the balance sheet date because the subsequent consummation of the transaction confirms recognition of the deferred tax asset is no longer appropriate. We believe the use of the approach in this paragraph or the approach in Paragraph 6.088 is an accounting policy election that, once made, should be applied consistently to all acquisitions.

**6.090** In certain circumstances, for tax purposes, acquisition-related costs may result in a separate nonamortizable intangible asset. These intangible assets may only result in a tax deduction upon liquidation or sale of the entity. In this case, although these costs do not become part of the tax basis of the investment, they should be treated similar to outside

basis differences which are also not deducted for tax purposes except upon liquidation or sale of the entity. Therefore, we believe the accounting for the tax benefits of those costs should be analogous to the accounting for outside basis differences and thus it is appropriate to apply the guidance in ASC paragraphs 740-30-25-9 and 25-11 through 25-13 by analogy. A deferred tax asset would not be recognized unless the temporary difference is apparent to reverse in the foreseeable future under ASC paragraphs 740-30-25-9 and 25-11 through 25-13.

**6.091** The deferred tax effects related to acquisition-related costs should always be recognized outside of the acquisition accounting for the business combination irrespective of the fact that those costs may be treated as tax-deductible goodwill for tax purposes. Because acquisition-related costs are not accounted for as part of the acquisition accounting, a deferred tax asset related to acquisition-related costs characterized as tax-deductible goodwill for tax purposes is recognized separately from the acquisition accounting and therefore not included in the determination of first and second component goodwill.

**6.092 Transaction Costs in the Target's Financial Statements.** Transaction costs incurred by the target are expensed as incurred or as services are received unless the costs relate to the issuance of debt or equity securities. For tax purposes, transaction costs not related to the issuance of debt or equity securities may be immediately deductible or capitalizable. The ultimate tax treatment of capitalizable transaction costs depends on whether the business combination is taxable and whether it is ultimately consummated. Generally, capitalizable transaction costs incurred by the target are tax deductible if either the business combination is not consummated or it is taxable. Capitalizable transaction costs that the target incurs in a nontaxable business combination are often permanently nondeductible.

**6.093** When determining the tax effects of the transaction costs, we believe that in the precombination period, the target should recognize a deferred tax asset for all deductible transaction costs incurred. When determining the tax deductibility of the capitalizable transaction costs, we believe that the target should consider the likelihood that the business combination will be consummated, and whether it will be treated as taxable or nontaxable. Therefore, if the target expects either the business combination will not be consummated or a taxable business combination will be consummated, then a deferred tax asset should be established for the capitalizable transaction costs incurred during the precombination period. Conversely, if the target expects that a nontaxable business combination will be consummated and expects the acquisition-related costs would be permanently nondeductible, then it would not establish a deferred tax asset for the capitalizable transaction-related costs under ASC paragraph 740-10-25-30. If a nontaxable business combination is consummated after the balance sheet date but before the financial statements are issued and the target had initially expected it to be taxable, we believe it should write off the previously established deferred tax asset as of the balance sheet date because the subsequent consummation of the nontaxable transaction indicates that recognizing a deferred tax asset is no longer appropriate.

**Example 6.20: Accounting for an Immediate Deduction Taken in Subsidiary Financial Statements When Pushdown Accounting Is Used**

On September 1, 20X7, Company A acquired all of the common stock of Target in a nontaxable transaction. At the date of acquisition, Target had \$175 in existing debt, the terms of which required repayment, including a \$50 penalty, within 30 days after a change in control. Accordingly, Target's debt was paid in full shortly after the acquisition.

Company A's financial statement carrying amount is pushed-down to Target's stand-alone financial statements. Accordingly, Target will present its stand-alone financial statements with a change in basis on September 1, 20X7, with a predecessor period from January 1, 20X7 to August 31, 20X7, and a successor period from September 1, 20X7 to December 31, 20X7.

For tax purposes, Target is required to file two stub period tax returns, one for the period from January 1, 20X7 to August 31, 20X7 and one for September 1, 20X7 to December 31, 20X7. For tax purposes, the \$50 penalty is deductible by Target in its January 1 to August 31 stub period return. However, for book purposes, the \$50 penalty is incorporated into the fair value measurement of the underlying debt recognized as part of the acquisition accounting (see Section 7 of KPMG Handbook, *Business combinations*) and will not be reflected as an expense in the predecessor financial statements.

Target should record a current tax benefit in the predecessor period to recognize this deduction taken on its tax return. However, Target also will need to consider the deferred taxes for the future tax consequence of the deduction recognized in the tax return but not in the financial statements. In preparing its predecessor tax basis balance sheet as of August 31, 20X7, Target now has a debt obligation with a tax basis that is \$50 greater than its book basis due to accruing the \$50 penalty for tax purposes but not book purposes.

Therefore, the penalty results in a temporary difference for Target at August 31, 20X7. Accordingly, for the predecessor financial statements prepared through August 31, 20X7, a deferred tax liability should be established for this taxable temporary difference (i.e., debit deferred tax expense and credit deferred tax liability). The current tax benefit of the tax deduction in the predecessor period is offset by the deferred tax expense resulting from the recognition of the deferred tax liability.

Target will never recognize the penalty as an expense for book purposes in either the predecessor or successor financial statements. Nevertheless, for the predecessor financial statements for the period through August 31, 20X7, there is a temporary difference between what has been recognized for tax purposes and what has been recognized for book purposes and the effect of that temporary difference should be reflected in the predecessor financial statements, in the same period in which the current tax benefit of the penalty is recognized.

**6.094 Common Control Mergers.** Transfers of net assets or exchanges of shares between entities under common control are not business combinations and are generally accounted for similarly to the pooling-of-interest method (as-if pooling-of-interests), whereby the separate financial statements of the combining entities for periods before the combination are restated on a combined basis. ASC paragraphs 740-10-25-3 and 45-21, ASC subparagraph 740-20-45-11(g), ASC paragraphs 740-30-25-18, 805-50-05-4 and 15-6

**6.095** The deferred tax consequences of changes in the tax bases of the combined entity's remaining assets and liabilities caused by the common control merger (excluding changes in tax status, see Paragraph 6.095a) would be included in equity. If the common control merger results in recognition of deferred tax assets from changes in the tax bases of assets and liabilities, valuation allowances initially required upon recognition of those deferred tax assets also would be included in equity. ASC subparagraph 740-20-45-11(g)

**6.095a** Changes in existing valuation allowances due to changed expectations about the realization of existing deferred tax assets, the write-off of existing deferred tax assets that the combined entity no longer expects to realize as a result of the common control merger, and the initial recognition of deferred taxes resulting from a change in an entity's tax status should be included by the combined entity in determining its income tax expense from continuing operations. Generally, changes in valuation allowances occurring in subsequent periods would also be included in the determination of income tax expense from continuing operations. While changes in existing valuation allowances and deferred tax assets are reflected in the relevant historical periods when restating the financial statements on a combined basis (or in future periods for changes in those amounts after the merger), a change in tax status is recognized in the period of the common control merger – i.e., the historical results are not restated.

**6.096** A deferred tax asset is recognized at the time of the transaction for the excess of the tax basis over the financial statement carrying amount of an investment in the stock of a subsidiary only if it is apparent that the temporary difference will reverse in the foreseeable future, generally interpreted in practice to be within one year. Similar to changes in existing valuation allowances due to changed expectations about the realization of deferred tax assets, we believe that the recognition of a deferred tax asset for a previously existing outside basis difference of an investment in the stock of a subsidiary occurs due to the changed expectations about the realization of the deferred tax asset. Therefore, in that circumstance, the tax benefit of the outside basis difference should be recognized in income tax expense from continuing operations.

### **Example 6.21: Accounting for the Change in an Outside Basis Difference Resulting from a Common Control Merger**

A foreign parent has a wholly owned U.S. domestic subsidiary (Subsidiary A). Subsidiary A owns 100% of Subsidiary B, and Subsidiary B previously was included in the consolidated U.S. income tax return of Subsidiary A. Effective July 1, 20X8, Subsidiary B was merged into Subsidiary A. For tax purposes, when Subsidiary B was

liquidated, Subsidiary A received a fair value tax basis in the individual assets and liabilities that were transferred from Subsidiary B as the transaction was a taxable transaction. Subsidiary B recognized a gain for tax purposes on the liquidation and resulting distribution of the assets and liabilities to Subsidiary A. This gain on the transfer will not be eliminated in the consolidated tax return and therefore results in a current tax expense. Subsidiary A's tax basis in the assets and liabilities transferred also is stepped up to fair value from the transaction, while the recorded amounts in the foreign parent's consolidated financial statements of the assets and liabilities continued to be based on the historical carrying amounts because the transaction was a common control merger. Consequently, there are additional temporary differences on the assets and liabilities created by the transaction.

Subsidiary A previously had not recognized a deferred tax asset for the deductible outside basis difference of its investment in Subsidiary B because it was not apparent that the temporary difference would reverse in the foreseeable future in accordance with ASC paragraph 740-30-25-9. As a result of the legal merger, Subsidiary A had a taxable gain and a step-up in the tax basis of the assets and liabilities with respect to its investment in Subsidiary B.

In this situation, the recognition of the tax benefit of the outside basis difference of the investment (i.e., the deferred tax benefit recognized from the step-up in the tax basis of the assets and liabilities) occurred due to the changed expectations about the realization of the deferred tax asset. Therefore, Subsidiary A should recognize this deferred tax benefit as well as the current tax expense from the taxable gain in income tax expense from continuing operations.

**6.097** In some situations, one of the combining entities may have a valuation allowance for deferred tax assets that exists at the merger date. Under ASC Topic 740, if a consolidated tax return is expected to be filed after the merger date, a deferred tax asset may be recognized in certain cases by eliminating either combining entities' existing valuation allowance for deferred tax assets. Those tax benefits may be recognized if the combined entity concludes it is more-likely-than-not that those tax benefits will be realized in the future. (Note that operating losses of one of the combining companies cannot offset taxable income of another combining entity in the restated prior periods because a consolidated tax return cannot be filed for those periods.) Future realization of those tax benefits ultimately depends on the existence of sufficient taxable income within the carryforward period. That taxable income may result from (1) the reversal of the other entity's taxable temporary differences after the merger date (but before the carryforward expires, if the carryforwards have expiration dates), or (2) combined taxable income that is generated after the merger date. Such sources of taxable income may be currently scheduled/forecasted or may result from consideration of qualifying tax-planning strategies. Determined in that manner, the valuation allowance for deferred tax assets of the combined entity may be less than the sum of the valuation allowances in the separate financial statements of the combining entities before the merger date. That tax benefit (i.e., reduction of the valuation allowance) is recognized as part of the adjustment to restate the financial statements on a combined basis for prior periods.



**6.098** Example 6.22 illustrates the effect of recognizing the tax benefits of an operating loss carryforward in the restated periods in a common control merger.

### Example 6.22: Operating Loss Carryforward in Common Control Merger

ABC Corp. and DEF Corp. are both wholly owned subsidiaries of XYZ Corp. and have merged to form Company Q in a common control merger accounted for as an as-if pooling-of-interests on January 1, 20X7, the first day of each entity's fiscal year. Both ABC and DEF applied ASC Topic 740 in their separate financial statements for each year in the three-year period ended December 31, 20X6. The tax rate for all years is 21%. (Assume that the limitations on the use of built-in losses and built-in gains under U.S. tax law are not applicable.)

ABC reported the following amounts in its financial statements for the periods indicated.

	20X4	20X5	20X6
Deferred tax liability	\$ —	\$ 4,200	\$ 6,300
Deferred tax expense	\$ —	\$ 4,200	\$ 2,100

All of ABC's temporary differences are taxable temporary differences. The deferred tax liability of \$4,200 at December 31, 20X5 represents the tax effect of \$20,000 of taxable amounts scheduled to reverse in 20X7 ( $\$20,000 \times 21\%$ ). The deferred tax liability of \$6,300 at December 31, 20X6 represents the tax effect of \$30,000 of taxable amounts scheduled to reverse in 20X7 ( $\$30,000 \times 21\%$ ).

DEF has never had any temporary differences and has an operating loss carryforward for tax purposes of \$30,000 at December 31, 20X6 (\$15,000 arose in 20X5 and \$15,000 arose in 20X6). Without considering the effects of the merger, DEF has recognized a deferred tax asset of \$6,300 and a corresponding valuation allowance of \$6,300 as of December 31, 20X6.

DEF's operating loss carryforward may be used to offset taxable income reported by Company Q in the carryforward period after the merger. As of the merger date, Company Q concludes that a valuation allowance is necessary for the deferred tax asset related to DEF's operating loss carryforward, because the carryforward can only offset taxable amounts resulting from the reversal of 80% of ABC's taxable temporary differences under the provisions of the tax law (see Paragraphs 6.100a and 4.016a for additional discussion of the 80% limitation).

The deferred tax assets and liabilities at December 31, 20X5 are calculated as follows on a combined basis:

- A deferred tax liability of \$4,200 (21% of \$20,000) is recognized for the tax effect of ABC's taxable temporary differences.

- A deferred tax asset of \$3,150 (21% of \$15,000) is recognized for the tax benefit of DEF's operating loss carryforward that arose in 20X5.
- No valuation allowance would be necessary at December 31, 20X5 because \$16,000 of taxable temporary differences expected to reverse in 20X7 (80% of ABC's \$20,000 in total taxable temporary differences) would support full realization of DEF's \$15,000 of total operating loss carryforwards.

A net deferred tax liability and deferred tax expense of \$1,050 (\$4,200 less \$3,150) would be reported in the restated December 31, 20X5 financial statements.

The deferred tax assets and liabilities at December 31, 20X6 would be calculated as follows on a combined basis:

- A deferred tax liability of \$6,300 (21% of \$30,000) is recognized for the tax effect of ABC's taxable temporary differences.
- A deferred tax asset of \$6,300 (21% of \$30,000) is recognized for the tax benefit of DEF's net operating loss carryforward.
- A valuation allowance of \$1,260 ((20% of \$30,000) × 21%) is recognized because only \$24,000 of taxable temporary differences expected to reverse in 20X7 (80% of ABC's \$30,000 in total taxable temporary differences) would be available to support realization of DEF's \$30,000 of total net operating loss carryforwards.

The net deferred tax liability is \$1,260 (\$6,300 deferred tax liability less \$5,040 net deferred asset (\$6,300 - \$1,260)) and the deferred tax expense is \$210 for financial reporting purposes in the restated December 31, 20X6 financial statements.

A comparison of selected amounts on a separate company and combined basis are presented below:

**As of and for the year ended December 31, 20X5**

	<b>ABC Corp. (Separate)</b>	<b>DEF Corp. (Separate)</b>	<b>Company Q (Combined)</b>
Deferred tax asset	\$ —	\$ 3,150	\$ 3,150
Valuation allowance	—	(3,150)	—
Deferred tax liability	<u>(4,200)</u>	<u>—</u>	<u>(4,200)</u>
Net deferred tax asset (liability)	\$ (4,200)	\$ —	\$ (1,050)

## As of and for the year ended December 31, 20X6

	ABC Corp. (Separate)	DEF Corp. (Separate)	Company Q (Combined)
Deferred tax asset	\$ —	\$ 6,300	\$ 6,300
Valuation allowance	—	(6,300)	(1,260)
Deferred tax liability	<u>(6,300)</u>	<u>—</u>	<u>(6,300)</u>
Net deferred tax asset (liability)	\$ (6,300)	\$ —	\$ (1,260)

The recognition of a deferred tax asset for DEF's operating loss carryforward reduced cumulative deferred tax expense of the combined entity by \$5,040 (\$3,150 in 20X5 and \$1,890 in 20X6.)

**6.099** Tax-deductible goodwill may arise in a common control merger treated as a taxable business combination for income tax reporting purposes. Goodwill would not be recorded for financial reporting purposes because of the application of as-if pooling accounting. A deferred tax asset would be recorded with a credit to equity for the entire tax basis of the tax-deductible goodwill, consistent with the accounting for other changes in the tax bases of other assets and liabilities as previously discussed.

**6.100 Change in Estimated Section 382 Limitations.** Some net operating loss carryforwards of acquired entities are limited under section 382 of the Internal Revenue Code. The limitation is generally calculated at the time of the business combination. However, the limitation may be subject to change because of interpretation of the tax law. As discussed in Paragraph 6.044, deferred tax assets, including those related to carryforwards, should be calculated using recognition and measurement principles of ASC Subtopic 740-10 when accounting for tax uncertainties. Accordingly, management should recognize a deferred tax asset (less any necessary valuation allowance) for net operating loss carryforwards if a portion of the carryforwards is more-likely-than-not of remaining after applying section 382, and should measure the recognized deferred tax asset at the largest amount that is greater than 50% likely of being sustained. Subsequent changes in the amount of the deferred tax asset as a result of changes in interpretation of tax law related to the available net operating loss carryforward should be recorded in earnings.

**6.100a Net Operating Loss Carryforwards in the United States.** Before U.S. tax reform was enacted in 2017, net operating losses could be carried back two years and carried forward 20 years. The new law repeals the pre-enactment carryback provisions for net operating losses (except for certain farming losses and net operating losses of property and casualty companies) and provides for the indefinite carryforward for net operating losses arising in tax years ending after December 31, 2017. In addition, net operating losses arising in tax years beginning after December 31, 2017 may offset only 80% of taxable income in a given year. See Paragraph 4.016a for additional discussion.

**6.101 Identifiable Intangible Assets.** Deferred taxes are not recognized on temporary differences related to goodwill for which the amortization is not deductible for tax purposes. That exception does not apply to identifiable intangible assets (e.g., patents, licenses, core deposit intangibles, customer lists, trademarks, franchise agreements, noncompete agreements, reacquired rights, or in-process research and development), even if those assets have indefinite useful lives under ASC Topic 350 or amortization is not deductible for tax purposes. Accordingly, deferred taxes should be recognized on temporary differences related to identifiable intangible assets.

**6.102** In many nontaxable business combinations, there may be no tax basis related to identifiable intangible assets. If there is no tax basis, the amount assigned to an identifiable intangible asset for financial statement purposes represents a taxable temporary difference for which a deferred tax liability should be recognized. If the identifiable intangible asset is assigned a tax basis, for example in a taxable transaction, any difference between the amount assigned to the identifiable intangible asset for financial reporting purposes and its tax basis is also a temporary difference for which deferred taxes should be recognized.

**6.103 Tax-to-Tax Differences in the Shares of an Acquired Subsidiary.** Acquired tax-to-tax differences are differences between an acquiring entity's tax basis in the shares of an entity acquired in a nontaxable business combination and the individual tax bases of the acquired entity's underlying assets and liabilities. ASC paragraph 740-10-25-31 states the excess tax basis of the shares of an acquired entity over the tax basis of the net assets of the acquired entity does not meet the definition of a temporary difference. The ASC Topic 740 definition of a temporary difference includes only differences between the financial statement carrying amount and the tax basis of assets and liabilities. ASC paragraph 740-10-25-31

**6.104 Acquired Deductible Outside Basis Differences of a Subsidiary.** The difference between the acquiring entity's tax basis in the shares of the acquired entity and the financial statement carrying amount of the investment in the subsidiary is a temporary difference under ASC Topic 740 unless the parent expects to recover the investment in a tax-free transaction, even though the acquiring entity's investment account is eliminated in the consolidated financial statements. A deductible temporary difference exists when the tax basis of the investment in the shares of the subsidiary exceeds the financial statement carrying amount of the investment. However, a deferred tax asset is recognized for that deductible temporary difference "only if it is apparent that the temporary difference will reverse in the foreseeable future." ASC paragraphs 740-30-25-9 through 25-13 and 942-740-25-3 through 25-4

**6.105** If the acquiring entity does not initially recognize a deferred tax asset at the date of the acquisition for failure to meet the foreseeable future requirement, but subsequently recognizes that deferred tax asset, we believe that the related benefit should be recorded as a reduction to income tax expense, unless it is considered a measurement period adjustment. See Paragraph 6.047 for discussion of measurement period adjustments.

**6.106 Acquired Taxable Outside Basis Differences of a Domestic Subsidiary.** An excess of a financial statement carrying amount over the tax basis of an investment in a domestic subsidiary may be a temporary difference. However, if the parent expects to recover the investment in a tax-free transaction, as permitted under the tax law, the excess of the financial statement carrying amount over the tax basis is not a taxable temporary difference for which a deferred tax liability should be recognized. See additional discussion of this exception to the recognition of deferred taxes at Paragraph 2.038. ASC paragraphs 740-30-25-7 through 25-8

**6.107** The tax charge from subsequently recognizing a deferred tax liability on an acquired taxable amount related to an outside basis difference of a domestic subsidiary for which a deferred tax liability was not recognized at the date of the acquisition generally should be recognized as a component of income tax expense. ASC paragraphs 740-10-35-4 and 45-15

**6.108 Acquired Taxable Outside Basis Difference of a Foreign Subsidiary.** A deferred tax liability may need to be recognized for the excess of a financial statement carrying amount over the tax basis of an investment in a foreign subsidiary. However, if the parent expects to recover the investment in a tax-free transaction or an entity has specific plans for the subsidiary such that taxation of the outside basis difference will be indefinitely postponed, ASC Subtopic 740-30 does not require the entity to establish the deferred tax liability. The determination of whether a deferred tax liability should be recognized for a taxable outside basis difference in a foreign subsidiary at the combination date should be made by the acquiring entity without regard to the previous assertions of the acquired entity and will depend on whether all or a portion of the difference meets the indefinite reversal criterion of the Subtopic. If the criterion is met, no deferred tax liability would be recorded at acquisition and if the criterion is not met, the deferred tax liability would be established by the acquired entity through acquisition accounting (generally as an increase to goodwill). See additional discussion of the indefinite reversal criterion at Paragraphs 7.004 - 7.007. ASC paragraphs 805-740-25-3 through 25-4

**6.109** Subsequent changes in an entity's assessment of the indefinite reversal criterion are accounted for as an adjustment of income tax expense in the period of change. For example, if a deferred tax liability is not recognized upon consummation of a business combination because of the application of the ASC Subtopic 740-30 exception, subsequent recognition of a deferred tax liability due to a change in circumstances should be recognized as a component of income tax expense. ASC paragraphs 740-30-25-17 and 25-19, and 45-2

**6.109a Acquired Temporary Differences That May Meet ASC Topic 740 Recognition or Scope Exceptions.** As discussed in Paragraphs 6.104 through 6.109 in the context of certain outside basis differences, the acquiring entity should consider and apply the guidance about the recognition of deferred taxes provided for under ASC Subtopic 740-30 and ASC paragraphs 740-10-25-3, 740-10-15-4 and 942-740-25-1 (if applicable) to basis differences acquired in a business combination. For example, no deferred tax liability is recognized under ASC Topic 740 for acquired pre-1988

deductions that are subject to recapture, unless it becomes apparent that the tax will be recaptured in the foreseeable future. That exception to recognizing a deferred tax liability for pre-1988 bad debt reserves generally also applies to acquired pre-1988 bad debt reserves. In some cases, however, pre-1988 deductions are recaptured as a result of the acquisition (e.g., if an acquired thrift institution was converted to a bank). In those circumstances, a deferred tax liability should be recognized in acquisition accounting. If a deferred tax liability for acquired pre-1988 bad debt reserves is recognized after the acquisition, a charge to income tax expense should be recognized.

**6.110 Leveraged Leases.** According to ASC paragraph 840-30-30-15, the amount assigned to leveraged leases acquired in a business combination should take into account the estimated future tax effects of remaining future cash flows (a net-of-tax approach). Therefore, according to ASC subparagraph 740-10-25-3(c), deferred taxes should not be established for temporary differences related to acquired leveraged leases as of the acquisition date. ASC paragraphs 840-30-30-15, 840-30-45-6 through 45-7, 840-30-55-17 through 55-18, and 55-39 through 55-46

**6.111** In February 2016, the FASB issued ASU 2016-02, *Leases*. The new standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date.

**6.112 Anticipated Changes in Applicable Enacted Tax Rates.** The future enactment of a change in tax rates may not be anticipated when measuring deferred taxes. Accordingly, deferred tax assets and liabilities should be measured based on rates enacted at the business combination date even if expected tax rate changes were considered in negotiating the consideration transferred or a change in tax rates was enacted after the acquisition date but during the measurement period. ASC paragraphs 740-10-25-2 and 30-2, 35-4, and 45-15

**6.112a Changes in Applicable Enacted Tax Rates during the Measurement Period but after Consummation of the Business Combination.** Changes in deferred tax assets and liabilities as a result of a change in applicable enacted tax rates after the consummation of a business combination should be recognized as a component of income tax expense even if the measurement period for the business combination has not ended. If an entity makes business combination measurement period adjustments in reporting periods after the enactment of a new tax rate and those adjustments relate to a business combination that was consummated before the change in tax rate, we believe it should compute the measurement period adjustments to the acquired assets, liabilities and goodwill based on the enacted tax law as of the acquisition date. Then, outside of the business combination accounting, the entity should make the necessary adjustments to the resulting deferred tax accounts for the change in tax law with a credit or charge to income tax expense (benefit) in the period the adjustment is identified. That adjustment is not considered when estimating the annual effective tax rate.

**6.113** Not used.

**6.114 Anticipating an Intra-entity Transfer of Assets When Measuring Acquired Assets and Liabilities.** The income tax effects of an intra-entity transfer of assets should be accounted for as a separate transaction even if the transfer was contemplated at the time the business combination was consummated. Accordingly, if the transaction is a transfer of inventory, the taxes paid and the reversal of deferred tax assets or liabilities in the seller's jurisdiction should be deferred and recognized when the inventory is sold outside the consolidated group rather than reflected as part of the acquisition accounting. If the transaction is a transfer of an asset other than inventory, the acquirer immediately recognizes the current and deferred income tax consequences of the transaction outside acquisition accounting.

**6.115 LIFO Inventories.** In a nontaxable business combination, the acquiree's tax basis in LIFO inventory immediately before acquisition is carried over. Differences between the financial statement carrying amount and tax basis of LIFO inventories arising in a business combination are temporary differences for which deferred taxes must be recognized. In a taxable business combination, inventory generally is recognized at fair value for both financial statement and tax purposes, and therefore there may be no temporary difference on which to recognize deferred taxes.

**6.116 Prohibition Against Discounting.** ASC Topic 740 prohibits discounting deferred taxes. Deferred tax assets and liabilities may not be discounted. ASC paragraph 740-10-30-8

**6.117 Tax Effect of a Change in Tax Basis on Subsidiary Financial Statements When Pushdown Accounting Is Not Used.** An acquirer may elect to not push down the tax effects of an acquisition to the stand-alone financial statements of the acquired entity. Depending on the nature of the acquisition, the tax basis of the individual assets and liabilities of the acquired entity may change, even when the acquisition accounting entries have not been pushed down to the acquiree's stand-alone financial statements. The change in the tax basis of the acquired entity's assets and liabilities results in adjustments to deferred taxes in the stand-alone financial statements of the acquired entity. The effects of the adjustment are recognized as an adjustment to additional paid-in capital, if it is not part of a change in status of the acquiree. If it is part of a change in status, the effects of the adjustment are recognized either in income tax expense from continuing operations or equity. See Paragraph 5.028a for additional discussion. ASC paragraphs 740-20-45-11(g) and 805-740-25-13

**6.118** A valuation allowance recorded as of the acquisition date for the newly created deferred tax assets should also be recognized with an adjustment to equity (or in income tax expense from continuing operations, if it is part of a change in status). However, a subsequent change to the valuation allowance or a change in the valuation allowance for existing deferred tax assets (including the write-off of existing deferred tax assets that the acquired entity can no longer realize as a result of the business combination) should be recognized as a component of income tax expense from continuing operations. ASC paragraph 740-10-45-21 and subparagraph 740-20-45-11(g)

### **Example 6.23: Temporary Difference Related to Second Component Goodwill in the Separate Financial Statements of an Acquired Entity When Pushdown Accounting Is Not Applied**

Company A acquires Company B, which includes Subsidiary C, in a transaction that constitutes a business combination. Following the acquisition, Company A, Company B, and Subsidiary C are included in one consolidated income tax return. Subsidiary C is a nonpublic company with a contractual requirement to issue separate audited financial statements. Company C elected not to apply pushdown accounting for its separate financial statements under the Pushdown Accounting Subsection of ASC Subtopic 805-50, *Business Combinations – Related Issues*. However, Company A made an election in connection with the transaction that resulted in tax deductible goodwill attributable to Subsidiary C. Because Subsidiary C's tax deductible goodwill exceeds its financial statement goodwill of \$0 (due to not applying pushdown accounting), there is second component tax goodwill for Subsidiary C. This second component tax goodwill creates a temporary difference as of the acquisition date.

We believe Subsidiary C should recognize the deferred tax asset associated with the second component tax goodwill at the date of acquisition with a corresponding credit to its additional paid-in capital.

Under this approach, changes to the deferred tax asset resulting from subsequent amortization of the tax deductible goodwill would result in deferred tax expense, which would be offset by the current tax benefit attributable to the deduction taken on the tax return. As a result, there would be no net effect on Subsidiary C's effective tax rate following the business acquisition for the second component tax goodwill amortization.

#### **6.119 Acquisition of Tax-Deductible Goodwill in a Nontaxable Business**

**Combination.** In certain nontaxable business combinations, the acquired entity has tax-deductible goodwill from a prior acquisition for which the acquiree receives carryover tax basis. The financial statement and tax basis of goodwill for determining first and second components of goodwill should be determined without regard to the source (current or prior acquisition) of the goodwill. Accordingly, the existence of tax-deductible goodwill from a prior acquisition reduces the amount of nondeductible goodwill otherwise calculated as part of the current acquisition accounting. The acquired tax-deductible goodwill represents first component goodwill when the acquired tax goodwill is less than financial statement goodwill. The entire financial statement goodwill is tax-deductible goodwill (i.e., first component goodwill) and the excess tax-deductible goodwill is second component tax goodwill if the acquired deductible goodwill exceeds the financial statement goodwill. ASC paragraphs 805-740-25-8 through 25-9

**6.120 In-Process Research and Development (IPR&D).** ASC Topic 805 requires all intangible assets acquired to be measured at fair value. In addition, ASC Topic 350 requires intangible assets acquired in a business combination that are used in research and development activities (regardless of whether they have alternative future use) to be



considered indefinite lived until the completion or abandonment of the associated research and development activities. Under ASC Topic 350, those assets classified as indefinite lived are not amortized but are tested for impairment under ASC Topic 350. Once the development effort is completed, the useful life of the asset is determined based on the guidance in ASC paragraph 350-30-35-3 and the IPR&D asset recognized in acquisition accounting is amortized over its estimated useful life.

**6.121** In a business combination an entity recognizes deferred taxes for IPR&D if the amount recorded for financial statement purposes differs from the tax basis.

**6.122** If a business combination results in recognition of IPR&D for accounting purposes, that IPR&D may be classified as an identifiable intangible asset for tax purposes or as tax goodwill. If the IPR&D is classified as tax goodwill, the tax basis of the IPR&D is considered to be zero and tax-deductible goodwill will be increased for the amount assigned to IPR&D for financial reporting purposes; thus, it should be considered in determining first component and second component tax goodwill. If that is the case, because the tax basis of the IPR&D is zero, an entity should record a deferred tax liability for the temporary difference related to IPR&D. Additionally, a deferred tax asset would be recognized on the second component tax goodwill.

**6.123** After initial recognition, acquired IPR&D is classified as an indefinite-lived intangible asset and subject to annual impairment testing until development is completed or abandoned. While the IPR&D is still being developed and considered to be an indefinite-lived intangible asset, any related deferred tax liability (recognized at the acquisition date or in subsequent periods as the asset is amortized for tax purposes) may not be a future source of taxable income for the realization of deferred tax assets with expiration dates because the timing of the reversal of the related deferred tax liability may be expected to be after the deferred tax asset expires. We believe an entity should schedule the reversal period of the deferred tax liability related to the IPR&D based on the estimated remaining development period plus the estimated useful life after completion in assessing the realizability of deferred tax assets. In some cases, an entity can reliably estimate the remaining development period, but the estimated useful life is contingent on future events – e.g., failure to obtain regulatory approval of a drug candidate may result in abandoning the IPR&D. In those cases, we believe an entity would base its expectation of the reversal period on the current facts and circumstances associated with the asset. For example, if the entity expects the temporary difference to reverse in five years, but there is uncertainty about whether it will do so through use or abandonment, we believe it schedules the reversal over the five-year period. We believe it would be inappropriate to simply default to reversal in the indefinite period just because there is uncertainty about the nature of the reversal.

**6.124 Recognizing the Tax Effects of the Effective Settlement of a Preexisting Relationship in a Business Combination.** Preexisting relationships between the acquirer and acquiree should be identified and assessed to determine whether they have been effectively settled as a result of the business combination transaction and should therefore be accounted for separately from the business combination. Because the acquirer consolidates the acquiree following a business combination, preexisting relationships are

generally effectively settled as a result of the combination (i.e., following the business combination, such transactions are eliminated in the postcombination consolidated financial statements). See Section 11 of KPMG Handbook, *Business combinations*, for additional guidance on accounting for the settlement of a preexisting relationship in a business combination. ASC paragraph 805-10-55-21

**6.125** A preexisting contractual relationship effectively settled as a result of a business combination is measured under ASC paragraph 805-10-55-21, and the difference between the amount so measured and any amounts previously recognized by the acquirer are recognized as a gain or loss at the acquisition date. An entity also should record the tax effects of the settlement outside the business combination.

**6.126** Examples 6.24 and 6.25, which are based on Example 2 in ASC paragraphs 805-10-55-30 through 55-32, illustrate the accounting for the effective settlement of a supply contract as a result of a business combination. These examples have been modified to illustrate the accounting for the tax effects for the settlement of a preexisting relationship and for the change in the U.S. tax rate enacted in 2017.

#### **Example 6.24: Effective Settlement of a Supply Contract as a Result of a Business Combination**

ABC Corp. purchases electronic components from DEF Corp. under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than rates at which ABC could purchase similar electronic components from another supplier. The supply contract allows ABC to terminate the contract before the end of the initial 5-year term only by paying a \$6 million penalty. With 3 years remaining under the supply contract, ABC pays \$50 million to acquire DEF's assets and liabilities in a taxable business combination, which is the fair value of DEF based on what other market participants would be willing to pay.

Included in the total fair value of DEF is \$8 million related to the fair value of the supply contract with ABC. The \$8 million represents a \$3 million component that is *at-market* because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships, and so forth) and a \$5 million component for pricing that is unfavorable to ABC because it exceeds the price of current market transactions for similar items. DEF has no other identifiable assets or liabilities related to the supply contract, and ABC has not recognized any assets or liabilities related to the supply contract before the business combination.

In this example, ABC recognizes a loss of \$5 million (the lesser of the \$6 million settlement provision stated in the contract and the amount by which the contract is unfavorable to the acquirer) separately from the business combination. The \$3 million at-market component of the contract is part of goodwill.

The fair value of the net tangible assets is \$35 million. While the loss of \$5 million is accounted for separately from the business combination for financial reporting

purposes, it will generally be included as part of the tax basis for tax purposes. The tax rate is 21%. The net tangible assets and goodwill have the following recognized amounts for financial reporting purposes and tax bases in millions:

	<b>Fair Value</b>	<b>Tax Basis</b>
Net tangible assets	\$ 35	\$ 35
Goodwill	<u>10</u>	<u>15</u>
	<u>\$ 45</u>	<u>\$ 50</u>

ABC records the following entries at the acquisition date to record the business combination (in millions):

	<b>Debit</b>	<b>Credit</b>
Net tangible assets	35	
Goodwill	10	
Cash		45
Loss on settlement of a preexisting relationship	5	
Deferred tax asset	1	
Deferred tax benefit		1
Cash		5

Because the settlement of the preexisting relationship is not accounted for as part of acquisition accounting, a deferred tax asset related to \$5 million of the total tax basis in goodwill of \$15 million is recognized as the tax effect of the loss on settlement of a preexisting relationship and results in a \$1 tax benefit accounted for outside of the acquisition accounting. The determination of first and second component goodwill only considers \$10 million of the total tax basis in goodwill and results in no deferred tax amount in the acquisition accounting journal entry.

### **Example 6.25: Effective Settlement of a Contract between the Acquirer and Acquiree in Which the Acquirer Had Recognized a Liability before the Business Combination**

Assume the same facts as in Example 6.24, except that ABC Corp. recognized a \$6 million liability for the supply contract before the business combination. In that situation, ABC recognizes a \$1 million settlement gain on the contract in earnings at the acquisition date (the \$5 million measured loss on the contract less the \$6 million loss previously recognized). In other words, ABC has, in effect, settled a recognized liability of \$6 million for \$5 million, resulting in a gain of \$1 million.

ABC records the following entry at the acquisition date to record the business combination (in millions):

	Debit	Credit
Net identifiable assets	35	
Goodwill	10	
Cash		45
Liability	6	
Cash		5
Gain on settlement of a preexisting relationship		1

ABC records the following entry at the acquisition date to record the reversal of the deferred tax asset related to the \$6 million liability related to the supply contract (in millions) and the origination of the deferred tax asset for the \$5 million of tax-deductible goodwill:

Income tax expense	0.21	
Deferred tax asset - goodwill	1.05	
Deferred tax asset - liability		1.26

The tax effect of the gain on settlement of a preexisting relationship of \$1 million results in a \$0.21 tax expense accounted for outside of the acquisition accounting.

**6.127** Not used.

**6.128 Measuring Tax Bases When a Final Tax Return Is Not Filed.** Acquired deferred tax assets and liabilities should be measured at the acquisition date determined for financial reporting purposes, which may require an entity to estimate the tax bases of the acquired assets and liabilities when a tax return is not filed by the acquired entity as of the acquisition date. For example, the most recently filed tax return for an entity acquired in a stock acquisition on June 8, 20Y0 may be as of December 31, 20X9. Regardless, acquired deferred tax assets and liabilities should be measured using the financial statement carrying amounts and the tax bases of the acquired assets and liabilities as of June 8, 20Y0.

**6.129 Acquiring a Foreign Branch.** The income or loss of a U.S. entity's foreign branch is included in the U.S. entity's U.S. tax return in the period the income or loss is earned. Accordingly, a foreign branch's basis differences may result in a deferred tax consequence in both the foreign tax jurisdiction and the U.S. tax jurisdiction, both of which should be reflected in the acquisition accounting. When calculating the total tax effect of basis differences, the entity should consider all relevant provisions of the tax law in both jurisdictions, such as the availability of foreign tax credits/carryforwards (or deductions, if the entity expects to deduct foreign taxes as opposed to using foreign tax credits) and withholding taxes. See discussion about measuring the U.S. federal effect of

foreign branch temporary differences beginning at Paragraph 7.068. ASC paragraph 740-10-55-24

### Example 6.26: Acquisition of a Foreign Branch

On January 1, 20X7, ABC Corp., a U.S. corporation, acquires Foreign Target in Country A in a taxable business combination for \$2,500. Before negotiating the business combination, the previous owners of Foreign Target elected to check-the-box so that Foreign Target was and will continue to be treated as a foreign branch for U.S. tax purposes. For U.S. tax purposes the tax basis of the assets acquired and liabilities assumed are stepped up to fair values. No such step-up in basis occurs for Country A tax purposes. ABC expects to claim a credit for foreign taxes incurred by Foreign Target. The financial statement carrying amounts and tax bases are as follows:

	<b>Financial Statement Carrying Amount</b>		<b>Tax Basis: United States</b>		<b>Tax Basis: Country A</b>
Fixed assets	\$ 150	\$	150	\$	150
Intangibles	\$ 600	\$	600	\$	—
Goodwill	\$ 1,750	\$	1,750	\$	—

Assuming the tax rate in Country A is 15% and the tax rate in the United States is 21%, ABC would recognize the following deferred taxes in acquisition accounting:

- Establish a Country A deferred tax liability for \$90 ( $\$600 \times 15\%$ ).
- Establish a U.S. deferred tax asset for \$19 related to the federal tax effect of the foreign tax associated with the Country A deferred tax liability. The acquisition of Foreign Target is a transaction subject to section 901(m), *Denial of Foreign Tax Credit With Respect To Foreign Income Not Subject To United States Taxation By Reason Of Covered Asset Acquisitions*. Section 901(m) essentially disallows foreign tax credits for foreign taxes imposed in excess of what would have been imposed if the foreign country provided for a basis step-up on the assets, and the resulting increase to depreciation and amortization deductions. However, the disallowed foreign tax credit can be claimed as a deduction. Therefore the benefit is limited to \$19 ( $\$90 \times 21\%$ ).

During 20X7, Foreign Target breaks even for U.S. GAAP reporting purposes. At the end of 20X7, assuming a 10-year tax life for all assets in the United States and Country A and a 10-year financial statement life for fixed assets and intangibles, ABC would record the following entries:

	Debit	Credit
Current tax expense (Country A)	9	
Current tax payable		9
To recognize one year of taxable income in the Country A (\$60 of taxable income in Country A due to \$60 less depreciation expense for tax purposes).		
Deferred tax liability (Country A)	9	
Deferred tax benefit		9
To recognize partial reversal of the deferred tax liability for one year of amortization related to the excess financial statement carrying amount in the intangible assets.		
Current tax payable (U.S.)	39	
Current tax expense		39
To recognize the benefit of one year of amortization of first component goodwill in the United States and the deduction of the Country A current taxes ( $(1,750 / 10 \text{ years} + 9 \text{ of foreign tax expense}) \times 21\% = 39$ ).		
Deferred tax expense	39	
Deferred tax liability		37
Deferred tax asset		2
To recognize a deferred tax liability for the difference between the financial statement carrying amount and U.S. tax basis of first component goodwill ( $175 \times 21\% = 37$ ) and reduction of the U.S. deferred tax asset for the federal effect of foreign taxes ( $9 \times 21\% = 2$ ).		

### 6.130 Settlement of Target's Share-Based Payment Awards in a Business

**Combination.** An acquirer may unilaterally settle unvested share-based payment awards of an acquiree's employees without requiring further service from these employees, resulting in the acquirer recognizing postcombination compensation expense. However, settlement of the awards may be fully deductible on the acquiree's last pre-acquisition short period tax return if separate tax returns are being filed for the predecessor and successor periods. The income tax deduction would reduce the acquiree's taxable income and adjust the acquiree's income taxes payable (receivable) balance or create an NOL carryforward that is available to reduce the acquirer's postcombination taxable income. Questions may arise about when and how to account for the tax consequences (deduction claimed by acquiree) of the postcombination compensation expense that is recognized by the acquirer separately from the business combination. Because the acquirer was required to recognize postcombination expense separately from the business combination, we believe that any tax effects should also be recognized separately from the business combination such that there is no adjustment to income taxes payable (receivable) or deferred tax asset for an NOL carryforward established in the acquisition date balance sheet. Rather, the benefit of the tax deduction that creates a deferred tax asset (to the

extent such deduction increased an NOL carryforward) or reduction in income taxes payable or increase in income taxes receivable (to the extent such deduction adjusts income taxes payable (receivable)) results in a tax benefit for the acquirer in the postcombination financial statements. Alternatively, it may be acceptable to recognize all tax consequences in purchase accounting (i.e., the acquisition date balance sheet would include an adjustment to income taxes payable (receivable) or a deferred tax asset related to an NOL carryforward created by the deduction claimed on the acquiree's tax return and would also include a deferred tax liability representing the taxable temporary difference related to the acquirer's future compensation expense). Although the balance sheet presentation of each alternative would differ, the same amount of goodwill would be recognized and the same tax effects would be reflected in the postcombination income statement.

**6.131** Not used.

### **THE TAX EFFECTS OF CHANGES IN OWNERSHIP INTERESTS WHILE RETAINING CONTROL**

**6.132** ASC Subtopic 810-10, *Consolidations - Overall*, specifies that changes in the parent's ownership interest in a subsidiary while retaining control are accounted for as equity transactions. This would include a change in an ownership interest in a subsidiary due to (a) the parent's purchase of additional ownership interests in a subsidiary, (b) the parent's sale of a portion of its ownership interests in its subsidiary while retaining control, (c) the subsidiary's reacquisition of some of its ownership interests, or (d) the subsidiary's issuance of additional ownership interests but leaving the parent with a controlling interest. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted is recognized in the parent's equity.

#### **6.133 Tax Consequences of Transactions Involving Noncontrolling Interests.**

Because a change in a parent's ownership interest in a subsidiary while retaining control is accounted for as an equity transaction, the direct tax effects of the transaction are also recognized in equity. In addition, there may be additional tax effects that are indirectly related to the transaction. Those tax effects should be recognized under the intraperiod tax allocation provisions of ASC Subtopic 740-20, *Income Taxes – Intrapерiod Tax Allocation*.

**6.134** For example, assume an entity sells 40% of its interest in a 100%-owned subsidiary that is included in its consolidated tax return. The entity retains control of the subsidiary and accounts for the sale as an equity transaction under ASC Subtopic 810-10. However, because it has reduced its ownership interest to 60%, it can no longer include the subsidiary in its consolidated tax return. The entity determines that it needs to establish a valuation allowance for certain deferred tax assets no longer realizable because of the exclusion of the subsidiary from its consolidated tax return. The tax effect related to establishing a valuation allowance is an indirect consequence of the change in the entity's ownership interest in the subsidiary and is recognized under the intraperiod tax allocation

guidance of ASC Subtopic 740-20. Under that approach, the change generally would be reflected in income tax expense from continuing operations in a manner similar to other changes in the beginning-of-year valuation allowance for deferred tax assets due to a change in circumstances that result in a change in judgment about realization of deferred tax assets in future years.

**6.135** Other indirect effects related to changes in an entity's noncontrolling interest may include changes in an entity's assertion related to its ability to recover its investment in a domestic subsidiary in a tax-free manner. The recognition of a deferred tax liability for the outside basis difference in its subsidiary would not be recognized as part of the equity transaction related to the change in the entity's noncontrolling interest.

**6.136** The tax effects directly related to changes in an entity's ownership interest in a subsidiary while retaining control are recognized in equity. Those tax effects may be current or deferred. The type of transaction will determine whether the direct tax effects of these transactions are current or deferred. For example, if an entity's subsidiary sells its own shares to a third party, the transaction does not result in a current tax effect but increases the outside basis difference in the subsidiary. That transaction may result in the recognition of an additional deferred tax liability with a corresponding charge to equity. However, if an entity sells a portion of its interest in a subsidiary to a third party at a taxable gain, the resulting current tax effect (and reversal of any previously recorded deferred tax related to the portion sold) is recognized in equity.

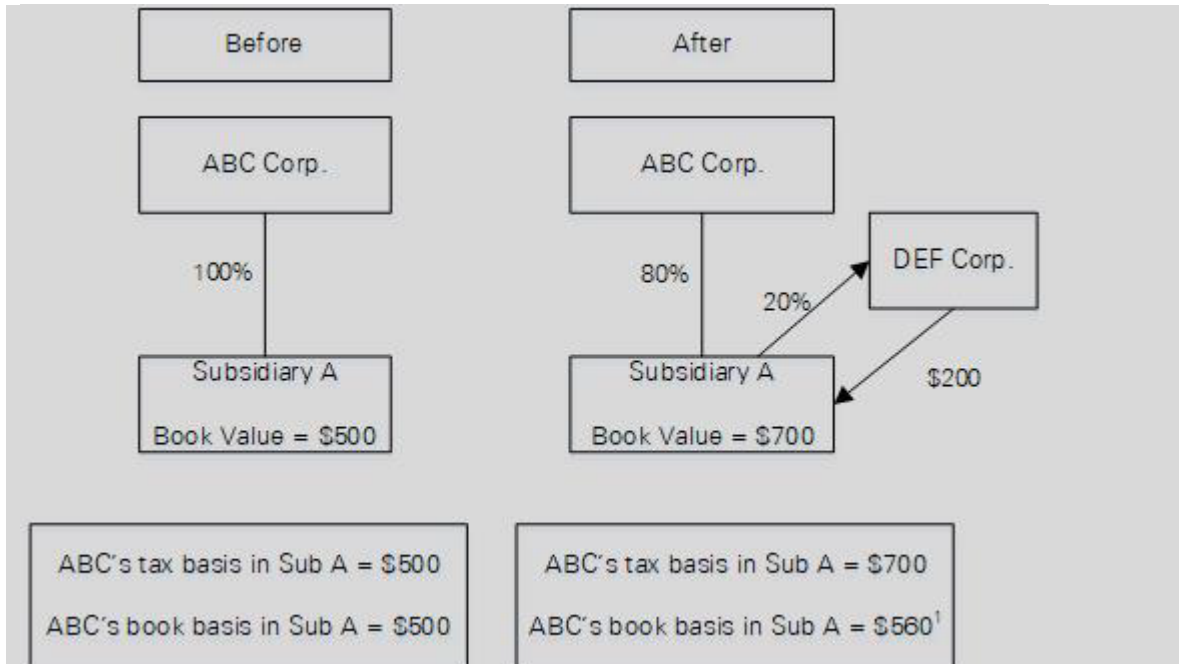
### **Example 6.27: Tax Effect of an Increase in a Noncontrolling Interest – Sale of Subsidiary Stock**

ABC Corp. owns 100% of Subsidiary A (a foreign subsidiary). Subsidiary A sells shares to DEF Corp. in exchange for \$200. The shares purchased by DEF represent a 20% ownership interest in Subsidiary A. ABC's book basis and tax basis in Subsidiary A is \$500 before the transaction. Subsidiary A has no earnings and profits for U.S. federal income tax purposes.

ABC would not owe U.S. tax on dividends paid out of earnings and profits (if any) by Subsidiary A because of the 100% dividends received deduction (see Paragraph 7.007d for additional discussion), but would be taxed at the statutory rate of 21% for the portion of the gain in excess of its attributable earnings and profits (if any) if it sells its investment in Subsidiary A. ABC expects to recover its investment through sale.

See diagram of the transaction below:





<sup>1</sup> \$700 × 80%

ABC records the following entry on its consolidated financial statements to reflect DEF's noncontrolling interest in Subsidiary A:

	Debit	Credit
Cash	200	
Noncontrolling interests		140 <sup>2</sup>
Additional paid-in capital		60 <sup>3</sup>

<sup>2</sup> \$700 × 20%

<sup>3</sup> (\$700 × 80%) - \$500

This transaction does not have a current tax effect on ABC. However, ABC's book basis in Subsidiary A increased by \$60 while the tax basis that would be relevant in a sale remained unchanged. This results in an outside basis difference of \$60 (\$560 book basis - \$500 tax basis) that would be subject to a 21% tax in the United States if ABC recovers its investment through a sale of its remaining interest.

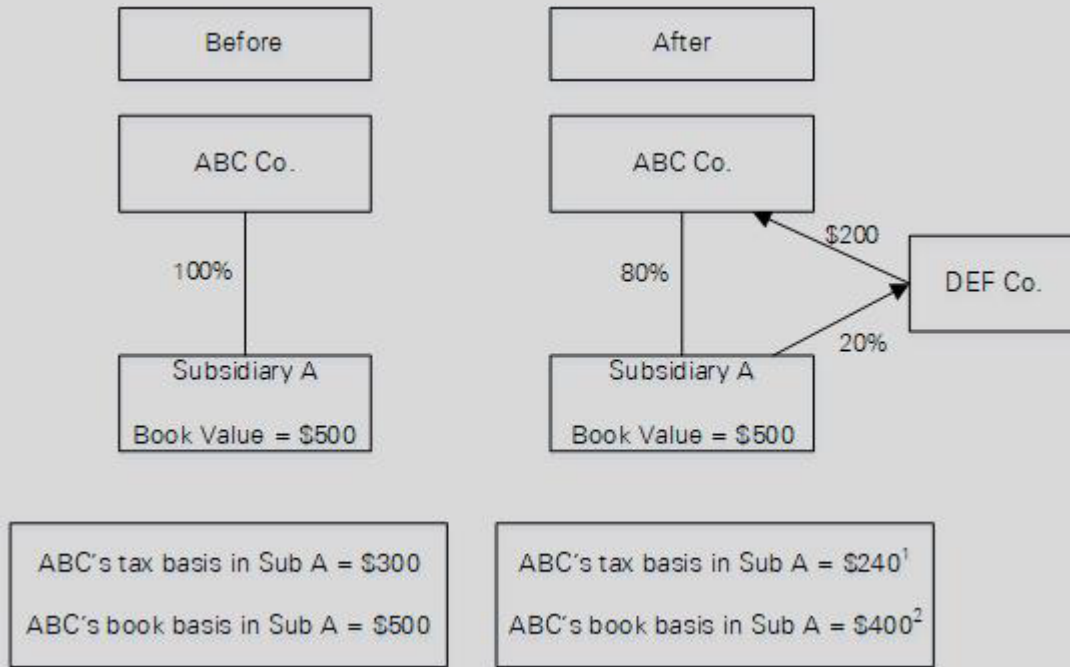
Subsidiary A is a foreign subsidiary and ABC determines that the indefinite reversal criterion of ASC paragraph 740-30-25-17 does not apply to the investment in Subsidiary A. Because ABC expects to recover its investment in Subsidiary A through sale, it must recognize a deferred tax liability directly related to the transaction between Subsidiary A and DEF (the noncontrolling interest shareholder). The U.S. tax rate applicable to the gain is 21% so ABC records the following entry in its consolidated financial statements:

Additional paid-in capital	13	
Deferred tax liability		13

**Example 6.28: Tax Effect of an Increase in a Noncontrolling Interest – Sale of a Parent’s Ownership Interest**

ABC Corp. owns 100% of Subsidiary A (a foreign subsidiary). ABC sells a 20% interest in Subsidiary A to DEF Corp. in exchange for \$200. Before the transaction, (a) ABC’s book basis and tax basis in Subsidiary A is \$500 and \$300, respectively and (b) ABC had not recognized a deferred tax liability for the \$200 outside basis difference because it expected to recover its investment through distributions up to \$300 (which would not be taxed as a return of capital) followed by a tax-free liquidation. Subsidiary A has no earnings and profits for U.S. federal income tax purposes.

In contemplation of the sale transaction, ABC reassesses its expected manner of recovery assertion and determines that it expects 20% of its investment to be recovered through sale, with the remainder recovered through tax-free return of basis transactions followed by a tax-free liquidation. ABC would be taxed at the statutory rate of 21% for the portion of the gain in excess of its attributable earnings and profits (if any) if it sells its investment in Subsidiary A. See diagram of the transaction below:



<sup>1</sup> \$300 × 80%

<sup>2</sup> \$500 × 80%

ABC changes its assertion about the expected manner of recovery of Subsidiary A. Although ABC changes its assertion in contemplation with the sale of the noncontrolling interest in Subsidiary A, it is not directly related to the transaction. ABC records the following entry (which could occur in an earlier period due to the change in assertion) to recognize an \$8  $((\$500 - \$300) \times 20\%) \times 21\%$  deferred tax liability for U.S. taxes

expected on a partial sale of its investment. ABC does not recognize a U.S. deferred tax liability for the remaining 80% of its outside basis difference because it expects to recover that portion through return of capital distributions (followed by a tax-free liquidation) that will not result in U.S. tax.

	Debit	Credit
Income tax expense	8	
Deferred tax liability		8

ABC records the following entry on its consolidated financial statements to reflect DEF's noncontrolling interest in Subsidiary A:

Cash	200	
Noncontrolling interests		100 <sup>3</sup>
Additional paid-in capital		100

<sup>3</sup>  $\$500 \times 20\%$

ABC's sale of a noncontrolling interest to DEF is a taxable transaction that has a direct current U.S. tax effect to ABC at a 21% rate (the 100% dividends received deduction does not apply to sale transactions). Because the tax effect of the gain on the sale of the noncontrolling interest is a direct tax effect of the transaction, the tax effect should be recognized in equity. ABC records the following entry:

Additional paid-in capital	29 <sup>4</sup>	
Current taxes payable		29

<sup>4</sup>  $(\$200 - [\$300 \text{ tax basis} \times 20\%]) \times 21\%$

Additionally, ABC records the reversal of the U.S. deferred tax liability for the reduction in the outside basis difference as follows:

Deferred tax liability	8 <sup>5</sup>	
Additional paid-in capital		8

<sup>5</sup>  $(\$500 \text{ book basis} - \$300 \text{ tax basis}) \times 20\% \times 21\%$

## ENDNOTES

<sup>1</sup> In February 2016, the FASB issued ASU 2016-02, *Leases*. The standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date.

<sup>2</sup> In February 2016, the FASB issued ASU 2016-02, *Leases*. The standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date.

## Section 7 - Foreign Operations

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**7.000** This section addresses the accounting for deferred taxes for inside and outside basis differences related to investments in foreign entities and other income tax consequences of foreign operations.

## **INVESTMENTS IN FOREIGN SUBSIDIARIES AND CORPORATE JOINT VENTURES**

**7.001** As discussed in Section 2, *Temporary Differences*, in consolidated financial statements, the assets and liabilities of a parent entity and its subsidiaries are presented as if the consolidated group were a single entity. Differences between the financial statement carrying amounts and tax bases of a subsidiary's assets and liabilities (inside basis difference) are temporary differences for which deferred taxes should be recognized. A difference between the financial statement carrying amount and the tax basis of the parent entity's investment in the stock of the subsidiary (outside basis difference) also may be a temporary difference even though that investment account is eliminated in the consolidated financial statements. The financial statement carrying amount of a parent's investment in a subsidiary is its controlling share of the subsidiary's equity adjusted for acquisition accounting adjustments, if any. In other words, the financial statement carrying amount of a parent's investment in a subsidiary generally is the amount the parent would report as an investment if the subsidiary had been accounted for under the equity method of accounting. ASC paragraph 830-740-25-6

**7.002** Outside basis differences related to a parent entity's investment in a foreign operation may result from undistributed earnings of the subsidiary, accumulated subsidiary losses, foreign currency translation gains and losses included in other comprehensive income, business combinations, etc. Those basis differences may result in future taxable or deductible amounts, for example, when (1) dividends are paid to the parent entity by the subsidiary; (2) the parent entity sells the stock of the subsidiary; (3) the subsidiary is liquidated; or (4) the subsidiary is merged into the parent entity. In other situations, the parent entity may be able to recover its investment in a subsidiary in a tax-free manner.

**7.003 Excess of Financial Statement Carrying Amount over Tax Basis of Investments in Foreign Subsidiaries and Foreign Corporate Joint Ventures.** As discussed in Section 2, there are certain exceptions to the recognition of a deferred tax liability for a taxable outside basis difference, including for a basis difference associated with an investment in the stock of a foreign subsidiary or certain foreign corporate joint ventures that are essentially permanent in duration (collectively referred to herein as foreign subsidiaries). A taxable outside basis difference associated with a foreign subsidiary may not be recognized if the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB Opinion No. 23, *Accounting for Income Taxes - Special Areas* (APB 23)) is met. A deferred tax liability is recognized when an entity no longer meets the indefinite reversal criterion.

**7.004 Indefinite Reversal Criterion of ASC Paragraph 740-30-25-17 (APB 23).** The exception to the recognition of a deferred tax liability for a taxable outside basis

difference of an investment in a foreign subsidiary in ASC Topic 740, *Income Taxes*, is based on the indefinite reversal criterion of ASC paragraph 740-30-25-17, which states:

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.

**7.005** ASC paragraph 740-30-25-19 goes on to state:

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.

**7.006** ASC paragraph 740-10-25-3 applies the exception to the entire taxable outside basis difference related to an investment in a foreign subsidiary without regard to the source of the difference. Specifically, ASC paragraph 740-30-25-18 states that a deferred tax liability is not recognized for an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration when the indefinite reversal criterion is met. As a result of the extension, differences resulting from, for example, cumulative translation adjustments, also meet the exception criterion. ASC subparagraph 740-10-25-3(a)

**7.007** Because ASC paragraph 740-30-25-17 establishes a presumption that all undistributed earnings of a subsidiary will be transferred to the parent entity, each reporting period an entity must have specific plans for reinvestment of undistributed earnings that demonstrate the taxation of the outside basis difference will be postponed indefinitely. Consideration should be given to all available information, such as historical actions, operating and capital plans of the subsidiary, the ability of the parent to continually reinvest if there is a change of market conditions, and financing needs and

cash flow requirements of the parent entity and tax laws in both the parent's and the foreign subsidiary's tax jurisdictions. ASC paragraphs 740-30-05-4 and 05-5

**7.007a Deemed Repatriation in the United States.** Under the U.S. tax reforms enacted in 2017, a U.S. shareholder's foreign earnings and profits (E&P) accumulated in specified foreign corporations (SFCs) under legacy tax laws were deemed repatriated for the last taxable year of a SFC that began before January 1, 2018. E&P were determined as the higher of the balance at November 2 or December 31, 2017. This one-time transition tax on those deemed repatriated earnings may, at the election of the taxpayer, be paid over eight years with no interest charged. The following proportions of the tax on deemed repatriated earnings are payable in each of the eight years:

8% in each of Years 1 to 5;

15% in Year 6;

20% in Year 7; and

25% in Year 8.

Payments would be accelerated on the occurrence of certain triggering events. See Paragraph 7.024a for additional discussion about the accounting for the transition tax.

**7.007b** Deemed repatriation in the United States did not eliminate the need for a U.S. taxpayer to consider its assertion about indefinite reinvestment of basis differences. A U.S. taxpayer that does not plan to repatriate its existing undistributed foreign earnings should continue to evaluate its ability to assert indefinite reinvestment to avoid recognizing a deferred tax liability for other items that trigger a tax effect on repatriation – e.g., section 986(c) currency gain/loss on previously taxed earnings and profits (PTEP), section 965(b) PTEP without tax basis (see Paragraph 7.085a), foreign withholding taxes and state taxes (see Paragraph 7.046a).

**7.007c** An entity that does not assert indefinite reinvestment should determine the liability based on the expected manner of recovery (e.g., remission of dividends, liquidation or sale - see additional discussion in Paragraph 7.024). Entities also may need to consider the tax consequences of PTEP (e.g., Subpart F income, global intangible low-taxed income (GILTI), section 956 inclusions, deemed repatriated earnings subject to the transition tax, section 965(b) PTEP) as the law provides that PTEP generally is deemed to be distributed before other earnings (see Paragraphs 7.007d and 7.085a for additional discussion).

**7.007d 100% Dividend Received Deduction in the United States.** U.S. tax law (after the 2017 tax reforms) allows a U.S. shareholder of a 10% foreign corporation a 100% dividends received deduction for the foreign-source portion of dividends received. The ability to make a distribution eligible for the deduction does not eliminate the need for a U.S. taxpayer to consider its assertion about indefinite reinvestment of undistributed earnings that are not PTEP. An entity that does not plan to repatriate its undistributed foreign earnings that are not PTEP (e.g., Subpart F income, GILTI, section 956 inclusions, deemed repatriated earnings subject to the transition tax, section 965(b)

PTEP) should continue to evaluate its ability to assert indefinite reinvestment to avoid recognizing a deferred tax liability for other items triggering a tax effect on repatriation – e.g., foreign withholding taxes and state taxes.

**7.008 Changes to the Indefinite Reversal Criterion.** As economic conditions change or as new transactions are planned as a result of changing economic conditions, an entity may reevaluate its global cash needs and revise its plans for repatriating or reinvesting foreign earnings. Changes in repatriation plans should be evaluated based on the specific facts and circumstances to determine how those changes affect the recognition and measurement of income tax liabilities and whether those changes in plans affect an entity's ongoing assertions related to the indefinite reinvestment of basis differences.

**7.009** A change of plans related to the indefinite reinvestment of basis differences caused by a change in previously unforeseen circumstances would not raise questions about the original application of the exception and would not necessarily taint the continuing application of the indefinite reinvestment assertion to the remaining taxable outside basis difference or future earnings. A one-time plan to repatriate existing funds from the foreign subsidiary that will result in recognizing previously unrecognized taxes in the parent's tax jurisdiction would not prohibit applying the exception to the remaining undistributed earnings or basis difference if management has sufficient evidence of specific plans to continue reinvesting the foreign subsidiary's remaining undistributed earnings. In evaluating whether the entity's plans can support continued application of the exception, the entity should consider the facts and circumstances that caused the change in conditions, the likelihood of those facts and circumstances recurring, the entity's expected actions if those facts and circumstances were to recur, and its specific plans to continue reinvestment.

**7.010** The following examples illustrate situations where changes in economic conditions or other facts and circumstances may affect an entity's plans for repatriating or reinvesting undistributed earnings of foreign subsidiaries.

- As a result of unexpected declines in stock price and other changes in economic conditions, an entity may initiate stock buy-back programs that previously had not been contemplated. Because the stock buy-back program will span a short period of time, the entity may consider funding the program through a one-time repatriation of cash from a foreign subsidiary. In those situations, the entity must determine whether the repatriation affects its previous application of the exception or taints its assertion to indefinitely reinvest the remaining foreign undistributed earnings. Assuming the stock buy-back program had not previously been contemplated and that the plans for the program developed as a result of changing economic or other conditions that previously had not been foreseen, the change in repatriation plans would not raise issues about the prior application of the exception. The tax effect of the change in plans would be recognized in the period of the change. The one-time repatriation of existing funds from the foreign subsidiary would not prohibit applying the exception to the remaining or future undistributed earnings or basis difference if management has sufficient



evidence of specific plans to continue reinvesting the foreign subsidiary's undistributed earnings.

- As a result of changes in economic conditions that may result in a decline in the value of certain companies, an entity may identify new acquisition targets that previously had not been considered viable acquisitions. The entity may consider a one-time repatriation of cash from a foreign subsidiary to fund the acquisition. In those situations, the entity must determine whether the repatriation affects its previous application of the exception or taints its assertion to indefinitely reinvest the remaining foreign undistributed earnings. Assuming the acquisition had not previously been contemplated and that the plans for the acquisition developed as a result of changing economic or other conditions that previously had not been foreseen, the change in repatriation plans would not raise issues about the prior application of the exception. The tax effect of the change in plans would be recognized in the period of the change. The one-time repatriation of existing funds from the foreign subsidiary would not prohibit applying the exception to the remaining or future undistributed earnings or basis difference if management has sufficient evidence of specific plans to continue reinvesting the foreign subsidiary's undistributed earnings.
- Reductions in the level of domestic operations may cause an entity to desire more domestic cash and, as a result, management may initiate an annual dividend payment program to repatriate future earnings from the foreign subsidiary where the dividends will be limited to future earnings. The entity should determine whether this change in plans would affect its indefinite reversal assertion. If management plans to (1) include only future earnings in distributions and to reduce or eliminate the dividend in the event of an earnings shortfall and (2) the facts and circumstances support the ability to cover existing obligations or fixed costs without the dividend in the event there are no foreign earnings, then the indefinite reversal assertion may remain intact with respect to the existing outside basis difference. Management would continue to be required to provide sufficient evidence that the existing outside basis difference continues to meet the indefinite reversal criteria. In that situation, the entity would recognize income taxes on future foreign earnings as the earnings are recognized to the extent of the tax effect of the anticipated dividends.
- A plan by management for dividend payments of a fixed amount per year generally would preclude applying the indefinite reversal exception to the existing outside basis difference because an entity would be unable to support an assertion of indefinite reinvestment of existing undistributed earnings without knowledge of whether future earnings of the subsidiary will be adequate to cover the fixed dividend. Accordingly, a plan for fixed amounts of dividend payments from the foreign subsidiary would generally result in recognizing deferred taxes on the existing basis difference.

- A tax jurisdiction may consider potential changes in its tax system on overseas profits. Potential changes might include shielding some of the overseas profits from domestic taxes, or taxing the profits regardless of whether they are repatriated. An entity's preliminary analysis of the effect of any potential change in the tax system of overseas profits does not automatically taint management's assertion of indefinite reinvestment of basis differences. For example, the deemed repatriation provision that was introduced in the United States in 2017 (see Paragraph 7.007a for additional discussion) may have triggered a different intention on the part of an entity such that it did plan to repatriate its undistributed foreign earnings because they had already been subject to U.S. federal taxation. Because that change was caused by a change in previously unforeseen circumstances, it did not (a) raise questions about the original application of the exception, or (b) taint the continuing application of the indefinite reinvestment assertion for future earnings.

**7.011 Applying the Indefinite Reversal Criterion to Selected Subsidiaries or a Portion of an Outside Basis Difference.** Meeting the indefinite reversal criterion is not an all-or-nothing test. Accordingly, a parent entity may conclude that only a portion of the outside basis difference meets the indefinite reversal criterion. In that case, a deferred tax liability is recognized on the portion of the outside basis difference related to undistributed earnings that are not expected to be indefinitely reinvested. In addition:

- An entity may choose to apply the indefinite reversal criterion to some, but not all, foreign subsidiaries.
- Current taxes should be recognized on earnings deemed distributed under section 951 of the IRC as Subpart F income. Similarly, the indefinite reversal criterion generally would not apply to the portion of an outside basis difference in a foreign subsidiary attributable to inside basis differences that on reversal will result in (a) Subpart F income (see discussion beginning in Paragraph 7.077) or (b) GILTI, if an entity is providing deferred taxes on GILTI (see discussion beginning in Paragraph 7.087a).
- An entity may continue to apply the indefinite reversal criterion for an existing outside basis difference even if there is a plan to repatriate future earnings from the foreign subsidiary if the parent entity has provided evidence of its specific plans to continue reinvestment of the foreign subsidiary's existing undistributed earnings.
- As discussed in Paragraph 7.010, the planned payment of fixed dividends in the future generally would preclude the application of the indefinite reversal criterion as an entity would be unable to support an assertion of indefinite reinvestment of existing undistributed earnings without knowledge of whether future earnings of the subsidiary will be adequate to cover the fixed dividend. However, planned dividend payments contingent on future earnings of the foreign subsidiary generally would not preclude the application of the indefinite reversal criterion to an existing outside basis difference if the parent

entity has provided evidence of its specific plans to continue reinvestment of the existing undistributed earnings.

- As discussed in Paragraph 7.008, as economic conditions change or as new transactions are planned as a result of changing economic conditions, an entity may reevaluate its global cash needs and revise its plans for repatriating or reinvesting foreign earnings. Changes in repatriation plans should be evaluated based on the specific facts and circumstances to determine how those changes affect the recognition and measurement of income tax liabilities and whether those changes in plans affect an entity's ongoing assertions related to the indefinite reinvestment of basis differences. See Paragraphs 7.008 to 7.010 for additional discussion and examples illustrating situations where changes in economic conditions or other facts and circumstances may affect an entity's plans for repatriating or reinvesting undistributed earnings of foreign subsidiaries.
- We believe the indefinite reversal criterion generally does not apply to basis differences associated with a foreign branch or other pass-through entity (such as check-the-box elections), because, in addition to being subject to local tax, the income of the foreign entity is included in the parent entity's taxable income without regard to distributions - i.e., the branch is not a subsidiary, as that term is used in ASC Subtopic 740-30. However, we understand that there is diversity in practice on this issue. As a result, we believe it is also acceptable to apply the indefinite reversal criterion to an outside basis difference that arises as a result of an unrecognized section 987 gain if the parent entity has provided evidence of its specific plans to continue reinvestment of the undistributed earnings in the foreign jurisdiction such that the tax due on the related foreign exchange gain or loss is postponed indefinitely. We believe a similar assertion can be made with respect to foreign withholding taxes. However, we believe if the parent asserts that the guidance for subsidiaries in ASC Subtopic 740-30 applies to a foreign branch, it must also apply the guidance for accounting for deductible outside basis differences (i.e., a deferred tax asset is recognized for those outside differences only if it is apparent that the temporary difference will reverse in the foreseeable future). See Paragraph 7.018 for additional discussion of the application of the indefinite reversal criterion for lower-tier subsidiaries of pass-through entities, Paragraph 7.039 for additional discussion of the measurement of deferred taxes resulting from cumulative translation adjustments when ASC paragraph 740-30-25-17 (APB 23) has not been applied, Paragraph 7.021 for additional discussion of how to account for deductible outside basis differences and Paragraph 7.068 for additional discussion of the accounting for temporary differences of foreign branches.
- The indefinite reversal criterion is not limited to the U.S. tax jurisdiction or to the tax jurisdiction of the ultimate parent entity. The indefinite reversal criterion may apply to a subsidiary that is itself a parent entity in a foreign country (outside the United States) with investments in subsidiaries in other

countries. The tax laws in the foreign countries should be considered to determine whether the indefinite reversal criterion may apply.

**7.012** The provisions of the indefinite reversal criterion are not met if the parent entity is unable to provide evidence of its plan to postpone taxation of the basis differences related to the foreign subsidiary indefinitely. For example, plans to sell a foreign subsidiary generally would preclude the application of the indefinite reversal criterion for the outside basis difference. In addition, if the tax laws in the tax jurisdiction of the parent entity require reporting taxable income for the earnings of foreign subsidiaries when earned rather than when distributed (e.g., similar to Subpart F income and GILTI in the United States), the application of the indefinite reversal criterion generally would also be precluded.

**7.013 Limited Application of the ASC Paragraph 740-30-25-17 (APB 23) Exception.** The indefinite reversal criterion of ASC paragraph 740-30-25-17 applies to investments in foreign subsidiaries and certain foreign corporate joint ventures. The exception therefore does not apply to investments accounted for under the equity method unless the investee meets the definition of a foreign corporate joint venture. Accordingly, determining whether an investee is foreign or domestic (see Paragraph 2.036 for additional discussion) and determining whether the investment is a corporate joint venture potentially have a significant effect on deferred taxes. See Paragraph 3.085 for additional discussion of the measurement of deferred taxes on the outside basis difference arising on equity method investments and Paragraph 7.055 for additional discussion of the effect of changes in ownership on the indefinite reversal criterion. ASC paragraphs 740-30-25-4 and 25-15

**7.014 Determining Whether a Foreign Investee Is a Corporate Joint Venture.** When determining whether a foreign investee is a corporate joint venture, an entity should first consider the guidance in the ASC Master Glossary, which defines a corporate joint venture as follows:

A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

**7.015** As discussed in ASC paragraph 740-30-05-7 (APB 23), joint venture arrangements include the participation of investors in the management of the joint venture and the agreement of investors in the plans for long-term investment. Accordingly, the exception to recognition of deferred taxes for investments in foreign corporate joint ventures applies only when investors participate in the management of the venture and there is a mutual agreement of the investors on the long-term investment plans. In addition, the indefinite reversal criterion generally would not apply if the investors do not have joint control over distributions from the venture (i.e., none of the individual venturers is in a position to unilaterally control distributions). A corporate joint venture is a corporation (i.e., not a pass-through entity). The ASC paragraph 740-30-25-17 exception does not apply to other equity method investments.

**7.016** The ASC Master Glossary definition does not specify that the corporate joint venture must have an unlimited life; however, we believe the ASC paragraph 740-30-25-17 exception only applies to those foreign corporate joint ventures that have the characteristics of a subsidiary, specifically those that are essentially permanent in duration (either pursuant to the joint venture agreement or as a result of the nature of its operations). ASC paragraph 740-30-05-7

**7.017 Investments in Variable Interest Entities.** In assessing whether outside basis differences on investments in variable interest entities (VIEs) meet the ASC paragraph 740-30-25-17 exception, consideration should be given to whether the primary beneficiary (parent entity) can control when the parent's basis difference will reverse. If the primary beneficiary (parent) can control how and when the basis difference will reverse (and the other ASC paragraph 740-30-25-17 conditions are met) then the ASC paragraph 740-30-25-17 exception may apply to investments in foreign VIEs. However, in many situations the primary beneficiary may be unable to control when the basis difference will reverse - e.g., it may not have control over the VIE's distributions or other decisions necessary to meet the indefinite reversal criterion under ASC paragraph 740-30-25-17. All facts and circumstances should be considered. See Paragraph 2.051 for additional discussion.

**7.018 Effect of a Foreign Holding Company on the Application of the Indefinite Reversal Criterion of ASC Paragraph 740-30-25-17 (APB 23).** In certain situations, a parent entity may establish a holding company to hold its investments in various foreign subsidiaries. As discussed in Paragraph 2.036, the assessment as to whether a subsidiary is domestic or foreign, and thus whether the ASC paragraph 740-30-25-17 exception may be applied, generally should be determined at each subsidiary level by reference to the subsidiary's immediate parent. However, it may be appropriate for the parent entity to apply the exception to its indirect investment in one or more of its foreign subsidiaries (through the use of the foreign holding company structure) if the holding company is expected to simply pass distributions on to the parent. The parent entity would be required to meet the indefinite reversal criterion, including providing evidence of specific plans for reinvestment, with respect to each lower-tier subsidiary for which the exception is being applied and the foreign holding company would be required to execute those specific plans.

**7.019** If the foreign holding company is a pass-through entity or the parent entity makes a check-the-box election to treat the foreign holding company as a branch for its local income tax purposes, the parent entity may apply the ASC paragraph 740-30-25-17 exception to its indirect investments in one or more of the lower-tier foreign subsidiaries provided the following conditions are met:

- The check-the-box election at the holding-company level does not trigger income tax in the parent entity's local jurisdiction on earnings of the lower-tier foreign subsidiaries, and
- The parent entity would not be taxed in its local jurisdiction on earnings of the lower-tier foreign subsidiaries if those subsidiaries were owned by the parent entity as direct investments.

**7.020 Prohibition against Applying the ASC paragraph 740-30-25-17 (APB 23) Criterion by Analogy.** The indefinite reversal criterion in ASC paragraph 740-30-25-17 should not be applied by analogy to other types of temporary differences. Accordingly, deferred taxes should be recognized for other temporary differences, including inside basis differences (foreign or domestic), even when the taxation of such differences may be indefinitely postponed. For example, an entity may own land that it intends to use indefinitely. The indefinite reversal criterion would not apply to an excess of the financial statement carrying amount over the tax basis of the land and a deferred tax liability should be recognized on that taxable temporary difference. In a similar situation, an inside basis difference may be created in certain foreign jurisdictions as a result of indexing for tax purposes or when there is a monetary asset or liability that is denominated in the foreign subsidiary's functional currency but has a tax basis denominated in the local currency that will be subject to tax in the foreign jurisdiction on settlement based on the local-currency-equivalent settlement amount (see additional discussion beginning at Paragraph 7.046). Because these inside basis differences have tax consequences on disposition or recovery of the asset or liability through operations at the financial statement carrying amount, they qualify as temporary differences for which deferred taxes should be provided (except when the basis difference relates to a nonmonetary asset and the subsidiary's functional currency is different than the local currency, see Paragraph 7.044). In certain circumstances, however, a basis difference may be subject to recapture or otherwise become taxable on liquidation of the subsidiary or distribution of earnings (e.g., when the tax basis of the asset is restated). In these situations, in addition to the deferred tax asset (or reduction of the deferred tax liability) associated with the tax basis adjustment itself, a separate deferred tax liability generally should be provided because the revaluation surplus subject to recapture will result in taxable amounts in future years based on the provisions of the tax law and therefore also qualifies as a temporary difference. ASC paragraphs 830-740-25-6 through 25-8

**7.021 Deductible Outside Basis Difference.** A deferred tax asset is recognized for the excess of the tax basis over the financial statement carrying amount of an investment in the stock of a subsidiary (or a foreign branch in certain circumstances, see Paragraph 7.011) only if it is apparent that the temporary difference will reverse in the foreseeable future, generally interpreted in practice to be within one year. The criteria of ASC Topic

360, *Property, Plant, and Equipment*, to be classified as held for sale may be useful in evaluating whether the reversal of the temporary difference will occur within the foreseeable future. See the discussion beginning in Paragraph 2.047 on evaluating foreseeable future, Example 2.9 about recognition of deductible outside basis difference in intra-entity sales of foreign subsidiaries, and Paragraph 9.170 for additional discussion of the appropriate presentation of the benefit when the subsidiary qualifies for presentation as a discontinued operation. ASC paragraphs 360-10-45-9 and 45-10, 740-30-25-9 through 25-13

#### **7.022 Net Tax Benefit Generated on Reversal of Taxable Outside Basis Difference.**

While the guidance in Paragraph 7.021 is specific to a deductible outside basis difference of an investment in a foreign subsidiary, we believe it may also be appropriate to consider in certain other situations in which a net tax benefit may be generated on reversal of an outside basis difference. For example, as discussed in Paragraph 7.024, when the statutory income tax rate for a foreign subsidiary is higher than the income tax rate for the parent, an excess foreign tax credit may be generated on remittance of foreign earnings to the parent entity, resulting in a possible net deferred tax asset associated with what would otherwise be a taxable outside basis difference. We believe these excess foreign tax credits that result on reversal of the taxable outside basis difference may be recognized in certain cases as deferred tax assets regardless of whether it is apparent they will reverse in the foreseeable future as long as the outside basis difference is not indefinitely postponed. These excess foreign tax credits result from the measurement of a taxable outside basis difference for which the exception to recording deferred taxes is not being applied. However, we also believe there is an acceptable alternative view that would limit the deferred tax assets to those for which it is apparent that they will reverse in the foreseeable future. These views should be considered an accounting policy election to be consistently applied and, if material, disclosed.

**7.022a** If a net deferred tax asset is recognized, it should be evaluated for realizability. Future distributions of future earnings of other foreign subsidiaries that would generate taxable income sufficient to realize the deferred tax assets for the excess foreign tax credits (note that foreign dividend income received by a U.S. parent entity generally does not provide a source of taxable income to support realizability of foreign tax credits in the United States due to the dividends received deduction introduced by the 2017 tax reforms, see Paragraph 4.119) should not be considered in evaluating realizability except to the extent that a deferred tax liability has been recognized for existing undistributed earnings of those subsidiaries or earnings have been remitted in the past. In addition, a tax benefit should not be recognized for the excess foreign tax credits resulting from favorable tax rates attributable to future distributions for which a deferred tax liability has not been recognized under the indefinite reversal criterion. See Paragraph 4.117 for further discussion about valuation allowance considerations for foreign tax credit carryforwards.

**7.023 Effect of a Deductible Outside Basis Difference on Applying the Indefinite Reversal Criterion of ASC Paragraph 740-30-25-17 (APB 23).** While a deferred tax asset should not be recognized for a deductible outside basis unless it is apparent that the temporary difference will reverse in the foreseeable future, a deferred tax liability should be recognized when a portion of that overall deductible basis difference results in taxable

income to the parent entity. For example, if a parent entity plans to repatriate some or all of a foreign subsidiary's existing undistributed earnings, or expects Subpart F (see discussion beginning in Paragraph 7.077) or GILTI if an entity is providing deferred taxes on GILTI (see Paragraphs 2.037b and 7.087a for additional discussion of GILTI), deferred tax liabilities should be recognized for that portion of the overall deductible basis difference when the parent entity does not have the basis to assert indefinite reversal for that portion, notwithstanding that the overall outside basis difference is deductible.

#### **7.024 Measurement of Deferred Tax Liabilities on Investments in Foreign**

**Subsidiaries.** If the ASC paragraph 740-30-25-17 (APB 23) exception to recognition of a deferred tax liability for the taxable outside basis difference on an investment in a foreign subsidiary does not apply, the assumptions used in the measurement of the deferred tax liability should be consistent with the parent entity's expectation as to how the difference will reverse (e.g., through remission of distributions, liquidation or sale). For example, if the taxable temporary difference is expected to reverse through distributions, the calculation of the deferred tax liability should reflect available dividends-received deductions (which could reduce the liability substantially - e.g., in the United States with its 100% dividends received deduction - see Paragraph 7.007d for additional information), the returns of previously-taxed income, tax credits received in the foreign tax jurisdiction on dividend distributions (see Paragraph 3.087) and foreign tax credits that will be available in the parent entity's tax jurisdiction as well as any withholding taxes. Similarly, a parent entity would consider whether capital gains rates would apply if the temporary difference is expected to reverse through sale. Similar considerations apply in situations involving recognition of deferred taxes on the outside basis difference of an investment accounted for under the equity method (see Paragraph 3.085). See Paragraphs 7.043 and 9.044 for additional discussion of the intraperiod tax allocation of deferred tax expense or benefit as it arises when an entity has not applied the ASC paragraph 740-30-25-17 exception and Paragraphs 7.054 and 10.085 for additional discussion of the intraperiod tax allocation of deferred tax expense or benefit when an entity changes its ASC paragraph 740-30-25-17 assessment. ASC paragraph 740-10-55-24

**7.024a Transition Tax Liability in the United States - Characterization.** As discussed in Paragraph 7.007a, under the U.S. tax reforms enacted in 2017, a U.S. shareholder's foreign E&P accumulated in SFCs under legacy tax laws were deemed repatriated for the last taxable year of a SFC that began before January 1, 2018. The one-time transition tax may be paid over eight years with no interest charged.

**7.024b** For controlled foreign corporations (CFCs) with the same year-end as the U.S. parent, we believe the parent should characterize the transition tax obligation as income taxes payable because the liability no longer represents the tax effect of a basis difference. Instead, the liability is determined based on an entity's accumulated foreign E&P for tax purposes. That amount is unlikely to approximate either the existing outside basis differences in the entity's CFCs or the existing retained earnings of those CFCs. Differences arise for many reasons, including GAAP versus tax accounting principles related to the recognition, timing and measurement of earnings; currency gains and losses; business combinations and restructurings. For entities that present classified



balance sheets, we believe the transition tax liability should be classified based on the anticipated timing of payment. See Paragraph 9.018a for additional discussion.

**7.024c** For CFCs with an earlier year-end (e.g., November 30) compared to the U.S. parent (e.g., December 31), we believed the parent could have classified the transition tax liability at initial recognition (i.e., the parent's year that ended before the CFC's fiscal 2018 year-end) as either a deferred tax liability or income taxes payable at its balance sheet date (e.g., December 31, 2017). We believed either presentation was acceptable in these circumstances because (a) under the provisions of the 2017 law, the deemed repatriation had not yet occurred at the U.S. parent's calendar year-end, supporting deferred tax liability presentation, and (b) the obligation has been incurred as of the parent's year-end, supporting income taxes payable presentation. However, in the period in which the deemed repatriation has occurred under the tax law, we believe the U.S. parent should present the obligations as income taxes payable, consistent with the guidance in Paragraph 7.024b.

**7.024d Measuring the Transition Tax Liability.** The FASB issued a FASB staff Q&A that states that entities should not discount the transition tax liability. The basis for this conclusion is Topic 740's prohibition on discounting, Subtopic 835-30's scope exception for transactions in which interest rates are affected by tax attributes and the possible variability in payment amount when the liability includes tax positions with uncertainty.

**7.025 Treatment of a Tax on an Entity as a Withholding Tax.** ASC subparagraph 740-10-15-4(b) indicates that a tax that is assessed on an entity should be treated as a withholding tax for the benefit of the recipients of the dividend only if *both* of the following conditions are met:

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

If both conditions are met, the tax is accounted for as a withholding tax and should be recorded in equity as part of the dividend distribution in the entity's financial statements. If the tax does not meet both conditions, it should be recognized as an additional income tax expense of the entity, generally in the period in which the income is earned. See Paragraph 3.087c for a discussion about how to account for additional taxes due on distribution when the dividend recipient does not receive an offsetting credit. ASC paragraphs 740-10-55-73 and 55-74, 15-4

**7.026** The guidance in ASC subparagraph 740-10-15-4(b) applies only to the presentation of a withholding tax in the financial statements of a corporation that distributes the dividend when that tax is a direct obligation of that corporation. In some situations, a withholding tax is attributed to the investor on its investment income. In those situations, the investor recognizes income tax expense in its financial statements, even if the

investment is accounted for under the equity method, because the tax is the investor's direct obligation, not the investee's obligation.

**7.026a** When the criteria in Paragraph 7.025 are met and a tax on an entity is treated as a withholding tax for the benefit of the recipients of the dividend, it is accounted for as an equity distribution for the issuer, and typically as an income tax for the recipient (assuming the tax is based on income). When the parent entity (the recipient) does not assert indefinite reinvestment, it should recognize a tax liability for withholding taxes. Withholding taxes generally are attributed to the parent and denominated in the local currency of the subsidiary. We believe that the parent should recognize in earnings changes to the withholding tax liability attributable to changes in exchange rates. See Paragraph 7.046a for additional discussion.

**7.026b Subpart F, GILTI and Section 965(b) PTEP.** As discussed in Paragraph 7.011, entities (even if they are applying the indefinite reversal criterion) generally should provide deferred taxes on the portion of an outside basis difference in a foreign subsidiary attributable to inside basis differences that on reversal will result in (a) Subpart F income (see Paragraph 7.077) or (b) GILTI, if an entity is providing deferred taxes on GILTI (see Paragraphs 2.037b and 7.087a for additional discussion of the GILTI deferred taxes policy election). Similarly, U.S. entities that offset positive E&P in one foreign subsidiary against an E&P deficit in another foreign subsidiary when determining the amount of taxable income subject to the 2017 transition tax may need to provide a deferred tax liability for "section 965(b) previously taxed earnings and profits," (see Paragraph 7.085a for additional information about the transition tax and section 965(b) PTEP).

**7.027-7.029** Not used.

**7.030 Valuation of Foreign Tax Credit Carryforwards.** Tax laws in the United States generally provide that a foreign tax credit (FTC) may be taken for taxes paid or deemed paid in foreign tax jurisdictions on foreign-source earnings that are included in the U.S. tax return. FTC carryforwards generally result if the foreign tax is in excess of the U.S. federal income tax incurred on the earnings. To the extent this condition persists (i.e., the foreign tax exceeds the U.S. tax), additional FTC carryforwards will be generated and existing FTC carryforwards may not be used. In addition, U.S. tax law (after the 2017 tax reforms) allows a U.S. shareholder a 100% dividends received deduction for the foreign-source portion of dividends received. Consequently, dividend income from foreign subsidiaries no longer provides a source of taxable income to support realizability of deferred tax assets related to foreign tax credit carryforwards. A valuation allowance should be established to offset the deferred tax asset related to FTC carryforwards if it is more likely than not those carryforwards will not be used (after considering qualified tax-planning strategies). See Paragraph 4.119 for additional discussion.

**7.031 Consideration of Future Credits.** As discussed above, a carryforward will provide no incremental tax benefit if tax credits generated in future years will be displaced by the carryforward and those new carryforwards will expire unused or are otherwise not realizable. The potential displacement of credits by carryforwards (or other similar displacement of one deferred tax asset by another deferred tax asset) should be

considered in determining the valuation allowance on deferred tax assets when the recognition of the asset depends on the entity's ability to generate future taxable income exclusive of reversing items. The displacement of future credits would not need to be considered when future taxable income generated by the reversal of existing taxable temporary differences is the source of taxable income that supports recognition of the deferred tax asset. See Paragraph 4.123 for additional discussion.

**7.032 Summary of the Accounting for Foreign Outside Basis Differences.** The requirements related to the recognition of deferred taxes for outside basis differences of foreign subsidiaries and foreign corporate joint ventures is summarized in the following table:

	<b>Outside Basis Differences of Foreign Subsidiaries and Foreign Corporate Joint Ventures</b>
<b>Future Deductible Amount</b>	Assess provisions of ASC paragraphs 740-30-25-9 through 25-13. Recognition of deferred tax asset is prohibited for differences unless it is apparent that the temporary difference will reverse in the foreseeable future. See Paragraph 7.021.
<b>Future Taxable Amount</b>	Assess provisions of ASC subparagraph 740-10-25-3(a) and ASC paragraphs 740-30-25-16 through 25-19 (APB 23). Recognize deferred tax liability unless the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) is met. See Paragraphs 7.003-7.013.

## FOREIGN CURRENCY TRANSLATION AND TRANSACTIONS

**7.033** The relationship between the functional currency financial statement carrying amounts and the functional currency tax bases of an entity's assets and liabilities can create temporary differences. Deferred taxes generally should be recognized for the tax consequences of these temporary differences in a foreign tax jurisdiction. The procedures for calculating deferred taxes when the local currency is the functional currency under the provisions of ASC Topic 830, *Foreign Currency Matters*, are different from the procedures for calculating deferred taxes when the local currency is different from the functional currency.

**7.034** ASC Topic 830 provides guidance for transactions denominated in a foreign currency and for operations in a foreign currency environment.

**7.035** In developing ASC Topic 830 the FASB acknowledged that operations of a global entity may be undertaken in different economic and currency environments, and that the financial position and results of these operations are best measured in the respective

currency of the primary economic environment in which those operations take place. Accordingly, ASC Topic 830 introduces two concepts in accounting for foreign operations: the foreign entity and the functional currency.

**7.036** A foreign entity is a distinct and separable operation of an entity whose financial statements are prepared in a currency other than the reporting currency of the reporting entity, and are combined or consolidated with, or accounted for by the equity method in, the financial statements of the entity. The functional currency of a foreign entity is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. If this environment is a highly inflationary economy, the parent's functional currency (the reporting currency) should be used as if it were the entity's functional currency.

**7.037** The functional currency approach requires:

- Measurement and recognition of foreign currency transactions of an entity in the entity's functional currency: At the date the transaction is recognized, each asset, liability, income, and expense arising from the transaction should be measured and recorded in the entity's functional currency using the exchange rate at which the transaction could be settled at the transaction date. At each balance sheet date, recognized monetary assets and liabilities that are denominated in a currency other than the entity's functional currency should be adjusted to reflect the exchange rate at which the related receivable or payable could be settled at that date. ASC paragraphs 830-20-25-1, 30-1, 35-1 and 35-2
- Translation of an entity's functional currency financial statements into the reporting currency (if different) for preparation of the entity's consolidated financial statements: At each balance sheet date, (a) assets and liabilities are translated at the exchange rate applicable to dividend remittances at the balance sheet date, and (b) income and expenses are translated at the exchange rate at the date on which those elements are recognized or at an appropriately weighted average exchange rate for the period of operations. The translation adjustments can be viewed as unrealized gains or losses. Therefore, the translation adjustments are reported in other comprehensive income and accumulated in the cumulative translation adjustment component of accumulated other comprehensive income until realized on sale or liquidation of the foreign entity. ASC paragraphs 830-10-55-10, 830-30-45-3, and 45-12

**7.038 Local Currency Is the Functional Currency.** When the local foreign currency is the functional currency, ASC Topic 740 requires measurement of deferred tax assets and liabilities for temporary differences between the functional currency financial statement carrying amounts of assets and liabilities (using U.S. generally accepted accounting principles but before translation to the reporting currency) and their functional currency tax bases (including any effects of indexing) in the foreign tax jurisdiction. The resulting deferred tax assets and liabilities measured in the functional currency are then translated

into the reporting currency (with the other assets and liabilities measured in the foreign currency) using the exchange rate at the balance sheet date.

### Example 7.1: Calculating Deferred Taxes on Temporary Differences When the Local Currency Is the Functional Currency and the Tax Basis Is Subject to Indexing

ABC Corp. has a wholly owned subsidiary (Subsidiary B) that operates in a foreign country whose tax rate is 30%. Subsidiary B's functional currency is the local currency. The applicable tax rate in the tax jurisdiction is 30%.

Subsidiary B has one temporary difference related to equipment that it acquired on January 1, 20X6 for FC 40,000. The equipment is depreciated on a straight-line basis over four years for both financial reporting and tax reporting purposes. Tax laws in the foreign tax jurisdiction require indexing the local currency tax basis of depreciable assets for the effects of inflation. The inflation index is multiplied by the end of the year adjusted tax basis (after the current year's depreciation) of the depreciable asset to determine the inflation index adjustment. The inflation index was 10% for 20X6 and 15% for 20X7.

As of January 1, 20X6, the current exchange rate was U.S. \$1 = FC 1. As of December 31, 20X6 the current exchange rate was U.S. \$1 = FC 1.5 (average exchange rate for 20X6 was U.S. \$1 = FC 1.2). As of December 31, 20X7, the current exchange rate was U.S. \$1 = FC 2.5 (average exchange rate for 20X7 was U.S. \$1 = FC 2.0).

Subsidiary B's temporary difference is calculated as follows:

		<b>Tax Basis</b>		<b>Financial Reporting Basis</b>		<b>Deductible (Taxable) Temporary Difference</b>
As of January 1, 20X6	FC	40,000	FC	40,000	FC	—
Depreciation expense		(10,000)		(10,000)		—
Inflation index adjustment		3,000		—		3,000
As of December 31, 20X6	FC	33,000	FC	30,000	FC	3,000
Depreciation expense		(11,000)		(10,000)		(1,000)
Inflation index adjustment		3,300		—		3,300
As of December 31, 20X7	FC	<u>25,300</u>	FC	<u>20,000</u>	FC	<u>5,300</u>

Subsidiary B's deferred tax asset for that deductible temporary difference is calculated as follows using the 30% tax rate in the foreign tax jurisdiction.

		Tax Basis		Financial Reporting Basis		Deductible Temporary Difference		Deferred Tax Asset
As of January 1, 20X6	FC	40,000	FC	40,000	FC	—	FC	—
As of December 31, 20X6	FC	33,000	FC	30,000	FC	3,000	FC	900
As of December 31, 20X7	FC	25,300	FC	20,000	FC	5,300	FC	1,590

Assuming that a valuation allowance is not recognized for the deferred tax asset because of carryback availability or expected future income in the foreign tax jurisdiction, Subsidiary B recognizes a deferred tax benefit of FC 900 for 20X6 and a deferred tax benefit of FC 690 for 20X7.

ABC would recognize the following deferred tax asset in connection with the translation of the financial statements of Subsidiary B<sup>1</sup>:

	U.S. \$ ABC Corp.
As of January 1, 20X6	\$ —
Deferred tax benefit (FC 900 ÷ 1.2)	750
Translation adjustment <sup>2</sup>	(150)
As of December 31, 20X6 (FC 900 ÷ 1.5)	\$ 600
Deferred tax benefit (FC 690 ÷ 2.0)	345
Translation adjustment <sup>3</sup>	(309)
As of December 31, 20X7 (FC 1,590 ÷ 2.5)	\$ 636

The translation adjustments calculated above are reported in other comprehensive income and accumulated in the cumulative translation adjustment component of accumulated other comprehensive income with other translation adjustments (see illustration in Example 9.28).

<sup>1</sup> This example does not incorporate the effects of foreign tax credits on the consolidated financial statements of ABC. See Example 7.2 for illustration.

<sup>2</sup> (FC 900 ÷ 1.2) - (FC 900 ÷ 1.5)

<sup>3</sup> (FC 900 ÷ 1.5) + (FC 690 ÷ 2.0) - (FC 1,590 ÷ 2.5)

### 7.039 Temporary Differences Arising as a Result of Currency Translation.

Translating a foreign subsidiary's assets and liabilities into the reporting currency after a change in exchange rates may affect a temporary difference for the parent entity in its investment in the foreign subsidiary. This portion of the temporary difference may equal

the cumulative translation adjustment because the adjustment changes the financial statement carrying amount of the parent's investment in the foreign subsidiary but does not change the parent's tax basis in that investment and therefore results in an (additional) outside basis difference. See Paragraph 7.001 for additional discussion of outside basis differences.

**7.040** Whether the parent of a foreign subsidiary recognizes deferred tax liabilities attributable to the portion of a taxable temporary difference resulting from translation adjustments depends on the application of the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) to the investment in the foreign subsidiary as discussed in Paragraph 7.003.

- If the indefinite reversal criterion applies to the entire investment in the foreign subsidiary, deferred taxes are not recognized on the portion of the temporary difference resulting from cumulative translation adjustments.
- If the indefinite reversal criterion does not apply to any part of the investment in the foreign subsidiary, deferred taxes are recognized on the portion of a taxable temporary difference resulting from translation adjustments. The assumption is that foreign exchange gains and losses will eventually be realized and therefore have a tax consequence when earnings are remitted to the parent or the subsidiary is sold.
- If the indefinite reversal criterion applies to only a portion of the investment in the foreign subsidiary, deferred taxes are not recognized on the portion of a taxable temporary difference resulting from translation adjustments associated with the portion of the overall temporary difference for which the indefinite reversal criterion applies; however, it may be appropriate to recognize deferred taxes on the entire portion of the temporary difference related to the remainder of the cumulative translation adjustment associated with that portion of the investment in the subsidiary for which the indefinite reversal criterion does not apply.

**7.041** As discussed in the context of overall deductible outside basis difference in Paragraph 7.021, deferred tax assets resulting from translation adjustments may not be recognized unless it is apparent that the temporary difference will reverse in the foreseeable future. ASC paragraphs 740-30-25-9 through 25-13

**7.042** As discussed in Paragraph 7.013, the exceptions discussed in Paragraphs 7.040 and 7.041 generally do not apply to equity method investments. Deferred tax assets and liabilities should be recognized on the portion of temporary differences resulting from translation adjustments of investments in common stock accounted for under the equity method unless (a) the taxable basis differences arose while the foreign equity method investment was a consolidated subsidiary (or corporate joint venture) and continue to be indefinitely postponed, or (b) the investment qualifies as a foreign corporate joint venture for which the ASC paragraph 740-30-25-17 (APB 23) exception may be applied. See Paragraphs 7.014 through 7.016.

### Example 7.2: Calculation of Outside Basis Differences for a Foreign Subsidiary

Parent Z owns 100% of ABC Corp. (a Euro functional entity). Parent Z has not historically recognized a deferred tax liability for its taxable outside basis difference related to its investment in ABC because it expected to recover its investment through tax-free distributions and an eventual tax-free liquidation.

On December 31, 20X7, Parent Z decides to accept an unsolicited offer to buy ABC. Accordingly, the taxable outside basis difference for Parent Z's investment in ABC does not meet the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23).

Parent Z accounts for GILTI as a period cost and does not anticipate that any of the inside basis differences will result in future Subpart F income. ABC does not have any previously taxed earnings and profits or other earnings and profits. Accordingly, a sale at the U.S. GAAP carrying amount would result in a capital gain to Parent Z at a U.S. income tax rate of 21%.

Assume the following as of December 31, 20X7:

U.S. GAAP carrying amount of Parent Z's investment in the stock of ABC	\$	25,400
Tax basis of Parent Z's investment in the stock of ABC	\$	20,000
Translation adjustment during the year	\$	900

The deferred tax liability related to Parent Z's outside basis difference for its investment in ABC at December 31, 20X7 is calculated as follows:

U.S. GAAP carrying amount of investment in ABC	\$	25,400
Tax basis of investment in ABC	\$	<u>20,000</u>
Excess of carrying amount of investment over tax basis	\$	5,400
Deferred tax liability at 21% tax rate	\$	1,134

Because \$900 of the \$5,400 of the total outside basis arises as a result of the current year translation adjustment, \$189<sup>1</sup> of the total \$1,134 deferred tax liability will be established with a charge to other comprehensive income while the remaining \$945 will be established with a charge to income tax expense allocated to continuing operations. See additional discussion of intraperiod tax allocation beginning in Paragraph 9.020, changes in indefinite reinvestment assertions in Paragraph 10.085 and use of the effective rate method in Paragraph 7.043.

<sup>1</sup> Computed as the effective tax rate 21% (\$1,134/\$5,400) applied to the \$900 translation adjustment during the year.



**7.043 Intra-period Tax Allocation of Deferred Tax Expense or Benefit Resulting from the Translation Adjustment.** The deferred tax expense or benefit associated with deferred taxes denominated in the parent's functional currency recognized on temporary differences resulting from translation adjustments are charged or credited to the translation adjustment component of other comprehensive income as such temporary differences arise (see Paragraph 9.044 for additional discussion of the intra-period tax allocation of income taxes on the translation adjustment and Paragraphs 10.085 to 10.086a for additional discussion of intra-period tax allocation on change in the indefinite reversal assessment under ASC paragraph 740-30-25-17 (APB 23)). ASC paragraphs 740-20-55-18 through 55-24 include an example of the intra-period tax allocation of deferred expense associated with unremitted earnings and translation adjustments. In that example, deferred expense for both the unremitted earnings and the translation adjustments are allocated using an effective tax rate that reflects foreign tax credits. It is also acceptable to allocate the amounts using the step-by-step approach.

### Example 7.3: Temporary Difference Resulting from Cumulative Translation Adjustment

On January 1, 20X6 Parent Entity, a U.S. entity, acquired all of the common stock of ABC Corp. for U.S. \$1,000 in cash. ABC operates in a foreign tax jurisdiction. ABC's functional currency is the local currency (FC).

Parent Entity's tax basis of the investment in the stock of ABC was U.S. \$1,000 on January 1, 20X6. On January 1, 20X6 the exchange rate was FC 1 = U.S. \$1. The average exchange rate for the year ended December 31, 20X6 and the exchange rate at December 31, 20X6 was FC 1 = U.S. \$1.10 and FC 1 = U.S. \$1.15, respectively. A summary of ABC's balance sheet at December 31, 20X6 in the foreign currency and in U.S. dollars is presented below:

	FC	U.S. \$
Assets	\$ 2,000	\$ 2,300
Liabilities	<u>800</u>	<u>920</u>
Stockholders' equity:		
Common stock and paid-in capital	1,000	1,000
Retained earnings	200	220
Cumulative translation adjustment	<u>—</u>	<u>160<sup>1</sup></u>
Total equity	\$ 1,200	\$ 1,380

ABC's pretax earnings consist of an FC 240 unrealized gain that will generate Subpart F income when realized. ABC has also recognized a deferred tax liability of FC 40 for local income taxes on that unrealized gain. The FC 40 deferred tax liability is expected to reverse in a period in which Parent Entity has Subpart F income and can realize the benefit of the foreign tax credit generated. ABC currently has no earnings and profits. Parent Entity expects to recover its investment in ABC through a sale after the Subpart F income is recognized and after the local deferred tax liability is settled.

At December 31, 20X6 there is a taxable temporary difference in the U.S. tax jurisdiction of U.S. \$380 between Parent Entity's financial statement carrying amount of U.S. \$1,380 and tax basis of U.S. \$1,000 of the investment in the stock of ABC due to an increase in assets represented by undistributed earnings of U.S. \$220 and the effect of the cumulative translation adjustment of U.S. \$160.

If the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) does not apply, the deferred tax liability on the basis difference would be recognized. Assume Parent Entity has a 21% U.S. tax rate. Parent Entity would make one of the following entries to recognize the deferred tax liability on its outside basis difference:

	Debit	Credit
Effective tax rate approach:		
Income tax expense ( $\$220 \times 11.32\%^2$ )	25	
Translation adjustment ( $\$160 \times 11.32\%^2$ )	18	
Deferred tax liability <sup>3</sup>		43

Step-by-step approach:

Income tax expense <sup>4</sup>	11	
Translation adjustment	32	
Deferred tax liability <sup>3</sup>		43

<sup>1</sup> The cumulative translation adjustment comprises two components:

Translation adjustment on opening equity FC 1,000 $\times$ (1.15 - 1.00)	\$ 150
Translation adjustment on net income FC 200 $\times$ (1.15 - 1.10)	\$ <u>10</u>

Cumulative translation adjustment	\$ 160
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<sup>2</sup> Represents the effective rate net of foreign tax credits on the temporary difference. Computed as total tax of \$43 divided by the outside basis difference of \$380.

<sup>3</sup> Computed as the net of a deferred tax liability for future Subpart F income of \$58 ( $(\text{FC } 240 \times 1.15) \times 21\%$ ), less \$46 ( $\text{FC } 40 \times 1.15$ ) of foreign tax credit (with an offsetting impact for the earnings and profit deduction and section 78 gross-up), plus a deferred tax liability for the capital gain that would be triggered upon a sale after recognizing the Subpart F income \$31 ( $\$1,380 - (\$1,000 + ((\text{FC } 240 - \text{FC } 40) \times 1.15)) \times 21\%$ ) for a net deferred tax liability of \$43.

<sup>4</sup> It is also acceptable to use the step-by-step approach for allocating deferred tax expense related to the investment in ABC. Under that approach, income tax expense allocated to continuing operations would be determined as if there was no translation adjustment amount. In that case, the carrying amount of ABC would be \$1,220 and the deferred tax to allocate to continuing operations would be computed as the net effect of future Subpart F income of \$55 ( $(\text{FC } 240 \times 1.10) \times 21\%$ ) less \$44 ( $\text{FC } 40 \times 1.10$ ) of foreign tax credit for a net deferred tax expense of \$11. See Paragraph 7.043.

### Example 7.4: Cumulative Translation Adjustment for Foreign Branch

ABC Corp. has a U.K. foreign branch (see the discussion beginning at Paragraph 7.068 about foreign branch temporary differences), therefore, the income (loss) of the foreign branch is included in U.S. taxable income each year on a current basis. In addition to recording the appropriate local and U.S. current and deferred taxes related to the U.K. branch's results, ABC also has recorded the U.S. deferred taxes on the outside basis difference resulting from an unrealized section 987 gain that relates to the branch's operations and net assets and allocated the related deferred tax expense in accordance with ASC paragraphs 740-20-55-18 to 55-24.

On January 1, 20X9, the U.K. branch made a cash remittance to the U.S. parent (ABC). For U.S. tax purposes, under Internal Revenue Code section 987, ABC recognizes taxable gain or loss for the foreign currency gain or loss attributable to the branch remittance.

Because ABC appropriately adjusted the deferred tax balances to the spot rate immediately before the remittance, the deferred tax benefit (to reverse the deferred tax liability) would offset the related current tax expense that results from the cash remittance. There is no net adjustment to other comprehensive income because the deferred taxes recorded at December 31, 20X8 are at the same spot rate as the cash remittance on January 1, 20X9. Accordingly, there is no net effect on income tax expense or benefit as a result of the January 1, 20X9 remittance.

If cash is remitted at any date other than a date as of which deferred taxes related to the unrealized section 987 gain have been calculated, ABC would need to true-up deferred tax balances for the current exchange rate prior to accounting for cash remittance received from the foreign branch.

Note: The above accounting would also apply to the portion of a temporary difference for a controlled foreign corporation associated with a cumulative translation adjustment where the parent does not assert indefinite reversal. (A controlled foreign corporation is defined in the Internal Revenue Code as a foreign corporation where more than 50% of the total combined voting power or value is owned directly, indirectly, or constructively by U.S. shareholders.)

### Example 7.5: Recognition of Tax Effects on Distribution of Earnings from a Foreign Subsidiary to Its Parent

Parent holds an investment in a subsidiary that constitutes a foreign operation. The subsidiary's functional currency is its local currency, which differs from Parent's reporting currency (US \$). Parent does not assert the ASC paragraph 740-30-25-17 (APB 23) exception to recording deferred tax liabilities on the outside basis difference and,

therefore, recognizes deferred taxes on the undistributed earnings held by the subsidiary. The deferred tax expense or benefit each year related to the translation adjustment is allocated to other comprehensive income and accumulated in the cumulative translation adjustment (CTA) component of accumulated other comprehensive income.

ASC paragraphs 740-20-55-18 through 55-24 describe the original accounting for the subsidiary's earnings:

#### Example 4: Allocation to Other Comprehensive Income

**55-18** Income taxes are sometimes allocated directly to shareholders' equity or to other comprehensive income. This Example illustrates the allocation of income taxes for translation adjustments under the requirements of Subtopic 830-30 to other comprehensive income. In this Example, FC represents units of foreign currency.

**55-19** A foreign subsidiary has earnings of FC 600 for Year 2. Its net assets (and unremitted earnings) are FC 1,000 and FC 1,600 at the end of Years 1 and 2, respectively.

**55-20** The foreign currency is the functional currency. For Year 2, translated amounts are as follows.

	<b>Foreign Currency</b>	<b>Exchange Rate</b>	<b>Dollars</b>
Unremitted earnings, beginning of year	<u>FC1,000</u>	<u>FC1 = \$1.20</u>	<u>\$1,200</u>
Earnings for the year	<u>FC 600</u>	<u>FC1 = \$1.10</u>	<u>\$ 660</u>
Unremitted earnings, end of year	<u>FC1,600</u>	<u>FC1 = \$1.00</u>	<u>\$1,600</u>

**55-21** A \$260 translation adjustment ( $\$1,200 + \$660 - \$1,600$ ) is reported in other comprehensive income and accumulated in shareholders' equity for Year 2.

**55-22** The U.S. parent expects that all of the foreign subsidiary's unremitted earnings will be remitted in the foreseeable future, and under the requirements of ASC Subtopic 740-30, a deferred U.S. tax liability is recognized for those unremitted earnings.

**55-23** The U.S. parent accrues the deferred tax liability at a 20 percent tax rate (that is, net of foreign tax credits, foreign tax credit carryforwards, and so forth). An analysis of the net investment in the foreign subsidiary and the related deferred tax liability for Year 2 is as follows.

	<b>Net Investment</b>	<b>Deferred Tax Liability</b>
Balances, beginning of year	\$1,200	\$240
Earnings and related taxes	660	132
Translation adjustment and related taxes	(260)	(52)
Balances, end of year	<u>\$1,600</u>	<u>\$320</u>

**55-24** For Year 2, \$132 of deferred taxes are charged against earnings, and \$52 of deferred taxes are reported in other comprehensive income and accumulated in shareholders' equity.

To extend the ASC 740 example, assume now that the FC 600 earnings for the year is distributed to Parent on March 31 of the following year when the exchange rate is FC1 = \$0.95. Further, assume that the subsidiary had no additional profit or loss for the first quarter of this year and that the distribution is a hybrid dividend that is not eligible for a dividends received deduction. This would yield the following amounts immediately after the FC 600 is distributed to Parent:

	<b>Foreign Currency</b>	<b>Exchange Rate</b>	<b>Dollar</b>	<b>Deferred Tax Liability (Asset)</b>
Undistributed earnings, beginning of period	FC1,600	FC1 = \$1.00	\$1,600	\$320
3/31 Dividends	(600)	FC1 = \$.95	(570)	(114)
Undistributed earnings after distribution	1,000	FC1 = \$.95	950	190
	Beginning of period	End of period	Change	Tax effect
CTA (in US\$)	(260)	(340)	80 *	16

\* \$80 = \$1,600 - \$570 - \$950

Therefore, the tax effects of the distribution would be recorded as:

*To reverse the deferred tax effects of the portion of the undistributed earnings being distributed to current, the following is recorded:*

	<b>Debit</b>	<b>Credit</b>
Deferred tax liability	114	
Deferred tax expense		114
Current tax expense	114	
Current taxes payable		114

*To allocate the deferred tax benefit to the translation adjustment in accordance with Parent's policy to use the ASC 740-20-55-18 approach, the following is recorded:*

	Debit	Credit
Deferred tax liability	16	
CTA		16

**7.043a** In December 2016, the IRS issued final and temporary regulations (the Regulations) that provide guidance under section 987 of the Internal Revenue Code<sup>1</sup>. Section 987 was enacted as part of the Tax Reform Act of 1986 to guide taxpayers on determining taxable income when a qualified business unit (QBU<sup>2</sup>) owned by a taxpayer has a functional currency different from that of the taxpayer. In general, under section 987, an owner of a QBU must include in its taxable income the QBU's annual taxable income or loss, and foreign currency exchange gain or loss with respect to the QBU. Because the statute provides limited guidance on the operational aspects of the calculations needed to comply with section 987, many taxpayers have used a methodology in regulations that were proposed in 1991 (but were eventually withdrawn in 2006).

**7.043b** Under the Regulations, a QBU maintains an income statement in its functional currency under U.S. tax principles, then converts each item of income, gain, deduction, and loss on the statement to the QBU owner's functional currency using the exchange rate conventions provided in the Regulations. As a general rule, items of the income statement are translated at the average exchange rate for the year. However, depreciation and amortization deductions (and other cost recovery deductions) and the basis of historic assets (that are not cost of goods sold) are translated at their historic exchange rates (defined as the average rate for the year the relevant asset was acquired or placed in service). In addition, the Regulations provide a complex convention for translating cost of goods sold, which generally translates cost of goods sold at the yearly average exchange rate and adjusts for inventoriable costs attributable to historic assets (e.g., depreciation) to account for the difference in the exchange rate from the current year and the year in which the asset from which the inventoriable cost was derived was acquired or placed in service. Taxpayers can make certain elections that affect the translation of the income statement items, including an election to translate all income statement items at the yearly average exchange rate.

**7.043c** The Regulations generally are effective for tax years beginning on or after the first day of the first tax year following December 7, 2022 (the *Amended Applicability Date*), which would be January 1, 2023, for a calendar year taxpayer. Taxpayers can elect to apply the Regulations for tax years beginning on or after December 7, 2016, provided the rules are consistently applied to all the taxpayer's QBUs. Taxpayers generally must transition to the rules in the Regulations using the *fresh start* transition method, which treats each QBU as terminating on the day before the Amended Applicability Date, and

transfer all its assets and liabilities to a new QBU on the Amended Applicability Date. No section 987 gain or loss is recognized as a result of the deemed termination.

**7.043d** Notwithstanding the generally delayed effective date of January 1, 2023, certain rules are currently effective, including rules that substantially restrict the recognition of losses in connection with certain QBU terminations, certain transactions that involve partnerships, and certain related party outbound transactions. Any section 987 loss deferred under these rules generally is recognized when the QBU makes subsequent remittances, or when the QBU ceases to be owned by a member of the controlled group. The amount of any section 987 loss deferred as a result of a transaction that occurs before the fresh start year is adjusted on the Amended Applicability Date to reflect the new methodology for calculating section 987 gain or loss prescribed in the Regulations.

### **Example 7.5a: Adopting the 2016 Section 987 Regulations**

*The following example illustrates the accounting for the issuance of the regulations in 2016, so the tax rates used are those that were in effect at December 7, 2016 and the expected adoption date used has not been adjusted for the subsequent deferrals.*

USCO, a U.S. Corporation, wholly owns UK, a foreign entity, which is treated as a disregarded entity for U.S. federal income tax purposes. USCO is a calendar year taxpayer. UK is a QBU for section 987 purposes and conducts a foreign trade or business in pounds (GBPs), using that functional currency for both U.S. GAAP and U.S. federal income tax purposes. USCO complies with section 987 based on the method prescribed in the 1991 proposed regulations. USCO has an accounting policy to apply the ASC 740-30 exceptions to any unrecognized section 987 gain or loss. The first year that the Regulations apply to USCO is the tax year that begins January 1, 2018. USCO does not expect to make section 987 elections. USCO's enacted tax rate in 2016 was 40% and the local income taxes of UK are ignored for simplicity.

UK was established on January 1, 2015 with a £4 million capital contribution. That same day, UK borrowed £6 million from an unrelated party, and used the funds to acquire its sole asset, a depreciable asset acquired for £10 million with a 20-year life for book purposes and a 10-year life for tax purposes. The straight-line method is used for both book and tax purposes. Operations are breakeven before considering the effects of depreciation, and any taxable loss generated can be recovered by offsetting with other USCO income. USCO has a long history of earnings that are expected to continue so no valuation allowance is needed on USCO's deferred tax assets. UK expects to own the depreciable asset and have the loan outstanding in 2018. Assume the exchange rates were:

- GBP 1: USD 1.7 when the asset was acquired on January 1, 2015
- GBP 1: USD 1.7 throughout 2015
- Averaged GBP 1: USD 1.4 for 2015 and 2016
- GBP 1: USD 1.2 on December 7, 2016

USCO has an unrecognized section 987 loss of \$1.6 million at December 7, 2016. Although USCO may make remittances from UK from time to time, before issuance of the Regulations there were no planned remittances that were apparent to occur in the foreseeable future. Accordingly, USCO did not recognize a deferred tax asset on the unrecognized section 987 loss.

As a result of the Regulations, USCO intends to make a remittance from UK before adopting the Regulations on January 1, 2018. That remittance will result in a deduction for half of the unrecognized section 987 loss. The other half of the unrecognized section 987 loss is never expected to be recognized under the Regulations. Because of USCO's intent to make a remittance, half of the unrecognized section 987 loss meets the criteria for recognition under ASC paragraph 740-30-25-9 (see Paragraph 7.021). At December 7, 2016, USCO recognizes a deferred tax asset of \$320,000 ( $\$800,000 \times 40\%$ ) with a corresponding deferred tax benefit.

Additionally, USCO will need to remeasure its deferred taxes for the depreciable asset because it will now have a different tax basis under the Regulations. The financial statement carrying amount of the asset was £9 million on December 7, 2016, and its U.S. tax basis under the 1991 proposed regulations was £8 million on that date. Accordingly, as of December 7, 2016, under the 1991 proposed regulations, there is a taxable temporary difference of £1 million ( $\text{£}8 \text{ million} - \text{£}9 \text{ million}$ ) for which a deferred tax liability of \$480,000 ( $\text{£}1 \text{ million} \times 40\% \times 1.2$  (the exchange rate on December 7, 2016)) is currently recognized.

Tax depreciation deductions of £1 million will be allowed in 2017 under the 1991 proposed regulations and \$11.9 million from 2018 through the end of the life of the asset under the Regulations ( $\text{£}10 \text{ million} \times 1.7$  is \$17 million of initial basis, with seven years of its ten-year life remaining;  $\$17 \text{ million} \times 7 / 10 = \$11.9 \text{ million}$ ).

This results in total tax basis of \$13.1 million ( $\text{£}1 \text{ million} \times 1.2 + \$11.9 \text{ million}$ ). Accordingly, there is a deductible temporary difference of \$2.3 million ( $\$13.1 \text{ million} - (\text{£}9 \text{ million} \times 1.2)$ ) for which a deferred tax asset of \$920,000 ( $\$2.3 \text{ million} \times 40\%$ ) should be recognized as of December 7, 2016. As a result, a deferred tax benefit of \$1.4 million is recognized for remeasuring the deferred taxes for the depreciable asset from a \$480,000 deferred tax liability to a \$920,000 deferred tax asset.

Finally, on adoption of the Regulations, USCO should consider the need for deferred taxes for the new unrecognized section 987 gain or loss related to the loan. At the Transition Date to the Regulations, the tax basis in the loan will be based on its historic rate and will be \$10.2 million ( $\text{£}6 \text{ million} \times 1.7$ ). The loan has a current financial statement carrying amount of \$7.2 million ( $\text{£}6 \text{ million} \times 1.2$ ). Accordingly, USCO would expect to create an unrecognized section 987 gain of \$3 million ( $\$10.2 \text{ million} - \$7.2 \text{ million}$ ) during the fresh start year under the Regulations, based on current exchange rates. As USCO may make remittances from UK from time to time, it does not meet the indefinite reversal criterion and would recognize a deferred tax liability and corresponding deferred tax expense of \$1.2 million ( $\$3 \text{ million} \times 40\%$ ) for the unrecognized section 987 gain on issuance of the Regulations.



In summary, USCO would recognize a \$320,000 deferred tax benefit for its existing unrecognized section 987 loss, a \$1.4 million deferred tax benefit for remeasuring its deferred taxes for the depreciable asset, and a \$1.2 million deferred tax expense for the unrecognized section 987 gain related to the loan. The net \$520,000 deferred tax benefit would be recognized in continuing operations in the period that includes December 7, 2016.

**7.044 Local Currency Is Not the Functional Currency – Nonmonetary Assets and Liabilities.** When the local currency is not the functional currency for foreign operations and the books of record are maintained in the foreign (local) currency, ASC Topic 830 requires remeasurement of the foreign operation's nonmonetary assets and liabilities into functional currency using historical exchange rates. The tax basis of assets and liabilities in these situations is often denominated in the local currency. Because remeasurement under ASC Topic 830 does not result in a transaction gain or loss as a result of exchange rate changes from the historical exchange rate to the current exchange rate for nonmonetary assets or liabilities under these circumstances, ASC Topic 740 prohibits the recognition of deferred taxes on such differences. To do otherwise would mean recognizing deferred taxes on exchange gains or losses that are not recognized under ASC Topic 830. Similarly, ASC Topic 740 also prohibits the recognition of deferred taxes on temporary differences that result from indexing for tax purposes related to nonmonetary assets or liabilities that are remeasured using historical exchange rates when the functional currency is not the local currency. ASC subparagraph 740-10-25-3(f), and paragraph 830-740-45-1

**7.045** Foreign deferred taxes are, however, recognized on temporary differences between the historical local-currency-equivalent financial statement carrying amount of a nonmonetary asset or liability and its local currency tax basis exclusive of the effects of indexing. For instance, a difference between the local currency tax basis and the historical local-currency-equivalent financial statement carrying amount of a nonmonetary asset may arise due to differences in the method of depreciation or life used for tax and financial reporting purposes. A foreign deferred tax asset or liability should be recognized on that temporary difference in the foreign tax jurisdiction and remeasured into the functional currency using the current exchange rate. Differences between the historical local-currency-equivalent financial statement carrying amount of a nonmonetary asset or liability and its local currency tax basis resulting from the effects of indexing are an exception to comprehensive recognition of deferred taxes and are recognized as the related deductions are taken on the tax return.

### **Example 7.6: Calculation of Deferred Taxes on Temporary Differences When the Local Currency Is Not the Functional Currency**

DEF Corp. is a wholly owned foreign subsidiary of ABC Corp. The U.S. dollar is the functional currency for DEF. On January 1, 20X6 DEF purchased equipment for FC 6,000. The exchange rate on that date was U.S. \$1 = FC 5.0. The equipment is depreciated over

three years for tax purposes and six years for financial statement purposes. At December 31, 20X6 the exchange rate is U.S. \$1 = FC 10. The enacted tax rate is 20% in the foreign tax jurisdiction. Tax law in the foreign jurisdiction does not permit indexing.

The portion of the temporary difference for which deferred taxes are recognized related to the equipment at December 31, 20X6 is calculated as follows:

	Foreign Currency Historical Cost		Tax Basis		Taxable Temporary Difference
Cost	FC	6,000	FC	6,000	
Accumulated depreciation		<u>1,000</u>		<u>2,000</u>	
	FC	<u><u>5,000</u></u>	FC	<u><u>4,000</u></u>	FC <u><u>1,000</u></u>

The foreign deferred tax liability is calculated by applying the enacted tax rate of 20% to FC 1,000 of the taxable temporary difference. The resulting foreign deferred tax liability of FC 200 is then remeasured using the current exchange rate to arrive at a deferred tax liability of \$20 for U.S. financial reporting purposes.

If the tax law in the foreign jurisdiction had permitted indexing and the indexing increased the December 31, 20X6 tax basis to FC 4,400, deferred taxes would still be recognized on FC 1,000 of the temporary difference as ASC Topic 740 prohibits the recognition of deferred taxes for the portion of the temporary difference caused by indexing when the reporting currency is the functional currency.

**7.046 Local Currency Is Not the Functional Currency – Monetary Assets and Liabilities.** While ASC Topic 740 provides an exception to the recognition of deferred taxes on temporary differences associated with nonmonetary assets and liabilities resulting from changes in exchange rates or indexing for tax purposes when the functional currency is not the local currency (as discussed in Paragraph 7.044), it does not provide a similar exception for temporary differences associated with monetary assets or liabilities that are denominated in the entity's functional currency that will be subject to tax in the foreign jurisdiction on settlement based on the local-currency-equivalent settlement amount. Notwithstanding that these temporary differences (that result from changes in exchange rates) do not give rise to foreign exchange gains or losses (because the transaction is denominated in the entity's functional currency, it is not a foreign currency transaction under ASC Topic 830), deferred taxes are provided if settling the asset or liability at its financial statement carrying amount would result in taxable income or loss in the local tax jurisdiction. Because the financial statement carrying amounts and tax bases of these assets or liabilities are not in the same currency, either a local-currency-equivalent financial statement carrying amount, or a functional-currency-equivalent tax basis, must be computed to determine whether a temporary difference exists. For example, deferred taxes may be measured as the difference between the current local-currency-equivalent financial statement carrying amount and the local

currency tax basis. A similar issue relates to monetary assets and liabilities that are denominated in the local currency when the local currency is not the functional currency. Monetary assets and liabilities denominated in the local currency give rise to transaction gains or losses in the functional currency financial statements under ASC Topic 830 (resulting in a change in the functional currency financial statement carrying amounts). However, this situation does not result in the recognition of deferred taxes because no basis difference generally exists when the financial statement carrying amounts and tax bases are converted into a common currency. For example, if the local-currency-equivalent financial statement carrying amount (which generally would not change solely as a result of exchange rate changes) were equal to the local-currency-equivalent tax basis, then the settlement of the asset or liability at the balance sheet date generally would not result in local taxation even though the financial statement carrying amount is adjusted each period for changes in exchange rates.

### **Example 7.7: Calculation of Foreign Deferred Tax Expense or Benefit for a Monetary Asset or Liability Denominated in the Functional Currency**

DEF Corp. operates in a foreign tax jurisdiction and is a wholly owned subsidiary of ABC Corp. The U.S. dollar is the functional currency for DEF. On December 31, 20X6 (when the exchange rate was U.S. \$1 = FC 1,000), DEF issued \$1,000 of U.S. dollar-denominated debt, resulting in a financial statement carrying amount of \$1,000 and a tax basis in the foreign tax jurisdiction of FC 1,000,000.

At December 31, 20X7, the exchange rate is U.S. \$1 = FC 1,250. While the financial statement carrying amount of the debt continues to be \$1,000 (because DEF's functional currency is the U.S. dollar), the FC-equivalent financial statement carrying amount has changed to FC 1,250,000 ( $\$1,000 \times \text{FC } 1,250$ ). In these circumstances (assuming a 30% tax rate in the foreign tax jurisdiction), DEF would recognize a deferred tax asset of \$60 which is the FC deferred tax asset ( $(\text{FC } 1,250,000 - \text{FC } 1,000,000) \times 30\% = \text{FC } 75,000$ ) remeasured into U.S. dollars at the end of period exchange rate ( $\text{FC } 75,000 / 1,250 = \$60$ ). In summary, DEF would have no pretax amount for the change in exchange rates, but would recognize a \$60 deferred tax benefit.

### **Example 7.8: Calculation of Foreign Deferred Tax Expense or Benefit for a Monetary Asset or Liability Denominated in the Local Currency**

DEF Corp. operates in a foreign tax jurisdiction and is a wholly owned subsidiary of ABC Corp. The U.S. dollar is the functional currency for DEF. On December 31, 20X6 (when the exchange rate was U.S. \$1 = FC 1,000), DEF issued FC 1,000,000 of foreign currency-denominated debt, resulting in a financial statement carrying amount of \$1,000 and a tax basis in the foreign tax jurisdiction of FC 1,000,000.

At December 31, 20X7, the exchange rate is U.S. \$1 = FC 1,250. While the financial statement carrying amount of the debt has changed to \$800 (FC 1,000,000/1,250) because DEF's functional currency is the U.S. dollar, the foreign-currency-equivalent financial statement carrying amount remains at FC 1,000,000 ( $\$800 \times \text{FC } 1,250$ ). In these circumstances, DEF does not recognize a deferred tax asset or liability because the foreign-currency-equivalent financial statement carrying amount of FC 1,000,000 is equal to the tax basis of FC 1,000,000. In summary, DEF would recognize a \$200 pretax currency transaction gain and no income tax expense.

**7.046a Local Currency Is Not the Functional Currency – Carryforwards.** Similar to temporary differences associated with monetary assets and liabilities, ASC Topic 740 does not provide an exception to the recognition of deferred taxes for carryforwards. Accordingly, deferred taxes for carryforwards are recognized based on the functional-currency-equivalent amount of the carryforward. Currency transaction gains and losses will arise on the remeasurement of deferred taxes for carryforwards. See Paragraph 7.047 for guidance on the presentation of transaction gains or losses resulting from the remeasurement of deferred taxes.

**7.046aa Measuring the Recipient's Liability for Withholding Taxes and Allocating the Related Deferred Tax Expense.** As discussed in Paragraph 7.026a, when a parent entity does not assert indefinite reinvestment, it should recognize a tax liability for withholding taxes and recognize in earnings changes to that liability attributable to changes in exchange rates. The liability is a foreign-currency denominated monetary liability for which ASC Topic 830 requires an entity to recognize transaction gains and losses in earnings (similar to monetary assets and liabilities that are denominated in the local currency when the reporting currency is the functional currency as discussed in Paragraph 7.046). An entity can elect a policy to present these transaction gains and losses in pretax income or income tax expense (benefit) (as long as that policy is consistently applied) but should include them in the aggregate transaction gain or loss disclosed under ASC Topic 830 (see Paragraph 7.047 for additional discussion about presentation of transaction gains and losses).

**7.046b** This guidance differs from the accounting for changes in U.S. dollar denominated income tax liabilities when fluctuations in exchange rates result in an increase or decrease to a U.S. parent's outside basis difference of its investment. For example, a U.S. parent that recognizes a U.S. dollar denominated state income tax liability on its outside basis difference in a subsidiary will adjust that liability through other comprehensive income when changes in exchange rates result in a translation adjustment that is recognized in other comprehensive income. The adjustment to that U.S. dollar denominated tax liability for changes in exchange rates arises because the U.S. parent's outside basis difference of its investment has changed and the tax effect of that basis difference change is allocated to other comprehensive income (see Paragraph 7.043 for additional discussion on allocating deferred tax expense to translation adjustments).

**7.046c** In contrast, the deferred tax liability for the withholding tax liability is denominated in a foreign currency. There has been no change in the parent's outside

basis difference from the foreign government's perspective – i.e., the parent's withholding tax obligation to the foreign taxing authority (which is payable in foreign currency) does not change with a change in exchange rates. Example 7.8a provides an illustration of recognizing deferred taxes on outside basis differences and allocating the related deferred tax expense when the parent had a withholding tax liability denominated in foreign currency.

### Example 7.8a: Deferred Tax Expense (Benefit) Related to Outside Basis Differences

#### Background

- U.S. Parent is a calendar year-end entity and a 100% shareholder of CFC1. CFC1 is a foreign subsidiary of U.S. Parent and also has a calendar year-end.
- The functional currency of U.S. Parent is the US dollar (USD) while the functional currency of CFC1 is FC for U.S. GAAP, U.S. income tax and local tax reporting purposes. The consolidated financial statements are presented in the group's reporting currency of the USD. Throughout 2017, the foreign exchange rate is 1.20 USD: 1 FC.
- CFC1 is not subject to local income taxes; however, there is a 10% withholding tax on distributions from statutory retained earnings of CFC1 to the United States. The withholding is remitted by CFC1 to the taxing authority in FC when distributions are made, but is attributed to U.S. Parent as an income tax of U.S. Parent for accounting purposes. There is also a 5% state income tax due on distributions of E&P from CFC1 to the United States. The state income tax is paid in USD by U.S. Parent.
- At December 31, 2017, CFC1 has accumulated statutory retained earnings of 1,000 FC and E&P of 1,000 FC. There are no book to tax basis differences in the calculation of statutory retained earnings and E&P.

During 2017, CFC1's statutory retained earnings and E&P are as follows:

	Foreign currency (FC)	Exchange rate (FC to USD)	USD
Unremitted earnings, 1/1/17	FC -	1.20	\$ -
Earnings	<u>1,000</u>	1.20	<u>1,200</u>
Unremitted earnings, 12/31/17	FC 1,000	1.20	\$ 1,200

- The Act requires U.S. Parent to include in gross income for U.S. federal income tax purposes, the USD equivalent of 1,000 FC of E&P as a one-time transition tax. U.S. Parent pays tax at a reduced tax rate on the inclusion. After being subject to the transition tax, the 1,000 FC of E&P is considered PTEP for U.S. federal income tax purposes and U.S. Parent receives \$1,200 of tax

basis in the PTEP. Based on the laws and Treasury guidance that exist at the balance sheet date, U.S. Parent concludes, based on supporting calculations, that it would receive a tax benefit at an 8% U.S. federal tax rate on any currency losses associated with the PTEP.

- Both the historic and future E&P will be subject to state income taxes at a 5% rate when remitted.
- U.S. Parent historically asserted indefinite reinvestment on its outside basis differences related to CFC1. In Q4 2017, U.S. Parent changes its internal treasury and funding plans and changes its assertion with respect to temporary differences associated with CFC1 because, in part, the Act results in a reduced tax cost on an actual remittance of CFC1 earnings.
- U.S. Parent expects to recover its investment in CFC1 through periodic distributions of earnings over its life, followed by a liquidation at an indefinite point in the future. It is apparent that the PTEP will be distributed in early 2019 and no valuation allowance would be required for any related U.S. federal deferred tax assets.
- U.S. Parent does not record U.S. federal deferred taxes as of December 31, 2017 with respect to the PTEP as its tax basis in the PTEP of \$1,200 equals the USD equivalent of the PTEP (1,000 FC x 1.20 = \$1,200).
- U.S. Parent calculates its deferred tax liability (DTL) for withholding and state income taxes as follows:

	<b>Withholding</b>	<b>State income taxes</b>
Statutory retained earnings or E&P	FC 1,000	FC 1,000
12/31/17 spot rate	<u>1.20</u>	<u>1.20</u>
USD equivalent	\$ 1,200	\$ 1,200
Tax rate	<u>10%</u>	<u>5%</u>
Deferred tax liability	\$ 120	\$ 60

As the entire deferred tax liability is attributable to 2017 earnings, the related deferred tax expense is allocated to income tax expense attributable to continuing operations.

During 2018, CFC1 generates an additional 600 FC of earnings. Accordingly, statutory retained earnings increases to 1,600 FC and E&P for state income tax purposes also increases to 1,600 FC. For U.S. federal income tax purposes, all of the 600 FC of earnings are E&P eligible for a 100% dividends received deduction. The average exchange rate for 2018 is 1.10 USD: 1 FC and the December 31, 2018 exchange rate is 1.00 USD: 1 FC.

CFC1's balance sheet is summarized as follows:

	12/31/17		12/31/18	
	FC	USD	FC	USD
Assets	FC 1,000	\$1,200	FC 1,600	\$1,600
Equity:				
Retained earnings	1,000	1,200	1,600	1,860
Currency translation adjustment	-	-	-	(260)
Total equity	FC 1,000	\$1,200	FC 1,600	\$1,600

CFC1's statutory retained earnings activity and state E&P activity during 2018 is summarized as follows, along with a rollforward of the related deferred tax liability recognized by U.S. Parent.

	Foreign currency (FC)	Exchange rate (FC to USD)	USD	Withholding DTL	State income tax DTL
Unremitted earnings, 1/1/2018	FC 1,000	1.20	\$1,200	\$120	\$ 60
Earnings	600	1.10	660	66	33
Currency related movement	-	-	(260)	(26)	(13)
Unremitted earnings, 12/31/2018	FC 1,600	1.00	\$1,600	\$160	\$ 80

U.S. Parent would also recognize a U.S. federal deferred tax asset for the currency loss related to the PTEP of 1,000 FC.

CFC1 PTEP	FC 1,000
12/31/18 exchange rate	1.00
USD equivalent	\$1,000
US Parent tax basis in PTEP	\$1,200
Deductible temporary difference	200
Tax rate	8%
Deferred tax asset	\$ 16

As discussed in Paragraph 7.046a, we believe the \$26 benefit arising from the remeasurement to current exchange rates of the FC denominated withholding deferred tax liability is a transaction gain under ASC Topic 830. U.S. Parent can elect a policy to present such transaction gains or losses in pretax income or in income tax expense as

long as the policy is consistently applied, but must disclose them as part of total transaction gains and losses in the notes to financial statements.

If U.S. Parent were expected to elect to take a foreign tax credit for the withholding taxes and could recognize the related deferred tax asset without a valuation allowance, we believe the benefit for the U.S. federal effect of the withholding deferred tax liability likewise would be recognized in income tax expense (benefit) from continuing operations.

The \$13 deferred tax benefit from the remeasurement on the state deferred tax liability, along with any federal effect of the state deferred tax liability, and the \$16 deferred tax benefit from the remeasurement of the U.S. federal deferred tax asset for the PTEP would be allocated under either the step-by-step approach or the effective tax rate approach (see Paragraph 7.043), which we generally would expect to result in these amounts being allocated to the translation adjustment component within other comprehensive income.

**7.047 Presentation of Transaction Gains or Losses Resulting from Remeasurement of Deferred and Current Taxes.** Transaction gains and losses resulting from remeasurement of foreign current and deferred tax assets or liabilities may be reported in pretax income with other transaction gains or losses or included in current or deferred tax expense or benefit, if that presentation is considered more useful. The transaction gain or loss related to income taxes must also be included in the aggregate transaction gain or loss disclosed in accordance with ASC Topic 830. ASC paragraph 830-740-45-1

#### **Example 7.9: Calculation of Foreign Deferred Tax Expense or Benefit and Transaction Gain or Loss**

DEF Corp. is a wholly owned foreign subsidiary of ABC Corp. The U.S. dollar is the functional currency for DEF. On December 31, 20X6 the exchange rate was U.S. \$1 = FC 1,000. At December 31, 20X7 the exchange rate was U.S. \$1 = FC 1,250 (the average exchange rate for 20X7 was U.S. \$1 = FC 1,125). At December 31, 20X8 the exchange rate was U.S. \$1 = FC 1,500 (the average exchange rate for 20X8 was U.S. \$1 = FC 1,375).

Assuming that DEF has net a foreign deferred tax liability of FC 40,000 as of December 31, 20X6, a net deferred tax asset of FC 40,000 as of December 31, 20X7, and no net deferred as of December 31, 20X8, deferred tax expense or benefit and transaction gain or loss are calculated as follows:



	Foreign Currency	Exchange Rate	U.S. Dollar
Net foreign deferred tax liability as of December 31, 20X6	FC (40,000)	\$1 = FC 1,000	\$ (40)
20X7 foreign deferred tax benefit	<u>80,000</u>	\$1 = FC 1,125	71
20X7 transaction gain (see calculation below)			<u>1</u>
Net foreign deferred tax asset as of December 31, 20X7	40,000	\$1 = FC 1,250	32
20X8 foreign deferred tax expense	<u>(40,000)</u>	\$1 = FC 1,375	(29)
20X8 transaction loss (see calculation below)			<u>(3)</u>
Net foreign deferred tax asset as of December 31, 20X8	FC <u>—</u>	\$1 = FC 1,500	\$ <u>—</u>
Calculation of 20X7 transaction gain:			
December 31, 20X6 foreign deferred tax liability at December 31, 20X6 exchange rate [FC (40,000)/1,000]			\$ (40)
December 31, 20X6 foreign deferred tax liability at December 31, 20X7 exchange rate [FC (40,000)/1,250]			\$ <u>(32)</u>
Transaction gain			\$ 8
20X7 foreign deferred tax benefit at 20X7 average exchange rate [FC 80,000/1,125]			\$ 71
20X7 foreign deferred tax benefit at December 31, 20X7 exchange rate [FC 80,000/1,250]			\$ <u>64</u>
Transaction loss			\$ <u>(7)</u>
20X7 net transaction gain			\$ <u>1</u>
Calculation of 20X8 transaction loss:			
December 31, 20X7 foreign deferred tax asset at December 31, 20X7 exchange rate [FC 40,000/1,250]			\$ 32
December 31, 20X7 foreign deferred tax asset at December 31, 20X8 exchange rate [FC 40,000/1,500]			\$ <u>27</u>
Transaction loss			\$ (5)
20X8 foreign deferred tax expense at 20X8 average exchange rate [FC (40,000)/1,375]			\$ 29

20X8 foreign deferred tax expense at December 31, 20X8 exchange rate [FC (40,000)/1,500]	\$ <u>27</u>
Transaction gain	\$ <u>2</u>
20X8 transaction loss	\$ <u><u>(3)</u></u>

**7.048 U.S. Dollar Foreign Jurisdiction Tax Returns.** Some entities whose functional currency is the reporting currency (the U.S. dollar) maintain their books and records in U.S. dollars and either elect or receive permission from the taxing authority to maintain their tax bases of assets and liabilities in the foreign jurisdiction in U.S. dollars (or another currency of their choosing). Once the tax return is filed, any resulting tax liability or tax recoverable amount is effectively monetized in the local currency by the local tax authorities at a current year exchange rate. Because no foreign currency tax basis is established for the assets and liabilities of these entities, the taxable or deductible temporary difference is denominated in U.S. dollars and therefore will not result in a foreign currency transaction gain or loss. Notwithstanding that the tax basis of assets and liabilities in these jurisdictions are denominated U.S. dollars (or another chosen currency), carryforwards are often denominated in the country's local currency. Accordingly, currency transaction gains and losses will arise on the remeasurement of deferred taxes for carryforwards.

**7.048a** Any current tax liability or tax recoverable amounts (assessed based on the current exchange rate) are typically denominated in a foreign currency and are therefore considered foreign currency transactions. Accordingly, these items will result in foreign currency transaction gain or loss for changes in exchange rates between the date the payable or receivable was recognized and the date of settlement (or the balance sheet date if not yet paid). As discussed in Paragraph 7.047, we believe the transaction gains and losses resulting from remeasurement of foreign current tax assets or liabilities may be reported separately or included in current tax expense or benefit, if that presentation is considered more useful; the transaction gain or loss related to income taxes must also be included in the aggregate transaction gain or loss disclosed in accordance with ASC Topic 830.

**7.049 Accounting for the Income Tax Effects of a Change in Functional Currency to a Currency Other than the Local Currency.** ASC Topic 830 requires the financial statements of a foreign entity be remeasured as if the functional currency were the reporting currency of its parent if the entity is in a country that is experiencing highly inflationary conditions. If an entity is operating in a country that becomes highly inflationary under the provisions of ASC paragraphs 830-10-45-11 through 45-13, the foreign entity must change its functional currency. When the reporting currency becomes the functional currency, translation adjustments related to prior periods remain in accumulated other comprehensive income and the translated financial statement carrying amounts of nonmonetary assets and liabilities at the end of the prior period are used as the accounting basis for those assets and liabilities in the period of the change and future periods. The same principles apply when there is a change in functional currency from

the local currency to a currency other than the local currency for other reasons (e.g., due to significant changes in economic facts and circumstances). ASC paragraphs 830-10-45-10 through 13, 55-24 through 55-26

**7.050** Deferred tax benefits recognized as a result of indexing before the reporting currency became the functional currency should not be reversed immediately, but instead as those benefits are realized on the tax return. Basis differences arising as a result of indexing for local tax purposes that occur after the reporting currency becomes the functional currency do not factor into the computation of deferred taxes, but are instead recognized in current taxes when the related deductions are taken on the tax return. Similarly, in determining the historical local currency-equivalent financial statement carrying amount of a nonmonetary asset or liability that was owned at the date of the change in the functional currency, the historical rate at the date of the change in currency would be used, rather than the rate at the date the asset was acquired or liability was assumed. Deferred tax balances in highly inflationary jurisdictions in reporting currency often decline rapidly regardless of the size of an entity's basis differences due to rapid devaluation of the local currency. See Paragraph 7.045 for additional discussion. ASC paragraph 830-10-45-16

**7.051 Accounting for the Income Tax Effects of a Change in Functional Currency to the Local Currency When an Economy Ceases to Be Considered Highly Inflationary.**

As discussed above, when a foreign subsidiary operates in an economy that is considered highly inflationary for accounting purposes, the reporting currency (e.g., U.S. dollar) should be used as the subsidiary's functional currency. If the subsidiary's functional currency would be the local currency absent the inflationary conditions, the subsidiary's functional currency is changed to the local currency when the economy ceases to be highly inflationary. Reporting currency financial statement carrying amounts are translated into the local currency at the date of the change using current exchange rates. The translated local currency financial statement carrying amounts become the new functional currency financial statement carrying amounts for the foreign subsidiary's nonmonetary assets and liabilities. Differences between the new functional (local) currency financial statement carrying amounts and the functional (local) currency tax bases represent temporary differences. ASC paragraphs 830-10-45-15, 55-13 and 55-14

**7.052** The effects of recognizing deferred tax assets and liabilities for temporary differences that arise as a result of a change in the functional currency when an economy ceases to be highly inflationary should be recognized in other comprehensive income and included in the cumulative translation adjustment component of accumulated other comprehensive income. ASC paragraphs 830-740-25-2 and 25-3, 45-2

**7.052a Accounting for the Income Tax Effects of a Change in Functional Currency to the Local Currency for Other Reasons.**

If a subsidiary changes its functional currency to the local currency for a reason other than the economy ceasing to be highly inflationary (e.g., due to significant changes in economic facts and circumstances), the financial statement carrying amount of nonmonetary assets and liabilities in local currency will be restated using the historical exchange rate. The effect of this change is reported with translation adjustments in other comprehensive income. The change in

functional currency for monetary items should have no effect because these items are measured at the current value in the reporting currency before and after the change in functional currency. As deferred taxes for temporary differences related to nonmonetary assets and liabilities prior to the change in functional currency would have been determined based on the historical local-currency-equivalent financial statement carrying amount, the change in the functional currency generally should not result in a change in the financial statement amount used in the determination of temporary differences used to recognize deferred taxes. ASC paragraph 830-10-45-9

### Example 7.10: Calculation of Deferred Taxes on Temporary Differences When Economy Ceases to Be Considered Highly Inflationary

DEF Corp. is a wholly owned foreign subsidiary of ABC Corp. operating in a highly inflationary economy. On January 1, 20X6, DEF purchased equipment for FC 6,000. The exchange rate on that date was U.S. \$1 = FC 5. The equipment is depreciated over three years for tax purposes and six years for financial statement purposes. At December 31, 20X6, the exchange rate is U.S. \$1 = FC 10. As of January 1, 20X7, the economy of the subsidiary ceases to be considered highly inflationary. The enacted tax rate in the foreign jurisdiction is 20%.

The translation adjustment as of January 1, 20X7 is calculated as follows:

	Financial Reporting Basis		Tax Basis		Temporary Difference
Cost	FC	6,000	FC	6,000	
Accumulated depreciation		(1,000)		(2,000)	
Basis at December 31, 20X6	FC	<u>5,000</u>	FC	<u>4,000</u>	FC 1,000
Divided by historical exchange rate		<u>5</u>			
U.S. dollar equivalent		\$1,000			
Times the current exchange rate		<u>10</u>			
Basis at January 1, 20X7	FC	<u><u>10,000</u></u>	FC	<u><u>4,000</u></u>	FC <u>6,000</u>
Increase in recognized temporary difference resulting from change in functional currency					FC 5,000
Multiplied by tax rate					<u>20%</u>
Change in deferred foreign tax liability					FC 1,000
Divided by current exchange rate					<u>10</u>
Adjustment recognized in other comprehensive income					\$ <u><u>100</u></u>

This example only considers local income taxes and ignores any potential income taxes of a parent entity.

**7.053 Foreign Financial Statements Retrospectively Adjusted for General Price-Level Changes.** Reporting entities in highly inflationary economies that do not use the U.S. dollar as the reporting currency may prepare financial statements retrospectively adjusted for general price-level changes as provided in ASC Topic 255. When financial statements are adjusted for general price-level changes, temporary differences should be recognized for the difference between the indexed tax basis of the assets and liabilities and the related price-level restated amount for financial statement purposes using end-of-current-year purchasing power units (which eliminates the effect of inflation). Deferred tax expense or benefit should be calculated as the difference between the net deferred tax asset or liability at the end of the year and the net deferred tax asset or liability at the beginning of the year remeasured in purchasing power units as of the end of the year. The remeasurement of the assets and liabilities, including deferred tax assets and liabilities, is reported as an adjustment of beginning equity. ASC paragraphs 830-740-25-4 and 25-5, 30-1 and 30-2, 55-1 through 55-3

## FOREIGN OPERATIONS – SPECIFIC APPLICATION MATTERS

**7.054 Changes in ASC Paragraph 740-30-25-17 (APB 23) Assessment of Indefinite Reversal Criterion and Initial Recognition of a Deferred Tax Asset for a Deductible Outside Basis Difference.** The income tax effect of a change in an entity's assessment of the indefinite reversal criterion (resulting in the need to recognize a deferred tax liability or the need to eliminate a previously recognized deferred tax liability) should be recognized in the interim period of the change and is generally recognized in income tax expense attributable to income from continuing operations. The income tax effect of initially recognizing a deferred tax asset for a deductible outside basis difference should be recognized in the interim period in which the recognition threshold is met when (a) the disposal event is unusual or infrequent and significant, or (b) the subsidiary is reported separately as a discontinued operation. See Paragraphs 10.085 to 10.086a for additional discussion of the effects on interim period calculations and intraperiod considerations.

**7.055 Effect of Changes in Ownership on the ASC Paragraph 740-30-25-17 (APB 23) Indefinite Reversal Criterion.** The effect of a change in ownership on the ASC paragraph 740-30-25-17 indefinite reversal criterion depends on the level of ownership retained in the foreign entity after the partial sale. See Paragraphs 2.056-2.062 for additional discussion.

- **Consolidation to Equity Method.** In accordance with ASC paragraph 740-30-25-15, an entity that has not recognized a deferred tax liability on an excess of the financial statement carrying amount over the tax basis of an investment in a foreign subsidiary due to the indefinite reversal criteria will recognize a deferred tax liability for the outside basis difference in its retained equity method investment if it deconsolidates the subsidiary (unless the equity method investee is a foreign corporate joint venture that itself would be

eligible for application of the indefinite reversal criterion or it expects to recover the investment in a tax-free manner).

If there is a deductible outside basis difference for which a deferred tax asset was not recognized (because it was not apparent that the temporary difference would reverse in the foreseeable future), the investor will need to recognize a deferred tax asset (subject to a valuation allowance) when the investment goes from being a consolidated subsidiary to an equity method investment if recovery of the investment at its financial statement carrying amount would result in a tax deduction. ASC paragraphs 740-30-25-15, 45-3

- **Consolidation to Non-equity method.** If a portion of the investment is sold and the remaining investment will be accounted for under ASC Topic 321, *Investments—Equity Securities*, a deferred tax liability must be recognized on temporary differences, if any, for the entire excess of the remaining financial statement carrying amount over the tax basis of the investment as a charge to income tax expense. Similarly, if there is a deductible outside basis difference for which a deferred tax asset was not recognized (because it was not apparent that the temporary difference would reverse in the foreseeable future), the investor will need to recognize a deferred tax asset (subject to a valuation allowance) when the investment goes from being a consolidated subsidiary to a non-equity method investment if recovery of the investment at its financial statement carrying amount would result in a tax deduction.
- **Equity Method or Cost Method to Consolidation.** An entity that has recognized a deferred tax liability for a taxable outside basis difference in a foreign investment will eliminate that deferred tax liability if the investee becomes a subsidiary and the investor can apply the indefinite reversal criterion to its taxable outside basis difference under ASC paragraph 740-30-25-17 (APB 23) or it expects to recover the investment in a tax-free manner.

As discussed in Paragraph 7.021, a deferred tax asset is recognized for the excess of the tax basis over the financial statement carrying amount of an investment in the stock of a subsidiary or corporate joint venture only if it is apparent that the temporary difference will reverse in the foreseeable future. Accordingly, a deferred tax asset that has been recognized by an investor related to an investment in an equity method investee generally would be eliminated if the investee becomes a subsidiary. ASC paragraph 740-30-25-16

**7.056 Indexing Deductions Resulting in Net Operating Loss Carryforwards.** When the functional currency is not the local currency, differences between the financial statement carrying amounts and tax bases of nonmonetary assets resulting from indexing are not recognized until the related deductions are taken on the tax return. When an entity incurs a tax loss that cannot be carried back, indexing adjustments related to nonmonetary and monetary assets and liabilities taken on the tax return may become part of the entity's net operating loss carryforward, which may be subject to additional indexing going forward. Because deferred tax assets are considered monetary assets under ASC Topic 830 and are remeasured at current exchange rates (and not historical exchange rates), the prohibition on recognizing temporary differences due to indexing of assets and liabilities

that are remeasured using historical exchange rates does not apply. Entities should therefore recognize, subject to the usual assessment of realizability, a deferred tax asset for the entire net operating loss carryforward inclusive of the effect of indexing adjustments. ASC subparagraph 740-10-25-3(f)

**7.057 Elective Fair Value Revaluation of Assets.** In certain foreign tax jurisdictions an entity can elect a fair value step-up in tax basis on specific assets, paying a revaluation tax at the time the election is made. A deferred tax asset or reduction in a deferred tax liability generally would be recognized for the increase in tax basis. The revaluation tax and related change in deferred tax assets and liabilities generally would be recognized in income tax expense attributable to income from continuing operations. An elective fair value revaluation is not considered indexing for tax purposes. An entity whose local currency is not its functional currency should therefore record a deferred tax asset (or reduce an existing deferred tax liability) for the tax benefit associated with the fair value step-up in tax basis. A deferred tax liability should also be established if the revaluation surplus will be subject to tax on disposition of the assets or distribution to shareholders. ASC paragraphs 830-740-25-6 through 25-8

**7.058 Hedging a Net Investment in a Foreign Operation.** ASC Topic 815, *Derivatives and Hedging*, permits entities to hedge the net investment in a foreign operation with either a nonderivative or derivative financial instrument. In applying hedge accounting, the effective portion of the ASC Topic 830 transaction gain or loss (for a nonderivative hedging instrument) or the change in fair value (for a derivative hedging instrument) is generally recognized in other comprehensive income as part of the translation adjustment, unless a portion of the hedging instrument (or a portion of its fair value) is excluded from the assessment of hedge effectiveness. The reporting of the related tax effects follows the step-by-step approach, which generally results in the tax effects following the pretax effects. For example, the deferred tax expense or benefit associated with the portion of a temporary difference resulting from a pretax adjustment to other comprehensive income would likewise be allocated to other comprehensive income and the portion resulting from a pretax adjustment to income from continuing operations would likewise be allocated to income from continuing operations. Deferred taxes generally are required to be provided for temporary differences related to hedging instruments regardless of whether the entity has applied the ASC paragraph 740-30-25-17 exception to the outside basis difference of its net investment because ASC Subtopic 740-30, *Income Taxes – Other Considerations or Special Areas* (APB 23), does not apply to such instruments.

**7.058a After-Tax Investment Hedges and Changes in Tax Law.** Under ASC Topic 815, an entity is allowed to hedge the foreign currency exposure inherent in its net investment in a foreign operation on an after-tax basis. An entity that uses this strategy often asserts indefinite reinvestment of the hedged investment's basis differences and thus does not recognize deferred taxes on the outside basis difference related to its investment. Because the entity does recognize deferred taxes on the basis difference related to the hedging instrument, it generally tries to align the amount of its investment with the after-tax notional amount of the hedging instrument.

**7.058b** Changes in the enacted corporate tax rate will affect the effectiveness of these hedging relationships because it results in a mismatch between the pretax notional amount of the hedging instrument designated to hedge the investment and the pretax notional amount that is now necessary (after taking into account the new tax rate) to hedge the same investment.

**7.059 Deferred Taxes on Purchase Price Adjustments.** Goodwill and fair value purchase price adjustments of a foreign entity acquired in a business combination represent assets and liabilities related to the acquired foreign entity, regardless of whether the business combination adjustments are pushed down to the foreign entity. The total amount allocated to assets and liabilities (including goodwill) should therefore be converted into local currency at the current exchange rate on the acquisition date. Although ASC subparagraph 740-10-25-3(f) (see Paragraph 7.044 for additional discussion) prohibits the recognition of deferred taxes on such differences, this exception does not apply at the acquisition date in a business combination. Deferred taxes should be provided on the resulting temporary differences in the foreign subsidiary's tax jurisdiction (with the exception of nondeductible goodwill). See Paragraph 6.010 for additional discussion of temporary differences resulting from a business combination. ASC paragraphs 830-10-15-5 and 15-6, 830-30-45-11

**7.060 Is a Puerto Rican Subsidiary Foreign or Domestic?** As discussed in Paragraph 2.036, the determination as to whether a subsidiary is domestic or foreign generally should be based on the treatment in the parent entity's tax jurisdiction. U.S. federal income tax regulations define a domestic corporation as one organized under the laws of one of the 50 states or the District of Columbia. An entity is foreign if it is not domestic. Accordingly, for U.S. tax purposes, subsidiaries incorporated under the laws of Puerto Rico generally are considered foreign subsidiaries (unless those entities are dually chartered through organization in both the United States and Puerto Rico), and subsidiaries incorporated in the United States doing business in Puerto Rico are considered domestic subsidiaries.

**7.061 Puerto Rico Branch Profits Tax.** U.S. entities doing business in Puerto Rico must file a Puerto Rico tax return and pay income taxes on Puerto Rico sourced earnings. Certain branches of U.S. entities operating within Puerto Rico also are subject to a branch profits tax on their remitted earnings. We believe such branches should recognize in their separate financial statements current and deferred taxes related to this tax.

**7.062 Puerto Rico Effectively Connected Income.** On October 25, 2010, Puerto Rico enacted a tax law that includes a change to its effectively connected income sourcing rules and, if certain conditions are met, imposes an excise tax (instead of the general Puerto Rico income tax) on goods and services purchased by offshore companies. The excise tax on nonresident entities is imposed on purchases by those nonresident entities when the sum of (1) gross receipts from sales of personal property manufactured or produced and (2) services performed by a related person in Puerto Rico that derives a specific amount of its income from manufacturing or producing products or performing services for the nonresident, exceeds \$75 million for any of the three preceding years. Income from sales or services subject to the excise tax is treated as income of the



nonresident entity effectively connected with a Puerto Rican trade or business. The 4% excise tax applies to sales or services transactions during 2011 (that is, the 4% excise tax was effective for acquisitions of personal property or services by the nonresident entity after December 31, 2010). The rate of this excise tax phased down during subsequent years through 2016.

**7.063** As the excise tax is levied on a gross purchases basis and is not a measure of taxable profit, it is not an income tax and, therefore, ASC Topic 740 does not apply. Accordingly, an entity would not recognize deferred tax assets and liabilities for future tax consequences of the excise tax. An entity should classify the excise tax outside of income tax expense or benefit. To the extent the excise tax is determined to be eligible to be claimed as a foreign tax credit for U.S. federal income tax purposes, the credit will be included in income taxes similar to R&E or other tax credits.

**7.064 Puerto Rico Tax Burden Adjustment and Redistribution Act.** On June 30, 2013, Puerto Rico enacted into law a package of tax measures, referred to as the Tax Burden Adjustment and Redistribution Act. The law imposed a new tax on gross income for financial institutions and overhauled Puerto Rico's alternative minimum tax (AMT) regime for other taxpayers. For financial institutions, the tax is equal to 1% of gross income and is incremental to income tax (or AMT, if applicable). Financial institutions are eligible for an annual credit limited to .5% of gross income. The credit can only be used to offset income tax (or AMT, if applicable) and can be carried forward indefinitely. The credit is nonrefundable and there is no carry-back available. For nonfinancial institutions, the law revised the AMT computation to incorporate the gross income tax base. AMT is now the greater of (a) the sum of 30% of the alternative minimum net income plus the gross income tax, or (b) the sum of (i) 20% of the expenses incurred/paid to related parties, (ii) up to 2% on the purchases of tangible property from related parties, and (iii) the gross income tax. Beginning in 2016, a component of the AMT was no longer enforced as a result of a court ruling. AMT paid in Puerto Rico, like U.S. Corporate AMT, is entirely creditable and available indefinitely to offset regular income taxes payable in a future period. The new law also reinstated the income tax rates in effect under the 1994 Puerto Rico Internal Revenue Code and was generally effective for tax years beginning after December 31, 2012.

**7.065** Because the gross income tax for financial institutions is based entirely on gross income with little to no deduction for expenses or costs of sale, we do not believe it is an income tax (see additional discussion beginning in Paragraph 1.002). Accordingly, an entity would not include the gross income tax in income taxes and would not adjust deferred tax balances or its effective tax rate. However, we do believe the related 0.5% tax credit would result in recognizing a deferred tax asset and income tax benefit (subject to valuation allowance considerations) as the credit can be used to offset regular income tax (or AMT, if applicable) that is otherwise payable. This is consistent with the accounting for other income tax credits generated by non-income based qualifying expenditures (e.g., R&E credits) as discussed in Paragraphs 9.167 and 9.168.

**7.066** For nonfinancial institutions, the tax on gross income is not incremental to regular income tax, but rather is subsumed within an AMT regime that provides for 100% credit

against regular income tax (consistent with how the U.S. Corporate AMT regime interacts with regular income tax). Accordingly, we believe it generally should be accounted for under ASC paragraphs 740-10-30-10 through 30-12. Current AMT paid would be recognized in current tax expense and the related credit carryforward would be recognized as a deferred tax asset (subject to valuation allowance considerations) as discussed in Paragraphs 3.069 through 3.072.

**7.067** There is, however, diversity in practice on this issue. Some believe that notwithstanding the similarities to the U.S. Corporate AMT (relative to the interaction of the credit with the regular tax system), the revised tax regime is more akin to a tax regime where a taxpayer owes the greater of income-based tax or non-income-based tax. The accounting for those regimes is addressed in ASC paragraphs 740-10-55-139 through 55-144 (see additional discussion beginning at paragraph 9.135). While this guidance does not contemplate a credit mechanism that links the non-income-based tax to the income tax system (and therefore assumes that the entity will always incur a minimum amount of non-income based tax), we believe it would be acceptable to apply it by analogy.

**7.068 Foreign Branch Temporary Differences.** Because the income or loss of a U.S. entity's foreign branch is included in the U.S. entity's U.S. tax return in the period the income or loss is earned, a foreign branch's basis differences generally result in a deferred tax consequence in both the foreign tax jurisdiction and the U.S. tax jurisdiction. In addition, the consolidated entity will receive a foreign tax credit in the United States for taxes paid, deemed paid, or accrued, to the foreign jurisdiction on the same earnings. Usage of the FTCs is limited based on the foreign source earnings that are included in the U.S. tax return. FTC carryforwards generally result if the foreign taxes incurred are in excess of the US federal income tax on the earnings. Because a taxpayer generally is limited to using only the amount of FTCs necessary to offset the U.S. federal income tax incurred on the branch's earnings, carryforwards generally result if foreign-source income is taxed in the foreign jurisdiction at a rate higher than the U.S. tax rate. If income taxes paid in the foreign jurisdiction in future years will exceed taxes that would be paid by applying the U.S. statutory rate to the foreign-source income, for example, when the foreign income tax rate is higher than the U.S. statutory rate, FTC carryforwards will continue to be generated each year and existing FTC carryforwards may expire unused. This condition became more likely to exist after U.S. tax reform in 2017 because the U.S. tax rate was reduced to 21%.

**7.068a** When calculating the total tax effect of basis differences, the entity should consider all relevant provisions of the tax law in both jurisdictions, including withholding taxes and the availability of unborn future foreign tax credits that would be generated when foreign income taxes are incurred (or foreign tax credits that would be forgone when there is a loss in the foreign jurisdiction - see Paragraph 7.069).

**7.068b** Based on discussions with the FASB staff, we believe that entities generally would measure the U.S. federal effect of a foreign branch's temporary differences using the lesser of the foreign tax rate or the U.S. tax rate. When an entity uses the 'lesser of' rate, the U.S. deferred tax asset (for an anticipated FTC) or liability (for a forgone FTC, see Paragraph 7.069) will be limited to the amount of foreign tax credits that the U.S.

parent would be able to utilize if the foreign branch reported taxable income sufficient to realize its deferred tax assets or settle its deferred tax liabilities.

**7.068c** When an entity has more than one foreign branch, we would expect it to use a weighted average foreign tax rate that is computed based on the rates expected to apply in each foreign jurisdiction to the taxable income or loss necessary to realize the branches' deferred tax assets and liabilities. An entity would not consider future income beyond the amount necessary to recover or settle its existing deferred tax assets and liabilities when estimating the rate.

**7.068d** In addition, we understand the FASB staff believes that ASC Topic 740 also supports another approach. Entities also may measure the U.S. federal effect of a foreign branch's temporary differences as the adjustment to the amount of foreign tax credits that would be generated if the foreign branch realized its deferred tax assets or liabilities. This 'dollar-for-dollar' approach would not limit the U.S. deferred tax asset or liability to the amount of foreign tax credits that the U.S. parent would be able to use to measure those deferred taxes. Instead, an entity applying this approach would simply recognize U.S. deferred taxes equal to the dollar-for-dollar foreign tax credit it would report on its tax return when the branch recovers its deferred tax assets and settles its deferred tax liabilities.

**7.068e** Under either approach, the U.S. parent must evaluate whether it is more likely than not that all or a portion of its deferred tax assets will not be realized. An entity that (a) uses the 'dollar-for-dollar' approach and (b) operates the branch in a jurisdiction in which the income is taxed at a rate higher than the U.S. rate, is likely to have some amount of a valuation allowance because it generally would expect the future carryforward portion of the deferred tax asset to expire unused absent other sources of income of the appropriate character to realize the benefit.

### **7.069 Foreign Branch Deductible Temporary Differences and Carryforwards.**

Foreign branch losses may result in net operating loss carryforwards in the foreign tax jurisdiction at the same time as the losses are used in the United States to reduce other taxable income. The income or loss of a foreign branch is included in the U.S. tax return in the period the income or loss is earned. If no valuation allowance is needed on a foreign branch's deferred tax assets in the foreign jurisdiction, an entity would be required to recognize a deferred tax liability for the forgone foreign tax credits in the United States on the foreign-source earnings necessary to realize the deferred tax asset in the foreign jurisdiction. The foreign source earnings will be taxed in the United States without the benefit of a foreign tax credit (no foreign tax credit will be generated due to the branch's use of the deferred tax asset in the foreign jurisdiction) and may provide a source of future taxable income to support an entity's deferred tax assets (see Paragraph 4.124 for additional discussion). This is similar to a situation in which the branch has a deferred tax liability as discussed above. In those situations, the effect of unborn future foreign tax credits in the United States would be considered when measuring the U.S. deferred taxes.

### Example 7.11: Recognizing Forgone Foreign Tax Credits for a Foreign Branch

#### Background

Company A, a U.S. entity, operates Branch B in a foreign jurisdiction. Branch B's statutory income tax rate in the foreign jurisdiction is 30%. Company A's U.S. statutory income tax rate is 21%.

During 20X1, Company A's U.S. operations generated pretax book and taxable income of \$250, and Branch B incurred pretax book and a taxable loss of \$100. Branch B's taxable loss resulted in a \$100 net operating loss carryforward in the foreign jurisdiction and a \$30 deferred tax asset. No valuation allowance was required at December 31, 20X1. During 20X2, Company A's U.S. operations and Branch B's operations are expected to generate income of \$250 and \$400, respectively.

In summary, Branch B has the following amounts in the foreign jurisdiction:

	20X1	20X2
Pretax income	\$ (100)	\$ 400
Current tax expense	—	90
Deferred tax expense (benefit)	(30)	30
Total income tax expense (benefit)	\$ (30)	120

The table below reflects the actual current tax expense that Company A recognized in 20X1 and the amounts it expects to recognize in 20X2. In addition, the table shows the amount of foreign tax credit that ABC expects to generate in 20X2 if the foreign deferred tax asset did not exist and the branch had incurred \$120 of current tax expense:

	Actual	Forecast	Without DTA
Branch pretax income	\$ (100)	\$ 400	\$ 400
Company A pretax income	250	250	250
Taxable income	\$ 150	\$ 650	\$ 650
Current tax expense before credits	\$ 32	\$ 137	\$ 137
Foreign tax credit generated	—	(90)	(120)
Foreign tax credit utilized	—	(63) <sup>1</sup>	(63) <sup>1</sup>
Current tax expense	\$ 32	\$ 74	\$ 74

<sup>1</sup> Assumes \$300 of foreign source income after considering prior branch losses and that the foreign tax credit used is \$63 (\$300 foreign source income × 21% U.S. tax rate).

Other factors that influence the amount of foreign tax credit utilized, such as U.S. expense allocation, have been ignored.

Assume a valuation allowance would be required for the deferred tax asset for the \$27 of foreign tax credit carryforwards that are expected to exist at the end of 20X2.

### Analysis

If Company A's policy is to measure the U.S. federal effect of Branch B's temporary differences using the lesser of the foreign tax rate or the U.S. tax rate (i.e., the lesser-of approach), it would recognize a deferred tax liability of \$21 because it is the lesser of (a) \$21 (\$100 foreign net operating loss times the U.S. tax rate of 21%) and (b) \$30 (\$100 foreign net operating loss times the foreign tax rate of 30%).

If Company A's policy is to measure the U.S. federal effect of Branch B's temporary differences as the adjustment to the amount of foreign tax credits that would be generated if Branch B realizes its deferred tax asset (i.e., the dollar-for-dollar approach), it would recognize a deferred tax liability of \$30 (equal to the \$30 foreign deferred tax asset).

**7.069a Section 987 Regulations.** In December 2016, the IRS issued final and temporary regulations that provide guidance under section 987 of the Internal Revenue Code<sup>3</sup>. These regulations could significantly change how an entity measures taxable income of a foreign branch with a functional currency different from its owner. See additional discussion in Paragraph 7.043a.

**7.069b Foreign Branch Outside Basis Differences.** We believe the indefinite reversal criterion generally does not apply to outside basis differences associated with foreign branches or other pass-through entities (such as check-the-box elections), because, in addition to being subject to local tax, the income of the foreign entity is included in the parent entity's taxable income without regard to distributions. However, we understand that there is diversity in practice on this issue and as a result, we believe there are other acceptable views. See Paragraph 7.011 for additional discussion.

**7.070 Changes in Foreign Tax Laws.** Deferred tax assets and liabilities should be adjusted for the effects of a change in tax laws in the period that includes the enactment date. The enactment date under ASC Topic 740 is the date the legislation is signed into law or otherwise becomes fully enacted. As discussed in Section 5, *Changes in Tax Laws, Rates, or Status* (see Paragraph 5.004 for additional discussion of accounting for a change in tax law), IFRS Accounting Standards and many other countries' generally accepted accounting principles recognize the effects of tax law changes when the new tax law has been substantively enacted. In the case of IFRS Accounting Standards, IAS Standards 12, *Income Taxes*, does not provide guidance on the meaning of *substantive enactment*, but the IASB indicated in the joint deliberations with the FASB on the income tax convergence project that the term *enacted or substantively enacted* describes when the process of enactment is complete and when any remaining steps will not change the outcome. For example, substantive enactment for the United Kingdom occurs when the House of Commons passes a resolution under the Provisional Collection of Taxes Act.

This is consistent with the generally accepted accounting principles in the United Kingdom (glossary of FRS 102), which indicate that a U.K. tax rate can be viewed as having been substantively enacted if it is included in either: (a) a Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords (which is unable to block or amend the legislation) and Royal Assent; or (b) a resolution having statutory effect that has been passed under the Provisional Collection of Taxes Act 1968.

**7.071** The difference between the enactment date for ASC Topic 740 purposes and the date of substantive enactment for IAS Standards 12 purposes can result in entities reflecting the same change in tax law in different periods depending on the accounting standards being followed. For example, during 2007, the U.K. House of Commons passed new tax legislation on June 27 but the legislation did not achieve Royal Assent (was not signed by the Queen) until July 19. In this case, calendar-year entities applying IFRS Accounting Standards recognized the effect of the change in tax law in the second quarter (the period including June 27), and calendar-year entities applying U.S. GAAP recognized the change in the third quarter (the period including July 19).

**7.072** The determination of the enactment date will depend on the tax laws in the particular jurisdiction because the laws governing enactment of tax laws may vary by taxing authority. In many jurisdictions, the final steps required to enact a law may be considered to be perfunctory. Under ASC Topic 740 an entity cannot, however, recognize the effect of the change in law before formal enactment. For example, assume the National Diet of Japan (Japan's bicameral legislature) passed new tax legislation on June 27 but the new tax legislation was not signed by the Emperor of Japan until after June 30. Article 41 of the Japanese Constitution indicates that "The Diet shall be the highest organ of state power, and shall be the sole law-making organ of the State." Article 59 states that "A bill becomes a law on passage by both Houses, except as otherwise provided by the Constitution." The Emperor of Japan does not take part in the legislative process, but announces the law.

**7.073** In this example, because the legislation was passed by the Diet on June 27, entities that apply U.S. GAAP would adjust their deferred tax assets and liabilities as of that date. The substantive enactment date under IAS Standards 12 is also June 27 as that is the date the law is substantively enacted. This example of new tax legislation in Japan contrasts with new tax legislation in the United Kingdom, where legislation does not officially become law until signed by the Queen (as the Queen's signature is required for the legislation to be enacted).

**7.074 Reenactment of Entire Tax System.** In certain foreign jurisdictions, the entire income tax structure may have a specified term, necessitating reenactment for the income tax system to continue. In these unusual circumstances, deferred tax assets and liabilities in such jurisdictions generally are recognized and measured based on the presumption that the currently enacted tax laws and rates will be reenacted for future years. Changes in those tax laws and rates, other than reenactment of the system in its totality, should not be anticipated. See Paragraphs 5.011 and 5.012 for additional discussion.

**7.075 Profit-Sharing Laws.** In certain foreign countries, such as Mexico, employers are required to pay a specified percentage of taxable income to employees. Because the payments are required to be made to employees rather than to the government, the amounts paid out under these profit-sharing laws are not income taxes under ASC Topic 740. Payments related to the profit-sharing laws are employee compensation costs, not income tax expense. There have been diverse views expressed as to whether a balance sheet approach or deferred method should be used in accounting for these payments. However, because the payments are based on taxable income and the arrangement has the same economic effect on an entity as an income tax (including deferred consequences from existing basis differences), ASC Topic 740 is generally the appropriate model for the recognition of the deferred consequences caused by existing basis differences. The expenses, both current and deferred, should generally be shown as an operating expense along with other wage elements. This view is shared by the SEC staff and the International Practices Task Force of the AICPA.

**7.076** We believe that it is appropriate to apply the balance sheet methodology similar to ASC Topic 740 described above, including recognition of deferred profit sharing assets to the extent that such assets are considered recoverable based on analysis of the relevant facts and circumstances, including consideration of future income. However, we understand there is some diversity in practice with respect to whether an entity should recognize a deferred asset for these profit-sharing laws. Some believe that recognition of deferred assets would be inappropriate based only on expectations of future income. A consistently applied accounting policy for recognition of deferred assets from profit-sharing arrangements should be applied. Recognition of deferred liabilities under these profit sharing arrangements is required.

**7.077 Subpart F Income.** Generally, income of foreign subsidiary operations is taxable to its U.S. 10% or greater shareholders (U.S. Shareholders) under guidance around investment in U.S. property, GILTI or Subpart F or is not taxable to its U.S. Shareholders. Certain income described under the Subpart F rules is taxable to the U.S. Shareholders when included in a controlled foreign corporation's earnings (limited to the foreign subsidiary's E&P - see additional discussion in Paragraphs 7.082 through 7.085), regardless of whether the income is actually distributed to the U.S. Shareholders. (A controlled foreign corporation (CFC) is defined in the Internal Revenue Code as a foreign corporation where more than 50% of the total combined voting power or value is owned directly, indirectly, or constructively by U.S. shareholders.) The major categories of Subpart F income are foreign base company income and insurance income. Subcategories of foreign base company income include foreign personal holding company income, foreign base company sales income, and foreign base company services income. Additionally, the Subpart F rules require U.S. Shareholders to include currently in their U.S. gross taxable income their pro rata share of income earned by a CFC where the CFC's earnings have been invested in certain assets within the United States (such assets include tangible property, stock of a U.S. corporation, intellectual property acquired or developed by the foreign operation for use in the U.S., pledges and guarantees of obligations of U.S. entities or persons, and certain U.S. trade or service receivables).

**7.078** As discussed in Paragraph 7.011, because Subpart F income and income attributable to a foreign subsidiary's investment in U.S. property are included in a U.S. Shareholder's U.S. taxable income at the time earned by the CFC (regardless of whether those earnings are actually distributed to the U.S. Shareholder) current U.S. taxes should be recognized on the CFC's current earnings that are deemed distributed either as Subpart F income or income attributable to a foreign subsidiary's investment in U.S. property. Similarly, the indefinite reversal criterion and the apparent to reverse in the foreseeable future exception would generally not apply to the portion of an outside basis difference in a foreign subsidiary operation attributable to inside basis differences that on reversal will result in Subpart F income. The reversal of those inside basis differences will result in current tax in the United States under the Subpart F rules and thus the U.S. Shareholder does not have the ability to indefinitely defer the reversal of that portion of the outside basis difference. (An exception to this exists when Subpart F income characterization on reversal of a taxable inside basis difference is contingent on future income - see additional discussion in Paragraphs 7.082 through 7.085).

**7.079** For example, if \$100 of a total \$1,000 taxable outside basis difference is attributable to an inside basis difference that will reverse through normal operations and result in Subpart F income, we believe a U.S. deferred tax liability should be recognized for \$100 of the outside basis difference that will reverse on the reversal of the \$100 inside basis difference. The indefinite reversal criterion may continue to apply to the \$900 of earnings that are not subject to taxation in accordance with Subpart F.

**7.080** The Subpart F rules also affect a U.S. Shareholder's outside basis in its investment in the CFC. Income treated under Subpart F as taxable also results in an immediate deemed recontribution of the deemed dividend to the foreign subsidiary operation. The recontribution increases the U.S. Shareholder's tax basis in the stock of the foreign subsidiary operation. If, at a later date, an actual distribution is made by the foreign operation to its parent, the amounts that have already been taxed in the U.S. in accordance with Subpart F can generally be repatriated with no additional U.S. federal taxation (other than items such as foreign exchange gain or loss or gain on section 965(b) PTEP). The actual distribution would then reduce the U.S. Shareholder's tax basis in the stock of its foreign subsidiary operation, similar to the accounting for distributions from subsidiaries for financial reporting purposes.

**7.081** The rules related to Subpart F income and income from investments in U.S. property also apply to lower-tier foreign subsidiary operations that are indirectly owned by U.S. Shareholders through upper-tier foreign entities. For example, a U.S. entity owns 100% of a Dutch subsidiary which in turn owns 100% of a corporate entity in France, which makes a loan to the U.S. entity. As a result of the loan to the U.S. entity, the French corporate entity has made an investment in U.S. property which may be taxable to the U.S. entity. The U.S. entity should consider this potential taxable income in its current tax expense and when determining whether a portion of the outside basis difference related to the investment in the Dutch subsidiary meets the ASC paragraph 740-30-25-17 (APB 23) indefinite reversal criterion.



**7.082 Subpart F Income When an E&P Deficit Exists.** A subsidiary's Subpart F income generally is taxed in the United States when earned, but the amount of Subpart F income is limited to the subsidiary's E&P in that tax year (section 952(c)(1)). When Subpart F income is limited by a subsidiary's E&P, its non-Subpart F income generated in succeeding years, if any, is recharacterized as Subpart F income up to the amount previously limited (section 952(c)(2)).

**7.083** In E&P deficit situations, a question arises as to whether, and when, a deferred tax liability associated with current year Subpart F income (that has been limited due to the E&P deficit) should be recognized (assuming the U.S. parent otherwise appropriately applies the indefinite reversal criterion for its taxable outside basis difference in the subsidiary and does not have any inside basis differences that would reverse as Subpart F income absent the section 952(c)(2) recharacterization provisions). If management can support its representations about the indefinite reinvestment of the foreign subsidiary's basis differences at the balance sheet date, we believe there are two acceptable approaches regarding the recognition of a deferred tax liability associated with that current-year Subpart F income (that has been limited due to the E&P deficit). The approach used is an accounting policy election that should be consistently applied and, if material, disclosed.

**7.084** If an entity elects to apply the ASC paragraph 740-30-25-17 (APB 23) exception to the entire outside basis difference in the year of the E&P deficit, it would not consider the fact that a portion of the outside basis difference may later be re-characterized as Subpart F income if it generates future income. At the balance sheet date, there are no inside basis differences that later will result in Subpart F income *unless the subsidiary generates future income*. As discussed in Paragraph 7.011, planned dividend payments (or in this case, Subpart F income) contingent on future earnings of the foreign subsidiary generally would not preclude the application of the indefinite reversal criterion to an existing outside basis difference if the parent entity has provided evidence of its specific plans to continue reinvestment of the existing undistributed earnings. Under this policy, no deferred tax liability would be recognized for the tax effect of the possible future foreign subsidiary earnings that, if they materialize, will be recharacterized as Subpart F income. If there are future earnings, the tax will be recognized at that time.

**7.085** Alternatively, an entity could elect a policy to apply the ASC paragraph 740-30-25-17 (APB 23) exception only to the portion of the taxable outside basis difference in excess of the amount of possible future earnings that, if they materialize, will be re-characterized as Subpart F income. A parent entity is permitted to conclude that only a portion of the outside basis difference meets the indefinite reversal criterion (as discussed in Paragraph 7.011). Under this policy, a deferred tax liability is recognized on the portion of the outside basis difference representing the tax effect of the possible future foreign subsidiary earnings that, if they materialize, will be re-characterized as Subpart F income.

**7.085a Section 965(b) Previously Taxed Earnings and Profits (PTEP).** As discussed in Paragraph 7.026b, as part of determining the amount of taxable income subject to the 2017 transition tax in the United States (see Paragraph 7.007a for additional discussion),

in certain circumstances an entity was able offset positive E&P in one subsidiary (S1) against an E&P deficit of a second subsidiary (S2) to reduce the amount of taxable income recognized with respect to S1's E&P.

**7.085b** As a result of the deemed repatriation, all of S1's E&P became PTEP but the U.S. parent received additional tax basis in the stock of S1 only to the extent of the taxable income it recognized. As a result, the U.S. parent did not receive tax basis in the stock of S1 to the extent S2's E&P deficit reduced the taxable income inclusion. This resulted in the PTEP of S1 being greater than the tax basis received by the U.S. parent; this excess PTEP is sometimes referred to as 'section 965(b) PTEP'.

**7.085c** If the U.S. parent does not have tax basis in S1 from other sources, such as capital contributions on the original formation of the subsidiary, then the distribution of the section 965(b) PTEP may result in a capital gain to the U.S. parent.

**7.085d** The same situation could have occurred in a multi-tier structure in which the U.S. parent had a subsidiary with positive E&P (S1) and that subsidiary had a subsidiary with an E&P deficit (S2). US parent received tax basis in the stock of S1 equal to the net amount of E&P, but would have PTEP equal to S1's E&P. The earnings in S1 that were not included in the US parent's income because of the deficit in S2 would be section 965(b) PTEP.

**7.085e** As discussed in Paragraph 7.007c, when a foreign subsidiary makes distributions, the tax law generally will deem PTEP as distributed before other earnings. Thus, an entity that generates E&P in future years that is eligible for a 100% dividends received deduction may not be able to take advantage of that deduction when it distributes cash, because the tax law will deem the distribution to first be a distribution of section 965(b) PTEP – i.e., before any non-PTEP E&P is deemed distributed. If a distribution is deemed under the tax law to be a distribution of existing section 965(b) PTEP, and if the investor does not have adequate tax basis, the U.S. Parent may need to recognize a capital gain for tax purposes.

**7.085f** We believe whether an entity should recognize a deferred tax liability related to section 965(b) PTEP depends on which of following three scenarios applies to the entity's facts and circumstances:

*Entity asserts indefinite reinvestment on its entire outside basis difference*

If an entity asserts indefinite reinvestment of its entire outside basis difference in the year it generates section 965(b) PTEP, it would not consider the fact that a portion of the outside basis difference may become taxable if it distributes future earnings. Planned distributions contingent on future earnings of the foreign subsidiary generally would not preclude an entity from applying the indefinite reversal criterion to an existing outside basis difference if the entity has provided evidence of its specific plans to continue reinvestment of the existing undistributed earnings (see Paragraphs 7.011 and 7.084).

Under this scenario, no deferred tax liability would be recognized for the tax effect of possible future foreign subsidiary earnings that, if they materialize and are distributed,

will be deemed a distribution of existing section 965(b) PTEP and taxed as capital gain. If there are future earnings that would be taxed as capital gain and are not indefinitely reinvested, the tax will be recognized at the time the earnings are generated.

*Entity asserts indefinite reinvestment on a portion of its outside basis difference*

An entity could assert indefinite reinvestment only on the portion of the outside basis difference in excess of the amount of current and possible future earnings that, if they materialize and are distributed, will be deemed a distribution of existing PTEP (see Paragraph 7.085). This situation may arise if an entity plans to distribute a fixed amount of funds in the near term, but expects to meet the indefinite reversal criterion relative to future earnings beyond the fixed amount.

Under this scenario, a deferred tax liability is recognized on the portion of the outside basis difference representing the tax effect of possible future foreign subsidiary earnings that, if they materialize and are distributed, will be deemed a distribution of existing section 965(b) PTEP and taxed as capital gain. In addition, the entity would evaluate the need to recognize additional deferred tax liabilities related to this portion of the outside basis difference (in consideration of section 986(c) currency gain/loss, withholding taxes and state taxes).

*Entity does not assert indefinite reinvestment on its outside basis difference*

We believe an entity that has a taxable outside basis difference for which it does not assert indefinite reinvestment generally would recognize a deferred tax liability for the portion of the outside basis difference that relates to the existing section 965(b) PTEP. In addition, the entity would evaluate the need to recognize additional deferred tax liabilities on the remainder of its outside basis difference (in consideration of section 986(c) currency gain/loss, withholding taxes and state taxes).

However, if an entity would not be subject to tax on the section 965(b) PTEP unless it generates future earnings, we believe it would be acceptable for it to delay recognition until those future earnings materialize. The approach used is an accounting policy election that should be consistently applied and appropriately disclosed.

### **Example 7.11a: Section 965(b) PTEP With No Outside Basis Difference**

#### **Background**

U.S. Parent owns Sub 1 (S1) who owns Sub 2 (S2). S1 was formed with a \$1 initial contribution from U.S. Parent on January 1, 2016. Through September 30, 2016, S1 earns \$100 and forms S2 on October 1, 2016 with a \$100 contribution. S2 loses \$40 in 2016. S1 and S2 do not have any earnings or losses in 2017. U.S. Parent, S1 and S2 use a calendar year-end for U.S. tax and financial reporting purposes.

Under deemed repatriation, U.S. Parent is taxed on the excess of S1's positive E&P over S2's E&P deficit, or \$60. Future earnings are expected to be a mix of PTEP and newly

generated non-PTEP E&P that is eligible for the 100% dividends received deduction. Assume that under the tax law, all current and future PTEP is deemed distributed before future non-PTEP E&P is deemed distributed.

	<b>Non- PTEP E&amp;P</b>	<b>PTEP</b>	<b>Tax basis</b>	<b>U.S. GAAP net equity</b>
Sub 1:				
Initial contribution	\$ -	\$ -	\$ 1	\$ 1
Earnings	100	-	-	100
Equity in S2 earnings	-	-	-	(40)
PTEP for deemed repatriation	(60)	60	60	-
Section 965(b) PTEP	(40)	40	-	-
Total	\$ -	\$ 100	\$ 61	\$ 61
Sub 2:				
Initial contribution	\$ -	\$ -	\$ 100	\$ 100
Earnings	(40)	-	-	(40)
Section 965(b) PTEP	40	-	-	-
Total	\$ -	\$ -	\$100 <sup>1</sup>	\$ 60 <sup>1</sup>

<sup>1</sup>No deferred tax asset would be recognized for the deductible outside basis difference related to S2 unless the basis difference is expected to reverse in the foreseeable future.

In this situation, U.S. Parent has no outside basis difference in its investment in S1 (tax basis and U.S. GAAP carrying amount are both \$61). However, if S1 were to distribute future earnings, U.S. Parent will be taxed on the \$39 excess of total PTEP (\$100) over the tax basis in the stock (\$61, consisting of \$1 of tax basis from the initial capital contribution and \$60 from the deemed repatriation income).

If U.S. Parent asserts indefinite reinvestment of all of S1's basis differences, it would not recognize a deferred tax liability associated with the \$39 excess of total PTEP over the tax basis in the stock.

If U.S. Parent asserts indefinite reinvestment of S1's basis differences, but only in excess of the \$100 of PTEP, it would recognize a deferred tax liability associated with the \$39 excess of total PTEP over the tax basis in the stock even though it does not have an overall taxable outside basis difference related to its investment in S1. In addition, U.S. Parent also would need to recognize additional deferred tax liabilities related to the excess of total PTEP over the tax basis in the stock – e.g., section 986(c) currency gain/loss, withholding taxes and state taxes.

If U.S. Parent does not assert indefinite reinvestment of S1's basis differences, it can elect to either (a) not recognize a deferred tax liability associated with the \$39 excess of total PTEP over the tax basis in the stock because a distribution of all existing assets would not result in taxable gain, or (b) recognize the deferred tax liability because a distribution of future earnings that could otherwise be distributed without federal tax consequences would be taxable due to the \$39 excess of total PTEP over the tax basis in the stock. If U.S. Parent recognizes the deferred tax liability associated with the excess of total PTEP over the tax basis in the stock, it also would need to recognize additional deferred tax liabilities related to this basis difference – e.g., section 986(c) currency gain/loss, withholding taxes and state taxes.

**7.086 Liquidation of a Controlled Foreign Corporation.** Treasury regulations govern the liquidation of a controlled foreign corporation into its U.S. corporate parent. Under these regulations, any untaxed earnings and profits of the controlled foreign corporation, excluding the earnings of lower-tier subsidiaries, are deemed to be a dividend to the U.S. entity. The deemed dividend will often be eligible for a dividends received deduction and not subject to U.S. income tax. A U.S. shareholder whose expected manner of recovering its investment in a controlled foreign corporation is through liquidation should consider the future tax consequences of such a liquidation in determining whether to recognize deferred taxes, if any, related to the entity.

**7.087 Effect of Changes in Tax Laws – Otherwise Subpart F Income.** Certain income earned by a foreign subsidiary would be considered Subpart F income if not for a specific exemption in U.S. tax law (e.g., the look-through rules for payments from related CFCs under section 954(c)(6)). Such exemptions typically have expiration dates and are thus periodically subject to reinstatement. A U.S. entity applying the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) to its investment in its foreign subsidiary should record current and deferred taxes on the income (including the effect of foreign tax credits) related to periods after the expiration of the specific exemption, even if a new tax law is expected to be enacted (or has been enacted after the end of the reporting period) reinstating the exemption retroactively to the expiration date. On enactment to reinstate the exemption, related income taxes payable and related deferred tax assets and liabilities would be eliminated. See Paragraph 5.009 for additional discussion.

**7.087a Global Intangible Low-Taxed Income (GILTI).** As discussed in Paragraph 2.037b, for tax years of foreign corporations beginning after December 31, 2017, the U.S. 2017 tax reform Act provides that a U.S. shareholder of any controlled foreign corporation (CFC) must include in taxable income its pro rata share of GILTI. GILTI is considered the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. A taxpayer's GILTI is based on its aggregate, net tested income from its CFCs. While a pro rata amount of GILTI is associated with each CFC (and that amount increases the US taxpayer's tax basis in the CFC stock), the initial computation is done at an aggregate level.

**7.087b** As discussed in Paragraph 2.037c, entities can make a policy election to either provide deferred taxes related to GILTI or account for taxes on GILTI as a period cost when incurred. However, because GILTI deferred taxes, if provided, would be recognized only when basis differences exist that are expected to affect the amount of the GILTI inclusion on reversal, we do not believe an entity would provide GILTI deferred taxes if it does not expect to have a GILTI inclusion for the foreseeable future. Entities should disclose under ASC Topic 235 their accounting policies related to GILTI inclusions.

**7.087c** While there is no guidance about how to identify and measure deferred taxes related to GILTI, we believe entities that elect to do so, like Subpart F, generally will recognize deferred taxes when basis differences exist that are expected to affect the amount of the GILTI inclusion on reversal (see discussion of Subpart F beginning in Paragraph 7.077). We believe one acceptable approach is to apply the following two-step process.

### **Step 1 – Determine which CFC inside basis differences are GILTI temporary differences**

First, the U.S. parent would identify U.S. GILTI temporary differences as those inside basis differences at the individual CFCs that are expected to affect the amount of the aggregate GILTI inclusion on reversal. When recognizing deferred taxes on those inside basis differences, a parent would assume the CFCs' assets and liabilities will be recovered (or settled) at their financial statement carrying amounts. A parent also would evaluate deferred tax assets for realizability under ASC Topic 740's valuation allowance guidance.

In measuring deferred taxes, entities may need to consider the effects of the net deemed tangible income return (see Paragraph 7.087d), the section 250(a) deduction (see Paragraph 7.087e), and the deemed paid credit for foreign taxes (see Paragraph 7.087f).

### **Step 2 – Account for the 'residual' outside basis difference**

After an entity provides U.S. deferred taxes for CFC inside basis differences, it still may have a residual outside basis difference in one or more of its CFCs – i.e., a basis difference that does not relate to the underlying assets and liabilities of the CFC. The U.S. parent would account for those residual amounts under the guidance in ASC Topic 740 about outside basis differences.

We believe this two-step process is consistent with ASC Topic 740's principles for accounting for outside basis differences – i.e., the parent's income tax accounting should correspond with its expected manner for recovering its investment. The U.S. parent (1) provides deferred taxes on the portion of the outside basis difference that is expected to be recovered through normal operations through the reversal of inside basis differences, and (2) evaluates the remainder of the outside basis difference (the residual) to determine whether deferred taxes are necessary based on how it expects to recover the residual investment – e.g., through sale, distribution, liquidation. Some methods of recovering the

residual investment are not subject to tax, so an entity expecting to use one of those methods would not provide deferred taxes on the basis difference, if any, related to that residual.

We believe a U.S. parent may apply this two-step process regardless of the relationship between the financial statement carrying amount and tax basis of its investment in a CFC – i.e., even if the overall outside basis difference is deductible or there is no overall outside basis difference.

We understand that the FASB and SEC staffs do not believe this approach is inconsistent with the principles of Topic 740.

**7.087d GILTI: Net Deemed Tangible Income Return.** The net deemed tangible income return is generally defined as the excess of 10% of the aggregate of each CFC's qualified business asset investment (QBAI) over the amount of interest expense taken into account in determining the shareholder's net CFC tested income. QBAI is determined as the average of the adjusted bases in "specified tangible property." As discussed in Paragraph 3.075e, we believe the deduction for the net deemed return on the taxpayer's tangible business property may be akin to a special deduction or may represent a rate adjustment (i.e., considered in an entity's measurement of GILTI deferred taxes, if deferred taxes are provided - see Paragraph 2.037b) if an entity has the ability to reliably estimate its qualified business asset investment and the effect of the interest expense limitation. An entity should consistently apply its policy choice and consider disclosure in the notes to financial statements.

**7.087e GILTI: Section 250(a) Deduction.** Additionally, a deduction is permitted for 50% of an entity's GILTI (referred to as the section 250(a) deduction) for tax years beginning after December 31, 2017 and before January 1, 2026, with a reduction to 37.5% after December 31, 2025. As discussed in Paragraph 3.075c, we believe that if an entity believes that it will have positive taxable income and a GILTI inclusion (and has chosen to recognize deferred taxes to reflect that – see Paragraph 2.037b for additional discussion), it generally should reduce from 21% the rate it applies when measuring deferred taxes to the extent it can reasonably expect taxable income adequate to realize some or all of the section 250(a) deduction in the periods the related temporary differences are expected to reverse. However, if an entity does not expect to be eligible to take a section 250(a) deduction (e.g., because it is unable to make reliable estimates of taxable income, does not expect to have U.S. taxable income, or expects to offset taxable income with existing NOL carryforwards or other tax attributes), we believe that it would be inappropriate for that entity to reduce the rate applied to its GILTI temporary differences for the section 250(a) deduction.

**7.087f GILTI: Foreign Tax Credits.** As discussed in Paragraph 4.117a, for any amount of GILTI that is included in a U.S. shareholder's income, the U.S. tax law provides for a limited deemed paid credit of 80% of the foreign tax attributable to the tested income of the controlled foreign corporations (CFCs). The tax also requires a full (100%) inclusion for foreign taxes paid (the “section 78 gross-up”). Unused deemed-paid foreign tax credits attributable to GILTI cannot be carried forward or back. Similar to measuring

U.S. deferred taxes for the temporary differences of a foreign branch, we believe entities should consider the (limited) effects of foreign tax credits (or forgone foreign tax credits) when measuring GILTI deferred taxes. As discussed in Paragraphs 7.068 through 7.069, we believe that entities would measure the U.S. federal effect of GILTI temporary differences either (a) by applying to the GILTI temporary difference the lesser of the foreign tax rate or the U.S. tax rate (which could be 21% or a lower rate depending on the entity's facts and circumstances – see Paragraph 7.087d for additional discussion), or (b) as the adjustment to the amount of foreign tax credits that would be generated if the foreign branch realized its deferred tax assets or liabilities. An entity should provide U.S. deferred taxes for foreign tax credits (and forgone foreign tax credits) only for those events that are recognized in the financial statements at the balance sheet date. As a result, including the limited effect of a foreign tax credit will lead to a U.S. deferred tax asset for a CFC's foreign deferred tax liabilities and a forgone foreign tax credit will lead to a U.S. deferred tax liability for a CFC's foreign deferred tax assets. An entity would not provide U.S. deferred taxes for anticipated foreign tax credits on future income beyond the amount necessary to recover or settle its existing assets and liabilities. We understand that the FASB and SEC staffs do not believe this approach is inconsistent with the principles of ASC Topic 740.

**7.087g GILTI: Valuation Allowance Considerations.** We believe entities should include GILTI as a source of taxable income when assessing the need for a valuation allowance. See discussion in Paragraphs 4.124a through 4.124e about factors to consider when determining the effect of GILTI on the valuation allowance both when an entity does and does not provide GILTI deferred taxes.

**7.088 Dual Income Tax.** In some tax jurisdictions, a portion of taxable income is taxed at a reduced rate, and the remainder is taxed at the regular statutory rate. The amount that is taxed at the reduced rate may be determined annually by the taxing authority. A dual income tax is a type of graduated tax rate system. If graduated tax rates are expected to be a significant factor in determining taxes payable or refundable in future years, deferred tax assets and liabilities should be measured using the average graduated enacted tax rate that is expected to apply to the amount of estimated average annual taxable income. This approach requires the entity to estimate its average annual taxable income and apply the currently enacted rate structure (i.e., the discounted rate and level of taxable income to which it applies as it currently exists under the tax law) to compute its average graduated enacted tax rate. This computation should not anticipate any changes in the enacted rate structure. See Paragraph 3.053 for additional discussion on graduated tax rates. ASC paragraphs 740-10-55-136 through 55-138

**7.089 Alternative Tax Systems in a Foreign Jurisdiction.** When more than one tax system exists in a foreign jurisdiction, the tax rate used to calculate deferred taxes depends on the interaction between the systems. As discussed beginning in Paragraph 3.069, when one system (the alternative tax system) only accelerates the timing of tax payments owed under the foreign jurisdiction's other tax system (the regular tax system), the alternative tax system's tax rate should not be used in the measurement of deferred taxes. Any amount paid under the alternative tax system that can reduce taxes to be paid in the future under the regular tax system should be set up as deferred tax assets, similar



to the way U.S. AMT credit carryforwards were accounted for before the 2017 tax reforms. However, if any portion of the alternative tax owed is an incremental tax, deferred taxes should be measured using a combined tax rate consisting of the regular tax system's tax rate and the alternative tax system's incremental tax rate. See Paragraph 3.069 for additional discussion of alternative minimum tax systems. ASC paragraphs 740-10-25-44, 30-10 and 30-12

**7.090 Tax Effects of Transaction Gains or Losses on Intra-entity Loans Considered to Be of a Long-Term Investment Nature When the Local Foreign Currency Is the Functional Currency.**

A U.S. dollar denominated intra-entity loan to a foreign subsidiary that is deemed to be of a long-term investment nature is considered part of the net investment in the subsidiary. Accordingly, the related transaction gains or losses, and their related tax effects, are recognized in other comprehensive income in the U.S. parent entity's consolidated financial statements pursuant to ASC paragraph 830-20-35-3 (despite the fact that such gains and losses would be recognized in income from continuing operations for the subsidiary's separate financial statements). ASC subparagraph 740-20-45-11(b), and paragraph 830-30-45-5

**Example 7.11b: Gain/Loss on Intra-entity Loan Considered to Be of a Long-Term Investment Nature**

A U.S. entity has a U.S. dollar-denominated intra-entity loan to its foreign subsidiary that is deemed to be of a long-term investment nature. Accordingly, the transaction gains or losses related to the loan that the subsidiary recognizes in its income statement are included in other comprehensive income in the entity's consolidated financial statements. Further, the transaction gains or losses are included in the subsidiary's annual income tax returns.

ASC subparagraph 740-20-45-11(b) states that the tax effects of gains and losses included in comprehensive income but excluded from net income are charged or credited directly to other comprehensive income. Accordingly, in the entity's consolidated financial statements, the current tax expense or benefit from including the transaction gains or losses on the intra-entity loan in the subsidiary's annual tax returns should be reported in other comprehensive income in accordance with ASC paragraph 830-20-45-5.

**7.090a Accounting for Loans That are No Longer Considered to Be of a Long-Term Investment Nature.** As discussed in Paragraph 7.090, foreign currency gains and losses on an intra-entity foreign currency loan that is of a long-term investment nature are recognized in other comprehensive income when each of the entities that is party to the transaction is included (consolidated, combined or accounted for under the equity method) in the same financial statements. A transaction is considered to be of a long-term investment nature when settlement is not planned or anticipated in the foreseeable future.

**7.090b** For U.S. entities after the 2017 tax reforms, cash may be repatriated with less punitive U.S. tax consequences (see Paragraph 7.007a for additional discussion about deemed repatriation and Paragraph 7.007d for additional discussion about the 100%

dividends received deduction). Consequently, some entities are considering changes to their capital structures that may involve settling intra-entity foreign currency loans that were previously considered to be of a long-term investment nature.

**7.090c** The characterization of an intra-entity transaction as being of a long-term investment nature is largely based on management's intent, much like the intent to indefinitely reinvest a foreign subsidiary's undistributed earnings. As discussed in Paragraph 7.010, the 2017 U.S. tax reforms may trigger a different intention on the part of an entity – such that it now does plan to settle (or anticipate settling) intra-entity loans in the foreseeable future. We believe that if the change is caused by this change in previously unforeseen circumstances, it would not raise questions about the original assertion that the transaction was of a long-term investment nature.

**7.090d** If an entity decides that an intra-entity loan is no longer of a long-term investment nature, it should recognize in pretax income the transaction gains and losses that arise after the decision is made. The entity should keep in accumulated other comprehensive income the cumulative transaction gain or loss previously reported there until it sells, liquidates or substantially liquidates its investment in the foreign entity.

**7.091 U.K. Indexation of Real Estate Tax Basis.** Certain real estate in the United Kingdom is not depreciated for tax purposes but was indexed for inflation through December 31, 2017. The increase in tax basis from the indexation reduces the taxable gain when the real estate is sold but will not result in a capital loss if the real estate is sold for an amount less than the indexed value. However, a capital loss is recognized to the extent the selling price is less than the original unindexed tax basis of the real estate.

**7.092** Under ASC Topic 740, temporary differences are identified assuming that assets and liabilities are recovered or settled at their financial statement carrying amounts. We believe that if an entity expects to recover the financial statement carrying amount through use, the entity should recognize deferred taxes for the difference between the adjusted tax basis (i.e., excluding indexation) and the financial statement carrying amount (i.e., based on the assumption that it will have taxable income each year equal to the depreciation for financial reporting purposes to recover the asset's financial statement carrying amount).

**7.092a** If an entity expects to recover the financial statement carrying amount through sale rather than through use, we believe the entity should recognize deferred taxes for the difference between the financial statement carrying amount and the assumed tax basis on sale. The assumed tax basis on sale is the greater of (a) the lesser of the U.S. GAAP carrying amount or the indexed basis and (b) the original unindexed tax basis. See Example 7.12.

### **Example 7.12: Temporary Difference for Indexed Property**

ABC Corp. has a building that it intends to recover through sale. The property has a financial statement amount of \$1,000 and is depreciated ratably over 10 years at \$100 per

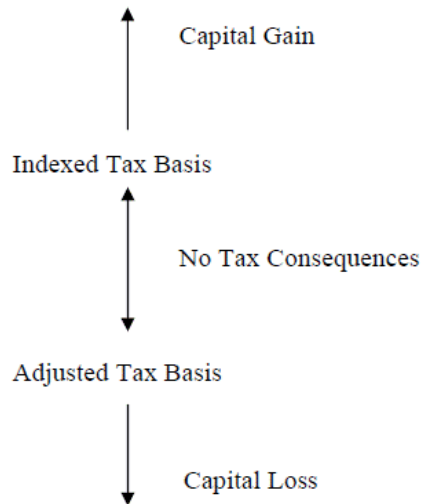
year. Furthermore, the original tax basis is \$500 and is indexed (increased) \$100 a year. Under the tax law, no capital loss is available unless the property is sold for an amount less than its original unindexed tax basis (\$500). The following is the calculation of the temporary difference for this asset.

	<b>Financial Statement Carrying Amount</b>	<b>Indexed Tax Basis</b>	<b>Tax Basis for Deferred Tax Purposes</b>	<b>(Taxable) Deductible Temporary Difference</b>
Year 1	1,000	500	500	(500)
Year 2	900	600	600	(300)
Year 3	800	700	700	(100)
Year 4	700	800	700	—
Year 5	600	900	600	—
Year 6	500	1,000	500	—
Year 7	400	1,100	500	100

**7.093** We believe it generally would be inappropriate to recognize tax benefits for the indexing for tax purposes to the extent that the indexed tax basis exceeds the financial statement carrying amount. That additional tax benefit generally would be recognized at the time of sale if the property were sold for a financial statement gain.

**7.094 U.K. Tax Law - Industrial and Agricultural Buildings.** In the United Kingdom, tax depreciation on industrial and agricultural buildings is not allowed in tax years subsequent to 2011.

**7.095** Industrial and agricultural buildings have two different tax bases. There is the *adjusted tax basis*, which is the original cost of the building less tax depreciation accumulated before 2012. Additionally, there is the *indexed tax basis* which is building's original cost plus an indexation allowance based on inflation through December 31, 2017, when indexing ceased. The tax consequences with respect to an industrial or agricultural building will depend on if the building is ultimately sold and the amount of the proceeds from such sale. Capital gains arise if the building is sold for an amount in excess of indexed tax basis. Capital losses only arise if the building is sold for an amount less than its adjusted tax basis. If the building is sold for an amount less than its indexed tax basis but greater than its adjusted tax basis, there would be no tax consequences. These provisions continue after the phase out of depreciation.



**7.096** As discussed in Paragraph 7.092, if an entity expects to recover the financial statement carrying amount through use, we believe the entity should recognize deferred taxes for the difference between the adjusted tax basis (i.e., excluding indexation) and the financial statement carrying amount.

**7.097** If an entity expects to recover the financial statement carrying amount through sale rather than through use, we believe the entity should recognize deferred taxes for the difference between the financial statement carrying amount and the assumed tax basis on sale. The assumed tax basis on sale (as discussed in Paragraph 7.092a) is the greater of (a) the lesser of the U.S. GAAP carrying amount or the indexed basis and (b) the original unindexed tax basis. As discussed in Paragraph 7.093, we believe it generally would be inappropriate to recognize tax benefits for the indexing for tax purposes to the extent that the indexed tax basis exceeds the financial statement carrying amount. See Example 7.12 for an illustration of this guidance.

**7.098 Foreign Tax on Partnerships.** In the U.S., an entity structured as a partnership is generally a pass-through entity in which partnership income, and the related tax, if any, is attributed to the partners (see Paragraph 9.118 for additional discussion). However, certain foreign jurisdictions may not view a partnership as a pass-through entity and may attribute partnership income and the related tax to the partnership itself. In these circumstances, because the foreign taxing authority does not view the partnership as a pass-through entity, it is appropriate to report the taxes on the partnership in the foreign jurisdiction as an income tax expense of the partnership.

**7.099 Ireland Research and Development Credit.** The Irish government allows a research and development (R&D) credit to provide entities with an incentive to develop a sustainable basis for long-term employment growth by reducing the economic costs of undertaking R&D activities. The amount of the credit is 25% of qualifying R&D expenditures. Qualifying expenditures are defined as incremental to R&D expenditures in the 2003 base year. The amount of the credit is limited to the greater of: (1) corporation income taxes payable by the entity for the 10 years prior to the accounting period in

which the qualifying expenditure was incurred, and (2) the amount of pay-as-you-earn (PAYE), pay related social insurance (PRSI), and levies (payroll taxes), which the entity is required to remit in the period in which the qualifying expenditure was incurred.

**7.100** Effective January 1, 2009, the amount of the tax credit may be recovered by offsetting it against the current year's corporation tax liability, and any unused credit may be recovered to the extent of any corporation tax for the preceding accounting period. Any remaining excess will be paid by the Revenue Commission in three installments as follows:

- (1) A payment of 33% of the excess will be made as the first installment;
- (2) The remaining excess balance will then be used to first reduce the corporation tax payable of the subsequent year and, if any excess still remains, a second installment amounting to 50% of the remaining excess will be made to the entity, and;
- (3) Any further excess will then be used to reduce the corporation tax payable of the subsequent year and, if an excess still remains, that amount will be paid to the entity as a third installment.

**7.101** As discussed in Paragraph 1.002 and the section beginning at Paragraph 9.135, ASC Topic 740 only applies to taxes based on income. For the R&D credit, income taxes paid in the prior 10 years represents the upper limit of amounts that can be credited rather than a basis for determining the amount of tax credits. In addition, the income tax system is only a methodology to administer the refunds to eligible parties. We believe that the tax credit is not income-based (is outside the scope of ASC Topic 740) and therefore the benefit of the credit is not presented as a reduction of income tax expense.

**7.102 Tax Migration.** Entities may execute legal steps that change the legal domicile and related tax jurisdiction of the entity from one jurisdiction to another jurisdiction. A tax migration occurs when the change in legal domicile and tax jurisdiction does not result from an intra-entity transfer. Tax migrations often result in a step-up in the tax basis of the assets and liabilities to fair value in the new jurisdiction. Tax migration is analogous to a change in tax status. Therefore, in accordance with ASC paragraphs 740-10-45-19 and 740-20-45-8, the effects of the migration should be included in income from continuing operations in the period in which the migration occurred. See the section beginning at Paragraph 5.019 for additional discussion on how to account for changes in tax status.

### **Example 7.13: Accounting for the Tax Effects Caused by a Tax Migration**

ABC Corp., a U.S. parent entity wholly owns a U.S. domiciled subsidiary, XYZ. On January 1, 20X9, ABC, as part of an overall centralization of its intellectual property and related operations, executes a series of legal steps which results in a change in XYZ's legal domicile and related tax jurisdiction from the U.S. to a foreign jurisdiction (hereafter, referred to as the tax migration). The foreign jurisdiction's tax laws treat the

change as the incorporation of a new entity, which gives rise to a step-up in the tax basis of the assets and liabilities to fair value in the foreign jurisdiction. The tax migration was not taxable in the United States and the earnings of XYZ will no longer be included in the U.S. return until such earnings are remitted to the United States. The migration of XYZ did not result from an intra-entity sale for tax or book purposes.

The tax effects of the migration are recognized in the period in which the migration occurred. Because the migration is analogous to a change in tax status, ABC includes the effects of the migration in income from continuing operations in accordance with ASC paragraphs 740-10-45-19 and 740-20-45-8. The tax effects of the migration include the elimination of any U.S. deferred taxes on the inside basis differences of XYZ's assets and liabilities, the recognition of the deferred taxes on the inside basis differences in XYZ's new tax jurisdiction (which include the step-up in tax basis), and recognition of deferred taxes on ABC's investment in XYZ, if applicable, depending on whether the indefinite reversal criterion applies to the outside basis difference.

## ENDNOTES

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<sup>1</sup> The Regulations generally do not apply to trusts, estates, S corporations, and partnerships (other than section 987 aggregate partnerships). Further, the Regulations generally do not apply to banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, and real estate investments trusts (collectively, *specified entities*), other than specified entities that engage in transactions primarily with related persons that are not themselves specified entities. Entities not subject to the Regulations must use a reasonable method to comply with section 987, and cannot rely on the Regulations.

<sup>2</sup> In general, a QBU is any separate and clearly identified unit of a taxpayer's trade or business, provided that separate books and records are maintained.

<sup>3</sup> The Regulations generally do not apply to trusts, estates, S corporations, and partnerships (other than section 987 aggregate partnerships). Further, the Regulations generally do not apply to banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, and real estate investments trusts (collectively, *specified entities*), other than specified entities that engage in transactions primarily with related persons that are not themselves specified entities. Entities not subject to the Regulations must use a reasonable method to comply with section 987, and cannot rely on the Regulations.

## Section 8 - Income Tax Issues Associated with Share-Based Payment Arrangements

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**8.000** Share-based payment awards are often part of an employee's compensation from the employer in return for services provided. Similarly, share-based payment awards can also be part of a nonemployee's income for services provided. As with other components of compensation or service cost, there is, generally, an income tax benefit to the grantor of the awards associated with the deductible amounts of compensation or service cost. The amount of the tax benefit and the date on which those benefits are received depend on the nature and terms of the award and the taxing jurisdictions involved. Generally, in the United States, share-based payment awards for the performance of services are either statutory (qualified) awards or nonstatutory (nonqualified) awards. Qualified awards are granted under, and governed by, specific Internal Revenue Code sections and only apply to employees providing services, while nonqualified awards are governed by the more general Internal Revenue Code principles surrounding the performance of services by employees or nonemployees. The examples in this Section are based on the provisions of the U.S. federal tax law for the performance of services. The terms 'employee' and 'employer' are used when the guidance applies only to employee share-based payment arrangements and 'service provider' and 'service recipient' are used when the guidance applies to both employee and nonemployee share-based payment arrangements for the performance of services. The effects of taxes for acquiring goods and the effects in other tax jurisdictions are not considered in the examples unless indicated.

## TAX IMPLICATIONS FOR GRANTEES FOR THE PERFORMANCE OF SERVICES

**8.001 Qualified Awards.** For U.S. federal income tax purposes, statutory, or qualified, awards include incentive stock options (ISOs), governed by Internal Revenue Code section 422, and options or awards granted under employee share purchase plans, governed by section 423. While section 423 plans may be qualified plans for tax purposes, ASC Subtopic 718-50, *Compensation—Stock Compensation—Employee Share Purchase Plans*, establishes the criteria for an employee share purchase plan to be deemed noncompensatory for financial reporting purposes (see Section 1 of KPMG Handbook, *Share-Based Payment*, for a discussion of these criteria and Section 11 for a discussion of the accounting for compensatory employee share purchase plans).

**8.002** ISOs and other qualified plans generally are limited to employees and give employees favorable tax treatment. Employees are not taxed until the stock that is acquired through the exercise of the share option or through an employee share purchase plan is sold. Additionally, the difference between what the employee paid for the shares (the exercise price) and the sales price of the stock is taxed at the lower capital gains tax rate provided that the long-term capital gain holding period is satisfied. In order to qualify as an ISO, certain requirements must be met:

- (1) ISOs must be granted pursuant to a plan that specifies the total number of shares to be issued and the employees or class of employees eligible to receive the options. The shareholders must approve the plan within the period beginning 12 months before and ending 12 months after the date the plan is adopted. Shareholder approval also is required for later amendments to the

plan to increase the number of authorized shares or to change the class of employees eligible to receive the share options.

- (2) ISOs must be granted within 10 years from the earlier of: (1) the date the ISO plan is adopted, or (2) the date the plan is approved by the shareholders.
- (3) ISOs must not be exercisable more than 10 years after the date of grant. If an ISO is granted to someone who owns 10% or more of the total combined voting power of the employer's stock (or its parent or subsidiary), the ISO must not be exercisable more than five years from the date of grant.
- (4) An ISO's exercise price must not be less than the fair market value of the stock on the date of grant. If an ISO is granted to someone who owns 10% or more of the total combined voting power of the employer's stock (or its parent or subsidiary), the ISO exercise price must be at least 110% of the fair market value of the underlying stock at the grant date.
- (5) During the employee's lifetime, the ISOs can be exercised only by the employee. Further, the ISOs must not be transferable, except at death.
- (6) To avoid a disqualifying disposition (see additional discussion in Paragraph 8.003), stock acquired from the exercise of ISOs must be held for two years from the date of grant, and the stock must be held for at least one year from the date of exercise.
- (7) From the date of grant until three months before the ISOs are exercised, the employee must remain employed by the granting corporation, or a parent, or subsidiary of such corporation.
- (8) The aggregate fair market value of employer stock underlying an ISO that can vest each year is limited to \$100,000. In making this determination, the value of employer stock is based on the fair market value at the date of grant.
- (9) The share option by its terms is not transferable other than by will or laws of descent and distribution.

**8.003** If an employee disposes of ISO stock before the statutory holding periods have been met, a disqualifying disposition occurs. As a result, in the year of the disqualifying disposition, the income attributable to the ISO is treated as ordinary income, not capital gains. The amount of taxable ordinary income is calculated as the lesser of: (1) the fair market value of the stock at the exercise date less the exercise price (e.g., intrinsic value at exercise), or (2) the sales proceeds less the exercise price. In addition, if an ISO award is modified, even if the modification has no direct accounting consequence, a disqualifying modification may have occurred (e.g., if the award is in-the-money at the date of the modification) and the award would be accounted for as a nonqualified award from that date forward.

**8.004** When determining whether there has been a disqualifying disposition, all dispositions of ISO stock are considered separately. As a result, the disqualifying disposition of one share of ISO stock will not taint the employee's remaining shares of ISO stock.

**8.005 Nonqualified Awards.** Share-based payment awards for the performance of services that do not meet the requirements of statutory plans are considered nonqualified awards. Nonqualified awards include nonstatutory stock options (NSOs), stock appreciation rights (SARs), nonvested stock (often referred to as restricted stock for tax purposes), and restricted stock units. When a share option or SAR is exercised or upon vesting (restricted stock and restricted stock units), the service recipient generally receives a tax deduction equal to the intrinsic value of the award on that date. Additionally, under the tax code, service providers receiving restricted property may make elections to either accelerate the timing of the taxable event (e.g., section 83(b) election) or, in certain situations, qualified employees receiving nonqualified options or RSUs may elect to delay or defer the taxable event (see additional discussion in Paragraph 8.016).

**8.005a** The 2017 tax reforms in the United States brought some changes to the tax treatment of certain qualified equity grants. The law indicated that restricted stock units (RSUs) are not eligible for section 83(b) elections (see Paragraph 8.016 for additional discussion) but it allows certain qualified employees to defer the timing of compensation for certain stock options and restricted stock unit plans for private companies. Under the 2017 provision, if *qualified stock* is granted to a *qualified employee*, then the employee may make an election within 30 days of vesting to have the tax deferred. The employee would have income and the employer would have a tax deduction in the earliest of:

- The first date the stock is transferable;
- The date the employee becomes an excluded employee;
- The first date the stock becomes readily tradable on an established securities market;
- The date that is five years after vesting; or
- The date the employee revokes the election.

This election is allowed only on qualified stock, which includes stock from the exercise of a stock option or the settlement of an RSU provided that the option or RSU was granted for the performance of services in a calendar year for which the corporation was an eligible corporation (i.e., the stock of the corporation may not be readily tradable on an established securities market during any previous year, in addition to meeting other eligibility requirements). The election must be made by the employee within 30 days of vesting. The employer must provide the employee with notice of eligibility to make the election. The 2017 provision is effective for options exercised, or RSUs settled, after December 31, 2017.

## TAX IMPLICATIONS TO THE GRANTOR FOR THE PERFORMANCE OF SERVICES

**8.006** A service recipient generally recognizes a deduction for U.S. federal income tax purposes equal to the ordinary income the service provider recognizes in the same period that the service provider recognizes that income. Therefore, the employer receives no

deduction for ISOs because they do not result in ordinary income to the employee unless there is a disqualifying disposition of shares that were received on the exercise of an ISO. At the date of a disqualifying disposition, the employee recognizes ordinary income and at the same time, the employer recognizes a corresponding tax deduction (which may be limited under section 162(m) - see Paragraph 8.033 for additional discussion). The capital gain or loss recognized by an employee as a result of this disposition of the security does not result in a taxable event for the employer.

### Example 8.1: Comparison of Tax Implications of Various Awards

This table summarizes the timing and type of income (ordinary income or capital gain) generally recognized by the service provider and tax deduction taken by the service recipient for various stock awards, assuming the service recipient is not subject to the restrictions under section 162(m).

Date	Event	Fair Market Value of Stock
January 1, 20X1	Grant of award	\$ 100
January 1, 20X2	Vesting of award	\$ 200
January 1, 20X3	Exercise of award	\$ 250
January 1, 20X4	Disposition of stock	\$ 300

	Grant Date	Vesting Date	Exercise Date	Disposition of Stock
<b>ISO—Exercise price = \$100; Employee holds shares one year post-exercise</b>				
Employee	No income	No income	No income <sup>1</sup>	Capital gain of \$200
Employer	No deduction	No deduction	No deduction	No deduction
<b>ISO—Exercise price = \$100; Disqualifying disposition—stock sold upon exercise</b>				
Employee	No income	No income	Ordinary income of \$150	
Employer	No deduction	No deduction	Deduction of \$150	
<b>NSO—Exercise price = \$100</b>				
Service provider	No income	No income	Ordinary income of \$150	Capital gain of \$50
Service recipient	No deduction	No deduction	Deduction of \$150	No deduction
<b>Share appreciation right—Base price = \$100</b>				
Service provider	No income	No income	Ordinary income of \$150	N/A
Service recipient	No deduction	No deduction	Deduction of \$150	N/A

**Nonvested stock—Purchase price = \$0**

Service provider	No income	Ordinary income of \$200	N/A	Capital gain of \$100
Service recipient	No deduction	Deduction of \$200	N/A	No deduction

**Nonvested stock—Purchase price = \$0—Code section 83(b) election**

Service provider	Ordinary income of \$100	No income	N/A	Capital gain of \$200
Service recipient	Deduction of \$100	No deduction	N/A	No deduction

<sup>1</sup> Although there is no regular income tax due on the date of exercise, the \$150 difference between the exercise price and the fair market value of the stock on the date of exercise is an adjustment for Alternative Minimum Tax purposes.

## DEFERRED TAXES

**8.007** Generally, the exercise of non-qualifying share options or the vesting of nonvested stock for nonqualified awards results in ordinary income for the service provider and a deduction for tax purposes for the service recipient equal to the intrinsic value of the award at that date. In most instances, there is a difference between the amount and timing of compensation cost recognized for financial reporting purposes and compensation cost that is deductible for income tax purposes. As a consequence, ASC Topic 718 provides that the cumulative amount of compensation cost should be considered a deductible temporary difference for which deferred taxes are recognized. ASC paragraphs 718-740-25-2 and 30-1

**8.008** These differences arise because:

- (1) Compensation cost for tax purposes generally is measured based on the intrinsic value of the award at the time of exercise (non-qualified share options) or vesting (nonvested stock) while compensation cost for financial reporting purposes for equity-classified awards is based on grant-date fair value, or
- (2) Although the ultimate amount of the tax deduction and the cumulative amount recognized for financial reporting purposes for liability-classified awards may be the same (e.g., for cash-settled SARs and many other liability-classified awards), the time period in which those amounts are reported for tax purposes as compared to financial reporting purposes may differ because the compensation cost for financial reporting purposes is recognized over the period from grant date to settlement date rather than at the settlement date.

**8.009** Under current tax law, ISOs do not result in tax deductions for an employer (provided employees comply with the requisite holding period requirements) and,

accordingly, do not create a deductible temporary difference. Tax benefits that arise because employees do not comply with the requisite holding periods (i.e., a disqualifying disposition occurs) are recognized in the financial statements only when such events occur. That is, the employer should not anticipate that a disqualifying event will occur and, therefore, no deferred tax asset or tax benefit is recognized prior to the disqualifying event. ASC paragraph 718-740-25-3

**8.010** Under ASC Subtopic 718-740, *Compensation - Stock Compensation - Income Taxes*, a deductible temporary difference is considered to arise for the cumulative amount of compensation cost recognized that ordinarily results in a future tax deduction for the service recipient. The deferred tax asset resulting from increases in the temporary difference (i.e., as additional compensation cost is recognized over the service or vesting period) is recognized in the period that the compensation cost is reported for financial reporting purposes. The deferred tax asset related to compensation cost for financial reporting purposes is not adjusted for changes in the intrinsic value of the award, but is adjusted for changes in tax laws or applicable rates (including changes due to service provider relocations), and other events that affect the service recipient's compensation cost such as forfeitures (either actual or estimated based on the service recipient's accounting for forfeitures - see Paragraph 8.010b), modifications (see Paragraph 8.010c), repurchases (which may trigger reversal of an existing deferred tax asset and recognition of a current tax benefit based on the cash repurchase price) and clawbacks (which may trigger reversal of an existing deferred tax asset if the award has not been exercised/has not vested or recognition of a current income tax liability if it has). Compensation cost that is capitalized as part of the cost of an asset, such as inventory or property, plant and equipment, is considered a component of the tax basis of the asset for financial reporting purposes. ASC paragraph 718-740-25-2

**8.010a Liability-classified Awards.** The guidance in Paragraph 8.010 generally also applies to liability-classified awards (e.g., cash-settled SARs) except that the *compensation cost recognized* results from the remeasurement to fair value of the liability for the award (as opposed to a generally predictable pattern over the service or vesting period). The deferred tax asset related to that compensation cost is adjusted as the liability is remeasured. As discussed in Paragraph 8.008, vesting of liability-classified awards generally does not result in excess tax benefits or deficiencies because the ultimate amount of the tax deduction and the cumulative amount recognized for financial reporting purposes generally is the same.

**8.010b Forfeitures.** An entity has an accounting policy election about how it accounts for forfeitures. One option is to make an estimate of expected forfeitures of share-based payment awards and recognize compensation expense based on that estimate. The second option is to account (and adjust compensation expense) for forfeitures when they occur. Under either policy, the entity adjusts its compensation cost and therefore also should adjust the related deferred tax asset.

**8.010c Modifications.** A modification of a share-based payment award generally is accounted for as a cancellation of the original award and the issuance of a new award. Modifications can result in:

- (a) a change to compensation expense based on the fair value of new award (and a possible change to the estimated forfeiture rate, if the service recipient's policy is to estimate forfeitures), which will change the amount of the service recipient's related deferred tax asset;
- (b) a change to the tax deductibility of the award, which will result in the service recipient eliminating an existing, or recognizing a new, deferred tax asset; or
- (c) a change to the financial reporting classification of the award (liability versus equity), which will change the measurement attribute of the award and the related deferred tax asset.

**Example 8.2: Recognition of Deferred Tax Assets That Arise from Share-Based Payment Arrangements—Part I**

ABC Corp. grants 10,000 nonqualified share options to employees on January 1, 20X5. The share options have an exercise price of \$15 per share option, which equals the market price of the stock on the date of grant. The awards cliff vest after two years of service. The grant-date fair value of the awards is \$5 per share option. The compensation cost for the employees who receive the share options is expensed in the period incurred (i.e., selling, general and administrative cost). On December 31, 20X7, all of the awards are exercised when the market price of the stock is \$20 per share. ABC has a tax rate of 21%. (It is assumed for simplicity in this example that the amount of the available tax deduction is equal to the compensation cost for financial reporting, but that generally will not be the case. Paragraphs 8.012 through 8.013c discuss the accounting for differences between compensation cost for financial statement purposes and the related tax deductions and Example 8.6 provides an illustration.)

ABC would record the following amounts to reflect the recognition of compensation cost and related tax effects:

	Debit	Credit
<b>20X5</b>		
Compensation expense	25,000	
Additional paid-in capital		25,000
(10,000 share options × \$5 / 2-year requisite service period)		
Deferred tax asset	5,250	
Deferred tax benefit		5,250
(\$25,000 × 21%)		
<b>20X6</b>		
Compensation expense	25,000	
Additional paid-in capital		25,000
Deferred tax asset	5,250	
Deferred tax benefit		5,250

	Debit	Credit
<b>20X7</b>		
Current taxes payable	10,500	
Deferred tax expense	10,500	
Current tax benefit		10,500
Deferred tax asset		10,500
 (10,000 share options × (\$20 – \$15) × 21%)		
The current tax benefit realized is based on intrinsic value at the date of exercise (\$20 – \$15).		

### Example 8.3: Recognition of Deferred Tax Assets That Arise from Share-Based Payment Arrangements—Part II

Assume the same information as in Example 8.2, except that the compensation cost for the award recipients is capitalized as part of ABC Corp.’s inventory cost. ABC has an inventory turnover of four times per year. (It is assumed for simplicity in this example that the amount of the available tax deduction is equal to the compensation cost for financial reporting, but that generally will not be the case. Paragraphs 8.012 through 8.013c discuss the accounting for differences between compensation cost for financial statement purposes and the related tax deductions.)

ABC would record the following amounts to reflect the recognition of compensation cost and related tax effects:

	Debit	Credit
<b>20X5</b>		
Inventory - Compensation cost	25,000	
Additional paid-in capital		25,000
 (10,000 share options × \$5 / 2-year requisite service period)		
Cost of goods sold	18,750	
Inventory - Compensation cost		18,750

As inventory is sold, the relevant compensation cost would be included in cost of goods sold. With an inventory turnover of four times per year, \$18,750 is included in cost of goods sold during the period and \$6,250 is included in ending inventory. No deferred taxes would be recognized for the \$6,250 recorded in ending inventory because this amount has not yet been included in either taxable income or net income for financial reporting purposes. As indicated in Paragraph 8.010, compensation cost that is capitalized as part of the cost of an asset is considered a component of the tax basis of that asset as well.

Deferred tax asset	3,938	
Deferred tax benefit		3,938
 (\$18,750 × 21%)		



	Debit	Credit
<b>20X6</b>		
Inventory - Compensation cost	25,000	
Additional paid-in capital		25,000
Cost of goods sold	25,000	
Inventory - Compensation cost		25,000
As inventory is sold, the relevant compensation cost would be included in cost of goods sold. With an inventory turnover of four times per year, \$25,000 is included in cost of goods sold (3/4 of 20X6 compensation cost + remaining 1/4 of 20X5 compensation cost) during the period and \$6,250 is included in ending inventory.		
Deferred tax asset	5,250	
Deferred tax benefit		5,250
<b>20X7</b>		
Cost of goods sold <sup>1</sup>	6,250	
Inventory - Compensation cost		6,250
<sup>1</sup> The amount of compensation cost included in 12/31/X6 inventory that is recognized during 20X7.		
Deferred tax asset	1,312	
Deferred tax benefit		1,312
Current taxes payable	10,500	
Deferred tax expense	10,500	
Current tax benefit		10,500
Deferred tax asset		10,500
(10,000 share options × (\$20 – \$15) × 21%)		
The current tax benefit realized via reduction in cash taxes payable is based on intrinsic value at the date of exercise (\$20 – \$15).		

#### Example 8.4: Recognition of Deferred Tax Liabilities That Arise from Share-Based Payment Arrangements

Assume the same information as in Example 8.3, except that the compensation cost for the award recipients is included in the costs incurred on a long-term construction contract, for which revenue is not recognized until the point in time that the project is completed. ABC Corp. began work on the contract on January 1, 20X5 and completes work on the contract on December 31, 20X8. (It is assumed for simplicity in this example that the amount of the available tax deduction is equal to the compensation cost for financial reporting. That generally will not be the case. Paragraphs 8.012 through 8.013c discuss the accounting for differences between compensation cost for financial statement purposes and the related tax deductions and Example 8.7 provides an illustration of the

accounting where there is a difference and the compensation cost has been allocated to a long-term construction contract.)

ABC would record the following amounts to reflect the recognition of compensation cost and related tax effects:

	Debit	Credit
<b>20X5</b>		
Construction-in-progress - Compensation cost	25,000	
Additional paid-in capital		25,000

No deferred taxes would be recognized because no amount is included in either taxable income or net income for financial reporting purposes.

<b>20X6</b>		
Construction-in-progress - Compensation cost	25,000	
Additional paid-in capital		25,000

No deferred taxes would be recognized because no amount is included in either taxable income or net income for financial reporting purposes.

<b>20X7</b>		
Current taxes payable	10,500	
Deferred tax expense	10,500	
Current tax benefit		10,500
Deferred tax liability		10,500

(10,000 share options × (\$20 – \$15) × 21%)

The current tax benefit realized via reduction in cash taxes payable is based on intrinsic value at the date of exercise (\$20 – \$15). Exercise of the option results in recognition of a deferred tax liability because the financial reporting basis of the construction-in-progress has not changed as of December 31, 20X7, but the capitalized compensation cost that is considered part of the tax basis of the asset as discussed in Paragraph 8.010 has been eliminated. ABC would measure that deferred tax liability based on the future compensation cost associated with these awards that it expects to recognize in net income (see Paragraph 8.013c for additional discussion). In this example, the deferred tax liability is equal to the reduction in income taxes payable, but only because the example assumes that the amount of the available tax deduction is equal to the compensation cost that will be recognized in net income for financial reporting.

<b>20X8</b>		
Contract expense	50,000	
Construction-in-progress - Compensation cost		50,000

Recognition of expense in period that contract is completed.

Deferred tax liability	10,500	
Deferred tax benefit		10,500

## ASSESSING THE NEED FOR A VALUATION ALLOWANCE

**8.011** Once recognized, ASC Topic 740 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax asset will not be realized. ASC Topic 718 specifies that differences between (1) the deductible temporary difference determined based on the cumulative amount of compensation cost recognized, and (2) the tax deduction inherent in the *current* fair value of an entity's stock (i.e., the current intrinsic value of a share option) is not considered in measuring either the deferred tax asset or the need for a valuation allowance for a recognized deferred tax asset related to the share-based payment arrangement. Consequently, a valuation allowance to reduce the carrying amount of a deferred tax asset related to a share-based payment arrangement is established only if the entity expects future taxable income to be insufficient to recover deferred tax assets. A valuation allowance would not be established just because the awards are out-of-the-money or they are unlikely to be exercised. However, if an entity is relying on projections of future taxable income (exclusive of reversing items) for its valuation allowance assessment, it should include in those projections future excess tax deductions associated with share-based payment awards. The provisions of ASC Topic 740 should be followed to determine whether a valuation allowance should be established. The factors listed in ASC Topic 740 that should be considered to determine whether a valuation allowance is required are:

- Will there be sufficient reversals of existing taxable temporary differences to offset the deferred tax asset;
- Is there future taxable income, exclusive of reversing temporary differences and tax loss carryforwards;
- Is there taxable income in previous carryback years against which current year tax losses can be utilized; and
- Are there tax-planning strategies that can be implemented, which would mean that it is more likely than not that the deferred tax asset will be realized.

See Paragraphs 4.047 and 4.108 for additional discussion. ASC paragraphs 718-740-30-2, 740-10-30-18

### Example 8.5: Valuation Allowance on Deferred Tax Asset

**Question.** ABC Corp. grants share options to employees. During the requisite service period, ABC recognizes cumulative compensation cost of \$100,000 and a related deferred tax asset of \$21,000. ABC prepares its financial statements as of December 31, 20X7. The share options expire on January 10, 20X8. Prior to the issuance of the 20X7 financial statements, all of the share options expire because they are out-of-the-money. ABC expects taxable profits in 20X8 in excess of the amount of its DTA. Should ABC record a valuation allowance on its deferred tax asset in its 20X7 financial statements due to the expected expiration of the options, without any tax benefits?

**Answer.** No. ASC Topic 718 does not permit ABC to consider the likelihood that the share options will expire unexercised or otherwise consider the current intrinsic value of the share options in determining whether there is a need to record a valuation allowance on the deferred tax asset related to the share-based payment arrangement. If ABC expects that future taxable income will be sufficient to provide for a recovery of the deferred tax asset, no valuation allowance would be recorded even when, as in this situation, ABC knows that it will not receive a tax deduction from the exercise of the share options. If material, ABC should disclose in its 20X7 financial statements that it expects the options to expire unexercised and that it does not expect to realize tax benefits.

On January 10, 20X8, when the share options expire, the deferred tax asset is eliminated in accordance with ASC paragraph 718-740-35-2 (see Paragraph 8.013a).

## ACCOUNTING FOR EXCESS TAX BENEFITS AND TAX SHORTFALLS

**8.012** The temporary difference related to the compensation expense for financial reporting purposes is eliminated when the tax deduction is taken. The amount of the tax deduction and related tax benefit may differ from the amount of cumulative compensation cost and related deferred tax asset that was recognized in the financial statements. The amount of the tax benefit may exceed the deferred tax asset previously recognized (an excess tax benefit or *windfall*) or it may be less than the deferred tax asset previously recognized (a tax deficiency or *shortfall*). If only a portion of an award is exercised, determination of the excess tax benefits is based on the portion of the award that is exercised.

**8.013** Not used.

**8.013a** Excess tax benefits and tax deficiencies are recognized in the period in which the amount of the deduction is determined - i.e., the period in which the uncertainty about (a) whether the entity will receive the deduction, and (b) the amount of the deduction, is resolved. For share options, the deduction typically is determined when the award is exercised or expires. For nonvested stock awards, the deduction typically is determined when it vests. ASC paragraph 718-740-35-2

**8.013b** The period in which the deduction is taken on the tax return might be different from the period in which the events giving rise to the deduction occur and the deduction is determined. For example, for an off-calendar year-end entity, the deduction for a share option may be determined in the period in which the holder exercises that option, but the deduction may not be taken on the tax return until the following tax year. In that case, the entity would recognize the excess tax benefit or deficiency in the period of exercise, because that is the period in which the amount of the deduction is determined. The time lapse may be even longer in other situations; for example, when the service provider makes a section 83(b) election - see Paragraph 8.005a for additional discussion.

**8.013c** There also may be situations in which the deduction is taken on the tax return before the compensation expense is recognized; for example, when compensation is capitalized for financial reporting purposes. In those situations, the service recipient recognizes the deduction (including the excess tax benefit or deficiency) in the period it is included in the tax return, because that is the period in which the deduction is determined. When the deduction is taken on the tax return before the compensation expense is recognized for financial reporting purposes, the entity recognizes both a current tax benefit (and a reduction in its current taxes payable) and a deferred tax expense (and a deferred tax liability). The deferred tax liability is measured based on the future compensation cost that the entity expects to recognize in net income. See Examples 8.4, 8.7 and 8.11 for illustrations. ASC paragraph 718-740-35-2

**Example 8.6: Excess Tax Benefit - Scenario 1**

Assume the same information as in Example 8.2, except that at the time of exercise, ABC Corp.'s stock price was \$22, resulting in a tax deduction of \$70,000 (10,000 share options × (\$22 – \$15)). This would result in an excess tax benefit because the tax deduction (\$70,000) exceeds the cumulative compensation cost (\$50,000). As a consequence, ABC would record the following amount in 20X7 when the share options are exercised:

	Debit	Credit
<b>20X7</b>		
Current taxes payable <sup>1</sup>	14,700	
Deferred tax expense	10,500	
Current tax benefit		14,700
Deferred tax asset <sup>2</sup>		10,500

<sup>1</sup> (10,000 share options × (\$22 – \$15)) × 21%. If no current taxes are due (e.g., ABC has a net operating loss), ABC would debit deferred tax asset for the tax effect (subject to valuation allowance considerations).

<sup>2</sup> (10,000 share options × \$5 = cumulative compensation cost of \$50,000) × 21%.

**Example 8.7: Excess Tax Benefit - Scenario 2**

Assume the same information as in Example 8.4, where the compensation costs have been allocated to a long-term contract, except that at the time of exercise, ABC Corp.'s stock price was \$22, resulting in a tax deduction of \$70,000 (10,000 share options × (\$22 – \$15)). This would result in an excess tax benefit because the tax deduction (\$70,000) exceeds the cumulative compensation cost (\$50,000). As a consequence, ABC would record the following amount in 20X7 when the share options are exercised:

	Debit	Credit
<b>20X7</b>		
Current taxes payable <sup>1</sup>	14,700	
Deferred tax expense	10,500	
Current tax benefit		14,700
Deferred tax liability <sup>2</sup>		10,500

ABC would make the same entries in 20X8 as illustrated in Example 8.4.

<sup>1</sup> (10,000 share options × (\$22 – \$15)) × 21%. If no current taxes are due (e.g., ABC has a net operating loss), ABC would debit deferred tax asset (and credit deferred tax benefit) for the tax effect (subject to valuation allowance considerations).

<sup>2</sup> (10,000 share options × \$5 = future compensation cost of \$50,000) × 21%. As discussed in Paragraph 8.013c, ABC measures its deferred tax liability based on the future compensation cost that it expects to recognize in net income.

### Example 8.8: Tax Shortfall

Assume the same information as in Example 8.6, except that at the time of exercise, ABC Corp.'s stock price was \$16, resulting in a tax deduction of \$10,000 (10,000 share options × (\$16 – \$15)). This would result in a tax shortfall because the tax deduction (\$10,000) is less than the cumulative compensation cost (\$50,000). As a consequence, ABC would record the following amount in 20X7 when the share options are exercised:

	Debit	Credit
<b>20X7</b>		
Current taxes payable <sup>1</sup>	2,100	
Deferred tax expense	10,500	
Current tax benefit		2,100
Deferred tax asset <sup>2</sup>		10,500

<sup>1</sup> (10,000 share options × (\$16 – \$15)) × 21%. If no current taxes are due (e.g., ABC has a net operating loss), ABC would debit deferred tax asset (and credit deferred tax benefit) for the tax effect (subject to valuation allowance considerations).

<sup>2</sup> (10,000 share options × \$5 = cumulative compensation cost of \$50,000) × 21%.

**8.014** The write-off of a deferred tax asset related to a tax deficiency is recognized as a charge to income tax expense. A tax deficiency results when the amount of the tax deduction and related tax benefit is lower than the amount of cumulative compensation cost and related deferred tax asset (net of the related valuation allowance, if any) recognized in the financial statements for the award. A tax deficiency would also result when vested and unvested share awards are cancelled and there are no replacement awards (because a deferred tax asset exists but no tax deduction will arise).

## INCENTIVE STOCK OPTIONS – DISQUALIFYING DISPOSITIONS

**8.015** As indicated in Paragraph 8.006, ISOs do not result in a tax benefit for the employer unless there is a disqualifying disposition. Regardless of an entity's experience with disqualifying events, ASC Topic 718 does not permit an entity to anticipate the disqualifying event. Consequently, ISOs will only result in the recognition of a tax benefit if there is a disqualifying event. At the time of the disqualifying event, the entire amount of the tax benefit is recognized in the income statement. If the disqualifying disposition occurs and some or all of the related compensation cost is capitalized (e.g., as part of inventory or property, plant and equipment), the employer also would need to

recognize a deferred tax liability based on the future compensation cost that it expects to recognize in net income (see additional discussion in Paragraph 8.013c).

### Example 8.9: Disqualifying Dispositions of ISOs

On January 1, 20X6, ABC Corp. grants 10,000 incentive stock options that cliff vest on December 31, 20X6. The exercise price of \$15 equals the grant-date stock price. The grant-date fair value of the ISOs is \$7 and all 10,000 share options are expected to vest. The share options are exercised on December 1, 20X7 when the stock price is \$25, and the employees immediately sell the stock in the open market, which constitutes a disqualifying disposition. ABC would record the following amount in 20X7 when the share options are exercised:

	Debit	Credit
<b>20X7</b>		
Current taxes payable <sup>1</sup>	21,000	
Current tax benefit		21,000

<sup>1</sup> (10,000 share options × (\$25 – \$15)) × 21%. If no current taxes are due (e.g., ABC has a net operating loss), ABC would debit deferred tax asset (and credit deferred tax benefit) for the tax effect (subject to valuation allowance considerations).

## RESTRICTED STOCK AND RESTRICTED STOCK UNITS

**8.016** Generally, nonvested stock grants (typically referred to as restricted stock for tax purposes) give rise to taxable income to the service provider at the time the restriction lapses (i.e., at vesting) equal to the difference between the market value of the stock and the exercise price, if any, on the date that the restriction lapses. Alternatively, if a service provider makes an Internal Revenue Code section 83(b) election within 30 days of the date of grant of the restricted stock, then the award will be taxed on the date of grant rather than in the future when the award vests. A section 83(b) election is generally available for grants of actual restricted stock, but not for grants of restricted stock units (see Paragraph 8.005a for additional discussion). Under section 83(b), taxable income to the service provider and the tax deduction to the service recipient is the intrinsic value of an award at the date of grant. Subsequent increases in the market value of the stock will be taxed to the service provider as a capital gain at the time of the sale of the stock. In addition, because the holding period for capital gains begins at the time a service provider has income related to the award, a service provider can dispose of the stock 12 months after the section 83(b) election is made and be taxed at the lower long-term capital gains rates. If the service provider does not make the section 83(b) election, the service provider would have to hold the stock for 12 months after vesting to qualify for long-term capital gain rates. While a section 83(b) election affects the amount and timing of a service provider's taxable income, it does not affect the award's vesting provisions or the service recipient's compensation expense for financial reporting purposes. Below is an example of the accounting for the tax consequences of restricted stock under two

scenarios, one in which the service provider does not make a section 83(b) election and the other in which the service provider does make the election.

### Example 8.10: Restricted Stock – No Section 83(b) Election

On January 1, 20X2, ABC Corp. grants 100,000 shares of restricted stock (i.e., nonvested stock) with a grant-date fair value of \$25 that cliff vest in five years. The stock price is \$50 on December 31, 20X6. ABC has a tax rate of 21%. ABC would record the following:

	Debit	Credit
<b>20X2 – 20X6 (annually)</b>		
Compensation cost <sup>1</sup>	500,000	
Additional paid-in capital		500,000

<sup>1</sup> 100,000 shares × \$25 / 5 years.

Deferred tax asset <sup>2</sup>	105,000	
Deferred tax benefit		105,000

<sup>2</sup> Compensation cost of \$500,000 × 21%.

Additional entry at December 31, 20X6 (vesting date)

Current taxes payable <sup>3</sup>	1,050,000	
Deferred tax expense	525,000	
Current tax benefit		1,050,000
Deferred tax asset <sup>4</sup>		525,000

<sup>3</sup> (100,000 shares × \$50 (fair value on vesting date)) × 21%. If no current taxes are due (e.g., ABC has a net operating loss), ABC would debit deferred tax asset (and credit deferred tax benefit) for the tax effect (subject to valuation allowance considerations).

<sup>4</sup> (\$5,000,000 tax deduction (100,000 shares × \$50) less \$2,500,000 cumulative compensation cost (100,000 × \$25)) × 21%.

### Example 8.11: Restricted Stock – Section 83(b) Election Made

Assume the same facts as in Example 8.10, except that the service providers make a section 83(b) election at the time of the grant. ABC Corp. would record the following:

	Debit	Credit
<b>20X2</b>		
Current taxes payable <sup>1</sup>	525,000	
Deferred tax expense	525,000	
Current tax benefit		525,000
Deferred tax liability		525,000

As discussed in Paragraph 8.013c, ABC measures its deferred tax liability based on the future compensation cost that it expects to recognize in net income.

<sup>1</sup> 100,000 shares × \$25 (grant date fair value) × 21%.



	Debit	Credit
<b>20X2 - 20X6 (annually)</b>		
Compensation cost <sup>2</sup>	500,000	
Additional paid-in capital		500,000
<sup>2</sup> 100,000 shares × \$25 / 5 years		
Deferred tax liability <sup>3</sup>	105,000	
Deferred tax benefit		105,000
<sup>3</sup> Deferred tax liability of \$525,000 set up on the grant date is reduced as compensation expense is recognized (100,000 × \$25 / 5 years × 21%).		

## DIVIDENDS ON SHARE-BASED PAYMENT AWARDS

**8.017** Some entities' share-based payment awards entitle service providers to receive dividends paid on the underlying equity shares or dividend equivalents during the vesting period for equity-classified share-based payment awards. For example, the terms of some entities' awards provide for dividends to be paid to service providers on nonvested shares (i.e., restricted stock grants) during the vesting period. ASC paragraph 718-10-55-45 specifies that "dividends or dividend equivalents paid to grantees on the portion of an award of equity shares or other equity instruments that vests shall be charged to retained earnings. If grantees are not required to return the dividends or dividend equivalents received if they forfeit their awards, dividends or dividend equivalents paid on instruments that do not vest shall be recognized as additional compensation cost." In addition, if dividends are paid on awards even if the underlying award is forfeited, the securities will be participating securities for purposes of calculating earnings per share (EPS). See KPMG Handbook, *Earnings Per Share*, for a discussion of the two-class method of determining EPS.

**8.018 - 8.019** Not used.

**8.020** In some tax jurisdictions, such as the U.S. when a section 83(b) election has not been made, the service recipient is entitled to receive a tax deduction for dividends paid to service providers holding unvested share-based payment awards, regardless of whether those dividends are charged to retained earnings or compensation cost for financial reporting purposes.

**8.021** ASC paragraph 718-740-45-8 states that a tax deduction resulting from dividends paid to a grantee holding an unvested, equity-classified share-based payment award that is charged to retained earnings should be recognized as income tax expense or benefit in the income statement.

### Example 8.12: Dividends Paid on Restricted Stock Unit Award

ABC Corp. grants 1,000 shares of restricted stock units (RSUs) that have a grant-date fair value of \$10. ABC pays a dividend of \$1.00 per RSU. Employees are entitled to keep any dividends paid even if the award is forfeited. ABC has a tax rate of 21%. ABC's accounting policy election is to estimate forfeitures in determining the amount of compensation cost to record each period (alternatively, ABC could have elected to recognize forfeitures as they occur, as permitted by ASC Topic 718). The original estimated forfeiture rate at the time of grant is 0% and is later revised to 10%. ABC would record the following:

	Debit	Credit
Compensation cost	10,000	
Additional paid-in capital		10,000
Deferred tax asset	2,100	
Deferred tax benefit		2,100
To record compensation cost and related tax benefit.		
Retained earnings	1,000	
Cash		1,000
Current taxes payable	210	
Current tax benefit		210
To record dividends on awards expected to vest and related tax effects.		
Compensation cost	100	
Retained earnings		100

To record compensation cost for dividends on 10% of the awards that are expected to be forfeited based on ABC's revised estimate. When an entity changes its expected forfeiture estimates (or actual forfeitures differ from previous estimates) in a subsequent period, dividends and dividend equivalents are reclassified between retained earnings and compensation cost. Because ABC has already recognized in earnings the income tax effect of the dividends related to 100% of the awards, there is no additional tax entry to make related to the \$100 of dividends that are being reclassified from retained earnings to compensation expense.

**8.022** Some entities' share-based payment awards entitle service providers to receive dividends paid on the underlying equity shares or dividend equivalents during the vesting period for liability-classified awards. ASC Topic 718 is not explicit in the accounting for

dividends or dividend equivalents that are paid on share-based payment awards that are liability-classified. Therefore, we believe the guidance in ASC Topic 480, *Distinguishing Liabilities from Equity*, should be used. Dividends paid on instruments classified as liabilities should be reflected as interest cost to be consistent with reporting those awards as liabilities. All dividend equivalents paid on share-based payment awards that are liability-classified should be recognized as compensation cost. In this situation, there will be an offsetting change in the fair value of the award that will neutralize the effect on income from the recognition of the dividend.

**Example 8.13: Recognition of Compensation Cost and Income Tax Benefit on Restricted Stock Units When Grantees Retain Dividends Paid on Forfeited Shares – Part I**

On January 1, 20X1, ABC Corp. grants 800,000 restricted stock units with a grant-date fair value of \$100 per unit and cliff-vest after four years of service. ABC's accounting policy election is to estimate forfeitures in determining the amount of compensation cost to record each period. At the grant date, ABC assumes an annual forfeiture rate of 3% and, therefore, expects to receive the requisite service for 708,234  $[800,000 \times (.97 \times .97 \times .97 \times .97)]$  of the share awards (91,766 estimated forfeitures). Employees ultimately forfeit 15,000 units during 20X1, 35,000 units during 20X2, 30,000 units during 20X3, and 15,000 units during 20X4 (95,000 actual forfeitures, 705,000 actual units vested). Assume that the actual forfeitures throughout the vesting period did not cause ABC to revise its estimate of forfeitures prior to the end of 20X4.

ABC will receive a tax deduction based on the fair value of the shares at the vesting date. Additionally, ABC declares and pays a \$5 per share annual dividend on December 31 of each year and employees with unvested shares units receive those dividends. Employees are not required to return dividends received on unvested awards that are subsequently forfeited. Assume all dividends paid to employees on the unvested shares are tax deductible to ABC. ABC's tax rate is 21%.

The fair value of the underlying shares is \$200 per share on the vesting date. Based upon the above facts, ABC would record the following:

	<b>Debit</b>	<b>Credit</b>
<b>20X1</b>		
Compensation cost $[(\$100 \times 708,234) / 4]$	17,705,850	
Additional paid-in capital		17,705,850
To recognize compensation cost for the awards expected to vest.		
Deferred tax asset $[\$17,705,850 \times 21\%]$	3,718,229	
Deferred tax benefit		3,718,229
To record deferred taxes on the book compensation cost.		

**8. Income Tax Issues Associated with Share-Based Payment Arrangements**

	<b>Debit</b>	<b>Credit</b>
Retained earnings [ $\$5 \times 708,234$ ]	3,541,170	
Compensation cost [ $\$5 \times (800,000 - 708,234 - 15,000)$ ]	383,830	
Cash dividends paid [ $\$5 \times (800,000 - 15,000)$ ]		3,925,000
To recognize dividends paid to holders of unvested awards expected to vest and holders of unvested awards not expected to vest.		
Current taxes payable [ $\$3,925,000 \times 21\%$ ]	824,250	
Current tax benefit [ $\$3,925,000 \times 21\%$ ]		824,250
To recognize tax benefit from deductible dividends.		
<b>20X2</b>		
Compensation cost [ $(\$100 \times 708,234) / 4$ ]	17,705,850	
Additional paid-in capital		17,705,850
To recognize compensation cost for the awards expected to vest.		
Deferred tax asset [ $\$17,705,850 \times 21\%$ ]	3,718,229	
Deferred tax benefit		3,718,229
To record deferred taxes on the book compensation cost.		
Retained earnings [ $\$5 \times 708,234$ ]	3,541,170	
Compensation cost [ $\$5 \times (800,000 - 708,234 - 50,000)$ ]	208,830	
Cash dividends paid [ $\$5 \times (800,000 - 50,000)$ ]		3,750,000
To recognize dividends paid to holders of unvested awards expected to vest and holders of unvested awards not expected to vest.		
Current taxes payable [ $\$3,750,000 \times 21\%$ ]	787,500	
Current tax benefit [ $\$3,750,000 \times 21\%$ ]		787,500
To recognize tax benefit from deductible dividends.		
<b>20X3</b>		
Compensation cost [ $(\$100 \times 708,234) / 4$ ]	17,705,850	
Additional paid-in capital		17,705,850
To recognize compensation cost for the awards expected to vest.		

**8. Income Tax Issues Associated with Share-Based Payment Arrangements**

	<b>Debit</b>	<b>Credit</b>
Deferred tax asset [ $\$17,705,850 \times 21\%$ ]	3,718,229	
Deferred tax benefit		3,718,229
To record deferred taxes on the book compensation cost.		
Retained earnings [ $\$5 \times 708,234$ ]	3,541,170	
Compensation cost [ $\$5 \times (800,000 - 708,234 - 80,000)$ ]	58,830	
Cash dividends paid [ $\$5 \times (800,000 - 80,000)$ ]		3,600,000
To recognize dividends paid to holders of unvested awards expected to vest and holders of unvested awards not expected to vest.		
Current taxes payable [ $\$3,600,000 \times 21\%$ ]	756,000	
Current tax benefit [ $\$3,600,000 \times 21\%$ ]		756,000
To recognize tax benefit from deductible dividends.		
<b>20X4</b> (including additional entry at December 31, 20X4 vesting date)		
Compensation cost [ $(\$100 \times 705,000) - (17,705,850 \times 3)$ ]	17,382,450	
Additional paid-in capital		17,382,450
To recognize compensation cost for awards that vested.		
Deferred tax asset [ $\$17,382,450 \times 21\%$ ]	3,650,313	
Deferred tax benefit		3,650,313
To record deferred taxes on the book compensation cost.		
Retained earnings [ $\$3,525,000$ current - $\$48,510$ prior year adjustment]	3,476,490	
Compensation cost [ $\$5 \times (708,234 - 705,000) \times 3$ years]	48,510	
Cash dividends paid [ $\$5 \times (800,000 - 95,000)$ ]		3,525,000
To recognize dividends paid to holders of awards that vested and to reclassify amounts from retained earnings to compensation cost for dividends in prior years on awards that were expected to vest but ultimately did not.		
Current taxes payable [ $\$3,525,000 \times 21\%$ ]	740,250	
Current tax benefit [ $\$3,525,000 \times 21\%$ ]		740,250
To recognize tax benefit from deductible dividends.		

	Debit	Credit
Current taxes payable [705,000 × \$200 × 21%]	29,610,000	
Deferred tax expense	14,805,000	
Current tax benefit		29,610,000
Deferred tax asset		14,805,000
To record tax benefit upon vesting of the awards.		

**Example 8.14: Recognition of Compensation Cost and Income Tax Benefit on Restricted Stock Units When Grantees Retain Dividends Paid on Forfeited Shares – Part II**

Assume the same information as in Example 8.13, except that the fair value of the shares on the vesting date is \$50 per share. All entries would be the same as in Example 8.13 except for the entry to record the realized tax benefit upon vesting.

	Debit	Credit
Current taxes payable [705,000 × \$50 × 21%]	7,402,500	
Deferred tax expense	14,805,000	
Current tax benefit		7,402,500
Deferred tax asset		14,805,000
To record tax benefit upon vesting of the awards.		

**GRADED VESTING AWARDS**

**8.023** As discussed in Section 2 of KPMG Handbook, *Share-Based Payment*, many share-based payment awards vest in increments or tranches over time rather than at the end of the service or vesting period. These are referred to as graded vesting awards. Accounting for the tax effects of awards with graded vesting follows the same concepts as awards that cliff vest. However, if an entity has valued and accounted for the award on a tranche-by-tranche basis, it would not know the amount of recognized compensation cost that corresponds to the exercised share options for calculating the tax effects resulting from that exercise. If an entity is unable to identify the specific tranche from which share options are exercised, under the guidance of ASC paragraph 718-20-55-34, it should assume that share options are exercised on a first-vested, first-exercised basis (which works in the same manner as the first-in, first out basis for inventory costing).

**8.024** If the award is valued as a single award with a single average expected term, the awards in each vesting tranche would have the same fair value. Furthermore, for awards that are valued as separate awards but the entity recognizes the aggregate fair value of all tranches using the straight-line method as if it were a single award, the separate values for

each tranche are no longer meaningful from an attribution or tax-benefit standpoint. For these awards (i.e., awards subject to graded vesting for which compensation cost is attributed using the straight-line method), the determination of excess or shortfall tax benefits would be based on the compensation cost recognized for financial statement purposes.

## **STOCK-BASED COMPENSATION AND TRANSFER PRICING**

**8.025** For entities that provide services to related parties, including cost-sharing arrangements for developing intangible property, U.S. tax regulations specify the costs to be taken into account in determining the price to be charged for those services. Accordingly, a U.S. parent reports taxable income for its foreign subsidiary's payment for such services, which typically will be greater than the amount of the costs included in determining the charge.

**8.026** As a general matter, in accordance with 2003 U.S. tax regulations that were effective beginning in 2004, the costs must include the value of share-based compensation identified with, or reasonably allocable to, the activity associated with the services provided. In most situations, the share-based compensation is valued at the amount reflected as a charge in the financial statements. However, the determination of the appropriate amount of share-based compensation is fact-specific and there are exceptions to both the inclusion of a charge for share-based compensation and the determination of the value used.

**8.027** On July 27, 2015 the Tax Court unanimously invalidated the 2003 U.S. tax regulations that required taxpayers to include the value of share-based compensation in their cost-sharing arrangements with related parties. In February 2016, the IRS appealed the decision to the Ninth Circuit, who reversed the Tax Court decision and upheld the regulations in June 2019. Altera petitioned the Supreme Court to review the appeals court decision, but that request was denied in June 2020. An entity needs to evaluate the positions it has taken and expects to take in consideration of these events using the recognition and measurement guidance in ASC Subtopic 740-10 (see Paragraphs 3.015 through 3.051).

**8.028** An entity that shares its compensation costs pro-rata with its subsidiary and determines the service charges for tax purposes based on the amount charged as a pretax expense in the financial statements (the grant method) should recognize in the period of grant (a) a deferred tax asset equal to the pretax compensation expense (as it is being recognized over the service or vesting period) times the entity's tax rate, and (b) a current U.S. income tax liability equal to the pretax compensation expense times the percentage of costs reimbursable from the subsidiary times the entity's tax rate. The entity would recognize excess tax benefits or deficiencies in the period in which the amount of the deduction is determined, generally in the period that the award is exercised (or vests) - see Paragraph 8.013a for additional discussion.

**8.029** An entity that shares its compensation costs pro rata with its subsidiary and determines the service charges for tax purposes based on the intrinsic value at the date of

exercise or vesting (i.e., the exercise method) should recognize in the consolidated financial statements in the period of grant (a) a deferred tax asset equal to the pretax compensation expense (as it is being recognized over the service or vesting period) times the percentage of costs not reimbursable from the subsidiary times the entity's tax rate, and (b) a deferred tax asset equal to the pretax compensation expense (as it is being recognized over the service or vesting period) times the percentage of costs reimbursable from the subsidiary times the subsidiary's tax rate (as long as the subsidiary receives a tax deduction in its local tax jurisdiction). The group also would recognize excess tax benefits or deficiencies in both tax jurisdictions in the period in which the amount of the deductions are determined, which is generally in the period that the award is exercised (or vests) - see Paragraph 8.013a for additional discussion.

## SHARE-BASED PAYMENT ARRANGEMENTS IN CONSOLIDATED PASS-THROUGH ENTITY STRUCTURES

**8.029a** A common example of a consolidated pass-through entity structure is an umbrella partnership C corporation (Up-C) structure. An Up-C structure enables owners of a pass-through entity (such as a limited partnership or limited liability company) to conduct an initial public offering (IPO) via a newly formed C corporation, which ultimately holds only an equity interest in the pass-through entity. The C corporation conducts an IPO, and the proceeds are either transferred to the pass-through entity in exchange for ownership interests or used to acquire some of the existing owners' interests in the pass-through entity. The C Corporation will typically have voting control over the pass-through entity and will generally consolidate it for financial reporting purposes, even though it may have a less than fifty percent economic interest.

**8.029b** Based on the terms of the IPO, the original owners may be able to immediately monetize a portion of their individual partnership interests, while retaining some of their economic interests in the partnership and maintaining voting control of the C corporation through a separate class of shares. The economic interest in the pass-through entity retained by the owners generally creates a noncontrolling interest reported by the C corporation until the partnership interests are redeemed or exchanged.

**8.029c** In a typical Up-C structure and certain other structures in which a C corporation consolidates a pass-through entity, any share-based payment awards that are issued to employees of the pass-through entity are indexed to or settled in shares of the C corporation. In the consolidated financial statements of the C corporation, compensation cost is recognized with an offset to additional paid-in capital. Compensation expense and an increase to equity similarly is recognized in the separate financial statements of the pass-through entity. Both the pretax accounting in consolidation and the income tax accounting can be complex because:

- the C corporation computes its outside basis difference in its consolidated investment using equity method principles (see Paragraphs 2.033 and 7.001);



- the pretax application of the equity method for the C corporation's investment in the pass-through entity related to granted but unissued share-based payment awards is subject to interpretation;
- the result of the grant, vesting and issuance of share-based payment awards on the C corporation's book basis differs depending on how the equity method principles are interpreted; and
- the principles of intraperiod tax allocations can be complex to apply when the pass-through entity is reported as a consolidated subsidiary and the tax basis received in the pass-through entity is measured at a different amount than the related share-based payment.

Example 8.14a illustrates two acceptable methods to account for share-based payment arrangements in consolidated pass-through structures and how to account for the related income tax effects. There may be other acceptable approaches. For additional guidance on other issues associated with Up-C structures, see Paragraphs 9.054 (accounting for tax receivable agreements) and 5.028b (accounting for the income tax effects of the recapitalization transaction). For additional guidance on other issues associated with consolidated pass-through entities, see Paragraphs 2.102 and 10.098.

#### **Example 8.14a: Restricted Stock Units Issued in an Up-C Structure**

On December 31, 20X0, ABC Corp. purchases 40,000 units representing a 40% economic interest in LLC, a consolidated entity for US GAAP financial reporting purposes. The remaining 60% noncontrolling interest is held by unrelated third parties. The tax rate is 25%.

On January 1, 20X1, ABC grants 10,000 restricted stock units (RSUs) to LLC employees at a grant date fair value of \$1.00 per share. The RSUs vest on January 1, 20X2.

On the vesting date, ABC issues 10,000 ABC shares to LLC employees and receives 10,000 new units from LLC. The fair value of the ABC shares on January 1, 20X2 is \$1.20 per share. This results in ABC receiving:

- \$12,000 tax basis in the 10,000 new LLC units; and
- a \$4,800 tax deduction for its share of LLC's tax compensation cost ( $\$1.20 \times 10,000 \text{ shares} \times 40\% \text{ ownership interest}$ ).

As a result of the transaction, ABC's ownership percentage of LLC increases from 40% to 45.45% ( $50,000 \text{ units} \div 110,000 \text{ total units}$ ).

We believe ABC may apply either of the following approaches to measure the amount of the noncontrolling interest with the indicated accounting for the income tax effects of the RSUs. Both of the approaches reflected below assume no valuation allowance is necessary. There may be other acceptable approaches.

**Method A: Equity Attribution Based on Actual Ownership**

*Year ended December 31, 20X0*

**Step 1: Record initial investment in LLC under equity method principles**

ABC records the following entry for its initial investment in LLC on December 31, 20X0:

	Debit	Credit
Investment in LLC	40,000	
Cash		40,000

*To record ABC's initial investment*

*Year ended December 31, 20X1*

**Step 2: Record grant and partial vesting of RSUs under equity method principles; attribute LLC's equity based on actual ownership amounts**

Under Method A, the equity of LLC is attributed to ABC and the noncontrolling interest on a pro rata basis only considering issued LLC units.

ABC records the following entries (under equity method principles) for the granting and vesting of the RSUs during 20X1:

Investment in LLC	10,000	
Additional paid-in-capital (APIC)		10,000

*To record ABC's effect of the vesting of the 10,000 RSUs granted to LLC employees (10,000 shares × \$1.00/share)*

Equity in losses - LLC	4,000	
Investment in LLC		4,000

*To record ABC's share of LLC's share-based payment expense (\$10,000 × 40%)*

Additional paid-in-capital	6,000	
Investment in LLC		6,000

*To reallocate LLC's equity between ABC and the noncontrolling interest holders based on their pro rata ownership interests in issued LLC units (( $\$100,000 \times 40\%$ ) – \$46,000 carrying amount of the investment in LLC after the other above entries)*

As of December 31, 20X1, the rollforward of ABC's investment in LLC under equity method principles and tax law is as follows:

<b>ABC Investment in LLC</b>		
	<b>Book basis</b>	<b>Tax basis</b>
January 1, 20X1	\$ 40,000	\$ 40,000
Vesting of RSUs	10,000	-
20X1 LLC earnings (losses)	(4,000)	-
Investment true-up	(6,000)	-
December 31, 20X1	\$ 40,000	40,000
Unborn tax basis *		10,000
		\$ 50,000

\* Tax basis to be received upon issuance of the LLC units for the portion of the share-based payment that has been recognized in the financial statements of \$10,000

As of December 31, 20X1, the rollforward of ABC's consolidated equity (before income tax entries) is as follows:

<b>Rollforward of consolidated equity before income tax entries</b>				
	<b>APIC</b>	<b>Retained earnings</b>	<b>Controlling equity</b>	<b>NCI</b>
January 1, 20X1	\$40,000	\$ -	\$ 40,000	\$60,000
Net income (loss)	-	(4,000)	(4,000)	(6,000)
Share-based compensation	10,000	-	10,000	-
NCI transaction	(6,000)	-	(6,000)	6,000
December 31, 20X1	\$44,000	\$(4,000)	\$ 40,000	\$60,000

### Step 3: Recognize consolidated income tax benefit

As a result of the transactions above, ABC recognizes a deferred tax asset for the investment in LLC, including the tax basis to be received upon issuance of the LLC units for the portion of the share-based payment that has been recognized in the financial statements ( $\$10,000 \times 25\%$ ) (see rollforward in step 2 above). The deferred tax benefit is allocated using the step-by-step approach and results in the following:

- \$1,000 ( $\$4,000 \times 25\%$ ) is recognized in continuing operations, and
- \$1,500 ( $\$6,000 \times 25\%$ ) is recognized as an adjustment to APIC.

A portion of the tax benefit is recognized in APIC because of the pretax adjustment recognized in APIC.

	Debit	Credit
Deferred tax asset	2,500	
Deferred tax benefit – continuing operations		1,000
Additional paid-in capital		1,500
<i>To recognize consolidated income tax benefit</i>		

January 1, 20X2

#### Step 4: True-up Investment in LLC on issuance

On completion of the vesting of the RSUs and issuance of the shares of ABC to the employees of LLC and the issuance of LLC units to ABC on January 1, 20X2, ABC records the following entries to true-up its investment to 45.45% (50,000 units ÷ 110,000 units) of LLC's equity ( $(\$100,000 \times 45.45\%) - \$40,000$ ):

Investment in LLC	5,450	
Additional paid-in-capital		5,450

*To true-up ABC's investment in LLC to 45.45% of LLC's issued equity*

The rollforward of ABC's consolidated equity (before income tax entries) is as follows:

#### Rollforward of consolidated equity before income tax entries

	APIC	Retained earnings	Controlling equity	NCI
January 1, 20X2	\$44,000	\$(4,000)	\$ 40,000	\$60,000
NCI transaction	5,450	-	5,450	(5,450)
December 31, 20X2	<u>\$49,450</u>	<u>\$(4,000)</u>	<u>\$ 45,450</u>	<u>\$54,550</u>

The rollforward of ABC's investment in LLC under equity method principles and tax law is as follows:

	Book basis	Tax basis
January 1, 20X2	\$ 40,000	\$ 40,000
Unit issuance	-	12,000 <sup>1</sup>
20X2 earnings	-	(4,800) <sup>2</sup>
Investment true-up	5,450	-
December 31, 20X2	<u>\$ 45,450</u>	<u>\$ 47,200</u>

Notes:

1 \$1.20 × 10,000 units

2 \$1.20 × 10,000 shares × 40%

### Step 5: Recognize income tax effects of issuance

ABC records the income tax effect of the completion of the vesting of the RSUs and the issuance of the ABC shares and the LLC units. The total income tax expense recognized of \$863 (\$2,063 of deferred tax expense minus \$1,200 of current tax benefit) is allocated using the step-by-step approach and results in the following:

	Debit	Credit
Income tax receivable	1,200 <sup>(A)</sup>	
Deferred tax asset	437 <sup>(B)</sup>	
Deferred tax expense – continuing operations	700 <sup>(C)</sup>	
Additional paid-in capital	1,363 <sup>(D)</sup>	
Deferred tax asset		2,500 <sup>(E)</sup>
Current tax benefit – continuing operations		1,200 <sup>(A)</sup>

Notes:

- (A) Receivable from the taxing authority for the current deduction taken by ABC for its share of the deduction at LLC for the fair value of the awards issued [ $((\$1.20 \times 10,000) \times 40\%) \times 25\%$ ]
- (B) Recognize the ending deferred tax asset for the deductible outside basis difference in LLC investment ((tax basis of \$47,200 minus the book basis of \$45,450) x 25% (see computations in step 4))
- (C) Equal to the deferred tax expense associated with the reduction of the tax basis in LLC from the loss passed-through from the LLC of \$1,200 ( $\$4,800 \times 25\%$ ), partially offset by the tax benefit inherent in the 10,000 LLC units received by ABC of \$500 ( $(\$12,000 \text{ tax basis in units} - \$10,000 \text{ recognized in the financial statements}) \times 25\%$ )
- (D) Equal to the tax-effect of the adjustment to APIC ( $\$5,450 \times 25\%$ )
- (E) Reversal of the beginning-of-year deferred tax asset (see step 3)

### Method B: Equity Attribution Based on Implied Ownership

*Year ended December 31, 20X0*

#### Step 1: Record initial investment in LLC under equity method principles

ABC records the following entry for its initial investment in LLC on December 31, 20X0:

Investment in LLC	40,000	
Cash		40,000

*To record ABC's initial investment*

*Year ended December 31, 20X1*

#### Step 2: Record grant and partial vesting of RSUs under equity method principles; attribute LLC's equity based on implied ownership amounts

Under Method B, the equity of LLC is attributed to ABC and the noncontrolling interest on a pro rata basis after adjustment for the reimbursement that ABC will receive for the

share-based payment awards that have been recognized in the financial statements. It does so by:

- attributing \$10,000 of the net equity of LLC to itself (the amount of the total share-based payment awards which have been recognized in the financial statements and for which ABC will be reimbursed on issuance of the shares), and
- attributing the remainder of the net equity of LLC (\$90,000) between itself and the noncontrolling interest based on the parties' pro rata share – i.e., \$36,000 to ABC ( $\$90,000 \times 40\%$ ) and \$54,000 ( $\$90,000 \times 60\%$ ) to the noncontrolling interest.

This results in LLC's total equity of \$100,000 being allocated \$46,000 to ABC (\$10,000 + \$36,000) and \$54,000 allocated to the noncontrolling interest.

ABC records the following entries (under equity method principles) for the granting and vesting of the RSUs during 20X1:

	Debit	Credit
Investment in LLC	10,000	
Additional paid-in capital		10,000
<i>To record ABC's effect of the vesting of the 10,000 RSUs granted to LLC employees (10,000 shares × \$1.00/share)</i>		
Equity in losses – LLC	4,000	
Investment in LLC		4,000

To record ABC's share of LLC's share-based payment expense ( $\$10,000 \times 40\%$ )

As of December 31, 20X1, the rollforward of ABC's investment in LLC under equity method principles and tax law is as follows:

<b>ABC Investment in LLC</b>		
	Book basis	Tax basis
January 1, 20X1	\$ 40,000	\$ 40,000
Vesting of RSUs	10,000	-
20X1 LLC earnings (losses)	(4,000)	-
Investment true-up	-	-
December 31, 20X1	\$ 46,000	40,000
Unborn tax basis*		10,000
		\$ 50,000

\* Tax basis to be received upon issuance of the LLC units for the portion of the share-based payment that has been recognized in the financial statements of \$10,000

As of December 31, 20X1, the rollforward of ABC's consolidated equity (before income tax entries) is as follows:

<b>Rollforward of consolidated equity before income tax entries</b>				
	<b>APIC</b>	<b>Retained earnings</b>	<b>Controlling equity</b>	<b>NCI</b>
January 1, 20X1	\$40,000	\$ -	\$ 40,000	\$60,000
Net income (loss)	-	(4,000)	(4,000)	(6,000)
Share-based compensation	10,000	-	10,000	-
NCI transaction	-	-	-	-
December 31, 20X1	\$50,000	\$(4,000)	\$ 46,000	\$54,000

### Step 3: Recognize consolidated income tax benefit

As a result of the transactions above, ABC recognizes a deferred tax asset for the investment in LLC, including the tax basis to be received upon issuance of the LLC units for the portion of the share-based payment that has been recognized in the financial statements ( $\$4,000 \times 25\%$ ) (see rollforward in step 2 above). The deferred tax benefit for the tax effect of 20X1 net income (loss) attributable to the controlling interest ( $\$4,000 \times 25\%$ ) is allocated using the step-by-step approach and is recognized in continuing operations.

	<b>Debit</b>	<b>Credit</b>
Deferred tax asset	1,000	
Deferred tax benefit - continuing operations		1,000

*To recognize consolidated income tax benefit*

*January 1, 20X2*

### Step 4: True-up Investment in LLC on vesting/issuance

On completion of the vesting of the RSUs and issuance of the shares of ABC to the employees of LLC and the issuance of LLC units to ABC on January 1, 20X2, ABC records the following entries to true-up its investment to 45.45% ( $50,000 \text{ units} \div 110,000 \text{ units}$ ) of LLC's equity ( $(\$100,000 \times 45.45\%) - \$46,000$ ):

Additional paid-in-capital	550	
Investment in LLC		550

*To true-up ABC's investment in LLC to 45.45% of LLC's issued equity*

The rollforward of ABC's consolidated equity (before income tax entries) is as follows:

<b>Rollforward of consolidated equity before income tax entries</b>				
	<b>APIC</b>	<b>Retained earnings</b>	<b>Controlling equity</b>	<b>NCI</b>
January 1, 20X2	\$50,000	\$(4,000)	\$ 46,000	\$54,000
NCI transaction	(550)	-	(550)	550
December 31, 20X2	\$49,450	\$(4,000)	\$ 45,450	\$54,550

The rollforward of ABC's investment in LLC under equity method principles and tax law is as follows:

<b>ABC Investment in LLC</b>		
	<b>Book basis</b>	<b>Tax basis</b>
January 1, 20X2	\$ 46,000	\$ 40,000
Unit issuance	-	12,000 <sup>1</sup>
20X2 earnings	-	(4,800) <sup>2</sup>
Investment true-up	(550)	-
December 31, 20X2	<b>\$ 45,450</b>	<b>\$ 47,200</b>

Notes:

- 1 \$1.20 × 10,000 units
- 2 \$1.20 × 10,000 shares × 40%

### Step 5: Recognize income tax effects of issuance

ABC records the income tax effect of the completion of the vesting of the RSUs and the issuance of the ABC shares and the LLC units. The total income tax benefit recognized of \$637 (\$1,200 of current tax benefit minus \$563 of deferred tax expense) is allocated using the step-by-step approach and results in the following:

	<b>Debit</b>	<b>Credit</b>
Income tax receivable	1,200 <sup>(F)</sup>	
Deferred tax asset	437 <sup>(G)</sup>	
Deferred tax expense – continuing operations	700 <sup>(H)</sup>	
Additional paid-in-capital		137 <sup>(I)</sup>
Deferred tax asset		1,000 <sup>(J)</sup>
Current tax benefit – continuing operations		1,200 <sup>(F)</sup>

Notes:

- (F) Receivable from the taxing authority for the current deduction taken by ABC for its share of the deduction at LLC for the fair value of the awards issued [ $((\$1.20 \times 10,000) \times 40\%) \times 25\%$ ]
- (G) Recognize the ending deferred tax asset for the deductible outside basis difference in LLC investment ( $(\text{tax basis of } \$47,200 \text{ minus the book basis of } \$45,450) \times 25\%$  (see computations in step 4))



- (H) Equal to the deferred tax expense associated with the reduction of the tax basis in LLC from the loss passed-through from the LLC of \$1,200 ( $\$4,800 \times 25\%$ ), partially offset by the tax benefit inherent in the 10,000 LLC units received by ABC of \$500 ( $(\$12,000 \text{ tax basis in units} - \$10,000 \text{ recognized in the financial statements}) \times 25\%$ )
- (I) Equal to the tax-effect of the adjustment to APIC ( $\$550 \times 25\%$ )
- (J) Reversal of the beginning-of-year deferred tax asset (see step 3)

## INTERIM REPORTING

**8.030** An entity should recognize excess tax benefits (windfalls) and shortfalls from the exercise of share options as a discrete item (i.e., not through an adjustment of the estimated annual effective tax rate) in the period that the windfall or shortfall occurs. ASC paragraph 740-270-30-8 states that an entity should not include in its estimated annual effective tax rate the tax related to a share-based payment award when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes.

**8.031** As indicated in Paragraph 8.015, a future event can give rise to an employer's tax deduction for an award that ordinarily does not result in a tax deduction for the employer. Regardless of an entity's experience with respect to historical employee actions, ASC Topic 718 does not permit an entity to anticipate the disqualifying disposition because the disqualifying disposition is outside of its control. Therefore, the tax benefits from disqualifying dispositions are recognized only in the period the employee makes the disqualifying disposition. We believe the tax effect of a disqualifying disposition generally should be considered a discrete item for interim reporting purposes.

### Example 8.15: Windfalls and Shortfalls During Interim Periods

ABC Corp., a calendar-year reporting entity, issued 100,000 nonqualified share options on January 1, 20X6 that cliff vest in one year. The grant-date fair value of the share options was \$5 per share option. The share options have an exercise price of \$15 per share option, which equals the market price of the stock on the date of grant. On January 15, 20X7, 50,000 share options are exercised when the market price is \$18 per share. The remaining 50,000 share options are exercised on April 15, 20X7 when the market price was \$30 per share. ABC would record the following amounts in its interim periods ending March 31, 20X7 and June 30, 20X7 financial statements:

	Debit	Credit
<b>March 31, 20X7</b>		
Current taxes payable <sup>1</sup>	31,500	
Deferred tax expense <sup>2</sup>	52,500	
Current tax benefit <sup>2</sup>		31,500
Deferred tax asset <sup>3</sup>		52,500

<sup>1</sup> Current tax deduction [(50,000 share options × \$3 (\$18 – \$15) intrinsic value) × 21%].

<sup>2</sup> Net shortfall of \$21,000 (deferred tax expense of \$52,500 – current tax benefit of \$31,500) = Cumulative compensation (50,000 share options × \$5) less tax deduction [(50,000 share options × \$3 (intrinsic value)) × 21%].

<sup>3</sup> Reversal of deferred tax asset on share options exercised [(50,000 share options × \$5 per share option) × 21%].

	Debit	Credit
<b>June 30, 20X7</b>		
Current taxes payable <sup>4</sup>	157,500	
Deferred tax expense <sup>6</sup>	52,500	
Deferred tax asset <sup>5</sup>		52,500
Current tax benefit <sup>6</sup>		157,500

<sup>4</sup> Current tax deduction [(50,000 share options × \$15 (\$30 – \$15) intrinsic value) × 21%].

<sup>5</sup> Reversal of deferred tax asset [(50,000 share options × \$5 per share option) × 21%].

<sup>6</sup> Net excess tax benefit from exercise of share options of \$105,000 (current tax benefit of \$157,500 – deferred tax expense of \$52,500).

### **Example 8.16: Excess Tax Benefits for Disqualifying Dispositions of ISOs During Interim Periods**

ABC Corp. is a calendar year-end reporting entity with a 21% tax rate.

On January 1, 20X6, ABC grants 10,000 incentive stock options that cliff vest on December 31, 20X6. The exercise price of \$15 equals the grant-date stock price. The grant-date fair value of the ISOs is \$7 and all 10,000 share options are expected to vest. The share options are exercised on April 15, 20X7, when the stock price is \$25. Immediately after exercise, the employees sell the stock in the open market, which results in a disqualifying disposition. ABC would record the following amount in Q2 20X7 when the share options are exercised:

	Debit	Credit
<b>Q2 20X7</b>		
Current taxes payable <sup>1</sup>	21,000	
Current tax benefit		21,000

<sup>1</sup> 10,000 share options × \$10 tax deduction per share (\$25 stock price upon exercise - \$15 grant-date exercise price) × 21%. If no current taxes are due (e.g., ABC has a net operating loss), ABC would debit deferred tax asset for the tax effect (subject to valuation allowance considerations).

As discussed in Paragraph 8.030, excess tax benefits (windfalls) and shortfalls from the exercise of share-based payment awards should be recognized as a discrete item (i.e., not through an adjustment of the estimated annual effective tax rate) in the period that the windfall or shortfall occurs. Accordingly, we believe that \$6,300 ((\$100,000 tax deduction - \$70,000 compensation cost) × 21% tax rate) of the total \$21,000 tax benefit should be considered a discrete item for Q2 20X7 interim reporting purposes. We also believe that the \$14,700 of remaining benefit relating to the \$70,000 of compensation cost (grant date fair value of \$7 × 10,000 shares) previously recognized

in the 20X6 financial statements generally should be considered a discrete item in Q2 20X7.

**8.032** Excess tax benefits may have an *indirect* effect when the amount of the excess tax deduction affects certain other deductions or credits, for example, research and experimentation credits. We believe an entity may make a policy election on how to consider the indirect effects of share-based compensation during an interim period. Acceptable policies include:

- *View A* - The tax effects of the entire share-based payment award, including direct and indirect effects, are excluded from the estimated annual effective tax rate on ordinary income.
- *View B* - The tax effects of the excess tax deduction or deficiency, including direct and indirect effects, are excluded from the estimated annual effective tax rate on ordinary income.
- *View C* - Only the direct effects of the excess tax deduction or deficiency are excluded from the estimated annual effective tax rate on ordinary income.

The policy elected should be consistently applied.

## SECTION 162(M) LIMITATION

**8.033** Before U.S. tax reform was enacted in 2017, section 162(m) of the Internal Revenue Code generally limited a publicly held corporation's deduction for non-performance-based compensation paid to its CEO and next three most highly compensated officers, not including the chief financial officer, (determined on the last day of the taxable year pursuant to the SEC rules) to \$1 million per year. Performance-based compensation, which was not subject to this limitation, generally included (a) compensation that was payable only if the covered officer satisfied objective performance targets set by a committee composed of outside directors based on shareholder-approved performance goals and (b) share options or share appreciation rights (if not granted in-the-money) granted by outside directors under a shareholder-approved plan that contained limits on the number of awards that could be granted to individual participants. Common types of compensation that were considered non-performance based and therefore are subject to the section 162(m) limitation included salary and restricted stock units or share options granted in-the-money that were subject only to service-based vesting.

**8.034-8.035** Not used.

**8.035a** The tax reforms enacted in 2017 made additional changes to section 162(m). The law expanded the scope and repeals the exceptions to the \$1 million deduction limitation.

**8.035b** The 2017 law expanded the definition of a covered employee to include the principal executive officer, principal financial officer and the top three other highest-paid officers. Further, once an employee is treated as a covered employee, the individual

remains a covered employee for all future years, including with respect to payments made after retirement, death, etc. An individual who is a covered employee in a tax year beginning after December 31, 2016 remains a covered employee for future years.

**8.035c** The provisions also eliminate the exceptions to the \$1 million deduction limitations so that commissions and performance-based compensation are now subject to the limitation. While the performance-based compensation exception was complex to apply, it was an often-used exception to link compensation to performance that could preserve a publicly held corporation's deduction.

**8.035d** The 2017 law provided a transition rule to the section 162(m) changes discussed in Paragraphs 8.035a through 8.035c. Under the transition rule, the 2017 law provisions do not apply to any remuneration paid under a written, binding contract that was in effect on November 2, 2017 and was not materially modified on or after that date. Compensation paid under a plan qualifies for this transition relief provided that the right to participate in the plan is part of a written, binding contract with the covered employee that was in effect on November 2, 2017, even if the covered employee was not actually a participant on November 2, 2017.

**8.035e** As discussed in Paragraph 1.026c, the American Rescue Plan Act of 2021 (ARPA) was signed into law on March 11. ARPA expanded section 162(m) to also include the five highest compensated employees other than those already subject to the limitation. This amendment is effective for taxable years beginning after December 31, 2026. The change to section 162(m) may affect the measurement of deferred taxes on compensation related temporary differences to the extent the compensation is expected to become deductible in tax years beginning after December 31, 2026. In that case, an entity should measure its deferred tax asset based on the amount that it expects to be able to deduct for covered employee compensation considering the section 162(m) limitation.

**8.036** There is no authoritative guidance describing how an entity should allocate the deductible and nondeductible compensation cost for financial reporting purposes when compensation cost is subject to the section 162(m) limitation and the compensation deduction includes share-based compensation and other compensation (salary, bonus, deferred compensation, etc.). In some situations, this will be relatively straightforward. For example, if an entity estimates that the combined compensation cost (i.e., grant-date fair value of share-based payment awards and other compensation) will not exceed the section 162(m) limit, then a deferred tax benefit (and corresponding deferred tax asset) would be recorded when the share-based payment expense is recognized in the income statement. In this situation, if the actual amount of deductible stock compensation cost upon exercise or vesting is greater than the grant-date fair value but the combined amount of stock and other compensation that becomes deductible exceeds the limit, then the excess is nondeductible. Because the tax benefit realized is greater than the deferred tax asset recorded, the entity would realize an excess tax benefit to be recorded in the income statement. Another possible scenario is that a highly compensated executive receives compensation that exceeds the section 162(m) limits and is granted share-based payments. The issue is how to allocate the tax deductible compensation between the

share-based portion of the award and other portion(s) of the award. The two most common methods used in practice are described below and illustrated in Example 8.17:

**Method A: *Pro Rata*** - the estimated tax deduction is allocated between share-based compensation and other compensation, and deferred taxes are only recognized for the estimated tax deduction associated with share-based compensation and the estimated tax deduction associated with the other-than-stock compensation.

**Method B: *Stock Compensation Last*** - other-than-stock compensation is considered first, so if that other compensation is equal to or greater than the section 162(m) limit, deferred taxes would not be recorded for the share-based compensation.

**8.037** In some circumstances, increases in one or more components of compensation beyond levels that the entity originally estimated result in compensation above the section 162(m) limits. At each period end, entities should consider whether facts and circumstances have changed such that the allocation between the deductible and nondeductible portions of the compensation paid to executives is different than previous estimates. Consistent with the guidance in Paragraph 8.010, the analysis of the deductible compensation for share-based awards should be based on the grant date fair value of the awards and should not consider any changes in the fair value of the share-based award that will affect the ultimate amount of deductible compensation for tax purposes. In other words, for this analysis, the amount of deductible temporary differences associated with the executive's compensation should be based on the combination of the estimated deductible amount of share-based award compensation for tax purposes using the grant date fair value and the other (non-stock based) compensation. Entities would record a change in estimate to eliminate a portion of the deferred tax asset for the share-based awards as a current period charge through the income statement if the amount of other compensation increases as compared with a prior estimate. This situation would occur because the cumulative compensation cost recorded no longer is expected to qualify as a deductible temporary difference. When the share-based award is settled and the actual amount of deductible compensation is determined, any difference between the estimated amount of deductible compensation for the share-based award and the associated deferred tax asset, if any, is recorded in the income statement as a discrete item for interim reporting purposes as discussed in Paragraph 8.030.

### **Example 8.17: Award Subject to Section 162(m) Limitation**

#### **Assumptions**

ABC Corp.'s CEO is one of the executives subject to the section 162(m) limitation. The CEO's salary is \$1,000,000. On January 1, 20X7, ABC grants to the executive 100,000 shares of nonvested stock with a grant-date fair value of \$5 per share. All 100,000 shares vest on December 31, 20X7 when the fair value of the stock is \$30 per share. ABC's tax rate is 21%.

Compensation cost recognized in financial statements:

	<b>Total</b>	<b>Expected to Be Deductible</b>
Salary	\$ 1,000,000	\$ 666,667
Share-based payment (100,000 shares × \$5)	<u>500,000</u>	<u>333,333</u>
	\$ 1,500,000	\$ 1,000,000

Compensation cost for tax purposes before limitations:

Salary	\$ 1,000,000	\$ 250,000
Share-based payment (100,000 shares × \$30)	<u>3,000,000</u>	<u>750,000</u>
	\$ 4,000,000	\$ 1,000,000

Percentage of financial statement compensation that would be deductible for tax purposes after section 162(m) limitation (\$1,000,000 / \$1,500,000) 66.67%

Percentage of actual compensation tax deductible after section 162(m) limitation (\$1,000,000 / \$4,000,000) 25%

The tax code does not distinguish between the allowable and non-allowable components of compensation. Two possible methods have been identified to account for the tax benefits in these types of situations - the *pro rata* method (Method A) and the *stock compensation last* method (Method B).

**Method A: Pro rata**

At January 1, 20X7, ABC expects \$1,000,000 in cash compensation and \$500,000 in compensation cost for nonvested stock for 20X7 based on the amounts to be reported in the financial statements. Of that amount, 66.67% is expected to be deductible for tax purposes after the section 162(m) limitation (\$1,000,000 / \$1,500,000). As a consequence, a deferred tax benefit would be recognized on 66.67% of the share-based payment compensation cost. During 20X7, ABC would recognize the following with respect to the share-based payment and cash compensation:

	<b>Debit</b>	<b>Credit</b>
Share-based payment expense	500,000	
Additional paid-in capital		500,000
Deferred tax asset	70,000 <sup>1</sup>	
Deferred tax benefit		70,000
Cash compensation expense	1,000,000	
Cash		1,000,000

	Debit	Credit
Current taxes payable	140,000 <sup>2</sup>	
Current tax benefit		140,000

<sup>1</sup>  $(\$500,000 \times 66.67\% \text{ estimated limitation} \times 21\% = \$70,000)$

<sup>2</sup>  $(\$1,000,000 \times 66.67\% \text{ estimated limitation} \times 21\% = \$140,000)$

At the end of the year, ABC determines that only 25% of the compensation cost measured for tax purposes is deductible  $(\$1,000,000 / \$4,000,000)$ .

As a consequence, ABC will realize a tax benefit of \$210,000 associated with all of the compensation paid to the CEO. The stock compensation portion of that tax benefit will be \$157,500  $(\$3,000,000 \times 25\% \times 21\%)$ , which could be allocated between the portion that is the recovery of the deferred tax asset originally recorded for the stock compensation (\$70,000) and the portion that represents an excess tax benefit. At December 31, 20X7, ABC would record the following to recognize the actual tax benefit for the period after the section 162(m) limitation:

For share-based payment:

Deferred tax expense	70,000 <sup>3</sup>	
Deferred tax asset		70,000 <sup>2</sup>

<sup>3</sup> To record the realization of the deferred tax asset (recorded above) upon vesting.

Current taxes payable	157,500 <sup>4</sup>	
Current tax benefit		157,500 <sup>5</sup>

<sup>4</sup>  $\$3,000,000 - \text{share-based payment compensation cost} \times 25\% \text{ deductible after section 162(m) limitation} \times 21\% = \$157,500$

<sup>5</sup> To record the realization of the income tax benefit.

For cash compensation:

Current tax benefit	87,500 <sup>6</sup>	
Current taxes payable		87,500

<sup>6</sup> To reflect the fact that the current tax benefit for the cash compensation was only \$52,500  $(\$1,000,000 \times 25\% \times 21\%)$  compared with \$140,000 benefit that was estimated originally.

The net effect of these entries is that ABC's income statement reflects \$1,500,000 of compensation cost and an income tax benefit of \$210,000.

This example illustrates one way that the pro rata method might be implemented. There also could be other acceptable approaches.

### **Method B: *Nonvested Stock Last***

At January 1, 20X7, ABC expects \$1,000,000 in cash compensation and \$500,000 in compensation cost for nonvested stock to become deductible during 20X7. No deferred tax asset is recognized on the nonvested stock as the cash compensation met the deductible limit.

At December 31, 20X7 under the nonvested stock last method, ABC would record the following journal entries:

	Debit	Credit
Current taxes payable	210,000	
Current tax benefit		210,000 <sup>7</sup>

<sup>7</sup> Realized income tax benefit ( $\$1,000,000 \times 21\%$ )

## SECTION 162(M)(6) LIMITATION FOR HEALTH CARE PROVIDERS

**8.038** Section 162(m)(6) limits the deduction for compensation earned by all officers, employees, directors, and other workers or service providers that provide services for a covered health insurance provider to \$500,000. This limit includes compensation that is deferred, performance-based, share-based, or earned under existing binding contracts, and disregards whether the compensation is paid during the taxable year or a subsequent taxable year. The limitation is determined based on the year in which services are provided, rather than the year in which compensation is paid. Under section 162(m)(6), all compensation arrangements earned by the employee in a taxable year are included in the calculation of the \$500,000 limitation, which may include compensation that is not deductible in the year it is earned.

**8.039** The share-based compensation deduction is taken on the employer's tax return in the year the compensation is included in the employee's tax return (which may be different from the period in which the compensation expense and related tax effects are recognized for financial reporting purposes - see discussion beginning in Paragraph 8.013a for additional information). For purposes of determining the section 162(m)(6) limitation, the employer allocates the deduction ratably to the periods the compensation is earned. Subsequent to this allocation, if the sum of the allocated share-based compensation plus other forms of compensation attributable to each period exceeds the \$500,000 limit, the share-based compensation deduction is limited.

## TAX BENEFITS OF SHARE-BASED PAYMENT AWARDS ISSUED IN A BUSINESS COMBINATION

**8.040** Not used.

## TAX BENEFITS OF NON-QUALIFIED AWARDS ISSUED IN A BUSINESS COMBINATION

**8.041** For a replacement award classified as equity that ordinarily would result in postcombination tax deductions under current tax law, an acquirer, as required by ASC Topic 805, recognizes in acquisition accounting a deferred tax asset for the deductible temporary difference that relates to the portion of the fair-value-based measure attributed to precombination employee service. ASC paragraph 805-740-25-10



**8.041a** However, if the employer is not required to grant replacement awards in connection with the business combination, but chooses to do so, the compensation expense and related tax effects of those awards are recognized in net income (in the post-combination financial statements).

**8.042** After the acquisition date, the tax deduction for a replacement award classified as equity may exceed the fair-value-based measure of the award. In that situation, the acquirer recognizes any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for that award related to pre- and postcombination service (the excess tax benefit) as income tax benefit in the income statement of the acquirer. This accounting is consistent with the accounting required by ASC Topic 718 for an excess tax benefit for a share-based payment award classified as equity that is granted outside of a business combination. If the acquirer's deduction is less than the fair-value-based measure of the award, the accounting is the same as that prescribed by ASC Topic 718 for other awards. The write-off of a deferred tax asset related to the deficiency, net of any related valuation allowance, also is recognized in earnings. ASC paragraph 805-740-45-5

**8.043** For portions of the award attributed to postcombination employee service, an entity recognizes in the post-combination financial statements, as an adjustment to net income, a deferred tax asset in the period that the compensation cost is recognized for financial reporting purposes.

### **Example 8.18: Tax Deductible Share-Based Replacement Awards**

ABC Corp. acquires DEF Corp. on January 1, 20X8. ABC issues a replacement award of 100 share options with a fair value of \$1,000 and an exercise price of \$2 to replace share options with a fair value on the acquisition date of \$1,000 held by DEF employees. The share option replacement awards are nonqualified share options. The original vesting for DEF's awards is graded, with 25% vesting each year, which results in \$792 being attributed to precombination compensation cost. ABC's tax rate is 21%.

At the acquisition date, ABC records a deferred tax asset of \$166 ( $\$792 \times 21\%$ ).

ABC records an additional \$44 ( $\$208 \times 21\%$ ) deferred tax asset in the two years following the acquisition as it recognizes the postcombination compensation cost.

Three years after the acquisition, the share options are exercised when the market value of the shares is \$8. ABC receives a \$6 tax deduction per share ( $\$8 - \$2$ ) and recognizes a tax deduction of \$600 on its tax return that reduces its current taxes payable.

Therefore, ABC has a deferred tax asset of \$210 recorded, but only receives a \$126 benefit upon the exercise of the award. This results in a deficiency of \$84 that is recorded as income tax expense. ABC records the following entry when the deduction is taken on the tax return:

	Debit	Credit
Current taxes payable	126 <sup>1</sup>	
Deferred tax expense	210	
Current tax benefit		126
Deferred tax asset		210
<sup>1</sup> \$600 × 21%		

## NON-TAX DEDUCTIBLE AWARDS

**8.044** If an acquirer issues replacement awards in conjunction with a business combination that do not result in tax deductions under the current tax law, no deferred tax asset is recognized for the portion of the award related to precombination services, because these awards do not create a future deductible temporary difference. This is the case for share options that qualify as incentive share options under the United States Internal Revenue Code. Although the acquirer may ultimately realize a tax benefit for the awards as a result of a disqualifying disposition, the acquirer should not anticipate that a disqualifying event will occur. Tax benefits that arise because employees do not comply with the requisite holding periods are recognized in the financial statements only when such events occur.

## DISQUALIFYING DISPOSITIONS OF NON-TAX DEDUCTIBLE AWARDS

**8.045** Tax benefits of non-tax deductible awards that subsequently become tax deductible due to an employee's disqualifying disposition should be recognized in income tax benefit in the period the benefit arises. We believe the tax effect of a disqualifying disposition generally should be considered a discrete item for interim reporting purposes.

### Example 8.19: Disqualifying Dispositions of Non-Tax Deductible Awards

ABC Corp. acquires DEF Corp. on January 1, 20X8. ABC issues a replacement award of 100 share options with a fair-value-based measurement of \$1,000 and an exercise price of \$2 to replace share options with a fair-value-based measurement on the acquisition date of \$1,000 held by DEF employees. The share option replacement awards are incentive stock options (ISOs), and thus no deferred tax asset is recorded at the acquisition date for the amount attributed to precombination service. The original vesting for DEF's awards is graded, with 25% vesting each year. \$792 is attributed to precombination compensation cost.

Three years after the acquisition the share options are exercised when the fair value of the shares is \$20 and, subsequent to exercise, there is a disqualifying disposition. ABC receives an \$18 tax deduction per share (\$20 - \$2). ABC's tax rate is 21%.

ABC records the following entry for the disqualifying disposition.

	Debit	Credit
Current taxes payable	378 <sup>1</sup>	
Current tax benefit		378

<sup>1</sup>  $(\$18 \times 100) \times 21\%$

Paragraph 740-270-30-8 states that an entity should not include in its estimated annual effective tax rate the tax related to an employee share-based payment award when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes. Accordingly, we believe that \$168  $(\$18 - \$10) \times 100 \times 21\%$  of the total \$378 tax benefit should be considered a discrete item for interim reporting purposes. We also believe that the \$210 of remaining benefit relating to the \$1,000 of compensation cost that was recognized either through accrual at the acquisition date (\$792) or in the statement of operations (\$208) in the post-combination period generally should be accounted for as a discrete item in the quarter in which the disqualifying disposition occurs.

8.046 Not used.

## OTHER TAXES

8.047 ASC paragraph 718-10-25-23 requires that payroll taxes be reflected as operating expenses in the income statement. ASC paragraph 718-10-25-22 requires the employer to recognize the payroll tax liability and corresponding payroll tax expense, on the date of the event triggering the measurement and payment of the tax to the taxing authority, which generally is the exercise date.

## TAX BENEFITS IN FOREIGN JURISDICTIONS

8.048 For share-based payment awards to service providers of a foreign subsidiary, in some cases, the foreign subsidiary does not receive a deduction on its foreign income tax return because it has not granted and does not settle a share-based payment award. However, the foreign subsidiary may receive a deduction on its foreign income tax return for a fee that the parent charges to the foreign subsidiary for the intrinsic value of the share-based payment award either on exercise of the award or vesting of a nonvested stock unit award (these arrangements are often referred to as *recharge* arrangements).

## STATEMENT OF CASH FLOWS

8.049 ASC Topic 718 requires that excess tax benefits from share-based payment arrangements be classified as cash flows from operating activities in the statement of cash flows.

8.050 Cash paid to a taxing authority for shares withheld to satisfy the employer's statutory income tax withholding obligation, is classified as a financing activity in the

## 8. Income Tax Issues Associated with Share-Based Payment Arrangements

statement of cash flows. This classification is consistent with how other repurchases of an entity's equity instruments are classified. See Section 16 of KPMG Handbook, *Statement of Cash Flows*, for further guidance.

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**9.000** This section describes the balance sheet presentation for income tax-related accounts as well as the allocation of total income tax expense or benefit among the components of comprehensive income and shareholders' equity. This section also addresses the financial statement disclosure requirements.

## **BALANCE SHEET CLASSIFICATION OF DEFERRED TAX ASSETS AND LIABILITIES**

**9.001** Not used.

**9.002 Noncurrent Presentation of Deferred Taxes.** An entity should present as a single net noncurrent amount the deferred tax liabilities and assets (net of the valuation allowance) of each tax-paying component of an entity in each tax jurisdiction. ASC Topic 740 does not permit offsetting net deferred tax assets and net deferred tax liabilities related to different tax jurisdictions or different tax-paying components. For example, an entity should not offset a net noncurrent deferred tax asset for state income taxes against a net noncurrent deferred tax liability for federal income taxes. An entity that operates in a number of tax jurisdictions may have a noncurrent deferred tax asset and a noncurrent deferred tax liability, as well as current income taxes refundable and current income taxes payable. The entity may also have noncurrent income taxes payable for unrecognized tax benefits and noncurrent income taxes receivable for the indirect effects in another jurisdiction. ASC paragraph 740-10-45-6

**9.003 – 9.012** Not used.

**Example 9.1** Not used.

## **BALANCE SHEET CLASSIFICATION OF TAXES PAYABLE OR RECEIVABLE AND UNRECOGNIZED TAX BENEFITS**

**9.013 Income Taxes Payable or Receivable.** Income taxes payable or receivable generally should include the amounts that are expected to be paid to or received from taxing authorities as a result of applying the provisions of the enacted tax law to the taxable income or loss for that year. If an entity has a tax payable and receivable in the same jurisdiction where a legally enforceable right to offset exists, net presentation may be appropriate if the criteria in ASC Topic 210, *Balance Sheet*, are met. If an unrecognized tax benefit exists, the guidance for net presentation in ASC paragraphs 740-10-45-10A and 45-10B apply. See Paragraph 9.016 for additional discussion. ASC Master Glossary, 740-10-45-3

**9.013a** Income taxes receivable (payable) anticipated to be settled in cash within a relatively short period (usually 12 months) or that are directly related to the operating cycle are generally presented as current in a classified balance sheet. Income taxes receivable (payable) are otherwise presented as noncurrent. See Paragraph 9.018 for



discussion of the classification of liabilities for unrecognized tax benefits. See Chapter 3 of KPMG Handbook, *Financial statement presentation*, for additional discussion of classification considerations. ASC paragraphs 210-10-45-1(g)(4) and 45-8(c)

**9.014 Presentation of Unrecognized Tax Benefits.** ASC paragraphs 740-10-45-10A through 45-12 require that unrecognized tax benefits be classified as an increase in income taxes payable or the reduction of a deferred tax asset for a net operating loss carryforward (or similar tax loss or credit carryforward, see Paragraph 9.016 for additional discussion). Deferred tax balances related to temporary differences may also be affected by unrecognized tax benefits because the computation of deferred tax assets and liabilities generally must be performed using a tax basis consistent with the principles of ASC Subtopic 740-10, *Income Taxes - Overall* (FIN 48) for unrecognized tax benefits (i.e., the more-likely-than-not tax basis presuming examination by the taxing authority and measurement in accordance with ASC paragraph 740-10-30-7; see the discussion of accounting for uncertainty in income taxes beginning in Paragraph 3.015) rather than the tax basis used in preparing the tax return. For example, ASC Subtopic 740-10 guidance for accounting for uncertainty in income taxes may result in the recognition of a deferred tax asset (or reduction of a deferred tax liability) for future deductible amounts that would be available if current year deductions are not sustained but would be allowed to be taken in future years. See the discussion beginning in Paragraph 3.115 for additional information and examples of such situations. ASC paragraphs 740-10-45-10A through 45-12

**9.015** When a liability for an unrecognized tax benefit has an indirect effect for which a deferred tax asset is generated (e.g., state exposures that will generate federal benefits when paid and foreign exposures that will generate U.S. foreign tax credits when paid), the liability and deferred tax asset would be presented gross on the balance sheet because the deferred tax asset in one jurisdiction would not be available to satisfy a liability in a different jurisdiction. The deferred tax asset would be subject to valuation allowance considerations relative to sources of taxable income in the jurisdiction in which the deferred tax asset exists (i.e., the liability for unrecognized tax benefits generally would not provide a source of future taxable income to realize the deferred tax asset when such tax effects exist in different tax jurisdictions). See Paragraph 9.123 for additional discussion and examples of such situations.

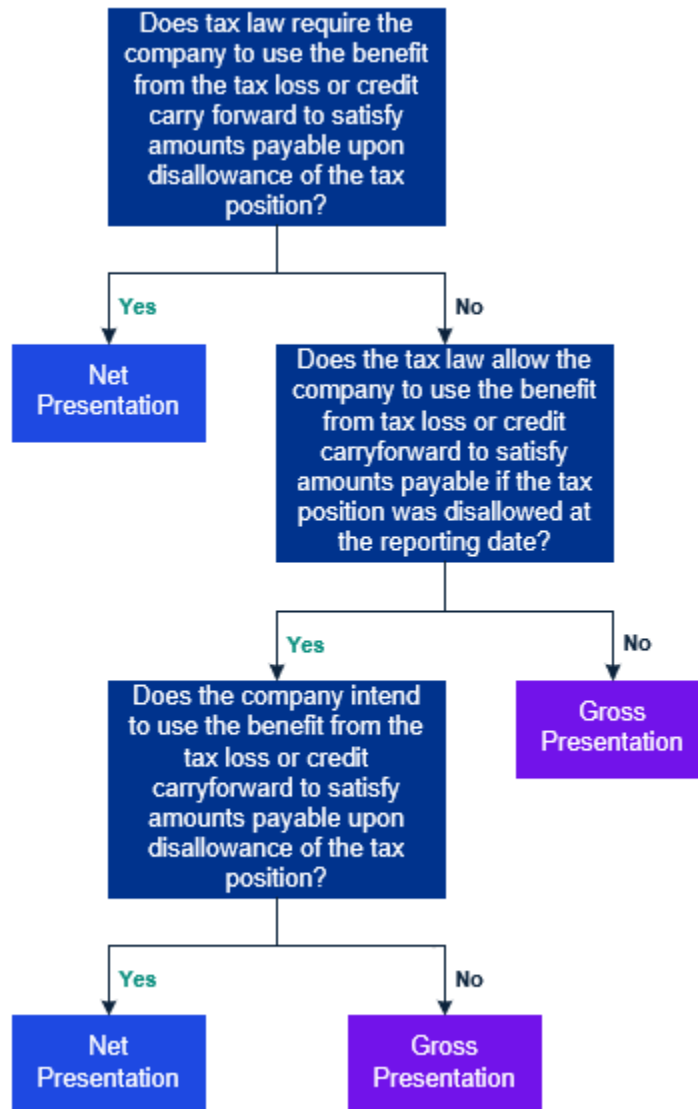
**9.016** Gross versus net questions also arise in the context of operating loss carryforwards and tax credit carryforwards (e.g., NOLs). When the unrecognized tax benefit is directly associated with a tax position taken in a tax year that results (or resulted) in the recognition of a deferred tax asset for an operating loss or tax credit carryforward for that year (e.g., an NOL), the deferred tax asset would be reduced for the unrecognized tax benefit because the computation of the deferred tax asset should be performed using the more-likely-than-not tax basis presuming examination by the taxing authority (see discussion beginning in Paragraph 3.015) rather than the tax basis used in preparing the tax return. When the unrecognized tax benefit is not directly associated with the tax loss or credit carryforward (e.g., if there was an unrelated NOL existing when the unrecognized tax benefit arose), ASC paragraphs 740-10-45-10A and 45-10B are applied to determine whether the deferred tax asset and unrecognized tax benefit are presented

gross or net. ASC paragraphs 740-10-45-10A and 45-10B require an entity to reduce its operating loss or tax credit carryforward deferred tax asset for an unrecognized tax benefit if either of the following conditions are met:

- (i) The tax law requires the entity to use the benefit of an operating loss or tax credit carryforward to satisfy the obligation; or
- (ii) The tax law allows (but does not require) the entity to use the benefit of an operating loss or tax credit carryforward to satisfy the obligation and the entity intends to satisfy it that way.

If neither of these criteria is met, the unrecognized tax benefit should be presented in the financial statements as a liability. The assessment should be made presuming the tax position is disallowed at the reporting date. Generally, under U.S. federal income tax law, we would expect these criteria to be met if carryforwards of the appropriate character exist. However, the criteria for net presentation may not be met, for example, if the unrecognized tax benefit arose in a tax year before the earliest carryback period of a net operating loss carryforward. For example, if an entity had an unrecognized tax benefit for the 20X1 tax year and an NOL carryforward arises in the 20X9 tax year, tax law may not permit the entity to carry the 20X9 loss back to the 20X1 tax year. In that situation, the 20X1 unrecognized tax benefit liability and the 20X9 NOL deferred tax asset would be presented gross.

**9.017** As discussed in paragraph 9.016, evaluating whether a deferred tax asset is required (or allowed) to be used under the tax law should be made presuming the tax position is settled for the reserved amount at the reporting date. The entity should not consider as part of the assessment whether the deferred tax asset is expected to be used (or may expire) before the taxing authority discovers the tax position (or before the statute of limitations lapses). Interest on an unrecognized tax benefit would not be accrued to the extent that it would not accrue under the tax law. Further, the unrecognized tax benefit would be disclosed as a gross unrecognized tax benefit in the tabular rollforward of unrecognized tax benefits, as discussed in Paragraph 9.097. This guidance is illustrated in Examples 9.2 and 9.3 and summarized in the following decision tree. In discussions with the FASB staff, we understand the guidance for reducing a deferred tax asset for an unrecognized tax benefit should also be applied to income taxes receivable (or to other tax assets like deposits) that are required (or allowed) to be used to satisfy an unrecognized tax benefit.



**Example 9.2: Gross versus Net – Unrecognized Tax Benefit Directly Related to NOL**

*Scenario A*

ABC Corp. has a net loss for financial reporting purposes in 20X7 of \$100 that includes a \$100 charge for certain expenses. ABC reports the same \$100 net loss on its tax return (i.e., it takes \$100 deduction for the expenses), resulting in a net operating loss carryforward. It is not more likely than not that ABC would sustain the \$100 deduction for tax purposes. Thus, if challenged by the taxing authority, ABC’s \$100 deduction is expected to be disallowed such that it would have no net operating loss carryforward

related to 20X7 (taxable income for 20X7 would be zero). ABC operates in only one tax jurisdiction.

Because the computation of the deferred tax asset for the NOL should be performed using its more-likely-than-not tax basis presuming examination by the taxing authority (rather than the tax basis used in preparing the tax return), no deferred tax asset would be recognized for the NOL (i.e., the financial statement carrying amount of the deferred tax asset would be reduced for the unrecognized tax benefit). Notwithstanding net balance sheet presentation, it would disclose the unrecognized tax benefit associated with the \$100 deduction in 20X7 if it is subject to the tabular rollforward disclosure in ASC subparagraph 740-10-50-15A(a)(2).

If the tax position discussed above had been a temporary difference, such that the \$100 current year disallowed deduction would be expected to result in a tax benefit in a future year (i.e., it would be disallowed in 20X7 as a current deduction but would be capitalized for tax purposes and allowed in a future year as it amortizes), a deferred tax asset would have been recognized related to the temporary difference for the costs that would be capitalized for tax purposes but not for book. No separate deferred tax asset for the NOL carryforward (or liability for the unrecognized tax benefit) would be reflected on the balance sheet but the unrecognized tax benefit would be disclosed in the tabular rollforward, if ABC discloses a tabular rollforward.

#### *Scenario B*

DEF Corp. has a net loss for financial reporting purposes in 20X7 of \$100 that includes a \$100 charge for certain expenses. DEF reports the same \$100 net loss on its tax return (i.e., it takes the \$100 deduction for the expenses), resulting in a net operating loss carryforward. In 20X7, it is more likely than not that it would sustain the \$100 deduction. DEF operates in only one tax jurisdiction.

During 20X9, there has been a change to the facts and circumstances such that it is no longer more likely than not that DEF would sustain the deduction for the expenses taken on the 20X7 tax return. Thus, if challenged by the taxing authority, DEF's \$100 deduction from the 20X7 return is expected to be disallowed such that it would have no net operating loss carryforward related to 20X7. Accordingly, DEF records income tax expense to eliminate the previously recognized tax benefit for the change in the unrecognized tax benefit for the \$100 deduction.

Assuming the 20X7 NOL had not been used in the intervening period (e.g., DEF experienced breakeven operations in 20X8), DEF's unrecognized tax benefit would be presented as a reduction of the deferred tax asset for the NOL because the computation of the deferred tax asset for the NOL should be performed using its more-likely-than-not tax basis presuming examination by the taxing authority (rather than the tax basis used in preparing the tax return). Had the 20X7 NOL been used in 20X8, the unrecognized tax benefit would be presented as a liability on the balance sheet. Notwithstanding *net* balance sheet presentation, DEF would disclose the unrecognized tax benefit associated

with the \$100 deduction in 20X9 if it is subject to the tabular rollforward disclosure in ASC subparagraph 740-10-50-15A(a)(1).

### **Example 9.3: Gross versus Net – Unrecognized Tax Benefit Not Directly Related to NOL**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

#### *Scenario C*

ABC Corp. has a net loss for financial reporting purposes in 20X7 of \$100 that includes a \$100 charge for certain expenses (Position #1). ABC reports the same \$100 net loss on its tax return (i.e., it takes the \$100 deduction for the expenses), resulting in a pre-2018 net operating loss carryforward. It is more likely than not that ABC would sustain Position #1 and that no valuation allowance is needed on the related deferred tax asset. It operates in only one tax jurisdiction.

During 20X8, ABC takes a tax position (Position #2) that reduces taxable income from \$80 to zero. Position #2 is not more likely than not of being sustained and is therefore expected to be disallowed if challenged by the taxing authority. However, if disallowed, ABC would be required under the tax law to use \$80 of its \$100 NOL carryforward generated in 20X7 to settle the taxes payable. Because ABC would be required to use \$80 of its \$100 NOL if Position #2 were disallowed at December 31, 20X8, the unrecognized tax benefit would reduce the deferred tax asset for the NOL on the 20X8 balance sheet. This would be true for the 20X8 balance sheet even if ABC expected to use the deferred tax asset before Position #2 was discovered and the related taxes became due. Though the unrecognized tax benefit reduces the deferred tax asset on the balance sheet, ABC would still disclose the gross unrecognized tax benefit associated with the \$80 deduction in 20X8 if it is subject to the tabular rollforward disclosure in ASC subparagraph 740-10-50-15A(a)(2).

If tax Position #2 had been a temporary difference, such that the \$80 disallowed in 20X8 would be expected to result in a tax benefit in a future year (i.e., it would be disallowed in the 20X8 but allowed in a future year), a deferred tax asset would have been recognized related to the temporary difference.

#### *Scenario D*

DEF Corp. begins 20X7 with a deferred tax asset for a \$10 million post-2017 NOL carryforward that is offset by a full valuation allowance. On its 20X7 tax return, DEF reports \$2 million of taxable income inclusive of a tax position that reduced total taxable income by \$1 million. The \$1 million tax position is not more likely than not of being sustained and is therefore expected to be disallowed if challenged by the taxing authority.

Assume:

- The tax law would allow DEF to use the NOL carryforward to offset 80% of taxable income, including \$800,000 of the taxable income that would result from the disallowance of the \$1 million tax position;
- That if the \$1 million tax position is disallowed, DEF would use the NOL carryforward to offset \$800,000 of the additional taxable income;
- DEF's tax rate is 21%; and
- The \$1 million unrecognized tax benefit would not result in a temporary difference and there are no other deferred tax assets or liabilities other than the NOL carryforward.

In this situation, DEF would reduce the carrying amount of the deferred tax asset and related valuation allowance for the NOL carryforward by the tax effect of \$2.4 million of the \$3 million of total taxable income in 20X7. This reduction in the carrying amount of the deferred tax asset assumes DEF will use the existing deferred tax asset to satisfy its liability for 80% of the \$2 million of taxable income reported on the 20X7 tax return and 80% of the liability for the unrecognized tax benefit for the \$1 million tax position because (a) the tax law allows DEF to use the benefit of the NOL carryforward to satisfy the unrecognized tax benefit if (or when) due and, (b) DEF intends to do so. DEF's balance sheet would show income taxes payable of \$84,000 related to the portion of DEF's reported taxable income that it cannot offset with its NOL carryforward, income taxes payable of \$42,000 related to the portion of the unrecognized tax benefit associated with the \$1 million tax position that DEF cannot offset with its NOL carryforward, a deferred tax asset and related valuation allowance of \$1.596 million (\$10 million beginning-of-year NOL carryforward minus \$2.4 million of more-likely-than-not taxable income available under the tax law to offset the carryforward (80% times \$3 million) times 21%).

If the tax law did not allow (or require) use of the NOL carryforward, or if DEF did not intend to use the benefit of the NOL carryforward, to satisfy the obligation for the \$1 million if (or when) it becomes due, the unrecognized tax benefit of \$210,000 would be presented as a liability on the balance sheet and an additional \$168,000 of the deferred tax asset for the NOL existing at the beginning of the year would remain (i.e., *gross* presentation). In that case, DEF would present income taxes payable of \$84,000 related to the portion of DEF's reported taxable income that it cannot offset with its NOL carryforward, income taxes payable of \$210,000 related to the unrecognized tax benefit associated with the \$1 million tax position, a \$1.764 million deferred tax asset related to the NOL carryforward, and a valuation allowance of \$1.764 million (\$10 million beginning-of-year NOL carryforward minus \$1.6 million of taxable income available under the tax law to offset the carryforward (80% times \$2 million) times 21%).

Under either presentation (gross or net), DEF would disclose the unrecognized tax benefit of \$210,000 associated with the \$1 million deduction in 20X8 if it is subject to the tabular rollforward disclosure in ASC subparagraph 740-10-50-15A(a)(2).

**9.018 Liabilities for Unrecognized Tax Benefits – Classified Balance Sheets.**

Liabilities for income taxes payable resulting from unrecognized tax benefits on positions taken or expected to be taken in the tax return for the current year or prior years should be classified based on the timing of expected cash payment. If the entity anticipates payment of cash within one year or the operating cycle, if longer, it should classify the liability as current. Otherwise, the obligation should be classified as noncurrent. An entity should consider all relevant factors, including the expected timing of examination, related appeals, and settlement when evaluating classification. If a liability is expected to be settled through the expiration of the statute of limitations within 12 months of the reporting date and management does not expect the related tax position to be examined or otherwise settled in cash within the next year or operating cycle, that liability should be classified as noncurrent. However, before the adoption of ASU 2023-09, the possible release of the liability should be disclosed (if significant) as a reasonably possible decrease in the amount of unrecognized tax benefits (see Paragraph 9.107 for additional discussion of the disclosure requirement with respect to reasonably possible changes in unrecognized tax benefits).<sup>1</sup> ASC paragraphs 740-10-45-11 and 45-12

**9.018a Liabilities for the 2017 U.S. Transition Tax – Classified Balance Sheets.** As discussed in Paragraphs 7.007a and 7.024a, the 2017 tax reforms enacted in the United States included a one-time transition tax on deemed repatriated foreign earnings that is payable over eight years. Because that liability generally does not represent the tax effect of a basis difference, we believe a U.S. parent should characterize the obligation as income taxes payable and classify it as current or noncurrent based on the anticipated timing of the payment (similar to classifying liabilities for unrecognized tax benefits as discussed in Paragraph 9.018).

**9.019 Prohibition of Net-of-Tax Presentation.** The FASB considered and rejected the net-of-tax approach to the presentation of assets and liabilities. Under the net-of-tax approach, an asset or liability would be presented in the financial statements net of the related deferred tax balance. For example, under a net-of-tax approach, a fixed asset with a historical cost basis of \$100 and a related deferred tax liability of \$21 would be presented in the financial statements as a \$79 fixed asset. ASC Topic 740 requires presentation of a \$100 fixed asset and a \$21 deferred tax liability. The same prohibition applies to income statement transactions within continuing operations. For example, the income tax benefit from a tax deduction of donated inventory should be presented as a component of income tax expense, not as a reduction to cost of goods sold. The only exception from the prohibition against net-of-tax presentation is certain acquired leveraged leases. See Paragraph 2.084 for additional discussion.

## INTRAPERIOD TAX ALLOCATION

**9.020** *Intraperiod tax allocation* is the process of allocating income tax expense or benefit to components of comprehensive income (such as continuing operations, discontinued operations and other comprehensive income) and directly to shareholders' equity.

**9.021** Total income tax expense generally is allocated using a *step-by-step approach*. Under this approach, an entity first determines the total income tax expense. It then computes the amount of income tax expense or benefit allocated to continuing operations and then proportionally allocates the remainder to items other than continuing operations. ASC Topic 740 also sets forth specific provisions about the allocation of some items that represent exceptions to the step-by-step approach. See Paragraph 9.026 for additional discussion of those exceptions.

**9.022** The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations plus or minus:

- The changes in the beginning-of-year valuation allowance for deferred tax assets due to a change in circumstances that result in a change in judgment about realization of deferred tax assets in *future* years;
- The tax effects of changes in tax laws or rates;
- The tax effects of changes in tax status; and
- The tax effects of tax-deductible dividends paid to shareholders.

The difference between the result of this calculation, which is the income tax expense allocated to continuing operations, and total income tax expense (current and deferred tax expense) is allocated to the other components. If there is only one item other than continuing operations for which the tax effect is not otherwise addressed in the exceptions to the step-by-step approach (see Paragraph 9.026), the remaining portion of total income tax expense is allocated to that item. If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations is allocated to each of those items in proportion to their individual tax effects on income tax expense or benefit for the year. ASC paragraphs 740-20-45-2, 45-12, and 45-14

**9.023** To determine the income tax effect allocated proportionally to components other than continuing operations an entity should use a *with-and-without* approach. Under the with-and-without approach, the tax effect of an item is the difference between total tax expense calculated without the item and total tax expense calculated with the item. Frequently, the tax effect determined using the with-and-without approach is equal to the income tax expense eventually allocated to the item using the step-by-step approach. The tax effect determined by the with-and-without approach generally should include all tax effects. ASC paragraph 740-20-45-14

#### **Example 9.4: Step-by-Step Approach to Intraproduct Tax Allocation**

In 20X7, ABC Corp. reported \$1,000 of income from continuing operations and \$1,000 of loss from discontinued operations. ABC also had a \$1,500 of pre-2018 net operating loss carryforward with a full valuation allowance as of December 31, 20X6 and December 31, 20X7. Assuming ABC has a 21% tax rate, it would attribute \$0 income tax



expense to continuing operations and \$0 income tax benefit to discontinued operations because (a) the net operating loss carryforward would have been sufficient to offset the taxable income generated from continuing operations, and (b) no additional benefit is recognizable related to the loss from discontinued operations because a full valuation allowance is necessary at year-end (i.e., total tax expense is \$0).

**9.024** When there are two or more components creating tax effects other than continuing operations, the sum of the tax effect of each item as computed using the with-and-without approach may not equal the remaining amount of income tax expense or benefit after the allocation to continuing operations. The following guidelines apply to allocating income tax expense or benefit to categories other than continuing operations in these situations: ASC paragraph 740-20-45-14

- (1) Determine the total effect on income tax expense or benefit for all net loss items.
- (2) Allocate the tax benefit determined in (1) above ratably to each loss item.
- (3) Calculate the difference between the amount allocated to all items other than continuing operations and (1) above (remaining tax expense).
- (4) Allocate the remaining tax expense determined in (3) above ratably to each net gain item.

### Example 9.5: Step-by-Step Approach to Intraproduct Tax Allocation

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

In 20X7, ABC Corp. reported a discontinued operations loss. U.S. pretax comprehensive financial reporting income for ABC in 20X7 consists of the following:

Continuing operations	\$ 9,000
Discontinued operations	(3,000)
Translation adjustment included in OCI	300
U.S. pretax comprehensive financial reporting income	<u>\$ 6,300</u>

A reconciliation between pretax U.S. comprehensive financial reporting income and U.S. federal taxable income in 20X7 consists of the following:

U.S. pretax comprehensive financial reporting income	\$ 6,300
Nondeductible expenses	1,000
Change in temporary differences	(2,300)
Taxable income	<u>\$ 5,000</u>

The nondeductible expenses are attributable to continuing operations and the net increase in taxable temporary differences is attributable to each category of comprehensive pretax income as follows:

Continuing operations (including \$700 related to Foreign Subsidiary A)	\$ 2,500 <sup>1</sup>
Discontinued operations	(500)
Translation adjustment (related to Foreign Subsidiary A)	<u>300</u>
	<u>\$ 2,300</u>

In 20X7, ABC's only foreign subsidiary, Foreign Subsidiary A, had undistributed earnings of \$700 for financial reporting purposes. In addition, the translation of Foreign Subsidiary A's local currency financial statements into U.S. dollars resulted in a translation adjustment of \$300 that was reported in other comprehensive income. The undistributed earnings are expected to generate Subpart F income in a future year; accordingly, the undistributed earnings translation adjustment related to Foreign Subsidiary A created temporary differences because they were not included in 20X7 taxable income. Since the intraperiod tax allocation is typically performed by tax-paying component, foreign tax expense has not been shown in this example; however, the U.S. federal effect of foreign deferred taxes has been considered in the measurement of the deferred tax liability for Subpart F income.

ABC has determined that the indefinite reversal criterion of ASC paragraph 740-30-25-17 does not apply to the temporary differences related to its investment in Foreign Subsidiary A. Therefore, it recognized a U.S. deferred tax liability of \$50 attributable to these temporary differences after considering the U.S. federal tax laws that govern income from foreign sources, such as the taxation of Subpart F income, the 100% dividends received deduction, section 78 gross-up and related credit rate for foreign taxes deemed paid, and foreign tax credit limitations. For simplicity, a tax of 5% (U.S. deferred tax liability of \$50 divided by temporary differences of \$1,000) is used throughout this example to illustrate the assumed deferred tax effect of these temporary differences on the components of comprehensive financial reporting income and that amount is allocated using the effective tax rate approach as discussed in Paragraph 7.043.

For purposes of this example the following additional assumptions are made:

- ABC had a post-2017 net operating loss carryforward at December 31, 20X6, of \$4,200, which can be used to offset only 80% of taxable income in a given year. As of December 31, 20X6, ABC had recognized a deferred tax asset of \$882 and a corresponding valuation allowance of \$882 because ABC's management had concluded that it was more likely than not that the benefit of that carryforward, ABC's only deferred tax asset, would not be realized. During 20X7, ABC used \$4,000 of the net operating loss carryforward to reduce taxes payable in 20X7. The management of ABC also concluded that it is more likely than not that the tax benefit of the remaining amount of the carryforward (\$200) as of December 31, 20X7 would be realized through the future reversal of the existing taxable temporary difference. Accordingly, the \$42 benefit of the remaining carryforward was recognized by elimination of the valuation allowance.

- There were no temporary differences at December 31, 20X6.
- It is more likely than not that the tax benefit of the future deductible amount of \$500 attributable to discontinued operations will be realized through the future reversal of the existing taxable temporary difference, and there are no other future deductible amounts.
- The tax rate for 20X7 and all future years is 21%.

Step 1—Calculate total income tax expense or benefit, including both current and deferred taxes.

### Current Tax Expense

Taxable income before net operating loss carryforward	\$	5,000	
Net operating loss carryforward		(4,000)	
Taxable income	\$	<u>1,000</u>	
Tax rate		21	%
Current tax expense	\$	<u><u>210</u></u>	

### Deferred Tax Expense

Taxable temporary differences (excluding temporary differences related to Foreign Subsidiary A)	\$	1,800 <sup>2</sup>	
Tax rate		<u>21</u>	%
		378	
Deferred tax liability related to Foreign Subsidiary A (\$1,000 × 5%)		<u>50</u>	
Deferred tax liability			\$ 428
Deductible temporary differences	\$	500	
Tax rate		<u>21</u>	%
	\$	105	
Deferred tax asset arising from net operating loss carryforward (\$882 less \$840 used in current year)		<u>42</u>	
Deferred tax asset			<u>147</u>
Net deferred tax liability at December 31, 20X7			281
Deferred tax liability at December 31, 20X6			<u>—</u>
Deferred tax expense			<u><u>\$ 281</u></u>
Total income tax expense			
Current tax expense	\$	210	
Deferred tax expense		<u>281</u>	
	\$	<u><u>491</u></u>	

Step 2—Calculate income tax expense or benefit, both current and deferred, related to continuing operations.

### Current Tax Expense

Pretax financial reporting income	\$	9,000	
Nondeductible expenses		1,000	
Change in temporary differences		<u>(2,500)</u>	
Taxable income before net operating loss carryforward		7,500	
Net operating loss carryforward <sup>3</sup>		<u>4,200</u>	
Taxable income		3,300	
Tax rate		21	%
Current tax expense	\$	<u><u>693</u></u>	

### Deferred Tax Expense

Future taxable amounts (excluding temporary differences related to Foreign Subsidiary A)	\$	1,800	
Tax rate		<u>21</u>	%
		378	
Deferred tax liability related to unremitted earnings of Foreign Subsidiary A (5% of \$700)		<u>35</u>	
Deferred tax liability at December 31, 20X7		413	
Deferred tax liability at December 31, 20X6		—	
Deferred tax expense	\$	<u><u>413</u></u>	
Tax expense related to continuing operations:			
Current tax expense	\$	693	
Deferred tax expense		<u>413</u>	
	\$	<u><u>1,106</u></u>	

Step 3—Calculate the total remaining tax effect of all components other than continuing operations.

Total expense (all components)	\$	491	
Tax expense relating to continuing operations		<u>1,106</u>	
Total tax benefit of all items other than continuing operations	\$	<u><u>(615)</u></u>	

Step 4—Allocate the amounts that remain (after the allocation to continuing operations) to other components in proportion to their individual effects on income tax benefit for the year.

	<b>Tax Expense (Benefit)</b>
Total tax benefit of all items other than continuing operations	\$ (615)
Less: amount allocated to net loss items (discontinued operations) using with and without <sup>4</sup>	(630)
Amount allocated to net gain items (translation adjustment)	<u>\$ 15</u>

The comprehensive tax expense or benefit allocated to each component is as follows:

	<b>U.S. Comprehensive Pretax Income (Loss)</b>	<b>U.S. Comprehensive Tax Expense (Benefit)</b>	<b>Effective Tax Rate</b>
Continuing operations	\$ 9,000	\$ 1,106	12%
Loss from discontinued operations	(3,000)	(630)	21%
Translation adjustment	300	15	5%
	<u>\$ 6,300</u>	<u>\$ 491</u>	6%

The translation adjustment account in other comprehensive income would be charged for the income tax effect of \$15 related to the translation adjustment for the year.

<sup>1</sup> Represents total increase in temporary differences attributable to continuing operations.

<sup>2</sup> \$2,500 (increase in taxable temporary differences attributable to continuing operations) - \$700 (related to Foreign Subsidiary A)

<sup>3</sup> Note that in this example, without consideration of items other than continuing operations, the entire net operating loss carryforward would have been used to offset current taxable income resulting in the entire benefit being allocated to continuing operations using the step-by-step approach.

<sup>4</sup> Total tax expense with discontinued operations of \$491 minus total tax expense without it of \$1,121.

**9.025 Intraproduct Tax Allocation in Interim Periods.** ASC Subtopic 740-270, *Income Taxes - Interim Reporting*, requires an entity, at the end of each interim period, to make its best estimate of the effective tax rate expected to be applicable for the full fiscal year as each interim period is viewed as an integral part of an annual period. Accordingly, an entity should perform its intraperiod tax allocation based upon its best estimate of ordinary income for the entire fiscal year together with items outside of ordinary income for the year-to-date period. This allocation is performed prior to determining the

estimated annual effective tax rate related to ordinary income. If changes in estimates result in a change to the allocation in a subsequent interim period within the same fiscal year, the year-to-date intraperiod tax allocation is recast in the period of change. See Paragraph 9.065 for additional discussion of allocating changes in valuation allowances and Paragraph 10.075 for additional discussion of intraperiod tax allocation in interim periods. ASC paragraph 740-270-45-2

**9.026 Exceptions to the Step-by-Step Approach.** As discussed above, there are certain exceptions to the step-by-step tax allocation approach. The following table identifies these exceptions, the general financial statement classification of the tax effects of the exceptions, and the first paragraph of this section that discusses the exception. In addition to the exceptions outlined below, ASC Topic 740 also provides specific guidance with respect to certain items that are charged or credited directly to shareholders' equity. See Paragraph 9.036a for additional discussion of those items.

<b>Exception to the Step-by-Step Tax Allocation Approach</b>	<b>General Classification of Tax Effect</b>	<b>Paragraph Reference</b>
The tax effects of change in tax law or rates	Continuing Operations (ASC paragraph 740-20-45-8)	9.030
The tax effects of changes in tax status	Continuing Operations (ASC paragraph 740-20-45-8)	9.033
The tax effects of tax-deductible dividends	Continuing Operations (ASC paragraph 740-20-45-8)	9.034
The tax effects of tax-deductible goodwill for acquisitions accounted for prior to adoption of FASB Statement 141(R)	Goodwill/Intangible Assets (Statement 109, par. 262)	9.035
Changes in the valuation allowance:		
<ul style="list-style-type: none"> <li>Change in the beginning of the year valuation allowance for deferred tax assets expected to be realized in future years</li> </ul>	Continuing Operations (ASC paragraph 740-10-45-20)	9.065
<ul style="list-style-type: none"> <li>Initial recognition of tax benefits resulting from changes in contributed capital</li> </ul>	Equity (ASC subparagraph 740-20-45-11(c))	9.067

<ul style="list-style-type: none"> <li>• For tax benefits recognized in subsequent years of a quasi-reorganization</li> </ul>	Direct addition to contributed capital (ASC paragraph 852-740-45-3 and ASC paragraph 220-10-45-10B)	9.067
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9.027 Not used.

**9.027a Losses from Continuing Operations.** An entity determines the tax effect of a loss from continuing operations without considering the tax effect of items that are not included in continuing operations.

9.027b Not used.

**9.028** The examples that follow this paragraph illustrate the guidance in ASC paragraph 740-20-45-7, which requires entities to follow the step-by-step approach without considering the tax effects of items that are not included in continuing operations when determining the tax benefit of a loss from continuing operations.

**Example 9.6: Loss from Continuing Operations and Gain from Discontinued Operations**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

ABC Corp. has a \$1,000 loss from continuing operations and a \$1,000 gain from discontinued operations. ABC has a 21% tax rate and no deferred tax assets or liabilities at the beginning or end of the year.

*Scenario 1: ABC forecasts future taxable income of at least \$1,250*

ABC first determines its total income tax expense is \$0  $(\$1,000 - \$1,000) \times 21\%$  and allocates this using the step-by-step approach.

It next determines the amount of income tax benefit to allocate to the \$1,000 loss in continuing operations. Because ABC forecasts future taxable income  $(\$1,000 = \$1,250 \times 80\%$ ; see Paragraph 4.016b) sufficient to support realization of the deferred tax asset that would have been generated  $(\$210 = \$1,000 \times 21\%)$  if there had been no gain from discontinued operations, it allocates an income tax benefit of \$210 to continuing operations.

Finally, ABC determines the amount of income tax expense to allocate to discontinued operations.

Total income tax expense $(\$1,000 - \$1,000) \times 21\%$	\$ 0
Tax benefit to continuing operations $(\$1,000 \times 21\%)$	<u>210</u>
Tax expense to discontinued operations $(\$0 + \$210)$	<u><u>210</u></u>

*Scenario 2: ABC forecasts no future taxable income*

ABC first determines its total income tax expense is \$0  $((\$1,000 - \$1,000) \times 21\%)$  and allocates this using the step-by-step approach.

It next determines the amount of income tax benefit to allocate to the \$1,000 loss in continuing operations. Because ABC does not forecast future taxable income sufficient to support realization of the deferred tax asset that would have been generated  $(\$210 = \$1,000 \times 21\%)$  if there had been no gain from discontinued operations (i.e., it would have needed a full valuation allowance without the gain in discontinued operations), it allocates no income tax benefit to continuing operations.

Finally, ABC determines the amount of income tax expense to allocate to discontinued operations.

Total income tax expense $((\$1,000 - \$1,000) \times 21\%)$	\$ 0
Tax benefit to continuing operations $(\$0 \times 21\%)$	<u>0</u>
Tax expense to discontinued operations $(\$0 + \$0)$	<u><u>0</u></u>

**Example 9.7: Loss from Continuing Operations with Overall Net Income**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

In 20X6, ABC Corp. sells certain assets that qualify as discontinued operations. The sale results in a gain of \$900. Excluding the gain on the sale of the discontinued operations, ABC has a loss of \$500 from continuing operations. ABC's tax rate is 21%.

*Scenario 1: ABC forecasts future taxable income of at least \$625*

ABC first determines its total income tax expense is \$84  $((\$900 - \$500) \times 21\%)$  and allocates this using the step-by-step approach.

It next determines the amount of income tax benefit to allocate to the \$500 loss in continuing operations. Because ABC forecasts future taxable income  $(\$500 = \$625 \times 80\%$ ; see Paragraph 4.016b) sufficient to support realization of the deferred tax asset that would have been generated  $(\$105 = \$500 \times 21\%)$  if there had been no gain from discontinued operations, it allocates an income tax benefit of \$105 to continuing operations.

Finally, ABC determines the amount of income tax expense to allocate to discontinued operations, as follows:

Total income tax expense $((\$900 - \$500) \times 21\%)$	\$ 84
Tax benefit to continuing operations $(\$500 \times 21\%)$	<u>105</u>
Tax expense to discontinued operations $(\$84 + \$105)$	<u><u>189</u></u>



*Scenario 2: ABC forecasts no future taxable income*

ABC first determines its total income tax expense is \$84  $((\$900 - \$500) \times 21\%)$  and allocates this using the step-by-step approach.

It next determines the amount of income tax benefit to allocate to the \$500 loss in continuing operations. Because ABC does not forecast future taxable income sufficient to support realization of the deferred tax asset that would have been generated  $(\$105 = \$500 \times 21\%)$  if there had been no gain from discontinued operations (i.e., it would have needed a full valuation allowance without the gain in discontinued operations), it allocates no income tax benefit to continuing operations.

Finally, ABC determines the amount of income tax expense to allocate to discontinued operations, as follows:

Total income tax expense $((\$900 - \$500) \times 21\%)$	\$	84
Tax benefit to continuing operations $(\$0 \times 21\%)$		<u>0</u>
Tax expense to discontinued operations $(\$84 + \$0)$	\$	<u><u>84</u></u>

### **Example 9.8 Loss from Continuing Operations, Discontinued Operations Book Loss and Tax Gain**

In 20X6, ABC Corp. has a loss of \$1,000 from continuing operations and a loss of \$600 from discontinued operations for financial reporting purposes but has taxable income of \$200 from discontinued operations when considering a permanent difference related to the write-off of nondeductible goodwill.

Under ASC paragraph 740-20-45-7 an entity does not consider the income tax effects of items outside continuing operations when it allocates total income tax expense or benefit to continuing operations. Therefore, ABC computes the income tax benefit allocable to its \$1,000 loss in continuing operations as the amount of benefit that would be realizable absent the activity in discontinued operations.

### **Example 9.8a Book Loss and Taxable Income from Continuing Operations and Other Comprehensive Income Gain**

In 20X6, ABC Corp. has a loss of \$1,000 from continuing operations for financial reporting purposes but has taxable income of \$200 from continuing operations after adjusting for permanent differences resulting from nondeductible expenses. ABC Corp. also has an unrealized gain of \$600 on a derivative designated in a cash flow hedge.

Under ASC paragraph 740-20-45-7 an entity does not consider the income tax effects of items outside continuing operations when it allocates total income tax expense or benefit to continuing operations. Therefore, ABC computes the income tax expense allocable to its \$1,000 loss in continuing operations absent the activity in other comprehensive income (\$42 = \$200 × 21%, assuming there are no deferred tax assets or liabilities at the beginning or end of year).

**Example 9.9: Applicable Tax Rate for Intraproduct Tax Allocation When There Is a Loss from Continuing Operations**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

ABC Corp. has a \$200 loss from continuing operations and a \$500 gain from discontinued operations. The loss of \$200 is considered ordinary and the gain of \$500 is considered capital for tax purposes. Tax law allows ordinary losses to offset capital gains when calculating taxable income. Assume there is a 21% tax rate for ordinary income and a 15% tax rate for capital gains in ABC’s tax jurisdiction.

*Scenario 1: ABC forecasts future ordinary taxable income of at least \$250*

ABC first determines its total income tax expense is \$45 (( $\$500 - \$200$ ) × 15%) and allocates this using the step-by-step approach. ABC uses a 15% rate when calculating total income tax expense because its taxable income is entirely capital gain.

ABC next determines the amount of income tax benefit to allocate to the \$200 loss in continuing operations. Because ABC forecasts future ordinary taxable income ( $\$200 = \$250 \times 80\%$ ; see Paragraph 4.016b) sufficient to support realization of the deferred tax asset that would have been generated ( $\$42 = \$200 \times 21\%$ ) if there had been no gain from discontinued operations, it allocates an income tax benefit of \$42 to continuing operations. ABC uses the 21% tax rate for ordinary income to compute the income tax benefit allocable to continuing operations because it (a) is projecting future ordinary income sufficient to realize the ordinary loss in continuing operations, and (b) does not consider the income tax effects of items not included in continuing operations.

Finally, ABC determines the amount of income tax expense to allocate to discontinued operations, as follows:

Total income tax expense (( $\$500 - \$200$ ) × 15%)	\$ 45
Tax benefit to continuing operations ( $\$200 \times 21\%$ )	<u>42</u>
Tax expense to discontinued operations ( $\$45 + \$42$ )	<u><u>\$ 87</u></u>

*Scenario 2: ABC forecasts future capital gain income of at least \$250, but no ordinary income*

ABC first determines its total income tax expense is \$45  $((\$500 - \$200) \times 15\%)$  and allocates this using the step-by-step approach. ABC uses a 15% rate when calculating total income tax expense because its taxable income is entirely capital gain.

ABC next determines the amount of income tax benefit to allocate to the \$200 loss in continuing operations. Because ABC forecasts future capital gain income  $(\$200 = \$250 \times 80\%)$ ; see Paragraph 4.016b) sufficient to support realization of the deferred tax asset that would have been generated  $(\$30 = \$200 \times 15\%)$  if there had been no gain from discontinued operations, it allocates an income tax benefit of \$30 to continuing operations. ABC uses the 15% tax rate for capital gain income to compute the income tax benefit allocable to continuing operations because it (a) is projecting future capital gain income sufficient to realize the ordinary loss in continuing operations, and (b) does not consider the income tax effects of items not included in continuing operations.

Finally, ABC determines the amount of income tax expense to allocate to discontinued operations, as follows:

Total income tax expense $((\$500 - \$200) \times 15\%)$	\$ 45
Tax benefit to continuing operations $(\$200 \times 15\%)$	30
Tax expense to discontinued operations $(\$45 + \$30)$	<u>\$ 75</u>

*Scenario 3: ABC forecasts no future taxable income*

ABC first determines its total income tax expense is \$45  $((\$500 - \$200) \times 15\%)$  and allocates this using the step-by-step approach. ABC uses a 15% rate when calculating total income tax expense because its taxable income is entirely capital gain.

ABC next determines the amount of income tax benefit to allocate to the \$200 loss in continuing operations. Because ABC does not forecast future taxable income sufficient to support realization of the deferred tax asset that would have been generated  $(\$42 = \$200 \times 21\%)$  if there had been no gain from discontinued operations (i.e., it would have needed a full valuation allowance without the gain in discontinued operations), it allocates no income tax benefit to continuing operations.

Finally, ABC determines the amount of income tax expense to allocate to discontinued operations, as follows:

Total income tax expense $((\$500 - \$200) \times 15\%)$	\$ 45
Tax benefit to continuing operations $(\$0 \times 21\%)$	0
Tax expense to discontinued operations $(\$45 + \$0)$	<u>\$ 45</u>

### Example 9.9a: Intraproduct Tax Allocation - Loss From Continuing Operations with End of Year Net Deferred Tax Asset

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

#### Background

At January 1, 20X9, ABC Corp. had a \$4,200 deferred tax asset for \$20,000 of NOL carryforwards that are subject to the 80% limitation under the tax law. ABC also had a \$630 deferred tax asset for a \$3,000 unrealized loss on a cash flow hedge that was recognized in other comprehensive income. ABC had a \$4,830 valuation allowance on all of its deferred tax assets.

For the year ended December 31, 20X9, ABC has a \$5,000 loss in continuing operations and a \$1,000 unrealized gain in other comprehensive income and no current tax. ABC needs a full valuation allowance as of December 31, 20X9 and has a 21% tax rate.

#### Step 1: Compute total income tax expense

Rollforward of deferred taxes:

	January 1, 20X9	Change	December 31, 20X9
Deferred tax asset - NOL	\$ 4,200	\$ 1,050 <sup>1</sup>	\$ 5,250
Deferred tax asset - cash flow hedge	630	(210) <sup>2</sup>	420
Valuation allowance	(4,830)	(840) <sup>3</sup>	(5,670)
Total	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

<sup>1</sup> \$1,050 = \$5,000 (loss in continuing operations) × 21%

<sup>2</sup> \$210 = \$1,000 (income in other comprehensive income) × 21%

<sup>3</sup> \$840 = \$4,000 (net loss) × 21%

#### Step 2: Allocate total income tax expense to continuing operations

Because ABC may not consider the unrealized gain in other comprehensive income when allocating income tax expense to continuing operations, and it needs a full valuation allowance on all of its deferred tax assets (including any deferred tax asset associated with the loss in continuing operations), it allocates no income tax benefit to continuing operations.

**Step 3: Allocate the remaining income tax expense to other comprehensive income**

ABC has \$0 total income tax expense and \$0 income tax benefit allocated to continuing operations, leaving \$0 income tax expense allocated to other comprehensive income.

**Example 9.9b: Intraproduct Tax Allocation - Loss From Continuing Operations with End of Year Net Deferred Tax Liability**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

**Background**

At January 1, 20X9, ABC Corp. had a \$4,200 deferred tax asset for \$20,000 of NOL carryforwards that are subject to an 80% limitation under the tax law. ABC also had a \$630 deferred tax liability for a \$3,000 unrealized gain on a cash flow hedge that was recognized in other comprehensive income. ABC had a \$3,696 valuation allowance on its deferred tax assets because its \$3,000 taxable temporary difference supports only \$2,400 of its NOL ( $\$3,000 \times 80\%$ ).

NOLs	\$ 20,000
Taxable temporary difference (limited to 80%: \$3,000 × 80%)	<u>(2,400)</u>
NOLs not supported	17,600
Tax rate	<u>21%</u>
Valuation allowance	<u><u>\$ 3,696</u></u>

For the year ended December 31, 20X9, ABC has a \$5,000 loss in continuing operations and a \$1,000 unrealized gain in other comprehensive income and no current tax. ABC needs a valuation allowance against deferred tax assets not supported by reversing taxable temporary differences as of December 31, 20X9 and has a 21% tax rate.

**Step 1: Compute total income tax expense**

Rollforward of deferred taxes:

	January 1, 20X9	Change	December 31, 20X9
Deferred tax asset - NOL	\$ 4,200	\$ 1,050 <sup>1</sup>	\$ 5,250
Deferred tax liability – cash flow hedge	(630)	(210) <sup>2</sup>	(840)
Valuation allowance	<u>(3,696)</u>	<u>(882)<sup>3</sup></u>	<u>(4,578)</u>
Total	<u>\$ (126)</u>	<u>\$ (42)</u>	<u>\$ (168)</u>

<sup>1</sup> \$1,050 = \$5,000 (loss in continuing operations) × 21%

<sup>2</sup> \$210 = \$1,000 (income in other comprehensive income) × 21%

<sup>3</sup> NOLs as of December 31, 20X9	\$ 25,000
Taxable temporary difference (limited to 80%: \$4,000 × 80%)	<u>(3,200)</u>
Net NOLs	21,800
Tax rate	<u>21%</u>
Valuation allowance as of December 31, 20X9	\$ 4,578
Valuation allowance as of January 1, 20X9	<u>(3,696)</u>
Change	<u><u>\$ 882</u></u>

In this example, ABC has total income tax expense of \$42 (despite its net loss for 20X9) because only 80% of its beginning and end of year taxable temporary differences provide a source of taxable income.

### Step 2: Allocate total income tax expense to continuing operations

Because ABC may not consider the current year unrealized gain in other comprehensive income when allocating income tax expense to continuing operations, and it needs a valuation allowance on any of its deferred tax assets not supported by reversing taxable temporary differences (including any deferred tax asset associated with the loss in continuing operations), it does not recognize any additional deferred tax asset as a result of the continuing operations loss and it allocates no income tax benefit to continuing operations.

Rollforward of deferred taxes, only considering continuing operations activity:

	January 1, 20X9	Change	December 31, 20X9
Deferred tax asset - NOL	\$ 4,200	\$ 1,050	\$ 5,250
Deferred tax liability – cash flow hedge	(630)	0	(630)
Valuation allowance	<u>(3,696)</u>	<u>(1,050)</u>	<u>(4,746)</u>
Total	<u><u>\$ (126)</u></u>	<u><u>\$ 0</u></u>	<u><u>\$ (126)</u></u>

### Step 3: Allocate the remaining income tax expense to other comprehensive income

ABC has \$42 total income tax expense and \$0 income tax benefit allocated to continuing operations leaving all of the \$42 income tax expense allocated to other comprehensive income.

	(Loss) Income	Tax (expense) benefit
Continuing operations	\$ (5,000)	\$ 0
Other comprehensive income	<u>1,000</u>	<u>(42)</u>
Total	<u><u>\$ (4,000)</u></u>	<u><u>\$ (42)</u></u>

### Example 9.10: Intraproduct Tax Allocation When There Is a Loss from Continuing Operations, Overall Net Income and Full Valuation Allowance

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

At January 1, 20X6, ABC Corp. has a \$1,000 deferred tax asset for which the related deferred tax benefit was previously recorded through other comprehensive income but offset by a full valuation allowance. For the year ended December 31, 20X6, ABC has a \$500 loss from continuing operations and an \$800 gain resulting from a new item in other comprehensive income that results in the recognition of a deferred tax liability. Assume ABC continues to need a valuation allowance for all deferred tax assets not supported by reversing taxable temporary differences as of December 31, 20X6, its tax rate is 21% and its deductible temporary difference is expected to reverse before the taxable temporary difference. Utilization of the 20X6 net operating loss carryforward and the one created by the reversal of the deductible temporary difference is limited to 80% of taxable income.

Total tax expense is computed as follows:

Deferred (carryforward): Net operating loss of  $\$500 \times 21\% = \$105$  benefit  
 Deferred: Gain in other comprehensive income of  $\$800 \times 21\% = \$168$  expense  
 Valuation allowance release due to net taxable gain ( $\$168 \times 80\%$ ) -  $\$105 = \$29$  benefit

Total tax expense =  $\$(105) + \$168 + \$(29) = \$34$

As of December 31, 20X6, the \$168 deferred tax liability supports \$134 of the deferred tax asset ( $\$168 \times 80\%$ ). The remaining \$971 requires a full valuation allowance.

Under ASC paragraph 740-20-45-7 an entity does not consider the income tax effects of items outside continuing operations when it allocates total income tax expense or benefit to continuing operations. Therefore, ABC computes the income tax expense or benefit allocable to its \$500 loss in continuing operations as the amount of benefit that would be realizable absent the activity in other comprehensive income. Because ABC may not consider the unrealized gain in other comprehensive income when allocating income tax expense to continuing operations, and it needs a full valuation allowance on all of its deferred tax assets absent that gain (including any deferred tax asset associated with the loss in continuing operations), it allocates no income tax benefit to continuing operations.

With \$34 of total income tax expense and \$0 allocated to continuing operations, ABC allocates \$34 of income tax expense to other comprehensive income.

### **Example 9.11: Intraproduct Tax Allocation When There Is a Loss from Continuing Operations and a Reclassification Adjustment**

As of December 31, 20X6, ABC Corp. has \$900 of net operating losses and a \$100 deductible temporary difference related to an unrealized loss on a derivative designated in a cash flow hedge resulting in a \$210 deferred tax asset and a \$210 valuation allowance. On January 1, 20X7, ABC terminates the derivative and the hedging relationship resulting in a \$100 ordinary loss for income tax purposes and a \$100 reclassification from other comprehensive income to earnings for financial reporting purposes. The reclassification adjustment results in a \$100 pretax loss in continuing operations and a \$100 pretax credit in other comprehensive income. Assume ABC had \$0 of pretax income for 20X7 excluding the loss on the derivative reclassified from other comprehensive income and, therefore, at December 31, 20X7 has \$1,000 of net operating losses resulting in a \$210 deferred tax asset and a \$210 valuation allowance.

Under ASC paragraph 740-20-45-7 an entity does not consider the income tax effects of items outside continuing operations when it allocates total income tax expense or benefit to continuing operations. Therefore, ABC computes the income tax benefit allocable to its \$100 loss in continuing operations as the amount of benefit that would be realizable absent the activity in other comprehensive income. Because ABC needs a full valuation allowance on all of its deferred tax assets, it allocates no income tax benefit to continuing operations.

**9.029 Intraproduct Tax Allocation in Prior Periods Recast for a Discontinued Operation.** When a component of an entity qualifies for discontinued operations presentation, the entity must recast its income statement for all comparative periods to separate the discontinued operation from the continuing operations. In those recast prior periods, we generally would expect the entity to reallocate the income tax expense or benefit previously recognized in continuing operations to continuing operations and discontinued operations using the step-by-step approach. The guidance on applying this concept when recasting interim periods for a discontinued operation is in ASC paragraphs 740-270-45-6 through 45-8 and Example 10.21 also provides an illustration. We believe that applying this guidance to annual periods also is acceptable. This approach simplifies the intraproduct tax allocation by not changing amounts previously allocated to other items outside of continuing operations and discontinued operations. Alternatively, an entity may perform a complete intraproduct tax allocation of income taxes in the retroactively recast annual financial statements following the step-by-step approach (see Example 9.5). Under either alternative, the total tax allocated should not be changed (e.g., for new information). In many circumstances, we believe the two approaches will give the same result.

**9.030 Allocation of Effect of Change in Tax Law or Rates.** The income statement effect of a change in tax laws or rates (including changes in the amount of a valuation allowance) is allocated to income tax expense from continuing operations in the period of enactment. For example, a change in tax law that affects only deferred tax assets and



liabilities of discontinued operations (or the valuation allowance for the deferred tax assets) is included in income from continuing operations and is not allocated to income or loss from discontinued operations. A with-and-without approach is used to isolate the effect of changes in tax law or rates. Under the with-and-without approach, the tax effect of the change in tax law or rates included in income from continuing operations is the difference between the entity's net deferred tax asset or liability (and current payable or receivable if the effect is retroactive) measured immediately before the change in tax law or rates and the net deferred tax asset or liability (and current payable or receivable if the effect is retroactive) measured using temporary differences as of the dates of enactment with the change in tax law or rate. The effect of a change in tax law or rates subsequent to a business combination that results in a change in deferred tax assets or liabilities or decrease in a valuation allowance that initially was recorded in a business combination also should be included in income tax expense from continuing operations; it is not recorded as an adjustment to the business combination accounting. See Section 5, *Changes in Tax Laws, Rates, or Status*, for additional discussion of changes in tax laws and rates. ASC paragraphs 740-10-25-48, 45-15 through 45-18, and 740-20-45-8

### Example 9.12: Recognizing the Tax Effect of a Change in Tax Rates

On December 21, 20X7, ABC Corp. has unrealized appreciation on its available-for-sale debt security portfolio of \$1,000. At the currently enacted tax rate of 35%, a deferred tax liability of \$350 was established related to the unrealized appreciation with a charge to other comprehensive income. The enacted tax rate changed to 21% on December 22, 20X7, effective from January 1, 20X8. None of the temporary difference related to the debt security portfolio is expected to reverse before 20X8.

ABC recorded the following entry when it recognized the unrealized appreciation through the date of enactment:

	Debit	Credit
Available-for-sale debt security	1,000	
Other comprehensive income		1,000
Other comprehensive income	350	
Deferred tax liability		350

The income tax effect of the December 22, 20X7 change in the tax rate is \$140 ( $(\$1,000 \times 35\%) - (\$1,000 \times 21\%)$ ). This effect is recorded as follows:

Deferred tax liability	140	
Income tax benefit (continuing operations)		140

As a result of recognizing the reduction of the deferred tax liability with an adjustment to the income statement, the accumulated other comprehensive income remains at \$650

(taxes of \$350 remain in accumulated other comprehensive income; the \$140 difference from the balance of the deferred tax liability is referred to as the *residual tax effect*).

**9.031 Residual Tax Effects within Other Comprehensive Income.** As discussed above, the tax effect of a change in tax law or rates included in income tax expense from continuing operations includes the entire difference between the with-and-without calculations. This difference includes the effect of changes in deferred tax assets and liabilities initially recognized through a charge or credit to other comprehensive income (e.g., for those items discussed beginning in Paragraph 9.036a). Including in continuing operations the effect of changes in tax laws or rates on deferred tax assets and liabilities that were originally established in other comprehensive income causes the accumulated deferred tax effects residing in accumulated other comprehensive income to be different from the financial statement carrying amount of the related deferred tax assets and liabilities. This difference is often referred to as a *residual tax effect*. A residual tax effect could also occur when there is a subsequent change in the valuation allowance as a result of a change in judgment about recoverability of deferred tax assets when the deferred tax asset and related valuation allowance were initially recorded in other comprehensive income, fair value adjustments when those fair value adjustments are recognized in other comprehensive income for financial reporting purposes and are currently taxed on the fair value adjustments and a rate change occurs, and for other reasons. As discussed in Paragraph 9.071, subsequent changes in valuation allowance for items in other comprehensive income due to changes in judgment about the realization of deferred tax assets in future years generally are recorded as a component of income tax expense from continuing operations rather than an adjustment to other comprehensive income. ASC paragraph 740-10-45-20

### Example 9.13: Identifying the Residual Tax Effect

ABC Corp. has a security with a financial statement carrying amount of \$5,000 and a tax basis (and historical cost) of \$4,000. When the \$1,000 unrealized gain was recognized, the applicable enacted tax rate used to measure the deferred tax liability was 35%. The unrealized gain was recognized as follows:

	<b>Debit</b>	<b>Credit</b>
Available-for-sale security	1,000	
Other comprehensive income		1,000
Other comprehensive income	350	
Deferred tax liability		350

As a result of a subsequent change in tax rate to 21%, the deferred tax liability was reduced to \$210, with a corresponding adjustment to deferred tax expense from continuing operations. ABC then had a \$140 residual tax effect in accumulated other comprehensive income, the difference between the financial statement carrying amount of the deferred tax

liability of \$210 and the \$350 charge to other comprehensive income that was initially recorded upon establishment of the deferred tax liability (before the change in the tax rate). This residual effect was caused by the income tax effect of the change in tax rate being recorded as an income tax benefit through continuing operations, whereas the initial deferred tax liability was recorded with a charge to other comprehensive income.

**9.032 Releasing Residual Tax Effects.** Residual tax effects typically are released when the item giving rise to the tax effect is disposed of, liquidated, or terminated. For example, residual tax effects associated with a deferred tax asset established for a pension liability generally remain in other comprehensive income until the plan is terminated (see additional discussion of pension and postretirement benefit obligations beginning in paragraph 9.045). However, determining how to release residual tax effects can be more complex when the effects relate to a large number of individual items within other comprehensive income, for example, a portfolio of available-for-sale securities. The accounting standards do not address how to release the residual charges and residual credits. However, the method used to release the residual amounts should be systematic, rational, and consistently applied. For example, an entity may consider using one of the following approaches:

- Specific identification approach – Allocate a pro rata portion of the residual tax effects to each item (e.g., available-for-sale security) and release the residual amounts into income tax expense when the individual items are sold. This approach requires that each item be tracked based on the tax rate applicable when the related deferred tax asset or liability was originally recorded in other comprehensive income.
- Portfolio approach – Allocate the residual tax effect to the entire portfolio and release the residual amounts only when the entire portfolio is liquidated. This approach does not require detailed record keeping. For example, no write-off of the residual tax effect related to available-for-sale securities would be required unless the entity no longer holds a portfolio of available-for-sale securities.

**9.033 Changes in Tax Status.** The tax effects of a change in tax status are charged or credited to income tax expense or benefit from continuing operations. These effects include deferred tax assets, liabilities, and any valuation allowance recognized when an entity converts from a nontaxable entity to a taxable entity, and the deferred taxes eliminated when an entity converts from a taxable to a nontaxable entity (see paragraph 5.030 for additional discussion of deferred tax liabilities that may remain for an S Corporation under the built-in-gain system). For example, an entity should recognize in income tax expense from continuing operations the effect of eliminating deferred tax assets and liabilities when the entity converts to nontaxable status even if the deferred tax assets and liabilities were initially recognized with an adjustment to other comprehensive income. This accounting treatment may result in residual tax effects in accumulated other comprehensive income like the accounting treatment for changes in tax laws or rates. ASC subparagraph 740-20-45-8(c)

**9.034 Tax-Deductible Dividends.** Tax-deductible dividends are considered an exemption from income tax for an equivalent amount of earnings. Accordingly, the tax benefit from tax-deductible dividends should be recognized as a reduction to income tax expense from continuing operations and should not be allocated to shareholders' equity. See Paragraphs 9.061 through 9.062 for additional discussion. ASC paragraph 740-20-45-8

**9.035 Benefits of Tax-Deductible Goodwill.** At the acquisition date, no deferred taxes are recognized on (a) the first component of goodwill (because by definition no basis difference will exist at the acquisition date), or (b) nondeductible goodwill (i.e., second component financial statement goodwill). However, deferred taxes should be recognized at the acquisition date for basis differences related to second component tax goodwill. Tax deductible goodwill includes any carryover-tax-deductible goodwill of the acquiree. Prior to the adoption of FASB Statement No. 141(R), a deferred tax asset was not recognized for second component tax goodwill at the date of a business combination. ASC paragraphs 805-740-25-3 and 25-4, 55-9 through 55-13

## TAX EFFECT OF CHARGES OR CREDITS DIRECTLY TO OTHER COMPREHENSIVE INCOME OR TO SHAREHOLDERS' EQUITY

**9.036** Not used.

**9.036a** In accordance with the step-by-step approach to intraperiod tax allocation, the income tax effects (current and/or deferred) of items other than continuing operations are allocated to the individual items in proportion to their individual effects on total income tax expense. Those individual tax effects should be determined using the with-and-without approach (see Paragraph 9.023). Amounts allocated to the following items should be charged or credited directly to the related components of other comprehensive income or shareholders' equity.

- Adjustments to retained earnings for certain changes in accounting principles or corrections of errors.
- Gains and losses included in comprehensive income but excluded from net income.
- Increases or decreases in contributed capital.
- Increases or decreases in the tax bases of assets and liabilities caused by transactions among or with shareholders; for example, a transaction accounted for as a pooling of interests (only qualifying business combinations initiated before June 30, 2001) or other transactions accounted for as poolings, such as common control mergers.
- Certain tax benefits that existed at the date of a quasi-reorganization.

**9.037 Changes in Accounting Principles.** The direct income tax effects of a change in accounting principle (including direct changes in the amount of a valuation allowance)

should follow the transition provisions of the new accounting principle. If the income tax effect of a change in accounting is presented as an adjustment to a cumulative effect income statement line outside of continuing operations, the income tax effect should also be included in the cumulative effect line. Similarly, if the cumulative change is presented as an adjustment to retained earnings in accordance with ASC Subtopic 250-10, *Accounting Changes and Error Corrections - Overall*, the income tax effect should likewise be included in the cumulative effect adjustment to retained earnings. In situations when an entity reports a change in accounting principle through retrospective application, the income statement effects generally are included in income tax expense in the prior periods and allocated using the step-by-step approach applied to the retrospectively adjusted numbers. The direct income tax effects of a change in accounting principle should be measured using the enacted tax law as of the date of the change in accounting principle and considering the enacted tax law for any period retrospectively adjusted. Any subsequent change in tax law, even if retroactive, continues to be recognized in continuing operations as described in Paragraph 3.068. ASC paragraph 250-10-45-8 and subparagraph 740-20-45-11(a)

**9.038** Certain accounting standards may not require or permit transition through a cumulative effect adjustment but rather are prospective. In those circumstances, the tax effect of the change also would be reported using the step-by-step approach applied to the amounts reported in prospective periods upon application of the new standard.

**9.039** In some cases, it may not be clear whether a tax effect is a direct effect of a change in an accounting principle. For example, for some entities, the election of the goodwill amortization alternative in ASC Subtopic 350-20, *Intangibles—Goodwill and Other – Goodwill*, may result in a reduction to their valuation allowances. Because the alternative allows all entities other than public business entities (PBEs), not-for-profit entities, and employee benefit plans within the scope of Topics 960 through 965, among other things, to amortize financial statement goodwill on a straight-line basis over 10 years (or less than 10 years if the entity demonstrates that a shorter useful life is more appropriate), existing deferred tax liabilities related to the first component of goodwill will reverse as financial statement goodwill is amortized (whereas without electing the alternative, those deferred tax liabilities had an indefinite reversal period).

**9.040** For example, assume ABC Corp. had a deferred tax liability related to the difference between the financial statement and tax basis of goodwill. ABC had previously recorded a valuation allowance on all of its deferred tax assets as all of its deferred tax assets would result in carryforwards that expire and it had determined it was more likely than not that it would not be able to realize its deferred tax assets. By electing the alternative to amortize financial statement goodwill, ABC determined that the reversal of the deferred tax liability related to the basis difference of goodwill should be considered a source of taxable income in assessing the realizability of its deferred tax assets (previously the reversal period was determined to be indefinite and the deferred tax liability was not expected to reverse in the same period as existing deferred tax assets). The deferred tax liability related to the basis difference of goodwill will eventually be reduced to zero as ABC recognizes goodwill amortization and its reversal can be scheduled. Based on the taxable income that would be generated by the reversal of the

deferred tax liability, ABC determined that a valuation allowance on a portion of its deferred tax assets was no longer needed.

**9.041** We believe in this situation, ABC should have recognized the change in the valuation allowance through income tax expense from continuing operations because it represented a change in judgment about the recoverability of the beginning of the year deferred tax asset due to changes in the expectation of income that would be generated by the entity in the current and future periods. ASC paragraph 740-10-45-20 requires that the tax effects of changes in the valuation allowance caused by changes in circumstances that result in a change in judgment about an entity's ability to realize deferred tax assets in future years should be charged to the income statement as a component of income from continuing operations. Additionally, election of the accounting alternative requires prospective transition (no retrospective or cumulative-effect adjustments), and the current year effect of the reversal of the deferred tax liability was related to amortization of goodwill, an ongoing element of continuing operations.

**9.042 Corrections of Errors.** The income tax effect of a correction of an error should be reported in the same manner as the error correction. ASC paragraphs 250-10-45-22 and 45-23 require net income for the period to include all items of profit and loss recognized during the period, including accruals of estimated losses from loss contingencies, but net income should not include corrections of errors from prior periods. Instead, a material error in the financial statements of a prior period discovered after the financial statements are issued should be reported as an error correction, by restating the prior-period financial statements. The step-by-step approach to report the tax effects would be based on the restated amounts.

**9.043 Other Comprehensive Income.** The tax effect of gains or losses recorded in other comprehensive income should be charged or credited directly to other comprehensive income. Such gains or losses include those arising from certain foreign currency items (ASC Topic 830), pension or other postretirement benefits (ASC Subtopics 715-30, 715-60, 715-20, 958-715), available-for-sale debt securities (ASC Subtopic 320-10), and derivatives designated in qualifying cash flow hedging relationships (ASC Topic 815).

**9.044 Deferred Taxes on the Cumulative Translation Adjustment.** The deferred tax expense or benefit related to deferred taxes recognized on temporary differences resulting from translation adjustments are charged or credited to the translation adjustment component of other comprehensive income. However, in situations involving a change in the indefinite reversal assessment under ASC paragraph 740-30-25-17 (APB 23), the tax effects associated with either the amounts as of the date of the change in facts or as of the beginning-of-year cumulative translation adjustment generally are allocated to net income (see Paragraphs 10.085a and 10.085b for additional discussion). In situations involving the initial recognition of a deferred tax asset for a deductible outside basis, the tax effects associated with the beginning-of-year cumulative translation adjustment generally are allocated to net income (see Paragraphs 10.086 and 10.086a for additional discussion). See Section 7, *Foreign Operations*, for additional discussion of situations in which taxable and deductible temporary differences related to the cumulative translation adjustment result in recognition of deferred taxes and specifically Paragraph 7.043 for

discussion of the intraperiod tax allocation of the related expense, Paragraph 7.046a for discussion of accounting for withholding tax liabilities, and Paragraph 9.170 for discussion of allocating deferred tax expense or benefit related to the outside basis difference of a discontinued operation.

**9.045 Allocation of Deferred Taxes for Pension and Other Postretirement Benefit Obligations.** Entities initially recognize the gains or losses and prior service costs or credits that arise during each period (but that are not yet recognized in the income statement under ASC Subtopics 715-30 and 715-60) as a component of other comprehensive income. In addition, entities reclassify some amount of gains or losses and prior service costs or credits out of accumulated other comprehensive income as amortization into net income under ASC Subtopics 715-30 and 715-60. The deferred tax effects of temporary differences (including the need for a valuation allowance on originating deferred tax assets – see Paragraph 9.071) arising as a result of an adjustment to other comprehensive income should likewise be allocated to other comprehensive income. The deferred tax effects associated with amounts that are being reclassified from accumulated other comprehensive income to components of net income should be allocated to income tax expense or benefit for the year in accordance with the step-by-step approach. For example, an increase to a pension liability attributable to a net actuarial loss arising during the year and its related tax effect would be recognized as a component of other comprehensive income. When such loss is subsequently reclassified into net periodic pension cost in accordance with ASC Subtopic 715-30, for example as a charge to income from continuing operations, the related tax effect (i.e., the amount equal to the related deferred tax asset or liability) will also be reclassified into income tax expense or benefit allocable to continuing operations. Changes in valuation allowances resulting from a change in judgment about the realizability of deferred tax assets associated with pension and other postretirement benefit obligations generally should be recognized as an adjustment to income tax expense attributable to continuing operations, notwithstanding that the initial recognition of the related deferred tax asset (and, if applicable, a related valuation allowance) was recorded as an adjustment to other comprehensive income. Such allocation may result in residual tax effects in accumulated other comprehensive income – see the discussion beginning in Paragraph 9.031 for additional information. Because changes in accumulated other comprehensive income in periods subsequent to the initial recognition of the deferred tax asset related to pension and other postretirement benefit obligations will include initial recognition of additional amounts and amortization of amounts previously recorded in accumulated other comprehensive income, entities will need to determine whether a change in the valuation allowance is the result of a change in judgment about the realizability of an existing deferred tax asset or the consequence of the initial recognition of a deferred tax asset. ASC paragraphs 715-20-55-5 through 55-13

**9.046 Unrealized Gains or Losses on Available-for-Sale Debt Securities.** Under ASC Subtopic 320-10, *Investments—Debt Securities - Overall*, unrealized gains and losses on available-for-sale debt securities are reported as a component of accumulated other comprehensive income (unless an unrealized loss represents an other-than-temporary impairment). When a debt security is in an unrealized gain or loss position and the entity uses the cost method for tax purposes (i.e., there is no change in the tax basis of the

security), a temporary difference will arise. If the entity uses the mark-to-market method for tax purposes (i.e., the debt security is treated as if it were sold and reacquired at its fair market value on the last business day of the tax year), there will be an effect on the taxable income or loss for the current period due to changes in value of the securities. In either case, the tax effects will be initially recognized directly in other comprehensive income as ASC subparagraph 740-20-45-11(b) requires that the tax effects of gains or losses included in other comprehensive income but excluded from net income (as well as the other items listed) be charged or credited to other comprehensive income. For example, assume at the end of the current year, an entity has \$1,000 of pretax income from continuing operations and a \$400 unrealized loss from an available-for-sale debt security that is recognized in other comprehensive income. In applying the step-by-step approach, the entity would allocate \$210 of income tax expense to continuing operations (assuming a 21% tax rate) and \$84 of tax benefit to other comprehensive income regardless of whether it was using the cost method or the mark-to-market method for tax purposes.

**9.047** When a valuation allowance is required on initial recognition of a deferred tax asset established through a credit to other comprehensive income (or in a later interim period within the same fiscal year), the charge to establish the valuation allowance also should be allocated to other comprehensive income. Similarly, if the deferred tax asset (and related valuation allowance) is reduced or eliminated as a result of recovery of the value of the security (i.e., through reduction of unrealized loss, unrealized gain, or sale), the change in those balances is reported as a component of accumulated other comprehensive income (i.e., the deferred tax asset and related valuation allowance are reversed against one another through offsetting adjustments to other comprehensive income). ASC paragraphs 740-20-45-4, 740-20-45-15 through 45-18

**9.048** If no valuation allowance was required at the time the unrealized loss was recognized but in a subsequent fiscal year a determination is made that it is more likely than not that the deferred tax asset will not be realized due to a change in circumstances resulting in a change in judgment on the availability of sufficient taxable income in future years, the resulting valuation allowance generally is recognized through a charge to continuing operations. Similarly, a reduction in a subsequent fiscal year of a valuation allowance initially established through other comprehensive income due to a change in circumstances resulting in a change in judgment on the availability of sufficient taxable income in future years generally will be recognized through a credit to continuing operations. If the entity generates taxable income in the current year that can use the benefit of the deferred tax asset, the elimination or reduction of the valuation allowance is allocated to that income in accordance with the step-by-step approach. See Paragraph 9.071 for additional discussion. ASC paragraphs 740-10-45-20, 740-20-45-4, 730-20-45-15 through 45-18

**9.049 Effect of Unrealized Loss on Available-for-Sale Debt Securities on Valuation Allowance.** In certain instances, a deferred tax liability recognized for the unrealized gain on an available-for-sale debt security recognized in other comprehensive income could result in a decrease in a preexisting valuation allowance against deferred tax assets. This could occur assuming the related taxable temporary differences would reverse within the



same time period as the deductible temporary differences giving rise to the deferred tax assets. Under ASC paragraph 740-20-45-17, the tax effect of a reduction to an existing valuation allowance solely due to a deferred tax liability related to the unrealized gain on an available-for-sale debt security, should be allocated to other comprehensive income under the step-by-step approach. For example, assume that at the end of 20X6, ABC Corp. had \$1,000 in deferred tax assets for capital loss carryforwards with a full valuation allowance (assume no other deferred tax assets). During 20X7, ABC purchased available-for-sale debt securities and at the end of 20X7 had an unrealized gain on these securities resulting in a \$210 deferred tax liability of a capital character, assuming a 21% tax rate, for which the related deferred tax expense was recognized in other comprehensive income. Assuming ABC had no income or loss, or generated any other temporary differences in 20X7, ABC can reduce its valuation allowance by \$210 if the deferred tax liability arising from the available-for-sale debt securities is scheduled to reverse (and such reversal would generate capital gain income) prior to the expiration of the deferred tax assets (capital loss carryforwards). Accordingly, ABC would record the \$210 decrease in the valuation allowance in other comprehensive income because the reduction is solely the result of the deferred tax liability related to the available-for-sale debt securities.

**9.049a** Not used.

**9.050 Tax Effects of Gains and Losses on Derivatives Designated in Qualifying Cash Flow Hedging Relationships.** The gain or loss on a derivative that is designated in a qualifying cash flow hedging relationship under ASC Topic 815, *Derivatives and Hedging*, is recognized in other comprehensive income. Therefore, the income tax effects of the gain or loss would also be recognized in other comprehensive income (along with any valuation allowance required on establishment of a deferred tax asset) and reclassified into earnings in the same period in which the related gains or losses are recognized in earnings. Entities should consider the unique aspects of derivative instruments under the tax law (e.g., application of *tax hedging*) in determining the tax effect of the transactions.

**9.051 Contributed Capital.** The tax consequences of transactions that increase or decrease contributed capital should be allocated directly to contributed capital. These tax consequences include the tax effect of items that are classified in equity for financial statement purposes, such as issuance costs recorded as a reduction of proceeds received on equity issuances for book purposes but are deductible for tax purposes. Other items include changes in the tax bases of assets and liabilities as a result of a transaction among shareholders (see Paragraph 10.146 for additional discussion), and the tax effects of the exercise of a financial instrument classified as equity by the issuer (e.g., equity classified warrants – refer also to Paragraph 9.057).

### Example 9.14: Tax Effect of Initial Public Offering Costs

During 20X8, ABC Corp. incurred costs in connection with the intended issuance of common stock via an initial public offering (IPO). ABC expensed these costs in its 20X8 financial statements, as the likelihood of the IPO was not considered probable.

As of December 31, 20X8 (fiscal year end), the criteria necessary to deduct the costs for tax purposes were not met. As these costs were capitalized for tax purposes and expensed for financial reporting purposes, ABC recorded a deferred tax asset to reflect this book and tax basis difference.

#### *Scenario 1*

ABC continued to pursue the IPO. When the IPO occurred in 20X9, the capitalized costs were no longer amortizable for tax purposes and the deferred tax asset was derecognized.

ASC subparagraph 740-20-45-11(g) indicates that 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 recorded on recognition of any related deferred tax assets. As the capitalized costs were no longer amortizable for tax purposes when the IPO occurred, the reduction of the related deferred tax asset should be recorded in equity in 20X9 in accordance with ASC subparagraph 740-20-45-11(g). In the more common situation, costs are capitalized for both tax and financial reporting purposes in anticipation of an IPO occurring. In this particular situation, in which the IPO was not probable, the costs were expensed in an earlier period and the elimination of the deferred tax asset is similar to a tax cost which would be charged to equity.

#### *Scenario 2*

If the fact pattern described above was changed so that the IPO did not occur, a deduction would be taken for the amount of the costs incurred. Upon taking the deduction, no temporary difference would exist, and the deferred tax asset would be reversed with an offsetting charge to income tax expense.

**9.052 Common Control Mergers.** Although ASC Topic 805, *Business Combinations*, eliminated the pooling-of-interest method for business combinations, the requirement in ASC Topic 740 to record the tax effect of increases in the tax bases of assets and liabilities in a business combination accounted for as a pooling-of-interests is still applicable for common control mergers. Accordingly, the deferred tax consequences of changes in the tax bases of the combined entity's remaining assets and liabilities or a decrease to an existing valuation allowance caused by the common control merger would be included in equity. If the common control merger results in recognition of deferred tax assets from changes in the tax bases of assets and liabilities, valuation allowances initially

required upon recognition of those deferred tax assets also would be included in equity. Increases in valuation allowances due to changed expectations about the realization of existing deferred tax assets as well as the write-off of existing deferred tax assets that the combined entity no longer expects to realize as a result of the common control merger would be included by the combined entity in determining its income from continuing operations. Changes in valuation allowances occurring in subsequent periods would also be included in the determination of income from continuing operations. See Paragraph 6.094 for additional discussion and Paragraph 10.148 for transactions within a consolidated group. ASC paragraph 740-10-45-21, ASC subparagraph 740-20-45-11(g)

### **9.053 Tax Benefits Realized as a Result of Transfers of Net Operating Loss**

**Carryforwards between Entities under Common Control.** Transfers of tax benefits between entities under common control should be accounted for as capital transactions. Accordingly, tax benefits realized as a result of transferring net operating loss carryforwards between entities under common control should be treated as capital contributions in the separate financial statements of the entity receiving the benefits and distributions in the separate financial statements of entity transferring the benefits.

#### **Example 9.15: Tax Benefits Realized as a Result of Transfers of Net Operating Loss Carryforwards between Entities under Common Control**

Subsidiary A is a 100% owned subsidiary of ABC Corp. Both ABC and Subsidiary A have operations in a foreign jurisdiction. Subsidiary A's operations have been profitable. ABC's operations have generated losses. ABC and Subsidiary A are not allowed to file a consolidated tax return under the tax law in the foreign jurisdiction; however, group relief is permitted whereby the losses of one entity in the group may be surrendered to another member that can use such losses.

ABC surrenders its operating loss carryforward to Subsidiary A. Subsidiary A reduces its taxable income by the surrendered losses.

In Subsidiary A's separate financial statements, the tax benefit it realizes by utilizing ABC's net operating loss carryforward should be treated as a capital contribution.

**9.054 Tax Receivable Agreements – Initial Recognition and Measurement.** Tax receivable agreements (TRAs) are contractual arrangements commonly used in IPO or other transactions where the historic owners of a business receive the right to a payment for a portion of the benefits from certain tax attributes (e.g., net operating loss carryforwards, a step-up in tax basis). The arrangements may involve existing corporate entities or Up-C structures whereby a newly formed corporation is used in the IPO. In Up-C structures, the new public entity uses cash raised in the IPO to acquire interests in a partnership or limited liability company where the operations of the business reside.

**9.055** Under a typical TRA, the historic owners will be paid a percentage (commonly 85%) of the benefits realized by the newly public entity for the tax attributes associated

with conditions that existed at the IPO date. For example, if the newly public entity amortizes a step-up in tax basis to reduce taxes by \$100, the pre-IPO shareholders will be paid \$85. Payments frequently are determined using a with-and-without calculation (i.e., the incremental benefit received by the entity beyond what it would have received had the step-up in tax basis not been present becomes the basis for the payment made to the pre-IPO shareholders). The future payments typically are not contingent on the pre-IPO shareholders continuing as shareholders of the newly formed public entity.

**9.056** Because the TRA results in a non-income tax related liability that results from a transaction with shareholders, we believe the adjustment related to the initial establishment of the liability should be treated as a reduction to equity. We also believe the liability generally should be measured at the undiscounted amount presumed payable under the TRA based on the deferred tax asset related to the stepped-up tax basis or tax attribute. We believe measurement at the undiscounted amount is appropriate because the liability is a function of the tax attribute (which is measured on an undiscounted basis), the timing of any payment is uncertain, and the arrangement is similar to payments between entities in a consolidated group and a transaction in which the interest rate would be affected by tax attributes (both of which generally are outside the scope of ASC Topic 835, *Interest*). For additional guidance on accounting for the establishment of a TRA liability, see Paragraph 5.028b. ASC subparagraph 740-20-45-11(g)

**9.056a** We believe there is more than one acceptable approach for determining the undiscounted amount presumed payable under the TRA based on the deferred tax asset. Two acceptable approaches are the mirror approach and the expected future taxable income approach.

- Under the mirror approach, an entity's TRA liability mirrors the amount of the related deferred tax asset, net of any valuation allowance.
- Under the expected future taxable income approach, an entity forecasts its overall expected future taxable income or loss (including the reversal of existing taxable temporary differences) to determine how much of the deferred tax asset that triggers payment under the TRA is expected to be realized, and recognizes a TRA liability based on that amount.

The amount of the TRA liability is likely to differ under these two approaches if an entity has (1) existing deferred tax liabilities, and (2) a valuation allowance for the deferred tax assets that are not supported by the deferred tax liabilities. In that case, the entity may not expect overall future taxable income (e.g., because it expects future losses to exceed the taxable income generated by the reversal of the existing taxable temporary difference), but ASC Topic 740 requires the entity to reduce the amount of the valuation allowance by the amount of the deferred tax liabilities that are of the same character and are scheduled to reverse in the same period as the deferred tax assets (see Paragraph 4.007).

**9.056b** Consider the following scenarios. In all scenarios, the entity has a \$1,000 deferred tax asset for a step-up in tax basis associated with an investment in a pass-through entity that is subject to a TRA and the percentage of that benefit that would be payable under

the TRA is 85%. The TRA liability amounts in each scenario do not consider the effects of the related deferred taxes (see Paragraph 9.056e).

<p><b>Scenario 1:</b> The entity has no deferred tax liabilities eligible to support the \$1,000 deferred tax asset and no valuation allowance. The entity believes the deferred tax asset is more likely than not to be realized based on its estimate of future taxable income (including the reversal of \$0 of taxable temporary differences).</p>	
Mirror approach	Expected future taxable income approach
The entity recognizes a TRA liability of \$850 ( $\$1,000 \times 85\%$ ).	The entity recognizes a TRA liability of \$850 ( $\$1,000 \times 85\%$ ).
<p><b>Scenario 2:</b> The entity has a \$1,000 deferred tax asset, a \$200 valuation allowance and no deferred tax liabilities. The entity believes \$800 of the deferred tax asset is more likely than not to be realized based on its estimate of future taxable income (including the reversal of \$0 of taxable temporary differences).</p>	
Mirror approach	Expected future taxable income approach
The entity recognizes a TRA liability of \$680 ( $(\$1,000 - \$200) \times 85\%$ ).	The entity recognizes a TRA liability of \$680 ( $(\$1,000 - \$200) \times 85\%$ ).
<p><b>Scenario 3:</b> The entity has a \$1,000 deferred tax asset, a \$200 valuation allowance, and an \$800 deferred tax liability that supports an equal amount of deferred tax assets. The entity believes the deferred tax asset is not more likely than not to be realized based on its estimate of future taxable income including the reversal of taxable temporary differences. In other words, future operating losses are forecasted to exceed the taxable income generated by the reversing taxable temporary differences. Accordingly, the entity concludes that absent the deferred tax liability, it would have a full valuation allowance reducing the \$1,000 deferred tax asset to zero.</p>	
Mirror approach	Expected future taxable income approach
The entity recognizes a TRA liability of \$680 ( $(\$1,000 - \$200) \times 85\%$ ).	The entity recognizes no TRA liability.

<b>Scenario 4:</b> The entity has a \$1,000 deferred tax asset, a \$1,000 valuation allowance and no deferred tax liabilities. The entity believes the deferred tax asset is not more likely than not to be realized based on its estimate of future taxable income (including the reversal of \$0 of taxable temporary differences).	
Mirror approach	Expected future taxable income approach
The entity recognizes no TRA liability.	The entity recognizes no TRA liability on its estimate of future taxable income.

**9.056c** In some situations, depending on the facts and circumstances, arrangements that are referred to as TRAs or have similar characteristics as TRAs are more appropriately accounted for as contingent consideration under ASC Topic 805, *Business Combinations*, accounted for as derivatives under ASC Topic 815, *Derivatives and Hedging*, or as financial instruments that have been issued as dividends under ASC Topic 505, *Equity*. These US GAAP Topics generally require fair value measurement for instruments within their scopes. See also Paragraph 6.046a for considerations for TRAs acquired in a business combination.

**9.056d** When an entity makes a payment to settle (or partially settle) a TRA liability, it generally obtains additional tax basis in a partnership or other assets. In addition, a portion of the payment may be deemed imputed interest and result in an immediate deduction. The additional tax basis and the imputed interest deduction will typically generate an additional liability under the TRA. We believe entities generally consider estimated imputed interest deductions, at least through the most recent balance sheet date, when they estimate the future tax consequences of settling the TRA liability and reflect the impact of those deductions when computing the amount payable under the TRA arrangement.

**9.056e** We believe the difference between the financial statement carrying amount of the TRA liability and its tax basis (if any) results in a temporary difference. The related deferred tax asset or liability (and ultimate TRA liability amount) generally is determined using the simultaneous equation approach (see Paragraph 6.015 for additional discussion). For example, assume an entity initially measures the financial statement carrying amount of the TRA liability at \$120 and it has no tax basis in the liability. At a 25% tax rate, the deferred tax asset is equal to \$40, which is the initial deductible temporary difference of  $\$120 \times (25\% \text{ tax rate} \div (1 - 25\%))$ . The entry to recognize the TRA liability and the related deferred tax asset is:

	Debit	Credit
Deferred tax asset	40	
Equity	120	
TRA liability		160

The resulting \$40 deferred tax asset is equal to  $25\% \times$  the \$160 final financial statement carrying amount of the TRA liability. On settlement of the TRA, a portion of the \$40 deferred tax asset is likely to reverse as the interest portion will be immediately deductible. The remainder will reverse when the additional tax basis in the partnership or other assets that arises on payment of the TRA liability becomes deductible – e.g., when the investment is sold or amortized. The portion of the deferred tax asset that will result in additional tax basis in the partnership or other assets is generally recognized, evaluated for realizability, and disclosed as part of the deferred taxes for the asset that will receive the step-up in tax basis.

**9.056f Tax Receivable Agreements – Subsequent Measurement.** An entity should re-evaluate its recognition and measurement of the TRA liability each reporting period and adjust it as necessary. As the pre-IPO owners are not required to continue as owners of the public entity, we believe subsequent changes in the measurement of the liability would be recognized in profit or loss, outside of income tax expense, because the remeasurement of the liability does not result (a) in an incremental amount payable to, or receivable from, a taxing authority, or (b) from an incremental amount recognized in equity. This accounting is similar to the accounting for liability classified contingent consideration in a business combination under ASC Topic 805.

**9.057 Basis Differences Resulting from Debt Proceeds Allocated to Equity.** In some situations, a portion of the proceeds received upon issuance of debt is allocated to shareholders' equity. This occurs most frequently when debt is issued with detachable warrants or with a beneficial conversion feature accounted for under ASC Subtopic 470-20, *Debt - Debt with Conversion and Other Options*. The allocation of proceeds to equity generally creates a temporary difference between the financial statement carrying amount of the debt (which has been reduced as a result of the allocation to equity) and the tax basis of the debt (which is typically equal to the proceeds). The related deferred tax liability is recognized through a charge to shareholders' equity. ASC paragraph 740-10-55-51

**9.057a** If a portion of debt proceeds are allocated to equity, the deferred taxes for the difference between the financial statement carrying amount of the debt and the corresponding tax basis will not be offset by a corresponding deferred tax asset or liability related to the equity component. The recognition of the initial deferred tax asset or liability related to the debt generally has been recorded with an adjustment to equity in accordance with ASC subparagraph 740-20-45-11(c), consistent with similar deferred tax liabilities recognized for convertible debt instruments with a beneficial conversion feature within the scope of ASC paragraph 740-10-55-51. Subsequent changes in the deferred tax asset or liability related to the debt should be recorded as a component of income tax expense. As discussed in Paragraph 2.108a, in August 2020, the FASB issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. Among other items, the ASU eliminates the specialized accounting for cash conversion options and beneficial conversion features embedded in convertible debt instruments. The ASU will result in fewer embedded conversion features being separately recognized from the host debt instrument, and therefore fewer temporary differences being identified at initial recognition of those instruments. Under the ASU, separation of a conversion

feature from a convertible debt instrument will be required only if the (1) conversion feature is required to be separately accounted for under Topic 815, *Derivatives and Hedging*, based on amended conditions, or (2) convertible debt is issued at a substantial premium.

**9.057b** In some situations, the establishment of a deferred tax liability will result in the reduction of a beginning-of-year valuation allowance on existing deferred tax assets. In that case, the reduction of the valuation allowance generally should also be allocated to equity since an entity determines the tax effect from the loss from continuing operations without considering the tax effect of items outside continuing operations.

**9.058 Tax Effect of Share-Based Payment Awards under ASC Topic 718, Compensation—Stock Compensation.** Tax benefits and deficiencies from employee and nonemployee awards are recognized as income tax benefit or expense. Section 8, *Income Tax Issues Associated with Share-Based Payment Arrangements*, discusses the income tax consequences of ASC Topic 718 and provides interpretive guidance and examples on income tax issues associated with share-based awards.

**9.059 Deferred Compensation Arrangements.** Deferred compensation arrangements where amounts earned are held in a Rabbi Trust may result in a tax deduction that differs from the compensation expense recognized for financial reporting purposes and should be accounted for in a manner similar to unqualified stock options. Under certain deferred compensation plans, recognized compensation expense will be paid in employer stock at a future date. The entity generally acquires treasury stock with a fair value equal to the compensation expense and designates that treasury stock as payable to the employee. The employee receives the stock (and any appreciation or depreciation in the stock) at some future date and delays the income tax obligation on the compensation. A deferred tax asset is recognized for the amount of the compensation expense recognized for financial statement purposes.

**9.060** If a deferred compensation plan does not permit diversification and must be settled by the delivery of a fixed number of shares of employer stock, subsequent changes in the fair value of the stock (and corresponding compensation obligation) are not recognized. The carrying amount of the treasury stock and deferred compensation obligation is eliminated when the plan is settled. However, the tax deduction for these arrangements generally will be the fair market value of the stock when the arrangement is settled. Accordingly, the tax deduction from the compensation arrangement will differ from the compensation expense recognized for financial statement purposes. Excess tax benefits and deficiencies from employee awards are recognized as income tax benefit or expense. Section 8 provides interpretive guidance and examples on income tax issues associated with share-based awards.

**9.060a** Not used.

**9.061 Dividends Paid on Allocated and Unallocated Shares Held by an ESOP.** Tax benefits on allocated and unallocated ESOP shares are recognized as income tax expense. Tax benefits from dividends paid on ESOP shares are allocated to income taxes from



continuing operations regardless of where the related compensation cost is presented (e.g., in discontinued operations). ASC paragraph 718-740-45-7

**9.062 Dividends Paid on Restricted Stock and Option Awards.** Employees may receive, as part of a share-based payment arrangement, dividends or dividend equivalents on (a) nonvested share awards and nonvested equity share unit awards during the vesting period or (b) share option awards until they are exercised. Such dividend protection provisions for share-based payment arrangements may entitle employees to receive (a) dividends or dividend equivalents on a nonvested equity share or a nonvested share unit, (b) payments equal to dividends on the underlying equity shares while a share option is outstanding, or (c) reductions to the exercise price of a share option based on the dividends paid on the underlying equity shares while the option is outstanding. In some cases, the payment of dividends on nonvested equity shares, nonvested equity share units, and outstanding share options is treated as deductible compensation for tax purposes, even though the payment of such dividends is charged to retained earnings in the employer's financial statements for awards expected to vest. Tax benefits and deficiencies from employee awards are recognized as income tax benefit or expense. Section 8 provides interpretive guidance and examples on income tax issues associated with share-based awards.

**9.063 Quasi-Reorganization Temporary Differences and Carryforwards.** Tax benefits for deductible temporary differences and carryforwards that exist at the date of a quasi-reorganization should be initially recognized as an adjustment to contributed capital. Similarly, benefits associated with deductible temporary differences and carryforwards that existed at the date of a quasi-reorganization that are initially recognized as a result of the release of a valuation allowance are recognized as an addition to contributed capital (see Paragraph 9.067). Quasi-reorganizations are also discussed beginning in Paragraph 10.117. ASC paragraph 852-740-45-3 and ASC paragraph 220-10-45-10B

**9.064 Tax Effects Arising in a Reorganization under the Bankruptcy Code.** The tax effects of temporary differences and carryforwards that exist as of the date of application of fresh-start reporting are recognized under the general principles of ASC Topic 740 with any adjustments reflected in income tax expense in the predecessor entity's final statement of operations. The initial recognition of tax benefits through the release of a valuation allowance established at the date of reorganization for deferred tax assets of pre-reorganization deductible temporary differences and carryforwards, and changes in the measurement of deferred tax liabilities for attribute reduction resulting from the discharge of debt established at the date of reorganization should be recognized as an adjustment to income tax expense. See Paragraphs 9.067 and 10.117 for additional discussion. ASC paragraphs 852-10-45-21 and 852-740-45-1

## INTERACTION BETWEEN INTRAPERIOD TAX ALLOCATION AND A VALUATION ALLOWANCE

**9.065** The basic principles for accounting for changes in the valuation allowance are as follows (certain exceptions are discussed below):

- The intraperiod tax allocation of changes in the valuation allowance as a result of *current* year operations (e.g., changes in a valuation allowance on originating deferred tax assets, changes in a valuation allowance on deferred tax assets existing at the beginning of the year as a result of current year income or loss) generally should follow the step-by-step approach (see the discussion beginning in paragraph 9.066a for additional information on specific exceptions and Paragraph 9.025 for additional discussion of changes in intraperiod tax allocation in a subsequent interim period in the same fiscal year).
- The effect of changes in the beginning-of-year valuation allowance that results from a change in circumstances that causes a change in judgment about the realization of deferred tax assets in *future* years should be included in income tax expense from continuing operations.

### Example 9.16: Allocating a Change in Valuation Allowance Using the Step-by-Step Approach for Deferred Tax Assets Originating During the Period

In 20X6, ABC Corp. recognized a \$2,000 loss from continuing operations and a \$6,000 loss from discontinued operations. ABC has a 21% statutory tax rate and no temporary differences originating in 20X6. The losses can offset 100% of taxable income.

The income tax benefit from the current year losses is \$1,680  $((\$2,000 + \$6,000) \times 21\%)$ . After assessing future taxable income, ABC concludes that a \$1,050 valuation allowance is required for the deferred tax assets, based on \$3,000 of estimated future taxable income (total deferred tax asset of \$1,680 – \$630 for the tax effect of estimated future taxable income). When allocating the \$630 net tax benefit  $(\$1,680 - \$1,050)$  to continuing operations and discontinued operations, ABC applies the step-by-step approach.

Under the step-by-step approach, ABC assesses the need for a valuation allowance for the \$420  $(\$2,000 \times 21\%)$  deferred tax asset arising from the loss from continuing operations. In this assessment, ABC also estimates \$3,000 of future taxable income (the same estimate of future taxable income used for total income tax expense), which supports the realization of the entire deferred tax asset resulting from continuing operations. Accordingly, the entire income tax benefit from the loss from continuing operations is recognized in continuing operations. The difference between the benefit recognized in continuing operations and total tax benefit is allocated to discontinued operations.

Income tax benefit allocated to discontinued operations is calculated as follows:

Total tax benefit	\$ (630)
Less tax benefit allocated to the loss from continuing operations	<u>420</u>
Tax benefit allocated to discontinued operations	<u><u>(210)</u></u>

In this example 100% of the valuation allowance is effectively allocated to discontinued operations.

### Example 9.17: Allocating a Change in Valuation Allowance Using the Step-by-Step Approach for Existing Deferred Tax Assets

ABC Corp. has \$10,000 of deferred tax assets and a corresponding valuation allowance at January 1, 20X6. In 20X7, it earned \$4,000 income from continuing operations and a \$4,000 loss from discontinued operations. Because net income is zero and there is no change in the assessment of future taxable income, the \$10,000 valuation allowance at the beginning of the year continues to be needed at December 31, 20X7. ABC has a 21% statutory tax rate and no temporary differences originated in 20X7.

Allocating income tax expense to continuing operations and discontinued operations using the step-by-step approach initially should ignore the loss from discontinued operations. ABC calculates income tax expense from continuing operations as \$840 ( $\$4,000 \times 21\%$ ). In addition, again ignoring the loss from discontinued operations, the current year income from continuing operations would permit the release of a portion of the beginning-of-the-year valuation allowance, resulting in a deferred tax benefit of \$840 (assuming the deferred tax assets were associated with NOLs arising in tax years beginning on or before December 31, 2017 - see Paragraph 4.016a for additional discussion). Accordingly, total income tax expense from continuing operations is zero. Income tax benefit from the loss from discontinued operations is also zero, because income tax expense from continuing operations is zero and total income tax expense is zero.

If the deferred tax assets were associated with NOLs arising in tax years beginning after December 31, 2017, the current year income from continuing operations would permit the release of \$672 of the beginning-of-the-year valuation allowance. Accordingly, total income tax expense from continuing operations is \$168. Income tax benefit from the loss from discontinued operations is \$168, because income tax expense from continuing operations is \$168 and total income tax expense is \$0.

If ABC did not have a beginning-of-the-year valuation allowance, the income tax expense allocated to continuing operations would have been \$840. In this situation, the income tax benefit from the loss from discontinued operations would be \$840, which is total income tax expense of zero less the \$840 income tax expense allocated to continuing operations. ASC paragraphs 740-20-45-7, 55-14

9.066 Not used.

**9.066a Allocation of Change in Valuation Allowance Resulting from Taxable Income from Items Other Than Continuing Operations.** An entity determines the tax effect from the loss from continuing operations without considering the tax effect of items outside continuing operations.

**Example 9.18: Intra-period Tax Allocation When There Is a Change in Judgment about the Need for a Valuation Allowance in Future Years**

In 20X7, ABC Corp. reported \$100 of pretax income from continuing operations and \$20 of pretax income allocated to other comprehensive income. Assume ABC's NOL carryforwards arose in the tax year beginning on or before December 31, 2017 (see Paragraph 4.016a for additional discussion). ABC also had the following as of December 31:

	20X7	20X6
NOL carryforward	\$ 180	\$ 300
Deferred tax asset	38	63
Valuation allowance	0	(63)

Due to a change in circumstances during 20X7, ABC now believes it will have substantial future operating income to fully realize the beginning of the year deferred tax assets. Therefore ABC concludes it is more likely than not that it will use its remaining operating loss carryforwards in future years (therefore no valuation allowance is needed as of December 31, 20X7).

In this example, ABC began 20X7 with zero net deferred taxes and ended the year with a net deferred tax asset of \$38. Therefore, the total tax benefit would equal \$38. There are no current taxes payable as all taxable income was offset by net operating loss carryforwards.

Assuming a 21% tax rate, ABC's income tax expense or benefit from continuing operations would include:

- (a) Current benefit from beginning-of-year net operating loss carryforwards - Because the tax benefit of an operating loss carryforward should be reported in the same manner as the source of the income in the current year (ASC paragraph 740-20-45-3), the benefit of using \$100 of the beginning-of-year operating loss carryforwards (for which the related deferred tax asset was previously offset by a valuation allowance) would be allocated to continuing operations. This results in net zero tax effect in continuing operations (the income tax expense on current income and the related payable is offset by the

reversal of the \$21 of the valuation allowance and the related deferred tax asset, all of which are allocated to continuing operations).

- (b) Future benefit from beginning-of-year net operating loss carryforwards - Changes in circumstances that cause a change in judgment about realizing a beginning-of-year deferred tax asset in future years should also be allocated to continuing operations (ASC paragraph 740-20-45-8). In this example, because ABC is releasing its entire valuation allowance (the remaining valuation allowance release is not attributable solely to an item outside of continuing operations), we generally would expect ABC to apply this guidance without considering the item recognized in other comprehensive income. With that perspective, ABC would have \$200 of remaining operating loss carryforwards, for which a deferred tax asset with no valuation allowance could be recognized due to the anticipation of future income. Accordingly, a deferred tax asset of \$42 could be recognized and a related income tax benefit of \$42 would be generated by the removal of the valuation allowance.

When considering (a) and (b) above, a net tax benefit of \$42 would be allocated to continuing operations.

ABC would recognize the remaining income tax expense of \$4 in other comprehensive income. Even though \$20 of operating loss carryforwards was used to offset pretax income from other comprehensive income, because the benefit of the carryforwards also was supportable by future income (i.e., not solely by the pretax income from other comprehensive income), the benefit of the valuation allowance release is allocated to continuing operations. See Paragraph 9.073 and related examples for additional discussion of intraperiod tax allocation considerations when there is a change in a valuation allowance resulting solely from a current period item not in continuing operations.

**9.067 Exceptions to the Step-by-Step Approach for Allocating Changes in the Valuation Allowance as a Result of Current Year Operations.** As discussed in Paragraph 9.065, changes in the beginning-of-year valuation allowance that result from a change in circumstances that causes a change in judgment about the realization of deferred tax assets in *future* years should be included in income tax expense from continuing operations while changes in the valuation allowance as a result of *current* year operations (e.g., changes in a valuation allowance on originating deferred tax assets or changes in a valuation allowance on deferred tax assets existing at the beginning of the year as a result of current year income or loss) generally should follow the step-by-step approach. However, ASC Topic 740 provides certain exceptions to the step-by-step approach for changes resulting from current year operations:

- The effect of a change in a valuation allowance for an acquired entity's deferred tax asset should adjust goodwill related to the acquisition if the change in the valuation allowance is within the measurement period and results from new information obtained about facts and circumstances that existed at the acquisition date. All other changes in the valuation allowance

for an acquired entity's deferred tax asset should be recognized as an adjustment to income tax expense from continuing operations. See the discussion beginning in Paragraph 6.047. ASC paragraphs 805-740-25-3 and 25-4, 45-2

- The tax benefit from releasing a valuation allowance initially established when a deferred tax asset originated from an increase or decrease in contributed capital, for example from deductible expenditures reported as a reduction of the proceeds from issuing stock (see Paragraph 9.051), should be credited to contributed capital. Paragraphs 9.070-9.071 address certain other items initially recognized as an adjustment to equity but for which backwards tracing of the valuation allowance is **not** appropriate. ASC subparagraph 740-20-45-11(c)
- The tax benefit for releasing a valuation allowance on deductible temporary differences and carryforwards as part of the application of fresh-start reporting are credited to income tax expense in the predecessor entity's final statement of operations. The post-reorganization release of a valuation allowance for pre-reorganization (i.e., reorganizations under the Bankruptcy Code) deferred tax assets and carryforwards should be reported as a reduction to income tax expense. See Section 10, *Other Considerations*, and Paragraph 9.064. ASC paragraphs 852-10-45-21 and 852-740-45-1
- The tax benefits of releasing a valuation allowance on deductible temporary differences and carryforwards that existed at the date of a quasi-reorganization are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years. See Section 10 and Paragraph 9.063. ASC subparagraph 740-20-45-11(f), ASC paragraph 852-740-45-3 and ASC paragraph 220-10-45-10B
- The effect of a change in the beginning-of-year valuation allowance that results solely from a current period item not part of continuing operations, is not allocated to continuing operations. See the discussion beginning in Paragraph 9.073. ASC paragraph 740-20-45-3

**9.068** The above exceptions apply only to the initial recognition of the tax benefits through the release of a valuation allowance that was initially established when the related deferred tax asset originated from the respective transaction. ASC paragraphs 740-10-45-20, 740-20-45-4

**9.068a Initial Recognition of a Valuation Allowance at Lease Inception.** An entity may need to recognize a valuation allowance at the inception of a lease because in any given tax year, only 80% of the taxable income generated from the reversal of the deferred tax liability associated with the right of use asset provides a source of taxable income to support realization of the deferred tax asset associated with the lease liability. We believe a valuation allowance necessary at lease inception, if any, should be recognized with a charge to income tax expense. See additional discussion beginning in Paragraph 4.144a.

**9.069 Decreases in a Valuation Allowance Due to Basis Differences Resulting from Debt Proceeds Allocated to Equity.** In some situations, as discussed in Paragraphs 9.057 and 2.103-2.109, a portion of the proceeds received upon issuance of debt is allocated to shareholders' equity, resulting in a deferred tax liability and an offsetting adjustment to equity. When the establishment of this deferred tax liability directly results in a reduction of a valuation allowance on existing deferred tax assets, the effect of that reduction in the valuation allowance generally should also be allocated to additional paid-in capital.

**9.069a - 9.069b** Not used.

**Example 9.19: Valuation Allowance Reductions Resulting from the Generation of Deferred Tax Liability When Convertible Debt with a Beneficial Conversion Feature<sup>2</sup> Is Issued and There Are Losses in Continuing Operations – Pre-2018 NOLs**

ABC Corp. has significant net operating loss carryforwards along with a related valuation allowance that reduces the net deferred taxes at the beginning and end of its fiscal year 20X0 to zero. At the beginning of 20X1, ABC issues debt with a beneficial conversion feature. The resulting accounting generates a deferred tax liability that normally would represent a source of taxable income available to realize deferred tax assets. ABC has no current tax in 20X1 due to the creation of additional net operating losses. The deferred tax assets created in 20X1 related to additional net operating losses exceed the deferred tax liability resulting from the beneficial conversion feature. The beneficial conversion feature credited to equity is the only item outside of continuing operations that affects the intraperiod tax allocation.

ABC would first compute its total income tax expense of \$0. Next, it would recognize a deferred tax asset for the originating net operating loss and a full valuation allowance (resulting in no net income tax expense or benefit) in continuing operations. It would not consider the credit to equity related to the beneficial conversion feature when determining the amount allocated to continuing operations under the step-by-step approach.

ABC would determine the amount of income tax expense to allocate directly to equity, as follows.

Total income tax expense	\$	0
Income tax benefit to continuing operations		<u>0</u>
Income tax expense to equity	\$	<u><u>0</u></u>

### **Example 9.19a: Valuation Allowance Reductions Resulting from the Generation of Deferred Tax Liability When Convertible Debt with a Beneficial Conversion Feature<sup>3</sup> Is Issued and There Are Losses in Continuing Operations – Post-2017 NOLs**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

Assume the same facts as Example 9.19, but utilization of ABC Corp's deferred tax assets will be limited to 80% of taxable income in a given year (i.e., the related net operating loss carryforwards arose in tax years beginning after December 31, 2017 – see Paragraph 4.016a for additional discussion). In this scenario, only 80% of the taxable income associated with the reversal of the deferred tax liability will support the deferred tax assets. Accordingly, ABC will have total income tax expense equal to 20% of the originating deferred tax liability and end 20X1 with a net deferred tax liability.

ABC would first compute its total income tax expense equal to 20% of the originating deferred tax liability. Next, it would recognize a deferred tax asset for the originating net operating loss and a full valuation allowance (resulting in no net income tax expense or benefit) in continuing operations. It would not consider the credit to equity related to the beneficial conversion feature when determining the amount allocated to continuing operations under the step-by-step approach.

Last, ABC would recognize an income tax expense directly in equity equal to the residual remaining after considering the total income tax expense and the income tax benefit allocated to continuing operations of zero. This results in net income tax expense allocated to equity equal to 20% of the originating deferred tax liability.

**9.070 Transactions among Shareholders.** Certain transactions among or with shareholders may change the tax basis of assets and liabilities or may restrict the use of deferred tax assets. For example, a change of control occurs when shareholders sell more than 50% of the stock of an entity within a specified period of time. Such a change of control may limit the amount of existing net operating loss carryforwards that are available to be used in future years. Other common transactions among or with shareholders that may have tax consequences include initial public offerings (see Paragraph 5.028b) or subsequent share issuances, conversion of convertible debt, major stock purchases by new investors, sales of stock by major shareholders, common control mergers (see Paragraphs 6.095-6.095a), and similar transactions. If a transaction with or among shareholders results in changes in the tax bases of assets and liabilities, the tax effect of those changes should be included in equity. If these changes in the tax bases of assets and liabilities are based on an initial estimate, a change resulting from a change in estimate should also be included in equity. If such transactions result in recognizing deferred tax assets for changes in the tax bases of assets and liabilities and it is determined at the date of the transaction that a valuation allowance is needed for those new deferred tax assets, the initial recognition of the valuation allowance should also be



recognized in equity as discussed in Paragraph 9.051. However, subsequent increases or decreases in the valuation allowance should be included in income tax expense. In addition, a transaction with or among shareholders that results in a change in an existing valuation allowance due to changes in expectations about the realization of existing deferred tax assets or a write-off of a preexisting deferred tax asset that an entity can no longer realize should be reported in income. If a transaction with or among shareholders is also part of a change in tax status, the tax effect may be included in continuing operations as discussed in Paragraph 5.028a. See Paragraph 10.147 for additional discussion. ASC paragraph 740-10-45-21 and ASC subparagraph 740-20-45-11(g)

**9.071 Other Decreases in a Valuation Allowance Initially Recognized as a Charge to Shareholders' Equity.** An initial decrease in a valuation allowance that was recognized as a charge to shareholders' equity, like other valuation allowance releases, generally should be recognized as an income tax benefit from continuing operations, unless the change in the valuation allowance is required to be traced forward under ASC subparagraphs 740-20-45-11(c) through 45-11(f) (e.g., initial releases of valuation allowances resulting from changes in contributed capital and initial release of valuation allowance for tax benefits that existed at the date of a quasi-reorganization) or such change is made in a subsequent interim period within the same fiscal year (as described in Paragraph 9.025). Changes in valuation allowances initially recorded through equity for changes in accounting principles or corrections of errors (ASC subparagraph 740-20-45-11(a)) and gains and losses in other comprehensive income (ASC subparagraph 740-20-45-11(b)) are not traced forward. Accordingly, the tax benefit from a decrease in a valuation allowance initially recognized for deferred tax assets attributed to these items not traced forward generally should be included in income from continuing operations. For example, changes in circumstances that result in a change in judgment about the realizability of a deferred tax asset for which a valuation allowance was initially established in a prior annual period through other comprehensive income for items such as unrealized losses on available-for-sale debt securities (see Paragraph 9.046) or qualifying cash flow hedging instruments (see Paragraph 9.050), pension and other postretirement benefit obligations (see Paragraph 9.045), and cumulative translation adjustments (see Paragraph 9.044) are not traced forward. However, when the change in a beginning-of-the-year valuation allowance is the result of current year operations (not the result of a change in judgment about future years' operations – see Paragraph 9.065), the step-by-step approach is applied to allocate the change. Refer also to Paragraph 9.073. ASC paragraphs 740-10-45-20, 740-20-45-4

### **Example 9.20: Release of a Valuation Allowance Initially Recognized with a Charge to Other Comprehensive Income**

At the beginning of the year, ABC Corp. has an unrealized loss on available-for-sale securities of \$1,000 and a related deferred tax asset of \$210. ABC recognized a \$210 valuation allowance when the unrealized loss was recorded and the valuation allowance was solely attributed to the unrealized loss. Accordingly, the net of tax amount in other accumulated comprehensive income is a debit of \$1,000.

During the year, ABC determined that the valuation allowance was no longer necessary as a result of a change in judgment about the realizability of the deferred tax assets in future years. The release of the valuation allowance should be recognized as an income tax benefit from continuing operations.

	Debit	Credit
Valuation allowance	210	
Deferred tax benefit (continuing operations)		210

**9.072** Not used.

**9.073 Changes Resulting Solely from a Current Period Item Not in Continuing Operations.** The intraperiod tax allocation of the tax effect of changes in the beginning-of-year valuation allowance resulting from current year operations should follow the step-by-step approach. We believe this approach allocates increases or decreases in a valuation allowance to items other than continuing operations only to the extent the event that is not part of continuing operations solely causes the change in valuation allowance. Otherwise, the change in the valuation allowance is allocated to continuing operations. Example 9.18 provides an illustration in which the change is not solely from the current period item not in continuing operations. ASC paragraph 740-20-45-3

**9.074** As a practical matter, it is often difficult for an entity to demonstrate that a change in a valuation allowance is solely related to an identifiable event recorded outside continuing operations. Those situations generally are limited to current year tax effects for income outside of continuing operations that are offset by deferred tax benefits for which a valuation allowance was recognized, and when an entity relies solely on the reversal of existing taxable temporary differences to support realization of its deferred tax assets (i.e., has a valuation allowance for the entire amount of deferred tax assets in excess of deferred tax liabilities that are available to offset those deferred tax assets). For example, if an entity has a valuation allowance for the entire amount of deferred tax assets in excess of deferred tax liabilities that are available to offset those deferred tax assets (which may be only 80% of the deferred tax liabilities for U.S. entities with post-2017 net operating loss carryforwards – see Paragraphs 4.016a and 4.016aa for additional discussion of the 80% limitation under U.S. tax law and the temporary changes under the CARES Act), a deferred tax asset or liability that results from an item recorded in equity generally would require the entity to recognize an additional valuation allowance (if the item gave rise to a deferred tax asset) or to release a valuation allowance (if the item gave rise to a deferred tax liability, assuming the proper character). In these circumstances, a portion of an overall change in the valuation allowance may be solely attributable to the item recorded in equity and therefore that portion of the change in valuation allowance should be allocated to equity in accordance with the step-by-step approach. The tax effect of the item charged or credited to shareholders' equity generally should be determined using the step-by-step approach.

**9.074a** When applying the step-by-step approach, an entity determines the tax effect from the loss from continuing operations without considering the tax effect of items outside continuing operations.

### **Example 9.21: Allocating an Increase in a Valuation Allowance to Other Comprehensive Income**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

At December 31, 20X6, ABC Corp. has deferred tax assets of \$6,000 and deferred tax liabilities of \$3,000. ABC evaluated the available sources of taxable income and concluded that a valuation allowance of \$3,600 ( $\$6,000 - (\$3,000 \times 80\%)$ ) was needed because (a) the deferred tax liabilities are the only source of taxable income to realize the deferred tax assets, and (b) on reversal, ABC expects that it will be limited to using only 80% of its reversing taxable temporary difference (see Paragraph 4.016a for additional discussion).

In 20X7, ABC had a \$20,000 loss from continuing operations. The loss resulted in an additional \$4,200 deferred tax asset. There were no changes to the amount of the deferred tax liabilities. An additional \$4,200 valuation allowance was recognized because ABC continues to be unable to identify future taxable income other than the reversal of existing taxable temporary differences.

Also in 20X7, ABC recognized an increase in its pension obligation that was not recognized as a component of net periodic pension cost and was therefore recorded in other comprehensive income under ASC Subtopic 715-20. This additional pension liability had a financial statement carrying amount of \$2,000, but no corresponding tax basis. Accordingly, a \$420 deferred tax asset was recognized for the difference between the financial statement carrying amount of the liability and the tax basis ( $\$2,000 \times 21\%$ ). A \$420 corresponding valuation allowance was also established.

ABC uses the step-by-step approach to identify the effect on the valuation allowance of the additional minimum pension liability recognized as a charge to other comprehensive income. ABC first determines that there is no overall income tax expense or benefit recognized. Next, ABC determines what the total tax benefit and valuation allowance are for continuing operations only (i.e., without the additional pension liability in this instance). For continuing operations only, the total tax benefit would be \$4,200, which would be offset by a \$4,200 increase in the valuation allowance. Because there is only one item other than continuing operations and the total tax benefit is \$4,620 offset by a \$4,620 valuation allowance, both the \$420 additional income tax benefit and corresponding valuation allowance related to the initial recognition of the additional pension obligation should be allocated to other comprehensive income.

### Example 9.22: Allocating a Decrease to a Valuation Allowance to Other Comprehensive Income

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

At December 31, 20X6, ABC Corp. had recorded a full valuation allowance to offset its deferred tax asset for its post-2017 NOL carryforward. There were no deferred tax liabilities or other sources of taxable income at December 31, 20X6.

During 20X7, ABC had no income or loss from continuing operations. Also during 20X7, ABC entered into an interest rate swap that was designated as the hedging instrument in a qualifying cash flow hedge accounted for under ASC Topic 815 such that unrealized gains/losses were included in other comprehensive income. The fair value of the swap increased significantly during 20X7 resulting in a significant deferred tax liability recorded through other comprehensive income. Based on the provisions of the tax law, the taxable income generated as a result of the reversal of this deferred tax liability would be available as a source of taxable income to realize 80% of ABC's deferred tax assets (see Paragraph 4.016a for additional discussion of the 80% limitation in the United States). Accordingly, ABC must reduce its valuation allowance in an amount equal to 80% of the deferred tax liability. There are no other sources of taxable income at December 31, 20X7.

In this situation, the reduction in the valuation allowance is not directly attributable to expectations of future taxable income from operations or other changes in circumstances, but can be identified as directly attributable to appreciation of ABC's cash flow hedging instrument arising in 20X7. Accordingly, because ABC can conclude that the decrease in the valuation allowance is solely attributable to an item recorded in other comprehensive income, the effect of the decrease in the beginning of the year valuation allowance is allocated to other comprehensive income.

Therefore, the tax effect in other comprehensive income is equal to 20% of the deferred tax liability amount in 20X7 because the tax effect associated with the increase in the fair value of the swap is offset by the deferred tax benefit equal to 80% of the deferred tax liability amount from the decrease in the valuation allowance for the deferred tax asset related to the NOL carryforward.

An entity determines the tax effect from the loss from continuing operations without considering the tax effect of items outside continuing operations.

As a result, if ABC had a loss in continuing operations in 20X7 for which no benefit was more likely than not of being realized, it would recognize:

- No net income tax expense or benefit in continuing operations, and

- An income tax expense in other comprehensive income equal to the residual remaining after considering the total income tax expense and the income tax benefit allocated to continuing operations of zero. This results in a net income tax expense equal to 20% of the originating deferred tax liability in other comprehensive income.

Paragraphs 9.027a, 9.049, and 9.066a and Examples 9.9a, 9.9b and 9.19 provide additional guidance and illustrations of intraperiod tax allocation when there is a loss in continuing operations.

### **Example 9.22a: Allocating an Increase to a Valuation Allowance to Discontinued Operations**

On September 15, 20X5, ABC Corp. a public entity, distributed all of the outstanding common stock of Spinco to its stockholders. Spinco prepared combined carve out financial statements and presented its tax provision under the separate return method. In the carve out financial statements, Spinco recorded a full valuation allowance, although historically ABC had not recorded a valuation allowance. Spinco will also need a valuation allowance in its financial statements after the separation. Beginning with the financial statements to be filed for the quarter ended September 30, 20X5, the historical financial results of Spinco will be reflected in ABC's consolidated financial statements as discontinued operations for all periods.

In connection with the spin-off, the existing deferred revenue on ABC's books was transferred to Spinco. Before the spin-off, the book and tax accounting for the deferred revenue were the same. Based on the tax code in ABC's tax jurisdiction, the transfer of the existing deferred revenue required ABC to accelerate recognition of the deferred revenue for tax purposes to just before the spin-off. Consequently, at the date of the spin-off, ABC incurred current taxes payable and generated a deferred tax asset. ABC recognized a valuation allowance for the deferred tax asset associated with deferred revenue contemporaneously with recognizing the deferred tax asset because Spinco is not more likely than not to realize the benefit of the deferred tax asset after the transfer of the deferred tax asset to Spinco. This deferred tax asset and related valuation allowance were transferred to Spinco in connection with the spin-off, and ABC retained the current tax liability.

We believe that because the deferred revenue deferred tax asset was created as a direct result of the spin-off transaction, and the valuation allowance was recognized on the initial establishment of the deferred tax asset, ABC should allocate the current tax expense, deferred tax benefit arising from recognition of the deferred tax asset, and the deferred tax expense arising from recognition of the valuation allowance to discontinued operations in its consolidated financial statements.

Example 10.41 provides an illustration of an entity that changes its judgment about the realizability of its beginning-of-year deferred tax assets as a result of a spin-off.

**9.075 Deductible Temporary Differences Replaced by a Carryforward.** The intraperiod tax allocation of tax benefits from a decrease in a valuation allowance depends on when the valuation allowance was established and for what purpose. The amount of a valuation allowance being traced forward is not affected if there is a change in the underlying asset for which the valuation allowance was initially established. For example, an operating loss or tax credit carryforward being traced forward (e.g., an operating loss carryforward resulting from deductible expenditures reported as a reduction of the proceeds from issuing capital stock) may reduce taxable income and taxes payable in a year in which new deductible temporary differences originate. The valuation allowance established for the operating loss or tax credit carryforward should continue to be traced forward until it is determined that the benefit of the new deductible temporary differences are more likely than not to be realized. In this situation, the operating loss carryforward is replaced by the originating deductible temporary difference. ASC paragraph 740-10-55-37

**9.076 Determining Which Carryforwards Are Used First (Ordering).** In some situations, entities may have net operating loss carryforwards that arose in more than one previous period. Further, the loss carryforward from each year may be composed partially of normal operating losses and tax benefits from an increase in contributed capital. Because the nature of the carryforward determines the intraperiod tax allocation of the related benefit, an entity will need a method for ordering the recognition of the benefits. Entities generally follow the provisions of the tax law for determining when a tax benefit has been realized or realizable (and if the tax law does not specify the sequence in which the carryforwards are used, a pro rata approach generally is used).

## FINANCIAL STATEMENT DISCLOSURES<sup>1</sup>

**9.077** The following list of financial statement disclosures may be used as a guide when reviewing or preparing annual income tax disclosures. This list of disclosures has been prepared as illustrative examples, may not include all required disclosures, and does not provide all disclosure alternatives. The form and extent of the disclosures will depend on the specific facts and circumstances in each situation. Other methods of disclosing the information may be acceptable.

In the separate financial statements of members of a group that files a consolidated tax return, disclosures required by ASC paragraph 740-10-50-17 should be provided. This includes entities that are not subject to tax and are disregarded by the taxing authority, but include an allocated amount of current and deferred tax expense in their separate financial statements under the election provided in ASC paragraph 740-10-30-27A. See Paragraph 10.062 for additional discussion.

**9.078** All entities should disclose the following information about accounting for income taxes.

**Tax Status and Accounting Policy Disclosures** (see Paragraph 9.080 for additional discussion)

- Accounting policy for accounting for income taxes. ASC paragraph 235-10-50-1
- Accounting policy for releasing residual income tax effects from accumulated other comprehensive income. ASC paragraph 220-10-50-1
- Accounting policy related to taxes on GILTI inclusions. FASB Staff Q&A: Topic 740, No. 5
- The amount of investment tax credits and related accounting policy. ASC paragraph 740-10-50-20

**Statement of Financial Position Related Disclosures**

- Components of the net deferred tax asset or liability. ASC paragraph 740-10-50-2
  - Total deferred tax liabilities,
  - Total deferred tax assets (before the valuation allowance), and
  - The total valuation allowance recognized for deferred tax assets.
- We believe entities should disclose facts and circumstances supporting the realizability of deferred tax assets, including:
  - Amount of taxable income and periods over which it must be earned to allow for realization of the deferred tax asset.
  - Actual levels of past taxable income.
  - Reasons for significant differences between actual levels of past taxable income and pretax book income.
  - Known trends, events, or transactions that are expected to affect future levels of taxable income.
  - An explicit statement by the entity that it believes that it is more likely than not to generate sufficient taxable income to realize the deferred tax assets.
- The amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes. ASC paragraph 740-10-50-3
- The portion of the valuation allowance for deferred tax assets (including operating losses and tax credit carryforwards) for which subsequently recognized tax benefits would be applied directly to contributed capital. ASC paragraph 740-10-50-3
- If a change in an entity's tax status becomes effective after year-end but before the financial statements are issued (or available to be issued), disclose the

change in the entity's tax status and the effects of that change, if material.  
ASC paragraph 740-10-50-4

- The types of temporary differences and carryforwards that give rise to significant portions of the entity's deferred tax assets (before any valuation allowance) and liabilities. ASC paragraphs 740-10-50-6 and 50-8

### Income Statement Related Disclosures

- The amounts of income tax expense or benefit allocated to the following: (see Paragraph 9.083 for additional discussion) ASC paragraphs 740-10-50-10 and 740-20-45-2, ASC paragraph 220-10-45-12 to 45-14A and 50-4 to 50-6
  - Continuing operations,
  - Discontinued operations,
  - Each component of other comprehensive income, including reclassification adjustments, and
  - Items charged or credited directly to shareholders' equity.
- Significant components of income tax expense or benefit attributed to continuing operations, including: (see Paragraph 9.084 for additional discussion) ASC paragraph 740-10-50-9
  - Current tax expense or benefit,
  - Deferred tax expense or benefit, excluding the effects of other components below,
  - Investment tax credits,
  - Government grants recognized as a reduction of income tax expense,
  - Benefits of operating loss carryforwards,
  - Tax expense that results from allocating certain tax benefits directly to contributed capital,
  - Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in tax status, and
  - Effects of adjustment to the beginning-of-the-year valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the deferred tax asset in future years.
- After the adoption of ASU 2023-09, income (or loss) from continuing operations before income tax expense (or benefit) disaggregated between domestic and foreign. See Paragraph 9.085a for additional discussion. ASC paragraph 740-10-50-10A
- After the adoption of ASU 2023-09, income tax expense (or benefit) from continuing operations disaggregated by domestic federal, domestic state, and



foreign. See Paragraph 9.085a for additional discussion. ASC paragraph 740-10-50-10B

- Before the adoption of ASU 2023-09, the nature of significant differences between the reported amount of income tax expense attributable to continuing operations and the expected amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. For a discussion of the rate reconciliation information required by non-PBEs after the adoption of ASU 2023-09, see Paragraph 9.090y. ASC paragraph 740-10-50-13
- The net change during the year in the total valuation allowance. ASC paragraph 740-10-50-2
- The nature and effect of any other significant matter affecting the comparability of the information for all periods presented. ASC paragraph 740-10-50-14
- The nature and financial effects of each event or transaction that is unusual or infrequently occurring, including income tax only unusual or infrequently occurring items. ASC paragraph 740-10-50-14

**Unrecognized Tax Benefit Related Disclosures** (see Paragraph 9.097-9.109 for additional discussion)

- Information on income tax uncertainties:
  - The accounting policy on classification of interest and penalties. ASC paragraph 740-10-50-19
  - The total amounts of interest and penalties recognized in the statement of operations. ASC subparagraph 740-10-50-15(c)€
  - The total amounts of interest and penalties recognized in the statement of financial position. ASC subparagraph 740-10-50-15(c)
  - Before the adoption of ASU 2023-09, for positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date: ASC subparagraph 740-10-50-15(d)
    - The nature of the uncertainty.
    - The nature of the event that could occur in the next 12 months that would cause the change.
    - An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.
  - A description of tax years that remain subject to examination by major tax jurisdictions. ASC subparagraph 740-10-50-15(e)

**Statement of Cash Flows Related Disclosures** (see Paragraph 9.110-9.112 for additional discussion)

- Before the adoption of ASU 2023-09, total income taxes paid. ASC paragraphs 230-10-45-25 and 50-2
- After the adoption of ASU 2023-09, income taxes paid (net of refunds received) disaggregated by domestic federal, domestic state, and foreign. ASC paragraph 740-10-50-22
- After the adoption of ASU 2023-09, income taxes paid (net of refunds received) to each individual jurisdiction in which income taxes paid (net of refunds received) is equal to or greater than 5 percent of total income taxes paid (net of refunds received). ASC paragraph 740-10-50-23

**Undistributed Earnings of Subsidiaries and Corporate Joint Ventures** (see Paragraph 9.095-9.096 for additional discussion)

- The following information whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures as discussed in Paragraph 9.095, Sections 2, *Temporary Differences*, and 7, *Foreign Operations*. ASC paragraph 740-30-50-2
  - Description of the types of temporary differences for which a deferred tax liability has not been recognized.
  - The types of events that would cause those temporary differences to become taxable.
  - Before the adoption of ASU 2023-09, cumulative amount of each type of temporary difference.
  - Amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable.
  - The amount of the deferred tax liability for temporary differences other than those in the item above (i.e., undistributed domestic earnings) that is not recognized in accordance with the provisions of ASC paragraph 740-30-25-18.

**Entities with Separately Issued Financial Statements That Are Members of a Consolidated Tax Return**

- In the separate financial statements of an entity that is part of a group that files a consolidated tax return, include the following. ASC paragraph 740-10-50-17
  - If an entity is both not subject to tax and disregarded by the taxing authority and has elected to recognize an allocated amount of consolidated

income taxes in its financial statements under the election provided in ASC paragraph 740-10-30-27A, the entity shall disclose that fact (see Paragraph 10.043 for additional discussion).

- Disclosure of the amount of current and deferred tax expense for each statement of earnings presented.
- Disclosure of tax-related receivables from or payables to affiliates for each statement of financial position.
- Disclosure of the principal provisions of the method of allocating taxes to members of the group and the effect of any changes in that method.

### Other Disclosures

- The total amount of goodwill that is deductible for tax purposes for each business combination that occurs during the reporting period. ASC subparagraph 805-30-50-1(d)
- For each year for which an income statement is presented, the total compensation cost as well as the total recognized tax benefit related thereto. ASC subparagraph 718-10-50-2(h)(1)(i)
- If not separately disclosed elsewhere, the tax benefit from stock options exercised during the annual period. ASC subparagraph 718-10-50-2A(a)
- Prior to the adoption of ASU 2023-02, investors in qualified affordable housing projects should provide information so that users understand the nature of the investments and the effect of the measurement of its investments and related tax credits on the entity's financial position and results of operations. In meeting those principles, the investor may consider disclosing:
  - The amount of affordable housing tax credits and other tax benefits recognized during the year;
  - The balance of the investment on the balance sheet;
  - If applying the proportional amortization method, the amount recognized as a component of income tax expense;
  - If applying the equity method, the amount of investment income or loss included in pretax income;
  - Any commitments or contingent commitments (e.g., guarantees or commitments to provide capital contributions), including the amount of equity contributions that are contingent commitments related to qualified affordable housing project investments and the year (or years) in which contingent commitments are expected to be paid; and
  - The amount and nature of impairment losses during the year resulting in forfeiture or ineligibility of tax credits or other circumstances. ASC paragraphs 323-740-50-1 and 50-2

- After the adoption of ASU 2023-02, a disclosure objective and certain disclosure requirements apply to all equity investments generating tax credits from tax credit programs for which the proportional amortization method is elected (regardless of whether the investment meets the proportional amortization method qualifying criteria). Disclosures include:
  - Required disclosures when the PAM is elected, regardless of whether it is applied
    - The amount of income tax credits and other income tax benefits recognized during the period, including the line item in the income statement and statement of cash flows in which they have been recognized.
    - The balance of the tax equity investments and the line item in which they are recognized on the balance sheet.
  - Required disclosures when the PAM is both elected and applied
    - The amount of investment amortization recognized as a component of income tax expense (benefit).
    - The amount of non-income-tax-related activity and other returns received that are recognized outside of income tax expense (benefit) and the line item in the income statement and statement of cash flows in which they have been recognized.
    - Significant modifications or events that resulted in a change in the nature of the tax equity investment or a change in the relationship with the underlying project.
  - Additional disclosures to consider in satisfying the disclosure objectives when the Pam is elected include
    - For tax equity investments accounted for using the equity method, the amount of investment income or loss included in pretax income.
    - Information about commitments or contingent commitments, including the amount of delayed equity contributions, and the year or years in which contingent commitments are expected to be paid.
    - The nature and amount of impairment losses recognized during the years, including whether they resulted from the forfeiture or ineligibility of income tax credits.
- See KPMG Handbook: *Tax credits* chapter 7 for further discussion on disclosure requirements after the adoption of ASU 2023-02.
- Entities that are subject to an additional tax on the distribution of earnings and that have an accounting policy to not recognize that until dividends are declared should disclose:

- A statement that if dividends are distributed, the entity will have to pay additional taxes at a rate of X% on all distributions, and that this amount will be recorded as an income tax expense in the period the entity declares the dividends;
- A statement of when the additional taxes will be owed to the government;
- The amount of retained earnings that if distributed would be subject to the tax;
- The amount of tax that would be owed if the entity distributed all of the retained earnings that would be subject to the tax; and
- If dividends were declared and additional tax provision recorded during the year an income statement is presented, this item would need to be separately presented in the effective rate reconciliation. That is, the materiality criteria in Rule 4-08(h) of Regulation S-X would not be applied to justify combining with other items.

Refer to Paragraph 3.087c for additional information.

- Disclosure regarding an estimate shall be made when known information available before the financial statements are issued or are available to be issued indicates it is at least reasonably possible that the estimate of the effect on the financial statements will change in the near term and the effect of the change would be material. Refer to Paragraph 9.113-9.114 for additional information. ASC paragraphs 740-10-50-21 and 275-10-50-8

**9.079 Additional Disclosures by Public Entities<sup>4</sup>.** Before the adoption of ASU 2023-09, entities that meet the definition of a public entity in ASC Topic 740 and that must provide disclosures under Regulation S-X are required to disclose the following information about their accounting for income taxes in addition to the preceding list of disclosures. As a reminder, there may be situations in which an entity is not a public entity as defined in ASC Topic 740 but is subject to the disclosure requirements in Regulation S-X – e.g., an entity whose financial statements are filed pursuant to Rule 3-09 as a significant equity method investee or Rule 3-05 as a significant acquiree in a business combination. Likewise, there are some entities that are public entities for ASC Topic 740 but are not subject to the disclosure requirements in Regulation S-X – e.g., smaller reporting companies filing on domestic forms.

After adoption of ASU 2023-09, entities that meet the definition of a PBE must disclose the following information about their accounting for income taxes in addition to the preceding list of disclosures.

### Statement of Financial Position Related Disclosures

- The tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax assets (before valuation allowance) or liabilities. ASC paragraph 740-10-50-6

- To the extent a benefit is recognized for significant effects of tax-planning strategies, and the benefit is in deferred taxes, significant amounts should be disclosed. SEC-2002 AICPA National Conference on Current SEC Developments; SEC Speech by Doug Alkema
- SEC filers are encouraged to disclose assumptions leading to the conclusion that deferred tax assets would be realized, such as:
  - Minimum amount of future taxable income that is needed to realize the deferred tax asset and whether the existing levels of pretax earnings for financial statement reporting purposes are sufficient to generate that minimum amount of future taxable income.
  - If existing levels of pretax earnings for financial reporting purposes are not sufficient to generate the minimum amount of income to support the realization of deferred tax assets, a discussion of the extent of future increase in profitability that is necessary to realize the deferred tax asset (quantified to the extent possible) and the significant assumptions relied upon by management in concluding that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the deferred tax asset (e.g., anticipated improvements in profitability resulting from gross margins, additional store openings, cost reduction programs, and corporate restructurings).
  - The historical relationship between pretax earnings for financial reporting purposes and taxable income including a discussion of the nature and amount of material differences between such amounts. A table reconciling pretax financial statement income to taxable income for each of the years for which financial statements are presented has been used to accomplish this objective.
  - A discussion of tax-planning strategies that would be available to generate future taxable income if the registrant were unable to generate sufficient taxable income from ordinary and recurring operations.
  - The annual amounts of net operating loss carryforwards for income tax purposes that expire each year.
  - If significant objective negative evidence indicates uncertainty about realization of the deferred tax assets, the countervailing positive evidence relied on by management in its decision not to establish a full valuation allowance against deferred tax assets should be identified.

### **Income Statement Related Disclosures**

- Before the adoption of ASU 2023-09, a reconciliation (using percentages or dollar amounts) between the reported amount of income tax expense attributable to continuing operations and the expected amount of income tax expense that would result from applying domestic federal statutory rates to pretax income from continuing operations. When the rate used by a reporting

entity is other than the U.S. federal rate, the rate used and the basis for using such rate is disclosed. To the extent a benefit is realized for significant effects of tax-planning strategies, the reduction in the effective tax rate, if significant, should be disclosed in the reconciliation. For a discussion of the rate reconciliation before the adoption of ASU 2023-09, see Paragraphs 9.086-9.090. SEC Regulation S-X Section 210.4-08(h)(2), ASC paragraph 740-10-50-12, SEC-2002 AICPA National Conference on Current SEC Developments; SEC Speech by Doug Alkema

- After the adoption of ASU 2023-09, a reconciliation (using percentages and dollar amounts) between the reported amount of income tax expense attributable to continuing operations and the expected amount of income tax expense. For a discussion of the rate reconciliation after the adoption of ASU 2023-09, see Paragraphs 9.090a-9.090y. ASC paragraphs 740-10-50-11 through 50-12C
- The domestic and foreign components of pretax income (loss). See Paragraph 9.085 for additional discussion. SEC Regulation S-X Section 210.4-08(h)(1)
- The amounts applicable to U.S. federal income taxes, foreign income taxes, and other income taxes disclosed separately for each major component of income tax expense (e.g., current and deferred). Amounts that apply to foreign income (loss) or to foreign or other income taxes that are less than 5% of the total of income before taxes or the component of tax expense, respectively, need not be separately disclosed. See Paragraph 9.085 for additional discussion. SEC Regulation S-X Section 210.4-08(h)(1)
- Where foreign pretax earnings are significant, the SEC Staff has recommended that registrants disclose:
  - A description of what is included in the foreign earnings line of the rate reconciliation;
  - The material jurisdictions that are included in the foreign earnings, and for those jurisdictions, registrants should consider disclosing (a) the pre-tax earnings, (b) the statutory and effective tax rates, and (c) material reconciling items between the statutory and effective tax rates; and
  - Trends, uncertainties, and expectations associated with the specific jurisdictions in which the entity operates.
- The aggregate dollar and per-share effects of a tax holiday and a description of the factual circumstances of the tax holiday, including the date on which the tax circumstances terminate. SEC Staff Accounting Bulletin Topic 11C
- A rollforward of the balance of the valuation allowance for each period for which an income statement is presented. Rule 5-04 of Regulation S-X
- For public entities as defined in ASC Topic 280, the amount of income tax expense for each reportable segment, but only if such are included in the measure of segment profit or loss reviewed by the chief operating decision

maker or are otherwise regularly provided to the chief operating decision maker. ASC subparagraph 280-10-50-22(h)

**Unrecognized Tax Benefit Related Disclosures** (see Paragraph 9.097-9.109 for additional discussion)

- Information on income tax uncertainties:
  - An annual tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum: ASC subparagraph 740-10-50-15A(a)
    - The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.
    - The gross amounts of increases in unrecognized tax benefits as a result of tax positions taken during the current period. See Paragraph 9.100 for discussion of the disclosure of decreases related to current period positions.
    - The amounts of decreases in the unrecognized tax benefits related to settlements with taxing authorities.
    - Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.
  - The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. ASC subparagraph 740-10-50-15A(b)
- The SEC staff generally expects a registrant that asserts that the earnings of its foreign operations will be indefinitely reinvested to disclose the tax effects of those foreign operations.

**Other Disclosures**

- If the entity is not subject to income taxes directly (such as partnerships), the net difference between financial statement carrying amounts of assets and liabilities and their tax bases. See Paragraph 5.029 for additional information required for such an entity converting to a C Corporation. ASC paragraph 740-10-50-16

The SEC staff also has requested registrants to disclose in MD&A: (1) the amount of cash and short-term investments related to foreign operations that management asserted was indefinitely reinvested, (2) a statement that the entity would need to accrue and pay taxes, if repatriated, and (3) a statement that the entity does not intend to repatriate funds, if true. The SEC staff is particularly concerned when a registrant may appear to have significant liquid assets, but asserts that a substantial portion of those liquid assets are not available to the entity without triggering tax implications. The staff has noted situations whereby entities derive a significant portion of their earnings from countries with low income tax rates that may not be sustainable because of fiscal imbalances in the country. In these situations, disaggregated disclosure related to operations in that country may be



appropriate, including disclosure of the portion of earnings attributable to that foreign operation.

**9.080 Tax Status and Accounting Policy Disclosures.** Accounting policy disclosure generally should describe the entity's income tax status and the method used to determine income tax expense or benefit and related balance sheet accounts. A summary of accounting policies may include the following:

- If an entity is both not subject to tax and disregarded by the taxing authority and has elected to recognize an allocated amount of consolidated income taxes in its financial statements under the election provided in ASC paragraph 740-10-30-27A, the entity shall disclose that fact (see Paragraph 10.043 for additional discussion).
- Method used to allocate income taxes if the entity is a member of a consolidated group (separate return method or pro rata method). See Paragraph 10.043 for additional discussion.
- Method used to recognize the income tax benefit from investment tax credits (flow-through method or deferral method). See section 4.3.30 in KPMG Handbook, *Income Tax Credits*, for additional discussion.

**9.081** In addition, the accounting policy disclosures should include a summary of the entity's tax status, including if the entity is tax-exempt (as required by ASC paragraph 954-740-50-1 for health care entities) or a common interest realty association (as required by ASC paragraph 972-740-50-1). This summary should identify if the entity is not subject to income taxes directly, which is a required disclosure for public entities before the adoption of ASU 2023-09 (PBEs after the adoption of ASU 2023-09). All entities are also required to disclose their policy for classifying interest and penalties related to income taxes, the method followed for accounting for investment tax credits, accounting for GILTI (see Paragraph 2.037d) and releasing residual income tax effects (see Paragraph 9.032). ASC paragraphs 740-10-50-16, 50-19, 50-20, FASB Staff Q&A: Topic 740, No. 5, and ASC paragraph 220-10-50-1

### Example 9.23: Accounting Policy Disclosure for a Taxable Entity

ABC Corp. accounts for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and for operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax laws and rates expected to apply to taxable income in the years in which the deferred tax assets or liabilities are expected to be realized or settled. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized.

ABC recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

ABC records interest related to income taxes in interest expense and penalties in operating expenses.

ABC accounts for residual income tax effects in accumulated other comprehensive income using the portfolio method and releases those residual amounts only when the entire portfolio of related assets or liabilities is liquidated.

ABC uses the deferral method of accounting for investment tax credits. Under this accounting policy, the benefit of investment tax credits is deferred and presented as deferred income. The deferred income is subsequently recognized as income tax expense (benefit) over the same period during which the related assets, which gave rise to the tax credits, are depreciated.

### **Example 9.24: Tax Status Disclosure for a REIT**

ABC Corp. qualifies as a REIT under sections 856 through 860 of the Internal Revenue Code of 1986, as amended. In general, entities that meet certain organizational and operational requirements and distribute at least 90% of their REIT taxable income to their shareholders in a taxable year will not be subject to income tax on the income they distribute. ABC has met the requirements for REIT status in all prior years and believes it will continue to qualify as a REIT and, accordingly, no liability has been recognized for income taxes, except for current and deferred taxes on certain property sales and on income of its taxable REIT subsidiaries.

### **Example 9.25: Tax Status Disclosure for a Partnership**

ABC Partners does not recognize federal income taxes because the partners are responsible for the tax on their share of the taxable income or loss and are entitled to any available tax credits on their income tax returns. In the event we are audited by the taxing authority and assessed additional amounts due to the underpayment of tax in previous tax years, we intend to make the push-out election allowed by Treasury. That election allows us to notify our partners of their share of imputed underpayment amounts for inclusion in their current tax returns.

**9.082 Components of the Net Deferred Tax Asset or Liability.** Public entities (before the adoption of ASU 2023-09 or PBEs after the adoption of ASU 2023-09) are required to disclose the tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax amounts. Nonpublic entities can omit the disclosure of amounts but should disclose the types of temporary differences and carryforwards that give rise to the significant components of deferred taxes. We believe temporary differences should generally be disclosed based on the related balance sheet caption. We believe a temporary difference is related to an asset or liability if reduction of the asset or liability causes the temporary difference to reverse. A reduction of an asset includes amortization, sale, or other realization of the asset. A reduction of a liability includes amortization (accretion), payment, or other satisfaction of the liability. An entity would make separate determinations whether a caption results in a deferred tax asset or a deferred tax liability for each tax-paying component. All entities are required to disclose total deferred tax assets before valuation allowance, total valuation allowance, and total deferred tax liabilities. ASC paragraphs 740-10-50-2, 50-6 and 50-8

**9.082a Disclosing Deferred Tax Assets and Liabilities for Lease Assets and Liabilities.** ASC 842 requires lessees to recognize most leases, including operating leases, on-balance sheet by recognizing a right-of-use asset and lease liability. Because the right-of-use asset and lease liability will often not have tax bases in many jurisdictions, the lessee also will need to recognize a deferred tax liability and deferred tax asset, respectively. The balance of the right-of-use asset (and the related deferred tax liability) may be almost equal to, but opposite of, the balance of the lease liability (and the related deferred tax asset) at the inception of the lease, and in some cases, throughout the lease term. However, consistent with disclosing temporary differences based on the related balance sheet captions, we believe that the right-of-use asset and lease liability give rise to two separate temporary differences when disclosing the types of temporary differences that give rise to a significant portion of deferred tax amounts as discussed in Paragraph 9.082. We believe an entity may not combine the deferred tax liability (for the right-of-use asset) and the deferred tax asset (for the lease liability) related to a single lease (or a portfolio of leases) for purposes of the tabular disclosure, even if those amounts must be combined for balance sheet presentation (see Paragraph 9.002).

**9.082b SEC Staff Accounting Bulletin (SAB) No. 121.** SAB 121 reflects SEC staff interpretive guidance about how entities (SEC registrants) should account for an obligation to ‘safeguard’ digital assets. It also outlines disclosures the SEC staff expects entities with these obligations to provide in their SEC filings. The SAB 121 digital asset safeguarding obligation liability and corresponding asset affect an entity’s deferred tax accounting. We believe the recognition of safeguarding obligation liabilities and related safeguarding assets requires entities to recognize deferred tax assets and deferred tax liabilities. We further believe that these deferred tax assets and liabilities should be disclosed on a gross basis for the reasons generally consistent with why deferred tax assets and liabilities arising from lease liabilities and right-of-use assets are presented on a gross basis as discussed in paragraph 9.082a.

**Example 9.26: Net Deferred Tax Assets and Liabilities Disclosure for a PBE (See discussion in Paragraph 9.079)<sup>4</sup>**

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 20X7 and 20X6 are presented below.

	20X7	20X6
Deferred tax assets		
Allowance for doubtful accounts	\$ 2,800	\$ 1,750
Inventories	3,100	2,500
Compensated absences liability	1,200	1,300
Net operating loss carryforwards	700	1,400
Operating lease liabilities	200	400
Pension plan liability	100	30
Available-for-sale debt securities	475	420
Derivative liabilities	390	25
Other	105	5
Total deferred tax assets	<u>9,070</u>	<u>7,830</u>
Less valuation allowance	<u>(85)</u>	<u>(20)</u>
Deferred tax assets, net of valuation allowance	<u>\$ 8,985</u>	<u>\$ 7,810</u>
Deferred tax liabilities		
Plant and equipment	\$ 14,000	\$ 11,100
Investment in affiliated entities	700	480
Right-of-use assets	250	420
Other	50	—
Total deferred tax liabilities	<u>15,000</u>	<u>12,000</u>
Net deferred tax liability	<u>\$ 6,015</u>	<u>\$ 4,190</u>

**9.083 Amounts of Allocated Income Tax Expense or Benefit.** Entities should disclose the amounts of income tax expense or benefit allocated to continuing operations; discontinued operations; each component of other comprehensive income, including reclassification adjustments; and items charged or credited directly to shareholders' equity for each year for which those items are presented. The disclosure may be presented either in the notes or on the face of the financial statements. The following example presents the amounts of income tax expense or benefit in the notes to the financial statements. ASC paragraph 740-10-50-10, ASC paragraph 220-10-45-12 and 50-4

**Example 9.27: Summary of Income Tax Expense Amounts Disclosure**

Total income tax expense for the years ended December 31, 20X7, 20X6, and 20X5 was allocated as follows:

	20X7	20X6	20X5
Income from continuing operations	\$ 3,185	\$ 2,397	\$ 1,909
Cumulative effect of a change in accounting principle	—	—	60
Other comprehensive income, for liability for pension plans recognized for financial reporting purposes	(70)	(120)	—
Other comprehensive income, for unrealized holding loss on debt securities recognized for financial reporting purposes	(55)	(25)	(10)
	<u>\$ 3,060</u>	<u>\$ 2,252</u>	<u>\$ 1,859</u>

**Example 9.28: Determining the Disclosure of Income Taxes Allocated to the Cumulative Translation Adjustment**

ABC Corp. has a foreign subsidiary, DEF Corp., that owns land with a deferred tax liability of FC100. DEF uses FC as its functional currency for U.S. GAAP reporting and as its tax reporting currency. ABC has a U.S. dollar functional currency and the group uses the U.S. dollar as the reporting currency.

At the beginning of the year the exchange rate is 1 to 1. Accordingly, the deferred tax liability is \$100. At the end of the year the exchange rate is 1 to 1.2. Accordingly, the deferred tax liability is \$120 at year-end. The increase of \$20 is included in the translation adjustment component of other comprehensive income.

Separately, ABC has a loan to DEF that is of a long-term investment nature and is denominated in FC. ABC has \$10 of foreign currency transaction gain associated with the loan that is allocated to the translation adjustment component of other comprehensive income and \$2 of related income tax expense (that also gets allocated to the translation adjustment component of other comprehensive income in performing the intraperiod tax allocation).

ABC should disclose only the \$2 of income tax expense resulting from the foreign currency transaction gain on the intra-entity loan as the amount of income tax expense

allocated to other comprehensive income because it is the only amount *allocated* under the intraperiod tax allocation approach. The \$20 related to the translation of the deferred tax liability is an additional translation adjustment, not part of total income tax expense that is allocated using intraperiod tax allocation. Accordingly, ABC would exclude the \$20 from the disclosure of income taxes allocated to translation adjustments.

**9.084 Pretax Income (Loss) and Income Tax Expense (Benefit) Allocated to Continuing Operations.** Entities are required to disclose the significant components of income tax expense or benefit allocated to continuing operations, such as current tax expense or benefit, deferred tax expense or benefit, investment tax credits, government grants, the benefits of operating loss carryforwards, expense resulting from the allocation of benefits directly to contributed capital, the effect of changes in tax law, rates or status, and changes in judgment about the need for a valuation allowance. There are a number of ways to satisfy this disclosure requirement, including a table of components income tax expense, line items in the rate reconciliation and by inclusion in a narrative in sentence form; however, we would generally expect a separation of current tax expense from deferred tax expense to be included in a tabular format. ASC paragraph 740-10-50-9

**9.085** Entities subject to Regulation S-X disclosures are required to disclose the components of pretax income (loss) as either foreign or domestic and further disclose amounts applicable to U.S. federal income taxes, foreign income taxes, and other income taxes separately for each major component. We believe income tax expense amounts should be classified based on which taxing authority the tax is paid to. For example, withholding paid to a foreign taxing authority would be classified as foreign. The SEC disclosure rule defines foreign income (loss) as “income (loss) generated from a registrant’s foreign operations, i.e., operations that are located outside of the registrant’s home country.” An entity may have difficulty identifying foreign income (loss). If so, the entity generally should assume that income taxed by a foreign jurisdiction is foreign income. SEC Regulation S-X Section 210.4-08(h)(1)

**9.085a** After the adoption of ASU 2023-09, all entities are required to disclose the following amounts for each annual reporting period presented: ASC paragraphs 740-10-50-10A and 50-10B

- pretax income (loss) from continuing operations, broken out between domestic and foreign; and
- income tax expense (benefit) from continuing operations, broken out between domestic federal, domestic state and foreign.

This disclosure provides similar, but not identical, information to that required by SEC regulations regardless of the adoption status of ASU 2023-09. SEC Regulation S-X Section 210.4-08(h)(1)

### Example 9.29: Significant Components of Income Tax Expense or Benefit Allocated to Continuing Operations Disclosure

For the years ended December 31, 20X7, 20X6, and 20X5, income from continuing operations before taxes of the Company, consists of the following:

	20X7	20X6	20X5
U.S. operations	\$ 8,095	\$ 7,405	\$ 4,046
Foreign operations	405	395	734
	<u>\$ 8,500</u>	<u>\$ 7,800</u>	<u>\$ 4,780</u>

Income tax expense attributable to income from continuing operations consists of:

	Current	Deferred	Total
Year ended December 31, 20X7:			
U.S. federal	\$ 1,065	\$ 2,615	\$ 3,680
Foreign	104	50	154
State and local	16	170	186
	<u>\$ 1,185</u>	<u>\$ 2,835</u>	<u>\$ 4,020</u>
Year ended December 31, 20X6:			
U.S. federal	\$ 520	\$ 1,550	\$ 2,070
Foreign	18	132	150
State and local	59	103	162
	<u>\$ 597</u>	<u>\$ 1,785</u>	<u>\$ 2,382</u>
Year ended December 31, 20X5:			
U.S. federal	\$ 1,337	\$ 190	\$ 1,527
Foreign	277	2	279
State and local	57	46	103
	<u>\$ 1,671</u>	<u>\$ 238</u>	<u>\$ 1,909</u>

The significant components of deferred tax expense attributable to income from continuing operations for the years ended December 31, 20X7, 20X6, and 20X5 are as follows:

	20X7	20X6	20X5
Deferred tax expense (exclusive of the effects of other components listed below)	\$ 1,935	\$ 2,235	\$ 238
Adjustments to deferred tax assets and liabilities for enacted changes in tax laws and rates	835	—	—
Increase (decrease) in beginning-of-the-year balance of the valuation allowance for deferred tax assets	65	(450)	—
	<u>\$ 2,835</u>	<u>\$ 1,785</u>	<u>\$ 238</u>

In December 2017 the U.S. government enacted comprehensive tax legislation, commonly referred to as the Tax Cuts and Jobs Act (the Act), which significantly revises the ongoing U.S. corporate income tax law by lowering the U.S. federal corporate income tax rate from 35% to 21%, implementing a hybrid territorial tax system, imposing a one-time tax on foreign unremitted earnings and setting limitations on deductibility of certain costs (e.g., interest expense and executive compensation), among other things.

The primary impacts of the Act relate to the corporate rate change, the accrual of the one-time tax on foreign unremitted earnings (the transition tax) and changes to the valuation allowance. The Company recognized approximately \$1.0 million of additional income tax expense associated with the rate change and \$0.5 million of additional income tax expense related to the one-time transition tax on certain foreign earnings, including the reversal of deferred tax assets resulting from the utilization of foreign tax credit carryforwards.

In addition, the Company has alternative minimum tax credit carryforwards of approximately \$0.7 million, which are available to reduce future Federal regular income taxes, and, under the Act, are refundable through 2020. The Company released the valuation allowance on the existing deferred tax asset for those carryforwards and recharacterized it as a receivable.

**9.086 Differences between Expected and Actual Tax Expense (Before the Adoption of ASU 2023-09).** Public entities are required to disclose a reconciliation (in percentages or dollar amounts) of the expected income tax expense attributable to continuing operations (amount of income tax expense that would result from multiplying pretax income from continuing operations by the federal statutory income tax rate or the income tax rate in the reporting entity's country of domicile if the reporting entity is foreign – see Paragraph 9.090) to the reported amount of income tax expense allocated to continuing operations. The tax effect of reconciling items is generally measured based on the tax rate



of the entity where the item occurs, not the tax rate used in determining expected tax. If no individual reconciling item amounts to more than 5% of the amount computed by multiplying the income before tax by the applicable statutory federal income tax rate, and the total difference to be reconciled is less than 5% of the computed amount, no reconciliation is required unless it would be significant in understanding the trend of earnings. Reconciling items that are individually less than 5% of the computed amount may be aggregated in the reconciliation. Nonpublic entities are not required to present a numerical reconciliation, but they must disclose the nature of significant reconciling items. Examples of individual reconciling items that are generally not combined include: SEC Regulation S-X Section 210.4-08(h)(1) and ASC paragraphs 740-10-50-12 through 50-14

- Changes in the amount of the valuation allowance
- Changes in recognition or measurement of tax positions
- Nondeductible expenses for tax purposes (e.g., excess compensation, penalties)
- Nontaxable income (e.g., interest on tax-exempt bonds)
- Tax credits and government grants
- Changes in tax laws, rates, or status (including changes in the estimated applicable enacted tax rate used to measure deferred taxes)
- State and local income taxes
- Income tax resulting from alternative minimum tax regimes that don't result in an offsetting credit carryforward – e.g., the base-erosion and anti-abuse tax (BEAT)
- Rate differential on income tax incurred in other jurisdictions
- Rate differential on domestic income tax incurred on foreign earnings – e.g., global intangible low-taxed income (GILTI, see Paragraph 7.087a for additional discussion), Subpart F income (see Paragraph 7.077).

**9.087** With respect to the income tax rate reconciliation disclosure, the SEC Staff has recommended that registrants:

- Clearly label items within the rate reconciliation and disclose the underlying nature of material reconciling items,
- Disclose each material foreign jurisdiction, its associated tax rate, and the amount of tax when there are material reconciling items,
- Do not aggregate or offset material reconciling items,
- Ensure consistency of reconciling items disclosed in the rate reconciliation with amounts reported elsewhere in the filing, and

- Evaluate whether adjustments presented as changes in estimates are better characterized as an error (e.g., a significant rate adjustment resulting from comparing the income tax return to the income tax provision).

**9.088** Generally, entities use the statutory rate to compute expected tax expense and include as a reconciling item the effect of the graduated rate system, if any. If another appropriate method is used to determine the expected rate (or the expected income tax expense) that method should be consistently applied and disclosed. The following example uses 21% for all years presented.

**Example 9.30: Reconciliation of Expected to Actual Income Tax Expense Disclosure (Before the Adoption of ASU 2023-09)**

Income tax expense attributable to income from continuing operations was \$3,185, \$2,397, and \$1,909 for the years ended December 31, 20X7, 20X6, and 20X5, respectively, and differed from the amounts computed by applying the statutory U.S. federal income tax rate of 21% to pretax income from continuing operations as a result of the following:

	<b>20X7</b>	<b>20X6</b>	<b>20X5</b>
Computed <i>expected</i> tax expense	\$ 2,975	\$ 2,730	\$ 1,673
Increase (reduction) in income taxes resulting from:			
Change in the beginning-of-the-year balance of the valuation allowance for deferred tax assets allocated to income tax expense	65	(450)	—
Change in recognition and measurement of tax positions	15	(20)	10
Adjustment to deferred tax assets and liabilities for enacted changes in tax laws and rates	15	—	—
Equity in earnings of affiliates subject to reduced taxation because of dividends received deduction for tax purposes	(31)	(10)	—
State and local income taxes, net of federal income tax benefit	121	105	67
Foreign tax rate differential	50	27	128
Other, net	(25)	15	31
	<u>\$ 3,185</u>	<u>\$ 2,397</u>	<u>\$ 1,909</u>

**9.088a - 9.088b** Not used.

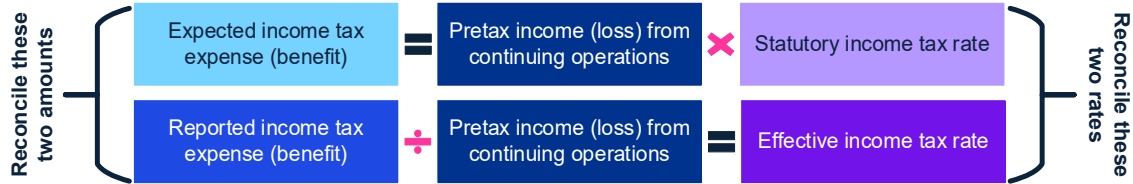
**9.088c Presentation of the Rate Reconciliation for Pass-through Entities.** In U.S. GAAP financial statements in which the reporting entity is a partnership or other pass-through entity, the applicable statutory federal income tax rate is zero as the entity does not generally directly incur income taxes. SEC Staff Accounting Bulletin Topic 6.I.1, Question 2

**9.089 Presentation of the Rate Reconciliation for Foreign Entities (Before the Adoption of ASU 2023-09).** In U.S. GAAP financial statements, foreign entities should normally use the income tax rate in the country of domicile of the parent of the group for purposes of preparing the rate reconciliation. Different rates should not be used for subsidiaries or other segments of a reporting entity. SEC Regulation S-X Section 210.4-08(h)(2)

**9.090** Entities subject to the disclosure requirements of Regulation S-X that use a rate different from the U.S. federal corporate income tax rate as the beginning point in the rate reconciliation should disclose the rate used and the basis for using that rate, even if that rate is the statutory income tax rate in the entity's country of domicile. When a combined rate (i.e., a rate that combines national and subnational taxes) is used as the beginning point in the rate reconciliation, the disclosures should describe the taxes included in the combined rate. SEC Regulation S-X Section 210.4-08(h)(2)

**9.090a Rate Reconciliation between Expected Income Tax Expense and Reported Income Tax Expense (After the Adoption of ASU 2023-09).** The objective of the rate reconciliation is to provide information (principally, nature and magnitude) about what causes the difference between the expected income tax and the reported income tax (see calculations below), which is particularly relevant when an entity operates in multiple jurisdictions. While all entities are required to disclose rate reconciliation information, the format and detail is different depending on the type of entity: ASC paragraphs 740-10-50-11 through 50-11A

- PBEs: Tabular reconciliation of the expected income tax expense (benefit) (i.e., expected or statutory income tax) and the reported income tax expense (benefit) on income from continuing operations (i.e., reported or effective tax) using both percentages and amounts, broken out into specific categories with certain reconciling items at or above 5% of the expected income tax (the 5% threshold) further broken out by nature and/or country. ASC paragraphs 740-10-50-12 through 50-12C
- Other entities: Qualitative discussion of nature and effect of significant differences between the statutory income tax rate and the effective tax rate by specific categories of reconciling items and by individual jurisdictions (the specific categories of reconciling items used for this purpose are the same as those used by PBEs in the tabular reconciliation). ASC paragraph 740-10-50-13



Before adoption of ASU 2023-09, public entities are required to disclose reconciling items in amounts *or* percentages (see Paragraphs 9.086-9.090). However, after the adoption of the ASU, PBEs are required to disclose both amounts *and* percentages. In addition, while entities subject to SEC regulations were already required to disclose reconciling items using a 5% threshold, the ASU provides incremental disaggregation guidance.

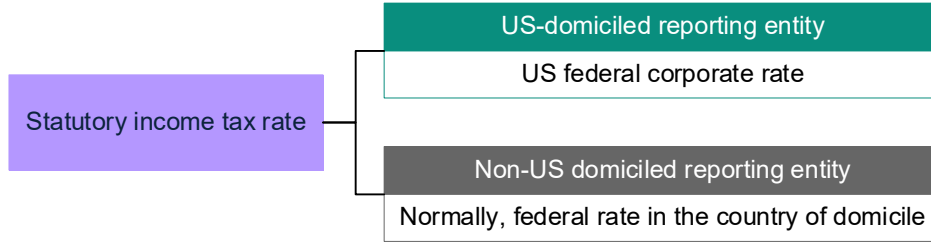
See KPMG Hot Topic: [Income tax disclosures](#), for additional discussion and KPMG observations.

**9.090b Rate Reconciliation Terminology (After the Adoption of ASU 2023-09).** For the purpose of the Rate Reconciliation section, we have used the following terminology and related meanings.

Terminology	Meaning in the Rate Reconciliation section
Federal	Refers to federal or national taxing jurisdictions at the country level.
Domestic federal or federal in the country of domicile	Refers to the country whose statutory income tax rate is reconciled to in the rate reconciliation. It refers to the US for US-domiciled reporting entities and the actual country of tax domicile for non-US domiciled reporting entities (except as discussed in Paragraphs 9.090c and 9.090d).
State	Refers to jurisdictions below the federal level. For the US, ‘state’ refers to US states, counties, cities and other subnational jurisdictions. For other countries, this refers to all subnational jurisdictions in a country. For example, for Canadian-domiciled reporting entities that use the Canadian statutory income tax rate in the rate reconciliation, ‘state’ refers to provinces, territories and other subnational jurisdictions.
Domestic	Refers to the federal and state jurisdictions in the country whose statutory income tax rate is reconciled to in the rate reconciliation.
Foreign	Refers to all jurisdictions outside the country whose statutory income tax rate is reconciled to in the rate reconciliation – this includes federal and state jurisdictions outside that country.

**9.090c Rate Reconciliation: Statutory Income Tax Rate (After the Adoption of ASU 2023-09).** The rate reconciliation begins with the statutory income tax rate and the expected income tax expense (benefit) calculated using the statutory income tax rate. For PBEs, the applicable statutory federal income tax rate in the country of domicile is used in the tabular reconciliation and different rates are not used for subsidiaries or segments.

However, for non-US-domiciled reporting entities, the statutory federal income tax rate in the country of domicile is ‘normally’ used in the tabular reconciliation. This guidance is consistent with current SEC regulations related to the rate reconciliation and is not expected to change practice. ASC paragraph 740-10-50-12

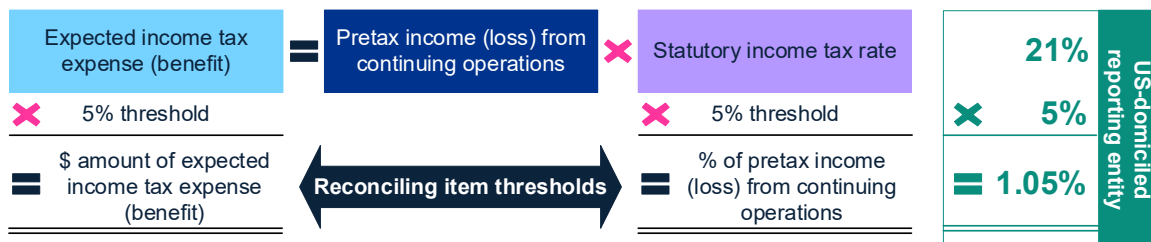


**9.090d** When a PBE uses a statutory income tax rate other than the US federal corporate income tax rate in the rate reconciliation, the rate used and the basis for using that rate must be disclosed, even if that rate is the statutory income tax rate in the PBE’s country of domicile. In addition, we believe the country whose rate is used in the reconciliation becomes the de facto federal country of domicile for purposes of applying the disclosure requirements throughout Topic 740. Using a de facto federal country of domicile (instead of the actual country of domicile) affects the: ASC paragraph 740-10-50-12

- reconciling items identified as federal, state and foreign in the rate reconciliation;
- income (loss) from continuing operations before income taxes identified as domestic and foreign;
- income tax expense (benefit) from continuing operations identified as federal, state and foreign; and
- amount of income taxes paid (net of refunds received) identified as federal, state and foreign.

**9.090e Rate Reconciliation Categories and Further Disaggregation (After the Adoption of ASU 2023-09).** The rate reconciliation includes multiple layers of information. ASC paragraph 740-10-50-12A

- The first layer breaks out the reconciling items into specific categories.
- The second layer further breaks out certain categories based on the 5% threshold. That threshold is met when the reconciling item is 5% or more of the expected income tax.



**9.090f** The following table provides information about each of the layers included in the rate reconciliation. Reconciling items are presented on a gross basis unless netting is explicitly permitted. ASC paragraph 740-10-50-12A

Worldwide	Domestic	Federal	<ul style="list-style-type: none"> <li>• Tax credits</li> <li>• Nontaxable or nondeductible items</li> <li>• Cross-border tax laws</li> <li>• Other reconciling items</li> </ul>	Further disaggregation by nature based on the 5% threshold
			<ul style="list-style-type: none"> <li>• Changes in tax laws or rates enacted in the current period</li> <li>• Changes in valuation allowances</li> </ul>	No further disaggregation required
		State income taxes, net of federal effect	No further disaggregation required	
	Foreign tax effects	By country based on the 5% threshold		
		Further disaggregation by nature based on the 5% threshold		
	Changes in prior year unrecognized tax benefits	No further disaggregation required		

**9.090g** When identifying reconciling items by nature, an entity considers the items’ fundamental or essential characteristics. Examples of these characteristics include the event giving rise to, or the activity associated with, the reconciling item. A reconciling item’s nature, effect and underlying causes, as well as any judgment exercised in its categorization, must either be evident in the tabular reconciliation or in supplemental explanations. ASC subparagraph 740-10-50-12A(b) and paragraph 740-10-50-12C

**9.090h Rate Reconciliation: Domestic Federal: Tax Credits (After the Adoption of ASU 2023-09).** The tax credits category includes federal tax credits generated in the country of domicile. However, when the credit relates to the same income during the same reporting period as cross-border taxes in the country of domicile (i.e., the tax credit is an inherent part of the cross-border tax law), the credit may be presented net in the cross-border tax laws category. Net presentation in the tax credits category is not appropriate. Items in the tax credits category are further disaggregated by nature based on the 5% threshold. ASC subparagraphs 740-10-50-12A(c)(3) and 740-10-50-12A(b)(1)

**9.090i Rate Reconciliation: Domestic Federal: Nontaxable or Nondeductible Items (After the Adoption of ASU 2023-09).** The nontaxable or nondeductible items category is not defined in the Codification, nor is any guidance provided in the ASU’s basis for conclusions. Items in the nontaxable or nondeductible items category are further

disaggregated by nature based on the 5% threshold. ASC subparagraph 740-10-50-12A(b)(1)

**9.090j** The nontaxable or nondeductible items category inherently permits an entity to net federal reconciling items that may decrease the effective tax rate with reconciling items that may increase the effective tax rate (i.e., nontaxable income and nondeductible expenses, respectively). However, if any individual reconciling item meets the 5% threshold, it is disclosed by its nature. If no individual reconciling item in the category meets the 5% threshold, an entity should determine whether certain reconciling items have common characteristics (i.e., the same nature) and, therefore, should be aggregated and separated from nontaxable and nondeductible items without that characteristic.

**9.090k** Given the inherent judgment called for in identifying reconciling items for inclusion in a category that lacks a specific definition, entities must keep in mind the requirement to disclose supplemental explanation of the judgment exercised in including reconciling items in this category if not otherwise evident in the rate reconciliation. ASC paragraph 740-10-50-12C

**9.090l Rate Reconciliation: Domestic Federal: Cross-border Tax Laws (After the Adoption of ASU 2023-09).** Reconciling items in the cross-border tax laws category include income taxes with the following characteristics: ASC subparagraph 740-10-50-12A(c)(3)

- imposed by the country of domicile;
- related to income earned in foreign jurisdictions; and
- is an incremental income tax.

Items in this category are further disaggregated by nature if they meet the 5% threshold. ASC subparagraph 740-10-50-12A(b)(1)

**9.090m** Reconciling items excluded from the cross-border tax laws category include those related to the following.

- *Income taxes on foreign income imposed by state taxing authorities in the reporting entity's country of domicile.* Instead, these taxes are included in the domestic state income taxes, net of federal effect category.
- *Income taxes imposed by countries other than the reporting entity's country of domicile.* Instead, these taxes are included in the foreign tax effects category and disaggregated by nature under the country imposing the tax if they meet the 5% threshold.

**9.090n** As discussed in Paragraph 9.090f, reconciling items are presented on a gross basis with limited exceptions. One exception permits the tax effects of a cross-border tax and related tax credit to be presented net in the cross-border tax laws category. However, this exception can only be applied when the country of domicile both taxes cross-border income and provides a tax credit on the same income during the same reporting period. It

is not appropriate to include in the cross-border tax laws category a tax credit that prevents double taxation when the tax it is intended to offset is not also in the cross-border tax laws category. ASC subparagraph 740-10-50-12A(c)(3)

**9.090o** One example is the tax effect related to global intangible low-taxed income (GILTI) and its related foreign tax credits, which may be presented on a net basis as a single reconciling item in the cross-border tax laws category. In contrast, a US federal foreign tax credit for taxes imposed by a foreign jurisdiction is not included in the cross-border tax laws category because the related tax is included in the foreign tax effects category. In this situation, the tax credit is presented in the domestic federal tax credits category. ASC subparagraph 740-10-50-12A(c)(3)

**9.090p Rate Reconciliation: Domestic Federal: Changes in Tax Laws or Rates Enacted in the Current Period (After the Adoption of ASU 2023-09).** The changes in tax laws or rates enacted in the current period category is limited to the cumulative tax effects of a change in enacted domestic federal tax laws or rates on current or deferred tax assets and liabilities at the date of enactment. Accordingly, this category includes both the impact of remeasuring deferred taxes and the adjustment to the balance of income taxes payable (refundable) for prior years. There is no requirement to further disaggregate this category. ASC subparagraphs 740-10-50-12A(a)(3) and 50-12A(c)(4)

**9.090q Rate Reconciliation: Domestic Federal: Changes in Valuation Allowances.** The changes in valuation allowances category includes valuation allowances on deferred tax assets related to federal income taxes in the country of domicile that were initially recognized or changed in the reporting period. There is no requirement to further disaggregate this category. ASC paragraph 740-10-50-12A

**9.090r Rate Reconciliation: Domestic Federal: Other Reconciling Items (After the Adoption of ASU 2023-09).** The domestic federal other reconciling items capture any reconciling item related to federal income taxes in the country of domicile that does not fall in any of the other domestic federal (national) categories (e.g., a special deduction). An other reconciling item is separately disclosed by nature if it meets the 5% threshold. Other domestic federal reconciling items that do not meet the 5% threshold may be aggregated into an 'other' line item presented for domestic federal income taxes. ASC paragraph 740-10-50-12A

**9.090s Rate Reconciliation: Domestic: State Income Taxes, Net of Federal Effect (After the Adoption of ASU 2023-09).** The domestic state income taxes, net of federal effect category represents income taxes imposed at the state level in the country of domicile, net of the related federal income tax effect. This category includes the entire amount of income tax expense for domestic state jurisdictions because an entity reconciles to a federal rate – i.e., the rate reconciled to excludes income tax rates imposed by domestic state jurisdictions. As a result, this category includes all of the following related to domestic state income taxes: ASC subparagraph 740-10-50-12A(c)(1)

- tax credits;
- nontaxable and nondeductible items;



- changes in valuation allowances; and
- changes in tax laws and rates.

Domestic state income taxes related to changes in current year unrecognized tax benefits are also presented in this category; however, changes in prior year unrecognized tax benefits are presented in the changes in prior year unrecognized tax benefits category.

**9.090t** Unlike the category for foreign tax effects, there is no requirement to disaggregate the reconciling items in this category quantitatively. However, PBEs must qualitatively describe the domestic state jurisdictions that make up greater than 50% (i.e., a simple majority) of the total effect of this category. The names of the individual jurisdictions that make up the majority are listed in the disclosure. To identify these jurisdictions, an entity starts with the domestic state jurisdiction that has the largest effect on the category and then adds the jurisdiction with the next largest effect, continuing to do so until the cumulative effect reaches greater than 50% of the total. ASC paragraph 740-10-50-12B

**9.090u Rate Reconciliation: Foreign Tax Effects (After the Adoption of ASU 2023-09).** With one exception, the foreign tax effects category includes all of the reconciling items associated with the difference between foreign income tax expense (or benefit) calculated using the domestic statutory income tax rate and the reported tax in the foreign jurisdictions. The one exception is for reconciling items presented in the changes in unrecognized tax benefits category. ASC subparagraphs 740-10-50-12A(b)(2) and 50-12A(c)(1)

**9.090v** In the foreign tax effects category, individual countries are disaggregated:

- if the country meets the 5% threshold in total; or
- if any individual reconciling item by nature in a country meets the 5% threshold, both the individual country and reconciling items meeting the 5% threshold are disaggregated.

This could result in disclosing a reconciling item for a foreign country regardless of whether the foreign country itself meets the 5% threshold. When disaggregating reconciling items by nature, an entity should consider the reconciling item's fundamental or essential characteristics. Disaggregation by nature is based on the reconciling item's gross amount (positive or negative). ASC subparagraph 740-10-50-12A(b)(2)

**9.090w Rate Reconciliation: Changes in Unrecognized Tax Benefits (After the Adoption of ASU 2023-09).** A change in unrecognized tax benefits from one annual period to the next could result from: ASC subparagraph 740-10-50-12A(c)(2)

- the initial recognition of an unrecognized tax benefit related to a tax position taken in the current annual reporting period; or
- a change in judgment about an unrecognized tax benefit related to a tax position taken in a prior annual reporting period, including initial recognition, derecognition or change in measurement.

**9.090x** The categorization of changes in unrecognized tax benefits depends on when the tax position was taken.

- A tax position taken in the current annual reporting period may be presented on a net basis with (and in the same category as) the related tax position. ASC subparagraph 740-10-50-12A(c)(2)(ii)
- A tax position taken in a prior annual reporting period is presented in the changes in unrecognized tax benefits category, which may be presented on an aggregate basis for all jurisdictions worldwide or may be disaggregated in the changes in unrecognized tax benefits category. ASC subparagraphs 740-10-50-12A(c)(2)(i) and (iii)

**9.090y Rate Reconciliation: Non-PBEs: Qualitative Disclosures about the Difference Between the Statutory Income Tax Rate and Effective Tax Rate (After the Adoption of ASU 2023-09).** Entities other than PBEs are not required to disclose a tabular rate reconciliation. Instead, they are required to qualitatively disclose the nature and effect of specific categories and individual jurisdictions that result in significant reconciling items. For purposes of categorizing reconciling items, an entity uses the rate reconciliation categories used by PBEs in the tabular reconciliation. ASC paragraph 740-10-50-13

**9.091 Valuation Allowance Disclosures.** Entities should disclose (1) the net change during the year in the total valuation allowance, (2) effects of adjustments to the beginning-of-the-year valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years, and (3) facts and circumstances supporting the realization of deferred tax assets. The net change during the year may be disclosed in a narrative that presents the net change in the valuation allowance, including those changes for which the tax effect was not recognized in income from continuing operations. The change in the beginning-of-the-year valuation allowance should reconcile to the difference in the valuation allowance amounts presented in the summary of deferred tax assets and liabilities. Also under Rule 5-04 of Regulation S-X, an SEC registrant that is not a smaller reporting company filing on domestic forms is required to file as of the last audited balance sheet date Schedule II, Valuation and Qualifying Accounts, if the information is not already disclosed in notes to financial statements. Schedule II includes a description of the account and a rollforward of the balance for each period for which an income statement is provided. ASC paragraphs 740-10-50-2 and 50-9(h)

**9.092** Facts and circumstances supporting the realization of deferred tax assets should be disclosed in sufficient detail to provide a financial statement user a reasonable basis to understand the amount of the valuation allowance. The disclosure should be tailored to the entity's specific facts and circumstances and should include the significant risks and uncertainties associated with the estimates of future taxable income used to support the realizability of deferred tax assets. In addition, the disclosures should include the portion of the valuation allowance that if released, will not result in a benefit to continuing operations, such as certain valuation allowances established for contributed capital. See

Paragraph 9.067. ASC Subtopic 275-10, *Risks and Uncertainties - Overall*, ASC paragraph 740-10-50-3

### Example 9.31: Valuation Allowance Disclosures

The valuation allowance for deferred tax assets as of December 31, 20X7 and 20X6 was \$75 and \$10, respectively. The net change in the total valuation allowance for each of the years ended December 31, 20X7 and 20X6 was an increase of \$65 and a decrease of \$500, respectively. The valuation allowance did not change in 20X5. The valuation allowance at 20X7 and 20X6 was primarily related to foreign net operating loss carryforwards that, in the judgment of management, are not more likely than not to be realized. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which those temporary differences are deductible.

Management considers the scheduled reversal of deferred tax liabilities (including the effect in available carryback and carryforward periods), projected taxable income, and tax-planning strategies in making this assessment. In order to fully realize the deferred tax asset, ABC Corp. will need to generate future taxable income from reversing taxable temporary differences of \$8,200 and future taxable income exclusive of reversing items of \$7,600 before the expiration of the deferred tax assets governed by the tax code. Taxable income for the years ended December 31, 20X7, 20X6, and 20X5 was \$3,045, \$1,485, and \$3,820, respectively. Based on the level of historical taxable income and projections for future taxable income over the periods for which the deferred tax assets are deductible, management believes that it is more likely than not that ABC will realize the benefits of these deductible differences, net of the existing valuation allowances at December 31, 20X7. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

Subsequently recognized tax benefits related to the valuation allowance for deferred tax assets as of December 31, 20X7, will be allocated as follows:

Income tax benefit that would be reported in the consolidated statement of earnings	\$ 65
Additional paid-in capital	10
	<u>75</u>
	<u><u>\$ 75</u></u>

**9.093** The SEC staff has cautioned registrants about the use of boilerplate disclosures about the valuation allowance in MD&A. For example, registrants often disclose that they considered the four sources of income in determining the realizability of deferred tax assets. However, this disclosure often is too vague because it does not give readers

sufficient information about the key judgments made in deciding whether to establish, adjust, or release a valuation allowance. A better disclosure would provide the relative magnitude of each source of taxable income that contributed to supporting the realizability of the DTAs as well as an evaluation of the negative evidence. In instances where registrants have either initially recognized or reversed an existing valuation allowance, the staff is likely to question the timing and judgments involved, particularly the key changes in the registrant's circumstances from previous periods.

#### **9.094 Amounts and Expiration Dates of Operating Loss and Tax Credit**

**Carryforwards.** The amounts and expiration dates of operating loss and tax credit carryforwards should be disclosed. The amounts generally will be from the tax returns, and tax law determines the expiration dates for an entity that files a tax return. However, an entity that is a member of a consolidated group that files a consolidated tax return may determine operating loss and tax credit carryforwards using the separate return method (see Paragraph 10.045) in its stand-alone financial statements. Under the separate return method, operating loss and tax credit carryforwards disclosed in the subsidiary's stand-alone financial statements may differ from consolidated tax return amounts. Amounts disclosed in the financial statements may also differ from the amounts reflected in the tax return if the related deferred tax assets are reduced on the balance sheet as a result of applying ASC Subtopic 740-10 (FIN 48) for unrecognized tax benefits (see Paragraph 9.014 for additional discussion). ASC paragraphs 740-10-30-27 and 30-28, 50-3

#### **Example 9.32: Operating Loss and Tax Credit Carryforwards Disclosure**

At December 31, 20X8, ABC Corp. has \$2,570 of net operating loss carryforwards for federal income tax purposes that arose before the 2018 tax year, which are available to offset future federal taxable income, if any, through 20Y7. In addition, ABC has \$90 of net operating loss carryforwards for federal income tax purposes that arose after the 2017 tax year, which are available to reduce future federal taxable income, if any, over an indefinite period. These post-2017 NOLs are available for a five-year carryback under the CARES Act, which was enacted in 2020.

**9.095 Unrecognized Deferred Tax Liabilities.** ASC Topic 740 requires entities to disclose information about deferred tax liabilities that are not recognized because of exceptions for taxable temporary differences related to the following items:

- Outside basis differences of foreign subsidiaries or foreign corporate joint ventures when the indefinite reversal criteria are met. ASC paragraph 740-30-25-18
- Undistributed earnings of a domestic subsidiary or domestic corporate joint venture that is essentially permanent in nature and arose in fiscal years beginning on or before December 15, 1992. ASC paragraph 740-30-25-18
- Bad debt reserves of savings and loan associations that arose in tax years beginning before December 31, 1987. ASC paragraph 942-740-25-1

- Policyholders' surplus of stock life insurance entities that arose in a fiscal year beginning on or before December 15, 1992. ASC paragraph 944-740-25-3

**9.096** These disclosures should include the types of temporary differences (e.g., the asset for which the temporary difference relates) and their amounts, a description of events that would result in those differences becoming taxable, and the amount of the deferred tax liability that is postponed indefinitely or, for investments in foreign subsidiaries and foreign corporate joint ventures, a statement that determining the amount is not practicable.

### **Example 9.33: Unrecognized Deferred Tax Liabilities Disclosure**

ABC Corp. has not recognized a foreign withholding tax liability of approximately \$273 for the undistributed earnings of its 60% owned foreign subsidiary that arose in 2006 and prior years because it currently plans to indefinitely reinvest those unremitted earnings. A deferred tax liability will be recognized if ABC can no longer demonstrate that it plans to indefinitely reinvest the undistributed earnings. As of December 31, 2006, the undistributed earnings of these subsidiaries were approximately \$3,417.

**9.097 Quantitative Disclosures of Unrecognized Tax Benefits (Public Entities Before the Adoption of ASU 2023-09; PBEs After the Adoption of ASU 2023-09).** ASC subparagraph 740-10-50-15A(a) requires public entities (before the adoption of ASU 2023-09; PBEs after the adoption of ASU 2023-09) to disclose a tabular reconciliation (a *rollforward*) of unrecognized tax benefits at the beginning of the year and tax benefits unrecognized at year-end, with separate line items for significant categories of gross changes during the period. This rollforward should include all unrecognized tax benefits, including those associated with timing differences for which offsetting deferred tax balances exist or those that may be offset entirely or in part by other recognized tax positions (e.g., positions that, if disallowed, would result in a benefit in another jurisdiction). The rollforward does not generally include interest and penalties but should include unrecognized benefits reflected in a liability for unrecognized tax benefits, a decrease in a deferred tax asset, or within an off-balance-sheet exposure. The ASC Master Glossary defines an *unrecognized tax benefit* as “the difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10”.

**9.098** A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period should include the following items (at a minimum): ASC subparagraph 740-10-50-15A(a)

- (1) The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior year.
- (2) The gross amounts of the increases in unrecognized tax benefits as a result of tax positions taken during the current year.

- (3) The amount of decreases in unrecognized tax benefits relating to settlements with taxing authorities.
- (4) Reductions to unrecognized tax benefits resulting from the lapse of the applicable statute of limitations.

**9.099** Because the disclosure requirements of ASC paragraph 740-10-50-15A for unrecognized tax benefits apply to all positions taken in returns filed or expected to be filed, any planned amendments to a previously filed tax return should also be considered for disclosure. As an amended return relates to a previous year, the fact it has not yet been filed does not preclude consideration of the tax return in the financial statements. The tabular reconciliation should include all unrecognized tax benefits, including those associated with tax positions expected to be taken in an amended return.

**9.100** Because disclosure is required on a gross basis, additions and reductions should be disclosed as separate line items. Although ASC subparagraph 740-10-50-15A(a) refers to disclosure of the gross amount of increases and *decreases* for positions for the current year, there should not be a *decrease* in the amount of unrecognized tax benefits related to tax positions taken during the current period because the tabular disclosures are intended to roll forward the unrecognized tax benefits over the annual period. In making the disclosure on a gross basis, indirect effects of applying ASC Subtopic 740-10 (FIN 48) should not offset the amount presented in the tabular disclosure. See Paragraph 9.123 for additional discussion.

**9.101** The table is required for unrecognized tax benefits on an aggregate, worldwide basis. No disaggregated information for individual tax positions or jurisdictions is required as part of the rollforward. When the amount of unrecognized tax benefits includes a significant effect from foreign currency translation or remeasurement under ASC Subtopic 830-10, *Foreign Currency Matters - Overall*, it may be appropriate to disclose the adjustments separately in the tabular rollforward.

**9.102 Disclosure of Settling a Tax Position (Public Entities Before the Adoption of ASU 2023-09; PBEs After the Adoption of ASU 2023-09).** The disclosure of settlements is intended to reflect the cash paid or the sacrifice of assets, such as a refund claim or a carryforward, upon settlement. Accordingly, if an entity were to settle a \$100 unrecognized tax benefit for \$20, it would disclose a decrease in the unrecognized tax benefit pursuant to ASC subparagraph 740-10-50-15A(a)(1) (i.e., the gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period) of \$80 and a decrease in the unrecognized tax benefit due to settlement pursuant to ASC subparagraph 740-10-50-15A(a)(3) (i.e., the amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities) of \$20. Similarly, if an entity were to settle a \$100 unrecognized tax benefit for \$120, it would disclose an increase in the unrecognized tax benefit pursuant to ASC subparagraph 740-10-50-15A(a)(1) of \$20 and a decrease in the unrecognized tax benefit due to settlement pursuant to ASC subparagraph 740-10-50-15A(a)(3) of \$120. ASC paragraph 740-10-50-15A

**9.103** When an unrecognized tax benefit is associated with a refund claim, the disclosure of settlement is intended to reflect the total amount of the unrecognized tax benefit that was forgone in the settlement. For example, assume ABC Corp. files a refund claim in 20X7 for \$100, but recognizes a benefit under ASC paragraph 740-10-25-6 (FIN 48) for only \$30 (and thus discloses an unrecognized tax benefit of \$70 in its 20X7 financial statements). In 20X8, ABC settles the refund claim and receives a check from the IRS for \$10 of the \$100 claim. The tabular rollforward of unrecognized tax benefits would be as follows:

Unrecognized tax benefits as of January 1, 20X8	\$ 70
Gross increase in unrecognized tax benefits for prior year positions (15A(a)(1))	20
Decreases due to settlements (15A(a)(3))	(90)
Unrecognized tax benefits as of December 31, 20X8	<u>\$ —</u>

If ABC settles the refund claim and receives a check from the IRS for \$40 of the \$100 claim, the tabular rollforward would be as follows:

Unrecognized tax benefits as of January 1, 20X8	\$ 70
Gross decrease in unrecognized tax benefits for prior year positions (15A(a)(1))	(10)
Decreases due to settlements (15A(a)(3))	(60)
Unrecognized tax benefits as of December 31, 20X8	<u>\$ —</u>

**Example 9.34: Unrecognized Tax Benefits Tabular Disclosures**

A reconciliation of the beginning and ending amount of total unrecognized tax benefits for the years ended December 31, 20X9, 20X8, and 20X7 are as follows:

	20X9	20X8	20X7
Balance, beginning of year	\$ 51,505	\$ 54,106	\$ 56,459
Increases related to prior year tax positions	3,859	585	659
Decreases related to prior year tax positions	(120)	(823)	(432)
Increases related to current year tax positions	383	1,532	1,743
Settlements	(421)	(1,732)	(587)
Lapse of statute	(1,726)	(2,163)	(3,736)
Balance, end of year	<u>\$ 53,480</u>	<u>\$ 51,505</u>	<u>\$ 54,106</u>

**9.104 Items Affecting the Effective Tax Rate (Public Entities Before the Adoption of ASU 2023-09; PBEs After the Adoption of ASU 2023-09).** ASC subparagraph 740-10-50-15A(b) requires disclosure of the total amount of unrecognized tax benefits that, if recognized, would affect the *effective tax rate*. The use of effective tax rate in ASC Subtopic 740-10 (FIN 48) is intended to be consistent with the use of that term in ASC Subtopic 740-270 (see additional discussion beginning in Paragraph 10.065). Examples of items that when resolved may not affect the effective tax rate include tax positions associated with discontinued operations, items that would be recorded directly in shareholders' equity, and items for which recognition of the unrecognized tax benefit would result both in the reversal of an income tax liability and a corresponding decrease in an income tax receivable, decrease in a deferred tax asset or increase in a deferred tax liability (e.g., uncertainties associated with timing or uncertainties that have indirect effects such as benefits in another jurisdiction). Accordingly, this amount may be computed as the total unrecognized tax benefits disclosed pursuant to ASC subparagraph 740-10-50-15A(a) less:

- (a) Amounts that would not affect the effective rate if recognized because they would be allocated to equity or some item other than income from continuing operations pursuant to the intraperiod tax allocation guidance in ASC Topic 740 and related literature;
- (b) Amounts that would be offset by the reversal of a deferred tax item in the same tax jurisdiction (for tax exposures that relate to timing uncertainty rather than ultimate validity of tax benefit); and
- (c) The amount that would be offset by the reversal of indirect effects in another tax jurisdiction (e.g., reversal of the federal benefit recognized as a deferred tax asset related to a state tax exposure). In this case only the portion of the state tax exposure that would represent the federal benefit (21%) would be excluded.

While disclosure of each of the items that will not affect the effective tax rate (such as unrecognized tax benefits that would be recorded directly in equity) is not required, it may be appropriate to disclose the effect of those items separately if they are significant and relevant to an understanding of the entity's financial statements. For example, when recognition of a benefit would result in a deferred tax asset (e.g., NOL carryforward) that would be subject to a valuation allowance based on conditions existing at the reporting date, disclosure of that fact would generally be appropriate. We do not believe an entity needs to consider the reversal of interest or penalty accruals when evaluating whether an unrecognized tax benefit would affect the effective tax rate if recognized. ASC subparagraph 740-10-50-15A(b)



**Example 9.35: Items Affecting the Effective Tax Rate Disclosure**

Included in the balance of unrecognized tax benefits at December 31, 20X7 are potential benefits of \$38,202 that, if recognized, would affect the effective tax rate on income from continuing operations.

**9.105 Disclosure of Interest and Penalties.** Entities are required to disclose the amount and classification of interest and penalties related to an underpayment of income taxes reported in the income statement and recognized on the balance sheet. ASC subparagraph 740-10-50-15(c)

**9.106 Disclosure of Open Tax Year by Major Jurisdiction.** Entities are required to provide a description of open tax years by major jurisdiction. The determination of what constitutes a *major jurisdiction* will vary from entity to entity, but consideration should be given to which filing jurisdictions contain the entity's significant tax exposures. A disclosure by broad category such as *federal*, *state*, and *foreign* generally would not be sufficient. Instead, the entity generally should identify specific filing jurisdictions in which significant tax uncertainties remain unsettled. We believe this disclosure requirement applies to all entities regardless of whether they have unrecognized tax benefits. ASC subparagraph 740-10-50-15(e)

**9.107 Qualitative Disclosures about Possible Changes in Unrecognized Tax Benefits (Before the adoption of ASU 2023-09).** Certain qualitative disclosures for tax positions are required when it is *reasonably possible* that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date. These disclosures should include the nature of the uncertainty, the nature of the events that could cause the change, and an estimate of the range of the reasonably possible change or a statement that an estimate cannot be made. The disclosures of reasonably possible changes generally should be provided for *positions* for which a significant change is reasonably possible. It generally would not be appropriate to limit those disclosures to aggregate amounts, although aggregation of certain positions may be appropriate if they are similar in nature and likely to be reviewed by the taxing authorities in a similar manner and timeframe or the individual tax positions are not significant. Individual tax positions should be separately disclosed based on a consideration of their significance, their qualitative characteristics, and the reasons why they may be subject to change in the next 12 months. For example, ASC paragraph 740-10-55-217 illustrates disclosure of a reasonably possible change in unrecognized tax benefits associated with transfer pricing and research credits as a result of an IRS exam. Regardless of whether an entity is disclosing individually significant tax positions or is appropriately aggregating similar positions, identifying items subject to the ASC subparagraph 740-10-50-15(d) disclosure requirement as *uncertain tax positions* or *tax exposures* would generally not be an adequate description of the *nature of the uncertainty* associated with that item. Some aggregation may also be appropriate for items that may not be significant individually but the aggregate change could be significant.

**9.108** *Reasonably possible* is defined in the ASC Master Glossary as a chance of the future event or events occurring that is more than remote. *Remote* is defined as an event having only a slight chance of occurring. Accordingly, a change in an estimate is reasonably possible if the likelihood of a change is more than slight. Possible changes in the total amount of unrecognized tax benefits may occur due to changes in judgment related to recognition or measurement or changes due to anticipated settlements with the taxing authority or expiration of the statute of limitations. These changes may result from a foreseeable tax examination, an ongoing tax examination, an anticipated settlement, the expected expiration of a statute of limitations, the results of tax cases, or any other event that could have an effect on the recognition or measurement criteria of ASC paragraph 740-10-30-7. Because there is a low probability threshold for disclosure of possible changes in unrecognized tax benefits, entities should have processes to identify significant categories of tax uncertainties that may vary significantly over the next 12 months. ASC subparagraph 740-10-50-15(d)

**9.109** We believe this disclosure is intended to provide information to users of the financial statements about items that may result in a significant change to the total amount of unrecognized tax benefits in the next 12 months. A disclosure that any tax position could change because of the inherent uncertainty associated with an entity's tax positions does not satisfy the objective of the requirement. Instead, entities should develop processes to identify significant categories of tax uncertainties that may vary significantly over the next 12 months relative to the total amount of unrecognized tax benefits. We believe the following process may provide a helpful framework for implementing this disclosure requirement.

*Step 1: Consider Events that Could Cause a Significant Change in Unrecognized Tax Benefits in the Next 12 Months*

As discussed above, changes in the total amount of unrecognized tax benefits may occur due to changes in judgment related to recognition or measurement, settlements with the taxing authority, or expiration of the statute of limitations. These changes may result from a foreseeable tax examination, an ongoing tax examination, an expected settlement, the anticipated expiration of a statute of limitations, the results of tax cases, or any other event that could have an effect on the recognition or measurement of tax positions under ASC paragraphs 740-10-25-6 and 740-10-30-7.

In complying with the ASC subparagraph 740-10-50-15(d) disclosure requirement, entities may identify events that may occur within the next 12 months that could result in changes to the unrecognized tax benefits. Entities are not necessarily required to identify every possible event that could cause a change in unrecognized tax benefits. Instead, entities should consider reasonably possible events that could change unrecognized tax benefits within 12 months of the reporting date. In the context of this disclosure requirement, we believe significance should be considered relative to total unrecognized tax benefits, the possible effect of the change on reported financial information, and other quantitative and qualitative characteristics.

*Step 2: Identify Tax Positions for which Unrecognized Tax Benefits Could Significantly Change Due to the Events Identified in Step 1*

After identifying events in step 1, entities would then evaluate which tax positions could significantly change within 12 months as a result of those events. As discussed above, aggregation of certain positions may be appropriate if they are similar in nature and likely to be reviewed by the taxing authorities in a similar manner and timeframe or the individual tax positions are not significant. Individual tax positions should be separately disclosed based on a consideration of their significance, their qualitative characteristics, and the reasons why they may be subject to change in the next 12 months.

*Step 3: Review Measurement Information in Determining the Range of Reasonably Possible Change for Tax Positions Identified in Step 2*

Finally, when determining the range of the reasonably possible change in unrecognized tax benefits for a tax position, entities should consider the information they evaluated in assessing the recognition threshold and/or measuring the tax benefit. The information considered in determining the largest benefit more than 50% likely of being realized on settlement should also be useful in determining the reasonably possible change in related unrecognized tax benefits in the 12 months following the reporting date. In determining the amount of reasonably possible change, entities should also consider the nature of the specific event identified in step 1 and its possible effect on the tax position. An entity may be able to estimate the reasonably possible change with more or less precision depending on the tax position and the nature of the event that could cause a change. A quantitative range generally should be estimable if an entity has identified specific events and specific tax positions in steps 1 and 2, above, even if the range of possible outcomes is wide relative to the position taken on the tax return.

Entities may also use other approaches to derive the information needed to satisfy the objective of this disclosure requirement. For example, entities may first identify tax positions that could result in a significant change in the total amount of unrecognized tax benefits and then identify and estimate the potential effect of events that are reasonably possible of occurring within the next 12 months. However, no matter which approach is chosen, the entity should be able to demonstrate that its procedures are sufficient to identify and evaluate tax positions for which it is reasonably possible unrecognized tax benefits will significantly increase or decrease in the 12 months following the reporting date.

**Example 9.36: Reasonably Possible Changes Disclosure**

ABC Corp., including its subsidiaries, files consolidated federal and state income tax returns. It is no longer subject to U.S. federal or state income tax examinations for years before 20X1. The Internal Revenue Service (IRS) commenced an examination of ABC's income tax returns for 20X5 in the second quarter of 20X7. As of December 31, 20X7,

the IRS has proposed certain significant adjustments related to ABC's claim of research credits. Management is currently evaluating those proposed adjustments but does not anticipate the adjustments would result in a material change to its financial position. However, ABC believes that it is reasonably possible that an increase of up to \$11 million in unrecognized tax benefits related to research credits may be necessary within the coming year. In addition, ABC believes that it is reasonably possible that approximately \$6 million of its currently remaining unrecognized tax benefits, for which each of the tax positions are individually insignificant, may be recognized by the end of 20X8 as a result of a lapse of the statute of limitations.

**9.110 Statement of Cash Flows.** Cash payments to governments for taxes generally are classified as cash outflows from operating activities. Therefore, even though the cash proceeds from the sale of a discontinued operation are cash inflows from investing activities, any related income tax payments are cash outflows for operating activities within discontinued operations. Excess tax benefits from share-based payment arrangements are classified as operating cash inflows. Within the reconciliation from net income to net cash flows from operating activities, we would generally expect deferred tax expense or benefit to be presented with other adjustments for noncash items included within net income and changes in the balance of income taxes payable or receivable to be included with the effects of accruals of expected future operating cash receipts and payments. ASC subparagraph 230-10-45-17(c) and paragraph 230-10-45-28

**9.111** Entities are required to disclose the total income taxes paid in each year a statement of cash flows is presented. ASC subparagraph 230-10-45-25(f) and paragraph 50-2

**9.112** Cash paid to tax authorities by an employer when withholding shares from an employee award for tax withholding purposes is considered an outlay to reacquire the entity's equity instruments and is classified as a cash outflow for financing activities. See Section 16 of KPMG Handbook, *Statement of Cash Flows*, for additional discussion of cash flow considerations related to income taxes. ASC subparagraph 230-10-45-15(a)

**9.113 Risk and Uncertainties.** ASC Topic 275, *Risks and Uncertainties*, focuses primarily on disclosures about risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. These risks and uncertainties may result from, among other matters, the nature of the entity's operations, the use of estimates in the financial statements, and significant uncertainties in the entity's operations. Certain components of the calculation of income taxes, including the need for a valuation allowance on deferred tax assets, estimates about an entity's ability to indefinitely invest undistributed earnings of a foreign subsidiary, and the outcome of tax uncertainties, are areas that may be subject to risks and uncertainties disclosures.

**9.114** ASC Topic 275 requires disclosures in the financial statements about risks and uncertainties existing in the following four areas:

- Nature of operations;
- Use of estimates in the preparation of financial statements;
- Certain significant estimates; and
- Current vulnerability due to certain concentrations.

The four areas of disclosure are not mutually exclusive and information required may overlap. The disclosure format required by ASC Topic 275 is not prescriptive and disclosures may be grouped together, disclosed in various parts of the financial statements, or included as part of the disclosures required by other authoritative literature. ASC paragraph 275-10-50-1

### **Example 9.37: Risks and Uncertainties Disclosure**

#### **Background**

ABC Corp. sells a line of private-branded luxury goods for consumers through retail operations in the U.S. market and in Europe. Demand for the entity's products is dependent on consumer spending habits in the markets it serves.

As of December 31, 20X0, ABC has no temporary differences and has loss carryforwards of \$XX million that originated in prior years and that expire in varying amounts between 20X9 and 20Y4 as they arose in pre-2018 tax years. As of December 31, 20X0, the entity has a deferred tax asset of \$X.X million that represents the benefit of the \$XX million in loss carryforwards, and it has concluded at that date that a valuation allowance is unnecessary. The loss carryforwards arose during the entity's development stage when it was establishing its brand. In addition, the entity has not recognized a deferred tax liability for withholding tax on amounts invested in its foreign Subsidiary F as allowed under the indefinite reversal criterion of ASC paragraph 740-30-25-17.

ABC has earned, on average, \$X million income before tax (taxable income before carryforwards) in each of the last five years. Its 20X0 operating results were affected by the recent decreases in consumer spending; however, profitability remained at 60% of the levels of the last five years. It is reasonably possible that a prolonged slowdown or further deterioration of consumer spending in ABC's markets could reduce the demand for luxury goods and affect the entity's estimates of realizability or ability to leave funds indefinitely invested in the foreign subsidiary.

The example disclosure below does not include all of the income tax disclosures required by ASC Topic 740. It is intended to provide an example of the risks and uncertainty disclosures related to income taxes that may be required by ASC Topic 275.

#### **Disclosure**

ABC has recorded a deferred tax asset of \$X.X million reflecting the benefit of \$XX million in loss carryforwards, which expire in varying amounts between 20X9 and 20Y4

as disclosed in the table in Note XX, Income Taxes. Realization of this deferred tax asset is dependent on generating sufficient taxable income prior to expiration of the loss carryforwards. Although realization is not assured, management believes it is more likely than not that all of the deferred tax asset will be realized. The minimum amount of future taxable income required to realize the deferred tax asset balance at December 31, 20X0 is \$XX million. If the entity continues to generate the level of pretax income generated for the year ended 20X0 (\$X million) over the periods until the loss carryforwards expire, the amounts will be sufficient to generate the minimum level of future taxable income required to realize the deferred tax assets. Except for the effects of loss carryforwards, the amounts of pretax income for financial reporting purposes and taxable income have historically been the same.

The amount of the deferred tax asset considered realizable, however, could be significantly reduced in the near term if estimates of future taxable income during the carryforward period are reduced due to further decreases in consumer spending brought about by the current market conditions.

ABC has not recognized a deferred tax liability on the undistributed earnings of foreign Subsidiary F as allowed under the indefinite reversal criterion of ASC paragraph 740-30-25-17. The entity considers these amounts to be indefinitely invested in Subsidiary F based on specific plans for reinvestment of these earnings. However, further liquidity deterioration in the near term or a prolonged decrease in consumer spending could require ABC to change its plans and repatriate all or a portion of these undistributed earnings, which may increase current tax expense and current tax liabilities.

## FINANCIAL STATEMENT PRESENTATION AND DISCLOSURE – SPECIFIC APPLICATION MATTERS

**9.115** This subsection discusses other matters that should be considered when reviewing or preparing financial statement presentation and disclosures for income taxes.

**9.116 Uncertainty in Income Taxes for Pass-Through Entities.** ASC Topic 740 does not exempt pass-through entities from disclosing certain information related to the uncertainties in its tax positions. ASC paragraphs 740-10-50-15 and 19 require all entities (additional disclosures apply to public entities or PBEs, see additional discussion beginning in Paragraph 9.097) to disclose the following related to unrecognized tax benefits:

- (1) The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position;
- (2) Before the adoption of ASU 2023-09, for positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date: the nature of the uncertainty, the nature of the event that could occur in the next 12 months that

would cause the change, and an estimate of the range of the reasonable possible change or a statement that an estimate of the range cannot be made;

- (3) A description of tax years that remain subject to examination by major tax jurisdictions; and
- (4) The entity's accounting policy on classification of interest and penalties.

See Paragraph 9.119c for additional disclosure considerations for an entity subject to the centralized partnership audit regime.

**9.117** Because pass-through entities file informational returns that are subject to audit, the entity's financial statements should include a statement that these returns are subject to audit along with the years remaining subject to audit. For U.S.-based entities, the federal government generally will be a major tax jurisdiction. Determining disclosure of other major tax jurisdictions is a matter of judgment to be based on the domicile of the entity and the jurisdictions where income taxes are ultimately paid.

**9.118 Centralized Partnership Audit Regime.** The centralized partnership audit regime generally provides for assessment and collection of an imputed underpayment of tax, interest, and penalties at the partnership level. As a result, certain payments may be made by the partnership itself even though it continues to be a pass-through entity for income tax purposes.

**9.119** The centralized partnership audit regime generally applies to partnership tax years beginning after December 31, 2017 and to partnerships required to file a partnership return, except for (a) qualifying partnerships that affirmatively elect out for a tax year, and (b) other partnerships that elect an alternative mechanism, in accordance with rules established by the Secretary of the Treasury. The alternative mechanism, or 'push out election,' allows certain partnerships to notify the individual partners (that were partners in the year to which the adjustments relate) of their share of imputed underpayment amounts for inclusion in their current tax returns (resulting in the individual partners paying the tax).

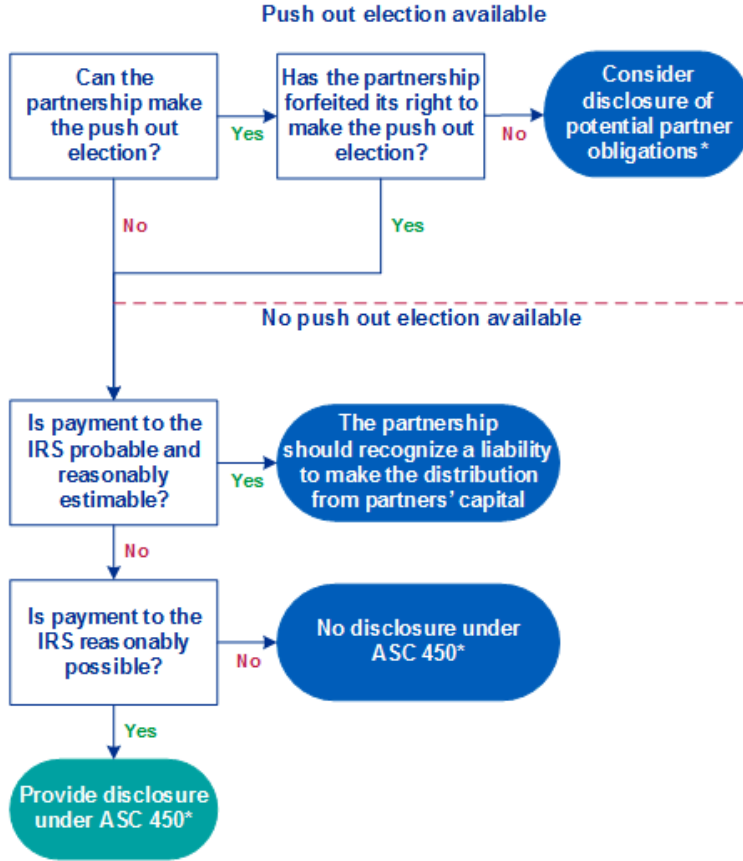
**9.119a** We believe that taxes on partnership income should continue to be attributed to the partners, even when subject to the centralized partnership audit regime. Payments made by a partnership on behalf of its partners are akin to distributions that are recognized with a charge to partners' capital. While a partnership is required to remit an identified underpayment unless it makes the push out election, the partnership remains nontaxable under the tax law and its taxable income and losses continue to flow through to its partners' individual tax returns. This conclusion is also addressed in the AICPA's Q&A Section 7.200.09, *Tax Accounting Considerations Under Partnership Audit Regime*.

**9.119b** Partnerships would recognize a liability to remit an underpayment when the obligation exists for accounting purposes – i.e., a distribution is effectively declared. We believe the distribution declaration date differs based on whether the partnership has the right to make the push out election. If a partnership has the right to make the push out election at the balance sheet date, a distribution has not been declared. However, those

partnerships should consider disclosing tax audits and providing their assessment about partners’ potential obligations.

**9.119c** If a partnership legally cannot make the push out election or it has forfeited its right to make the election, we believe the partnership has declared the distribution when a payment is probable and reasonably estimable. If payment to the IRS is not probable, but is reasonably possible, the partnership should make the disclosure by following the guidance for ASC Subtopic 450-20, *Loss Contingencies*.

We believe all partnerships should disclose their status under the tax law.



\*Disclose partnership status under the tax law – e.g. the existence of the collection mechanism and the partnership's ability to elect out or make the push out election

**9.119d State Pass-through Entity Taxes.** After the U.S. tax law limited individual taxpayers’ U.S. federal income tax deduction for state and local taxes to \$10,000, certain state and local governments enacted pass-through entity (PTE) taxes aimed to work around the federal limitation. Under these regimes, taxes are paid at the PTE level (e.g., partnerships or S Corporations) and generally result in a deduction on the PTE’s federal income tax return. Some of the regimes also create a state tax credit for the partners or shareholders that these owners can use to offset state personal income tax otherwise due, including tax on taxable income that flows through to the partners and shareholders. The overall arrangement has the effect of allowing the individual taxpayer owners to benefit



from taking a federal deduction for state and local taxes that may otherwise be restricted by the \$10,000 limitation that applies to individual taxpayers.

**9.119e** Depending on the facts and circumstances of how an individual jurisdiction enacts its PTE tax regime, taxes incurred at the PTE might be accounted for in the PTE financial statements (a) as income taxes, or (b) as equity distributions to partners/members (i.e., the taxes are paid on behalf of the partners/members; see Paragraph 9.164). We believe that although not necessarily determinative, the ability for the partner/member group to take credit against its income tax in the relevant jurisdiction for all or substantially all of the payments made by the PTE in that jurisdiction is an indicator that the taxes should be attributed to the partners/members and presented as equity transactions outside the scope of ASC Topic 740. ASC paragraph 740-10-55-226

**9.120 Classification of Interest and Penalties.** Classification of interest and penalties on the income statement represents an accounting policy decision that should be consistently applied. Interest may be classified as either income tax expense or interest expense; while penalties may be classified as either income tax expense or another appropriate expense classification (such as SG&A). While an entity may have differing policies for interest and penalties (e.g., interest above the line and penalties below the line), an entity's classification policy for interest income (or the reversal of interest expense) on its tax positions should be consistent with its policy for interest expense. If an entity's policy is to classify interest expense in income tax expense, interest income should likewise be classified as part of income tax expense. If an entity's policy is to classify interest on tax settlements in interest expense, interest income on tax settlements should likewise be classified as a reduction of interest expense or as interest income. Further, classification of interest and penalties on the balance sheet and the cash flow statement generally should be consistent with an entity's classification of interest and penalties on the income statement. ASC paragraph 740-10-45-25

**9.121 Intraproduct Tax Allocation of Changes in Unrecognized Tax Benefits.** Changes in unrecognized tax benefits should be allocated among continuing operations, discontinued operations, other comprehensive income, and items charged or credited directly to shareholders' equity based on the guidance provided beginning in Paragraph 9.020. For example, we believe adjustments related to unrecognized tax benefits for items recorded directly in equity, such as tax deductibility of equity issuance costs, should be recorded in equity.

**9.122** Based on the approach to backwards tracing for changes in the effects of tax uncertainties related to items recorded directly in equity, we believe adjustments made to income tax uncertainties directly associated with prior period discontinued operations generally would be recognized in discontinued operations pursuant to ASC paragraphs 205-20-45-4 and 45-5, 50-3A, and S99-2. However, others believe that backwards tracing for tax uncertainties related to discontinued operations is not required. In the absence of authoritative guidance, entities should make an accounting policy election for intraperiod tax allocation for changes in tax uncertainties related to discontinued operations and consistently apply that policy.

**9.123 Disclosure of Indirect Tax Effects of an Unrecognized Tax Benefit.** As discussed in Paragraph 3.059, an increase to the income tax payable as a result of applying ASC Subtopic 740-10 (FIN 48) on accounting for uncertainty in income taxes may result in indirect effects, for example, by generating benefits in another jurisdiction. In these situations, the indirect effects must also be considered. For example, if an entity increases its income taxes payable due to a state tax issue, a tax benefit would be established for the related federal benefit if a benefit would result when the entity is required to pay the liability for the state position. For purposes of disclosure, however, gross presentation is generally required for the *unrecognized tax benefit* in the tabular rollforward (ASC subparagraphs 740-10-50-15A(a) and 50-15A(b)), with net presentation required for the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (ASC subparagraph 740-10-50-15A(b)). For example, assume an entity has an unrecognized tax benefit of \$1,000 for a permanent state tax item that if disallowed would result in a \$210 federal tax benefit. The entity would recognize \$1,000 income tax payable for the unrecognized tax benefit and a \$210 federal deferred tax asset in its financial statements (these amounts would be presented gross on the balance sheet – see Paragraph 9.015 for additional discussion) and would disclose (i) the existence of \$1,000 of unrecognized tax benefits in the tabular rollforward, and (ii) the fact that \$790 of the total unrecognized tax benefits, if recognized, would affect the effective tax rate. Net presentation is appropriate for the ASC subparagraph 740-10-50-15A(b) disclosure of the potential effect on the effective tax rate because if the entity prevailed on the state position, the \$1,000 income tax liability (in the state jurisdiction) would be reversed as would the \$210 deferred tax asset (in the federal jurisdiction), resulting in recognition of \$790 of net tax benefit.

**9.124** Similar questions may arise related to the disclosure of interest accrued on unrecognized tax benefits and the related indirect effects of such accrual. Interest accrued on unrecognized tax benefits is not part of the *unrecognized tax benefit* disclosed pursuant to ASC subparagraph 740-10-50-15A(a), but instead should be disclosed pursuant to ASC subparagraph 740-10-50-15(c), regardless of where interest is classified in the financial statements. An entity is required to disclose the total amount of interest accrued under ASC paragraph 740-10-25-56 and is permitted to provide additional information with respect to any related potential income tax benefit as a result of the interest accrual. For example, assume an entity accrues \$105 of interest on a state tax item that if paid would result in a \$5 state tax benefit and a \$21 federal tax benefit ( $(\$105 - \$5) \times 21\%$ ). The entity should disclose \$105 of total interest accrued on unrecognized tax benefits, and could also disclose the potential \$26 of related state and federal tax benefit.

**9.125** Another example may be situations involving intra-entity transactions in which an international tax treaty affects the measurement of multiple tax positions associated with transfer pricing (see Paragraph 3.118 and Example 3.14 for additional discussion). As discussed above in the context of the state tax issue, the unrecognized tax benefit in one jurisdiction may not be presented on the balance sheet or disclosed in the notes to the financial statements net of the benefit in another jurisdiction in the tabular rollforward pursuant to ASC subparagraph 740-10-50-15A(a). However, such amounts would be

considered for purposes of calculating how much unrecognized tax benefit if recognized would affect the effective tax rate pursuant to ASC subparagraph 740-10-50-15A(b).

**9.125a** A similar situation may exist when a liability for an unrecognized tax benefit related to the timing for deducting at item is recorded. In that situation, a deferred tax asset may also be recognized on the balance sheet for the year the position is taken for the potential to deduct that item in a future period if the original tax position is not sustained. For the unrecognized tax benefit rollforward disclosure pursuant to ASC subparagraph 740-10-50-15A(a) for periods in which the indirect effect is presented as a deferred tax asset for the potential to deduct the item on a future tax return, we believe the unrecognized tax benefit rollforward should be disclosed gross of the indirect effect. For periods after the year in which the indirect effect becomes deductible, we believe the indirect effect should be netted against the unrecognized tax benefit in the rollforward disclosure. In other words, if the indirect effect is with the same taxing authority as the underlying unrecognized tax benefit, and both affect current taxes, we believe the indirect effect should be netted with the unrecognized tax benefit in the rollforward disclosure, even if the underlying unrecognized tax benefit and indirect effect relate to different tax years.

**9.125b** If a tax position taken by a U.S. entity results in an unrecognized tax benefit and also reduces the entity's GILTI inclusion, we believe the impact on GILTI is a direct effect of the tax position. Therefore, the GILTI impact should be included in the amount of the unrecognized tax benefits presented in the tabular disclosure.

**9.126 Disclosures about the Uncertainty in Income Taxes in Interim Period Reports.** The annual disclosures required by ASC paragraphs 740-10-50-15 and 50-15A (FIN 48) are not required to be repeated in condensed interim financial statements. For example, a rollforward of unrecognized tax benefits is not required to be reported in interim financial statements. Nevertheless, SEC registrants should update their annual disclosures in interim periods where events subsequent to the end of the most recent fiscal year have occurred that have a material effect on the registrant in accordance with Item 303 of Regulation S-K (Management Discussion and Analysis). Material events related to uncertainty in income taxes may include (but are not limited to) significant changes in unrecognized tax benefits and related interest and penalties, significant settlements of tax positions, and new information that results in significant changes in expectations related to the possible resolution of tax uncertainties. These disclosures would be similar to those currently required in interim financial statements for significant changes in estimates inherent in the preparation of financial statements.

**9.127 Inclusion of Unrecognized Tax Benefits Presented as Liabilities in the Contractual Obligations Table (Item 303 of Regulation S-K).** Item 303 of Regulation S-K requires a registrant to present, on an annual basis, obligations due in less than 1 year, 1-3 years, 3-5 years and more than 5 years, aggregated by type of obligation. In 2010, the SEC issued Interpretive Release, Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis (FR-83), which indicates that if uncertainties exist about the timing or amounts of contractual obligations such that an entity omits those amounts from the contractual

obligations table, it should include footnotes to the table that describe the nature and extent of the obligations. FR-83 also indicates that if a portion of such obligations are included in the table and other portions are not, an entity should elaborate on which contractual obligations are included in the table and which are not. The SEC staff confirmed at the September 2012 SEC/CAQ Regulations Committee meeting that this guidance applies to items such as interest payments and unrecognized tax benefits.

**9.127a Inclusion of the Transition Tax Liability in the Contractual Obligations Table.** As discussed in Paragraph 7.007a, under the U.S. tax reforms enacted in 2017, a U.S. shareholder's foreign earnings and profits (E&P) accumulated in specified foreign corporations (SFCs) under legacy tax laws were deemed repatriated for the last taxable year of a SFC that began before January 1, 2018. This one-time transition tax on those deemed repatriated earnings may be paid over eight years with no interest charged. Entities needed to report their deemed repatriation liabilities and elect their payment schedules in their first tax returns filed after the December 22, 2017 enactment date. We believe entities may conclude that attribution of the liability amount to the maturity categories within the contractual obligations table is appropriate because the uncertainties about the amount of the liability and the timing of its settlement are insignificant.

**9.128 Tax Effects of Non-GAAP Performance Measures.** SEC Compliance & Disclosure Interpretation (C&DI) Question 102.11 requires a registrant to include in a non-GAAP performance measure current and deferred income tax expense for each adjustment commensurate with the non-GAAP measure of profitability. While the SEC has not required a specific method for determining the tax effects of non-GAAP adjustments, based on discussion with the SEC staff, we believe that a registrant's non-GAAP disclosure should clearly explain how the registrant determined the current and deferred tax effects. For example, if a registrant chooses to calculate the combined current and deferred tax effect by multiplying each pretax adjustment by the applicable statutory income tax rates, the registrant should clearly describe that methodology as part of its non-GAAP disclosure.

**9.129 Presentation of Indemnifications of Income Tax Uncertainties.** As discussed in more detail in Paragraph 3.129, entities may enter into indemnification arrangements whereby third parties will contractually agree to reimburse the entity if a tax position is resolved unfavorably with the taxing authority. Rights related to indemnification from a third party should be accounted for under other applicable literature and should not be offset with the accounting for and disclosure of tax uncertainties under ASC Subtopic 740-10 (FIN 48). The accounting for and presentation of the tax uncertainty is based on the merits of the tax position without regard to the indemnification arrangement. Accordingly, notwithstanding that an entity may have an indemnification arrangement in place on a particular tax uncertainty, any unrecognized tax benefit related to that uncertainty would be included in the disclosures required by ASC Subtopic 740-10 without consideration of the possible offset provided by the indemnification arrangement.

**9.130 Assessing Materiality of Unrecognized Tax Benefit Related Disclosures.** Consistent with the guidance provided in ASC paragraph 250-10-S99-1 (SEC Staff Accounting Bulletin No. 99, *Assessing Materiality*), we do not believe that exclusive

reliance on quantitative measures of materiality is appropriate. In the context of unrecognized tax benefit related disclosures, a reasonable person relying on the financial statements may consider information about an entity's tax positions important in making investment decisions – whether that information includes disclosure of substantial unrecognized tax benefits or no unrecognized tax benefits. However, the format and level of commentary necessary to address the disclosure requirement may vary depending on the nature and extent of the entity's unrecognized tax benefits. We believe this guidance is equally applicable to those entities that are not SEC registrants.

**9.131 Applicability of Unrecognized Tax Benefit Related Disclosure Requirements to Leveraged Lease Transactions.** The disclosure requirements of ASC paragraphs 740-10-10-15 and 50-15A apply to tax uncertainties related to a leveraged lease transaction. ASC paragraph 840-30-35-44 states that “Tax positions shall be reflected in the lessor’s initial calculation or subsequent recalculation based on the recognition, derecognition, and measurement criteria in paragraphs 740-10-25-6, 740-10-30-7, and 740-10-40-2.” Furthermore, although there are special rules for accounting for the tax effects of a leveraged lease, those tax effects are not excluded from the scope of ASC Topic 740. Therefore, we believe that the disclosure requirements of ASC paragraphs 740-10-50-15 and 50-15A would apply to the extent that tax benefits were excluded from leveraged lease calculations based on the recognition and measurement provisions of ASC Subtopic 740-10 for uncertainty in income taxes. In February 2016, the FASB issued ASU 2016-02, *Leases*. The new standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date.

**9.132 Charges In Lieu of Income Tax Expense.** Total income tax expense is the sum of current tax expense and the change in deferred tax assets (net of any valuation allowance) and deferred tax liabilities. When a current tax benefit is attributed to an item in shareholders’ equity (see Paragraph 9.036a), a *charge in lieu of income tax expense* results. The charge in lieu of income tax expense is an increase to income tax expense to eliminate the effect of an income tax benefit that reduced the amount of taxes payable to the taxing authority and should not be a component of income tax expense from continuing operations. ASC subparagraph 740-10-50-9(f)

Items that frequently cause a charge in lieu of income tax expense include:

- An increase or decrease in contributed capital; and
- Deductible temporary differences and carryforwards that existed at the date of a quasi-reorganization.

### **Example 9.38: Calculating Charge in Lieu of Income Tax Expense**

ABC Corp. has no deferred tax assets or liabilities at the beginning or end of the year. In 20X7, pretax income is \$1,000. No deferred tax assets or liabilities originate in 20X7, but

ABC recognized a \$100 tax deduction for equity issuance costs recorded as a reduction of proceeds received for book purposes but that are deductible for tax purposes.

Pretax financial statement income	\$	1,000
Tax deductible equity issuance costs		<u>(100)</u>
Taxable income	\$	<u>900</u>
Current tax expense at 21%	\$	<u>189</u>

Total income tax expense (total current tax expense plus the change in deferred tax assets, deferred tax liabilities, and the valuation allowance) equals \$189. However, the benefit from the tax-deductible equity issuance costs should not be included in income tax expense from continuing operations (see Paragraph 9.051). The adjustment to income tax expense from continuing operations is calculated as follows:

Pretax financial statement income	\$	<u>1,000</u>
Current tax expense at 21%		<u>210</u>
Less actual income tax expense		<u>(189)</u>
Charge in lieu of income tax expense	\$	<u>21</u>

The income taxes related accounts should be recorded as follows:

	<b>Debit</b>	<b>Credit</b>
Current tax expense	189	
Income taxes payable		189
Charge in lieu of taxes (expense)	21	
Equity		21

The above entries result in total income tax expense from continuing operations equal to \$210.

**9.133 Tax Professionals' Fees.** Fees paid to outside professionals for tax advice, preparation of income tax returns, and other tax-related services, are not part of income tax expense. Accordingly, tax professionals' fees should be treated as general and administrative expenses. See Paragraph 3.080.

**9.134 Taxes That May or May Not Be Considered Income Taxes.** State taxes and excise taxes may be based on various measures that raise questions about the applicability of the provisions of ASC Topic 740. For example, state taxes may be based on adjusted operating results, revenues or gross receipts, or the greater of a capital tax or income tax and excise taxes on not-for-profits may be based on foundation investment income. ASC Topic 740 addresses financial accounting and reporting for the effects of income taxes that result from an entity's activities during the current and preceding years. Income taxes are defined in the ASC Master Glossary as "[d]omestic and foreign federal

(national), state, and local (including franchise) taxes based on income,” and accordingly, those taxes that are assessed on an income-based measure generally are accounted for under ASC Topic 740. Other taxes, such as franchise taxes solely based on net capital, represent taxes paid for the privilege of doing business in state. See the section beginning at Paragraph 1.001 for additional discussion of taxes that are within the scope of ASC Topic 740. In addition, see Paragraphs 9.151 and 9.158 for additional discussion of certain taxes based on gross receipts.

**9.135 - 9.139** Not used.

**9.139a Taxes Based Partially on Income** An entity that pays a franchise (or similar) tax that is partially based on income will account for the income-based portion of the tax as an income tax under ASC Topic 740, including recognizing deferred taxes, using the applicable statutory income tax rate, and then account for any incremental amount as a non-income-based tax. When determining the realizability of deferred tax assets, entities should not consider the effect of paying the non-income based portion of the tax in future periods.

**9.139b** The guidance in ASC subparagraph 740-10-15-4(a) significantly affects the accounting for franchise (and similar) tax regimes in which an entity pays the greater of an amount based on an income-based measure or a non-income-based measure. For example, as discussed in Paragraph 9.135, for taxable years ending on or before December 31, 2006 (see Paragraph 9.140 for additional discussion of the Texas margin tax legislation, which was effective for taxable years ending on or after January 1, 2007), franchise taxes in Texas were based on the greater of (1) 0.25% of the corporation’s net taxable capital or (2) 4.5% of the corporation’s taxable income, generally based on federal taxable income after certain adjustments. A tax regime structured like the pre-2007 Texas franchise tax is accounted for first as an income tax regime – i.e., the entity assumes it will always pay on the income-based measure and therefore will recognize and measure current and deferred taxes based on the statutory income tax rate. Then, if the entity ultimately pays its tax based on capital (or another non-income-based measure) because the capital-based computation results in an amount higher than the income-based measure, it recognizes as current expense the incremental amount (in excess of the amount based on the income-based measure) outside of income tax expense.

**9.139c** The following matters would be considered in determining the appropriate amount of income taxes under ASC Topic 740 for such tax systems:

- Even if an entity expects to be subject to the non-income-based measure in all future years, deferred taxes should be recognized on all temporary differences based on the applicable income tax rate. If the entity has net taxable temporary differences, the resulting deferred tax liability is not reduced by the amount of the non-income-based portion of the tax for each future year.
- Future losses should not be anticipated in determining whether a deferred tax liability should be recognized on taxable temporary differences under the income-based measure. As discussed in ASC paragraph 740-10-25-38, future

losses should not be anticipated for purposes of eliminating a deferred tax liability on existing taxable temporary differences.

- A net deferred tax asset should be recognized on net deductible temporary differences even if the entity expects that it will never be subject to the income-based measure. An entity should not consider the effect of potentially paying the non-income-based measure in future years when evaluating the realizability of its deferred tax assets. Rather, the entity should assess the need for a valuation allowance on its deferred tax assets based on whether it would be more likely than not to realize those deferred tax assets assuming it is subject only to the income-based measure.
- Uncertainty in the income-based portion of the tax should be evaluated under the recognition and measurement principles of ASC paragraphs 740-10-25-6 and 30-7, while uncertainty in the non-income-based portion of the tax should be evaluated under the requirements for non-income-based taxes.

**9.139d** Some tax regimes are structured similar to the pre-2007 Texas franchise tax but instead require the entity to pay based on the lesser of an amount based on an income-based measure and a non-income-based measure. For example, the Texas margin tax (applicable to tax years beginning after January 1, 2007, see Paragraph 9.140) generally requires payment of a .75% tax on an entity's Texas-sourced taxable margin, as defined in the law. The taxable margin equals the lesser of (1) 70% of an entity's total revenue (2) total revenue less \$1 million or (3) 100% of total revenue reduced for, at the annual election of the taxpayer (a) cost of goods sold or (b) compensation. We believe these taxes generally should be accounted for as income taxes under ASC Topic 740, similar to *greater-of* tax regimes. However, there are some differences. For example, there is never an incremental amount of taxes payable resulting from a non-income-based measure under these regimes. In addition, when applying ASC Topic 740 to a *lesser-of* regime, we believe it may be appropriate for an entity to identify its temporary differences (and measure the related deferred taxes) based on which measure it expects to apply when its basis differences reverse. For example, if an entity expects to be subject to the 70% of total revenue measure of taxable margin, the entity applies a rate of 70% of the enacted tax rate to those Texas-apportioned revenue-related temporary differences (e.g., difference between the financial statement carrying amount and the tax basis of bad debts, contract liabilities, etc., see Paragraph 9.145). We do not believe this method of identifying temporary differences (and measuring the related deferred taxes) would be appropriate when applying ASC Topic 740 to a *greater-of* regime.

**9.139e** Whether a tax regime is a *lesser-of* regime as described in Paragraph 9.139d may depend on the facts and circumstances. Some tax law clearly operates as a *lesser-of* regime, similar to the post-2006 Texas law. Other tax law may identify a primary non-income-based measure as the tax base but also effectively provide a tax rate adjustment that is computed in reference to an income-based measure. In those cases, it may be more appropriate to account for the regime as a non-income-based tax in its totality.

**9.139f** Because (a) the total tax assessed can never be less than the income-based measure in a *greater-of* regime, and (b) any incremental tax above the income-based



measure is not based on income, we believe an entity must recognize deferred tax amounts under ASC Topic 740 for *greater-of* regimes as if it is subject only to the income-based measure.

**Example 9.38a: Franchise Tax Partially Based on Income**

ABC Corp. pays franchise taxes equal to the greater of 0.25% of its net taxable capital or 4.5% of its net income.

ABC had net taxable capital of \$10,000 and net income of \$1,000 as of, and for the fiscal year ended, December 31, 20X0. Assume ABC has no temporary differences at the beginning or end of the period.

ABC computed its current tax as follows.

Potential tax based on net capital ( $10,000 \times .25\%$ )	\$ 25
Potential tax based on net income ( $1,000 \times 4.5\%$ )	\$ 45

Because ABC pays based on the greater of the two above calculations, its current tax for 20X0 is \$45 (the income-based measure). ABC recognizes \$45 as current income tax expense.

In this example, ABC had no temporary differences. However, if a temporary difference arose during 20X0, ABC would provide deferred taxes at 4.5% for that temporary difference.

If ABC instead had \$100,000 of net taxable capital and net income of \$1,000 and all other factors remained the same, ABC would compute its current tax as follows.

Potential tax based on net capital ( $100,000 \times .25\%$ )	\$ 250
Potential tax based on net income ( $1,000 \times 4.5\%$ )	\$ 45

Because ABC pays based on the greater of the two above calculations, its current tax for 20X0 is \$250 (the capital-based measure). ABC recognizes \$45 as current income tax expense and \$205 as current operating expense (outside of income tax expense).

In this example, ABC had no temporary differences. However, if a temporary difference arose during 20X0, ABC would provide deferred taxes at 4.5% for that temporary difference, notwithstanding that it has (and may expect to continue to) pay based on the capital-based measure in the future.

**9.140 Income Taxes Based on Alternative Income Measures: Texas Margin Tax**

**Legislation (2006).** On May 18, 2006, the Texas governor signed into law a Texas margin tax (as amended by the technical corrections legislation that was passed in June of 2007) that restructured the state business tax by replacing the taxable capital and earned

surplus components of the franchise tax with a new *taxable margin* component for taxable years ending on or after January 1, 2007. Taxpayers subject to the margin tax include every taxable entity doing business or chartered or organized in Texas including, but not limited to, partnerships, corporations, limited-liability corporations, business trusts, professional associations, and other entities. The legislation excludes certain entities from the margin tax including, but not limited to, sole proprietors, general partnerships directly owned entirely by natural persons, passive entities that meet certain criteria, insurance entities paying Texas premiums tax, certain family limited partnerships, and other passive trusts. House Bill 32, the Franchise Tax Reduction Act of 2015, was signed into law on June 15, 2015. The bill, which applies to original reports filed on or after January 1, 2016, permanently reduced Texas franchise tax rates.

**9.141** The Texas margin tax generally requires payment of a .75% tax (or .375% for a retailer or wholesaler) on an entity's Texas-sourced *taxable margin*, as defined in the law. The taxable margin equals the lesser of (1) 70% of an entity's total revenue or (2) 100% of total revenue reduced for (a) cost of goods sold or (b) compensation, at the annual election of the taxpayer. Total revenues are defined as total revenues reported on the entity's federal tax forms reduced for certain items including, but not limited to, bad debts expensed for federal income tax purposes, foreign royalties and dividends, net distributive income from partnerships, and certain dividends and interest from federal obligations. Special provisions apply to entities that provide legal services, staff leasing services, management companies, and health care providers. Cost of goods sold are defined as all direct costs of acquiring or producing goods including, but not limited to, direct costs (labor, materials, depreciation), and certain indirect costs. Cost of goods sold excludes, among other items, selling costs, distribution costs, officers' compensation, interest, and income taxes. Compensation costs are defined as including wages and cash compensation paid to employees and costs of benefits to employees. However, wages and cash compensation is limited to \$300,000 (adjusted for inflation) per recipient. The June 2007 technical corrections legislation provided additional clarification on how the revenue apportionment and cost of goods sold provisions are applied in situations involving a combined group (affiliated groups engaged in a unitary business are required to file a combined margin tax return; controlling interest is defined as more than a 50% direct or indirect ownership interest).

**9.142** The June 2007 legislation also provided margin tax relief for certain small businesses by providing a percentage discount from margin tax liability based upon an entity's total revenues. Entities with total revenues of less than \$300,000 receive a 100% discount and not be subject to the margin tax. The June 2007 legislation also established an alternative gross receipts tax computation for entities with total revenues of \$10 million or less. Under the revised law enacted June 15, 2015, the total revenue limitation was raised to \$20 million or less and the franchise tax rate was reduced from .575% to .331% for entities electing the alternative gross receipts tax computation. An entity electing the alternative gross receipts tax may not take any credits (e.g., the temporary credit discussed in Paragraph 9.147) or deductions allowed under the regular margin tax laws, except the small business percentage discount.

**9.143** The margin amount (whether 70% of total revenue or 100% of total revenue as adjusted for cost of goods sold or compensation) is apportioned in accordance with the provisions of the June 2007 legislation to the state of Texas to determine the taxable entity's apportioned margin. The resulting amount is then reduced by other allowable deductions to determine the entity's taxable margin. A limited tax credit is also available. See Paragraph 9.147.

**9.144** Because the tax base on which the Texas margin tax is computed is derived from an income-based measure, the margin tax is considered to be an income tax for financial reporting purposes and, therefore, the provisions of ASC Topic 740 related to the recognition of deferred taxes apply to the Texas margin tax. The effect on deferred tax assets and liabilities as well as taxes currently payable of the changes in the Texas tax law were included in income tax expense attributable to continuing operations in the period that included the enactment dates of May 18, 2006, June 15, 2007, and June 15, 2015 (see Paragraph 5.004 for additional discussion) and were computed using the enacted tax rates that were expected to apply in the periods in which the applicable temporary differences were expected to reverse based on whether the entity expected to be taxed on total revenue less costs of goods sold, total revenue less compensation, or 70% of revenue (see Paragraph 9.146 for additional discussion) in those future periods.

**9.145** Because each of the measures (i.e., cost of goods sold, compensation, or the 70% of total revenue limitation) of the taxable margin have their own applicable temporary differences, scheduling may be necessary if an entity expects to be subject to more than one measure of taxable margin in future years when the existing temporary differences are expected to reverse. When measuring deferred tax assets and liabilities, an entity should use the enacted tax rates that are expected to apply in the periods in which the applicable temporary differences associated with either the total revenue less costs of goods sold or total revenue less compensation measures of taxable margin are expected to reverse. To the extent an entity expects to be subject to the 70% of total revenue measure of taxable margin, the entity should apply a rate of 70% of the enacted tax rate to those Texas-apportioned revenue-related temporary differences (e.g., difference between financial statement and tax recognition of bad debts, deferred revenue, etc.). In some cases an entity will apply different measures of its taxable margin from year to year depending on which yields a smaller taxable margin. In those cases, it will be necessary for an entity to schedule its temporary differences consistent with ASC paragraph 740-10-30-9, which states, "If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized." Accordingly, entities may need to estimate which measure of margin tax will be used when their temporary differences will reverse. ASC paragraphs 740-10-55-129 and 55-130 provide an example of the application of this guidance when phased-in tax rate changes occur. See also Paragraph 5.016 for additional information.

**9.146** Some basis differences may not affect the determination of taxable margin. For example, depreciation not charged to cost of goods sold is not deductible under the margin tax, but when a depreciable asset not used to produce goods is sold, the taxable gain for Texas is computed as the proceeds less the federal tax basis (which would reflect tax depreciation previously taken on the federal return). Because depreciation not charged

to cost of goods sold does not affect the amount of margin tax assessed during the holding period (i.e., the book margin and taxable margin are the same, regardless of the amount of book depreciation recognized), the basis difference arising as a result of depreciation is not a temporary difference for Texas margin tax when the entity intends to hold the asset until the basis difference disappears. When an entity does not intend to hold the asset until the basis difference disappears (i.e., until a period in which there is no difference between the financial statement carrying amount and the federal tax basis), deferred taxes should be provided as the basis difference arises, but would be limited to the deferred tax on the basis difference that is expected to exist at the expected date of sale. Assume that the basis difference on a depreciable asset not used to produce goods at the beginning of year 1 is \$100 and the entity expects to sell the asset in year 5 when the basis difference (based on projected depreciation for book and tax) is \$60. The entity would provide deferred taxes in year 1 on the \$60 basis difference. No additional deferred taxes would be provided in years 2-5 provided the entity continued to expect to sell the asset in year 5. If changes in expectations result in a change to the entity's assessment of the expected time of sale, the adjustment to deferred taxes would be recognized in the period of change.

**9.147** In addition to the establishment of the margin tax, the tax legislation established a *temporary credit on taxable margin*, which provides for the potential future use of a portion of an entity's Texas business loss carryforwards that existed at the end of the fiscal year ending in 2006. As originally enacted, the computation of the credit contained numerous operational complexities and inconsistencies that made it questionable whether entities would be able to consistently calculate a temporary credit on taxable margin that would represent the amount of credit expected to be realized in future tax years. The Texas Comptroller's Office released a "New Franchise Tax Calculator" in June 2006 that provided an interpretation of the temporary credit, which was generally used to make a consistent calculation of the amount of temporary credit on taxable margin expected to be realized absent any further regulatory or legislative action. The June 2007 legislation modified the applicability and computation of the temporary credit. The temporary credit is computed based on the unused/unexpired business losses carrying into the 2008 tax return, can be used over 20 consecutive years (subject to certain annual limitations), and may be carried forward through 2027.

**9.148** Under ASC Topic 740, deferred tax assets (net of valuation allowances, if necessary) were established as of the enactment date of the legislation for the temporary credits that were expected to be available under the margin tax legislation.

**9.149 Self-Procurement Taxes on Entities Using Captive Insurance Arrangements.** Included in the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA), was a modification in a state's ability to tax transactions involving nonadmitted insurance. Nonadmitted insurance is defined to include "any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer eligible to accept such insurance." A nonadmitted insurer is defined, with respect to a particular state, to mean an insurer that is not licensed to engage in the business of insurance in that state. A captive insurance entity typically will be licensed to engage in business in a single state (such as Vermont) or foreign jurisdiction (such as Bermuda) and

would be considered a nonadmitted insurer in most other states in which its insurance risks are located. The modifications in the NRRRA appear to have expanded the exposure to self-procurement taxes of an entity that uses a captive insurance arrangement.

**9.150** We do not believe these potential additional state procurement taxes meet the definition of an income tax because the tax is not based on profits or earnings, and therefore they should not be accounted for under ASC Topic 740. Accordingly, an entity should not recognize deferred tax assets and liabilities for future tax consequences of the self-procurement tax. An entity should classify the self-procurement tax outside of income tax expense. See Paragraph 3.100 for additional information about accounting for non-income-based taxes.

**9.151 Ohio Tax Reform Legislation (2005).** On June 30, 2005, the Ohio governor signed into law the Ohio budget bill (Am. Sub. H.B. 66) that created a new chapter of the tax code that imposes a gross receipts tax, the Commercial Activities Tax (CAT), effective July 1, 2005. The CAT imposes a 0.26% gross receipts tax for the privilege of doing business on all persons with taxable gross receipts sourced to the state of Ohio. Taxpayers subject to the CAT include individuals and all entity forms, including, but not limited to, general partnerships, limited partnerships, LLCs, trusts, estates, and other entities. However, the legislation excludes certain entities from the CAT, such as certain financial institutions, public utilities (partial exclusion only) and insurance companies, unless those entities are included in a consolidated filing group. The CAT replaced the corporate franchise (income) tax (over phase-out periods through 2009) as well as the property tax on machinery and equipment and an inventory tax (over varying phase-out periods).

**9.152** The CAT requires payment of tax based on Ohio *gross receipts*. Gross receipts are broadly defined as all receipts that contribute to the production of income and specifically include amounts realized from the sale of property, performance of services, and the rental and licensing of property. Deductions permitted from gross receipts are limited and include (among other things) cash discounts taken, returns and allowances, bad debts, and amounts realized from the sale of accounts receivable (if the receipts from the underlying sales are included in the tax base). Taxpayers may not deduct costs of goods sold. Additionally, the first \$1 million of taxable gross receipts is taxed at a flat amount of \$150 and thus is excluded from the tax base subject to the CAT rate. The CAT became effective July 1, 2005 and was phased-in over a series of nine-to-twelve month periods from July 1, 2005 through March 31, 2009, using specified percentages of the total CAT otherwise due during those periods.

**9.153** Because the tax base on which the CAT is computed is not derived from an entity's net income or other income measure, but is simply a tax on gross receipts, the CAT is not an income tax and, therefore, the provisions of ASC Topic 740 do not apply to the CAT. Accordingly, deferred tax assets and liabilities should not be recognized for future tax consequences of the CAT.

**9.154** In addition to the establishment of the CAT, the Ohio tax reform legislation established a complex system providing for the potential future use of pre-CAT net

operating loss (NOL) carryforwards. During the five-year period in which the corporate franchise (income) tax was phased out, qualifying taxpayers (generally those taxpayers with more than \$50 million in Ohio NOL carryforwards from their 2005 franchise tax report) were permitted to either (i) deduct NOLs without limitation and claim no CAT credit for unused NOL carryforwards once the franchise (income) tax is phased out, or (ii) deduct a maximum of \$50 million of NOL carryforwards (collectively among members of a consolidated or combined group) from taxable income under the franchise (income) tax during the phase-out period and claim a full or partial CAT credit for unused franchise (income) tax NOL carryforwards in excess of \$50 million over the 20-year period from 2010-2030. CAT credits were available for use beginning in 2010, but are being gradually phased in over 10 years subject to various limitations on the amount of credits claimed for individual taxable years through 2029. If the aggregate credit claimed between 2010 and 2029 is less than the total credit computed at the date of the election, a refundable credit is payable to the taxpayer in 2030 for the remaining amount, provided that the entity continues to be a CAT taxpayer in 2030. Taxpayers were required to file an election by June 30, 2006 if they wished to convert qualifying pre-CAT NOL carryforwards into CAT credits.

**9.155** Assuming a taxpayer elected to convert its NOL carryforwards (in excess of \$50 million) into CAT credits, those credits collectively represent an asset of the taxpayer that should have been recognized upon making the election. We believe that the state of Ohio did, in substance, exchange existing deferred tax assets under the previous corporate franchise system for a long-term receivable, which will either be recovered through offset against a liability to the same counterparty (i.e., direct credit against CAT obligations in 2010 through 2029) or received in cash in 2030. The CAT credit therefore qualified as a separate asset as of the date the entity expressed its intent to make the necessary election (but no earlier than the enactment date of the change in tax law of June 30, 2005) because, assuming no future change in law, the election will result in a fixed cash benefit to the taxpayer. The CAT credit is distinguishable from a tax holiday, as discussed in ASC paragraphs 740-10-25-35 and 25-36, as the amount of probable benefit is fixed and all conditions necessary for eligibility to collect the credit are deemed nonsubstantive.

**9.156** Because the CAT credit represents a long-term monetary asset, its value is substantially affected by the long period until recovery or receipt of the cash refund over the next 25 years. Accordingly, we believe the asset should be carried at its present value under ASC Subtopic 835-30, *Interest - Imputation of Interest*. Such present value should be based on the entity's expected cash flows (i.e., the estimate of the effect on the CAT liability through 2029 as well as the residual refund, if any, to be received in 2030), discounted at a rate commensurate with the risk of default by the state of Ohio. Despite the fact that the CAT credit may manifest itself over a potentially unpredictable period, we believe that the term over which the entity has the contractual right to receive cash is sufficiently determinable such that interest should be imputed based on the expected timing of the benefits. ASC paragraph 740-10-30-8 that prohibits discounting does not apply because the CAT is not an income tax subject to ASC Topic 740.

**9.157** The method for accreting the discount is a policy decision that should be consistently applied. For example, entities may consider, among other models, the

guidance in ASC Subtopic 310-20, *Receivables - Nonrefundable Fees and Other Costs* or ASC Subtopic 325-40, *Investments—Other - Beneficial Interests in Securitized Financial Assets*.

**9.158 Accounting for San Francisco’s Gross Receipts Tax.** The city of San Francisco (the City) levies a gross receipts tax on entities with business activities attributable to the City.

**9.159** As discussed in Paragraph 9.134, only those taxes that are assessed on an income-based measure are accounted for under ASC Topic 740. Whether a gross receipts tax, like the San Francisco tax, is assessed on an income-based measure depends on the jurisdiction's definition of *gross receipts*. For example, many jurisdictions (e.g., Ohio, as discussed in Paragraph 9.151) do not consider 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 in those situations is not *net* of expenses, we believe that many gross receipts taxes are not taxes based on income and would not be subject to ASC Topic 740.

**9.160** We believe the San Francisco Gross Receipts tax generally is not based on a net income measure as there are limited considerations of deducting costs of investments and property.

**9.161** While ASC Topic 740 is not applied to the San Francisco Gross Receipts tax, general accrual accounting does apply. For example, where significant, a financial instrument received in exchange for a service and carried at fair value in the financial statements attracts an accrual for the applicable San Francisco Gross Receipts tax as its fair value changes.

**9.162** Not used.

**9.163 Presentation of Tax Effects of Noncontrolling (Minority) Interests.** ASC paragraph 810-10-50-1A requires that net income attributable to the parent and the noncontrolling interest be presented separately on the face of the consolidated financial statements. Accordingly, net income attributable to noncontrolling interests should be presented after tax, and the income tax expense associated with the noncontrolling interest’s share of subsidiary earnings is reflected in consolidated income tax expense.

### **Example 9.39: Measurement of Noncontrolling Interests in Taxable Entities**

ABC Corp. consolidates Subsidiary A, a 90% owned subsidiary. The statutory tax rate is 21%. Noncontrolling interest is reflected in the consolidated income statement of ABC for Subsidiary A’s 10% owners’ interest in the net income of Subsidiary A. Subsidiary A has pretax income of \$100,000 and \$21,000 of income tax expense. The following are the amounts included in the consolidated financial statements of ABC related to Subsidiary A.

Revenue	\$ 140,000
Less: Expenses	<u>(40,000)</u>
Income before income tax expense	100,000
Income tax expense	<u>(21,000)</u>
Net income	79,000
Less: Net income attributable to the noncontrolling interest	<u>(7,900)</u> <sup>1</sup>
Net income attributable to ABC Corp.	<u><u>\$ 71,100</u></u>

<sup>1</sup> (\$79,000 of Subsidiary A net income × 10%)

### Example 9.40: Measurement of Noncontrolling Interests in Pass-through Entities

ABC Corp. consolidates Subsidiary LLC (a limited liability corporation), a 90% owned subsidiary. ABC's statutory tax rate is 21%. Subsidiary LLC is a pass-through entity and is not subject to income taxes in its jurisdiction. Taxable income and losses flow through Subsidiary LLC to its owners. Subsidiary LLC has \$100,000 of pretax income and \$0 income tax expense. ABC's taxable income includes its share of Subsidiary LLC's taxable income. The following are the amounts included in the consolidated financial statements of ABC related to Subsidiary LLC.

Revenue	\$ 140,000
Less: Expenses	<u>(40,000)</u>
Income before income tax expense	100,000
Income tax expense (recorded at ABC Corp. level)	<u>(18,900)</u>
Net income	81,100
Less: Net income attributable to the noncontrolling interest	<u>(10,000)</u> <sup>1</sup>
Net income attributable to ABC Corp.	<u><u>\$ 71,100</u></u>

<sup>1</sup> (\$100,000 of Subsidiary LLC net income × 10%)

The tax effects of Subsidiary LLC attributable to the noncontrolling owners are passed through to those owners and do not affect the consolidated financial statements of ABC. The effect of excluding the tax on the noncontrolling interest's share of Subsidiary LLC's income in the consolidated financial statements results in a reconciling item when comparing expected tax expense at the statutory rate and actual tax expense.

**9.164 Presentation of Withholding Taxes.** Distributions to shareholders may be subject to withholding taxes. ASC paragraph 740-10-15-4 states that a tax assessed on an entity based on dividends distributed is, in effect, a withholding tax, a tax paid on behalf of the investor, and should be recorded in equity as part of the dividend distribution only if specified conditions are met (see additional discussion beginning in Paragraph 7.025). If the tax paid does not meet the requirements to be considered a withholding tax, the payments should be treated as additional income tax expense and allocated to the various components of comprehensive income and equity using the step-by-step approach. In



other situations, taxes are withheld on revenues or sales generated in a particular jurisdiction that are then applied to the entity's income taxes payable in that jurisdiction. Those taxes (also sometimes referred to as withholding taxes) are similarly allocated to the various components of the income statement and equity using the step-by-step approach. ASC paragraphs 740-10-15-4, 55-73 and 55-74, 55-226 to 55-228

**9.164a Presentation of Tax Effects of Equity in Earnings from Equity Method Investments.** Most SEC filers are required under Rule 5-03 of Regulation S-X to present equity in earnings from equity method investees after income tax expense, but before discontinued operations. Some entities, however, present equity in earnings as a component of pretax income, particularly when the investor conducts its business largely through its unconsolidated subsidiaries and the operations of those investees have been integrated into the investor's business or are otherwise closely related. We believe the income statement presentation of the investor's tax on equity in earnings of equity method investments generally depends on whether the equity in earnings is presented before or after income tax expense in the income statement.

- Scenario 1: If equity in earnings is presented in the income statement as an increase to pretax income, we believe equity in earnings generally would be presented on a gross (pretax) basis; therefore, the investor's income tax expense associated with the equity in earnings of equity method investments would be reflected in the income tax expense line item.
- Scenario 2: If equity in earnings is presented below income tax expense in the income statement, we believe the equity in earnings generally would be presented net of investor tax; therefore, the investor's income tax expense associated with the equity in earnings of equity method investments would be reflected in the equity in earnings line item. See Paragraph 10.071a for additional discussion.

**9.165 Taxes for Equity Securities.** An investor that receives a dividend from an investment in equity securities that are accounted for under ASC Topic 321 should account for the dividend and related withholding tax separately because the tax is an expense of the investor relative to the investee's/payor's accounting. For example, an investor that receives \$70 cash from an investee representing a \$100 dividend less \$30 withholding tax (a tax payment that meets the requirements to be a withholding tax) should recognize \$100 of dividend income and \$30 of income tax expense. The income tax expense recognized (\$30 in this example) should be the amount of the payment made by the investee on behalf of the investor. However, taxes paid by the investee that are not, actual or in effect, withholding taxes attributed to the investor based on the requirements of ASC paragraphs 740-10-15-4 and 55-226 through 22-228 should not be recognized as income tax expense by the investor but are instead a reduction of dividend income.

**9.166 Presentation of Tax Effects Allocated to Other Comprehensive Income.** ASC Topic 220, *Comprehensive Income*, requires the components of other comprehensive income to be presented in a financial statement either net of tax or before tax with one amount shown as the aggregate income tax expense or benefit. Regardless of the

presentation alternative, the amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments, is required to be disclosed on a financial statement or in the notes to the financial statements. ASC paragraphs 220-10-45-11 to 45-14A and 50-4 to 50-6

**9.167 Presentation of Tax Benefits of Other Tax Credits.** Nonrefundable, nontransferable credits that are provided under the relevant jurisdiction's income tax law generally should be recognized as a reduction of income tax expense and allocated using the step-by-step approach. This is consistent with ASC paragraph 740-10-25-46 that requires that the benefit from an investment tax credit accounted for under the flow-through method be recognized as a reduction of federal income tax expense. Refer to KPMG Handbook: *Income Tax Credits* for further discussion of the accounting for and presentation of various types of income tax credits.

**Example 9.40a:** Not used.

**9.167a - cc** Not used.

**Example 9.41:** Not used.

**9.168 Credit Carryforwards.** Under provisions of the applicable tax law, certain tax credits that are generated in one period cannot be claimed or refunded until after a specific date in a subsequent annual period. However, in that subsequent period, the tax credits can be claimed on an amended return for the period in which the credits were generated or on a current return. Classification of the tax credits depends on the intended method to claim the credits.

- If the entity intends to file an amended return for the same period in which the tax credit is generated, the tax credit represents an income tax benefit reflected in the current tax calculation as a reduction of the current tax expense and current tax liability (or tax refund receivable.)
- If the entity intends to recover the tax credit in a future period, a deferred tax asset should be recognized for the tax credit that is carried forward to reduce taxes related to future years.

**9.169 Presentation of Tax Amounts Related to Assets and Liabilities Held for Sale.** As discussed in further detail in Paragraph 2.049, ASC Topic 360, *Property, Plant, and Equipment*, provides criteria for determining when a disposal group qualifies for held-for-sale classification. The assets and liabilities of a disposal group classified as held for sale should be presented separately in the asset and liability sections, respectively, of the balance sheet. Because the disposal group is defined as including only those assets and liabilities that will be transferred in the transaction, the deferred tax assets and liabilities that result in future taxable or deductible amounts for the seller are generally not part of

the disposal group. For example, if the transaction is expected to be structured as a sale of assets (and liabilities) or another form that taxes inside basis differences, the deferred taxes associated with those individual assets and liabilities (as well as any deferred taxes associated with the outside basis difference, if any) would continue to be classified with the entity's other deferred tax assets and liabilities rather than in the assets held for sale or liabilities held for sale line items because such deferred taxes are not transferred with the sale of the component.

**9.169a** However, if the transaction is expected to be structured as a nontaxable sale of the shares (or other carryover basis disposition, including a spin-off transaction) of a subsidiary, an entity may elect to classify the deferred taxes associated with the individual assets and liabilities either as assets (or liabilities) held for sale or with the entity's other deferred tax assets and liabilities because the tax bases of the individual assets and liabilities will transfer with the subsidiary and will not affect the taxation of the seller's gain or loss on disposal. This accounting policy election for presentation of deferred taxes in a disposition of the shares of a subsidiary only applies to the inside basis differences; deferred taxes associated with outside basis differences that will reverse in the transaction, if any, should be classified as deferred tax assets or liabilities because such amounts do affect the taxation of the seller's gain or loss on disposal. Income taxes receivable (payable), including liabilities for unrecognized tax benefits, that are transferred with the subsidiary being disposed would also follow the policy adopted. Entities should clearly disclose their accounting policy and the related amounts of deferred tax assets and liabilities that will carryover with the disposal group.

**9.169b** Generally, in a carryover basis disposition, the reversal of deferred tax assets and liabilities and the transfer of income taxes receivable (payable), including liabilities for unrecognized tax benefits, is incorporated into the calculation of the seller's gain or loss on disposal rather than presented in income tax expense when the subsidiary is sold.

**9.170 Allocation of Changes to Deferred Taxes on the Outside Basis Difference of a Discontinued Operation.** As discussed in Paragraphs 2.047 and 7.021, a deferred tax asset is recognized for the excess of the tax basis over the financial statement carrying amount of an investment in the stock of a subsidiary only if it is apparent that the temporary difference will reverse in the foreseeable future. A parent's conclusion that such difference will reverse in the foreseeable future often coincides with its conclusion that the subsidiary qualifies for held-for-sale presentation under ASC Subtopic 360-10, *Property, Plant, and Equipment - Overall*, and in certain circumstances, as a discontinued operation under ASC Subtopic 205-20, *Presentation of Financial Statements – Discontinued Operations*. In these circumstances, the recognition of the related tax benefit (and subsequent changes to that tax benefit) generally should be allocated to discontinued operations, including the portion associated with the beginning-of-year cumulative translation adjustment (see Paragraphs 9.044 and 10.086 for additional discussion). We believe it is also acceptable to recognize the tax benefit in continuing operations. Similar guidance would apply to a parent's taxable outside basis difference (see Paragraph 10.085 for additional discussion). In that situation, however, initial recognition of the taxable outside basis difference may occur under ASC paragraphs 740-30-25-19 (APB 23), 25-7, and 25-8 before the subsidiary qualifies for held-for-sale or

discontinued operations presentation. Until such time, the tax effects are presented in continuing operations.

**9.171 Financial Statement Classification of Deferred Effects of Intra-entity Inventory Transfers.** The amount for income taxes paid by the seller on the gains resulting from intra-entity inventory transfers involving assets that remain within the consolidated group and the tax effect of any reversing temporary differences in the seller's tax jurisdiction (deferred tax effects of intra-entity transfers) do not represent the deferred tax consequences of temporary differences. Accordingly, the deferred tax effects of intra-entity inventory transfers generally should not be classified as the entity's deferred tax assets or liabilities; it generally is classified as other assets or liabilities. In addition, the deferred tax effects resulting from intra-entity transfers of inventory should not be adjusted for changes in tax rates that occur subsequent to the date of transfer. See Paragraph 2.063 for additional discussion on the accounting for tax effects of intra-entity transactions.

**9.172 2003 and 2010 Acts Affecting Retiree Healthcare Plans.** In 2003, the Medicare Prescription Drug, Improvement and Modernization Act (the 2003 Act) introduced a Medicare prescription drug benefit and established a tax-free federal subsidy for entities that sponsor qualifying retiree healthcare plans. As described in ASC paragraph 740-10-55-57, the reimbursement right from the federal subsidy was presented as a reduction of the employer's benefit obligation but, because the subsidy was not taxed under the 2003 Act, it was not considered when measuring the deferred tax asset for the future tax deductions that the employer expected to take when it incurred the prescription drug costs reflected in the existing benefit obligation. As a result, deferred tax assets related to future tax deductions for postretirement health care obligations were not reduced by the tax effect of the nontaxable payments that would be received for those obligations. To account for the deferred tax asset related to the subsidy, employers generally performed two calculations to record the effect of other postretirement benefit (OPEB) plans – *with subsidy* that included the subsidy amount and was used to record the liability, expense and other comprehensive income components in the financial statements and *without subsidy* that excluded the subsidy amount and was used to calculate the deferred tax asset and income tax expense for the plan.

**9.173** Under the Patient Protection and Affordable Care Act (PPACA) enacted on March 23, 2010, beginning in 2013, the tax deductible prescription drug costs were to be reduced by the amount of the federal subsidy, thus the *deductible temporary difference* related to the benefit obligation was also reduced. As a result of the reduction in the deductible temporary difference, entities that received the subsidy recorded a charge to income tax expense from continuing operations to write off a portion of their deferred tax assets related to their OPEB plan in the period that included the enactment date for the health care legislation, in accordance with ASC paragraphs 740-10-35-4 and 45-15.

**9.174** Entities will continue to have a residual tax effect within AOCI, due to the fact that there was no tax effect when the Medicare subsidy program was initially recorded, as it was expected to be tax free. However, when PPACA was enacted and the resulting amounts after 2012 were essentially not tax free, the tax effects were recorded to the

income statement rather than to OCI. Accordingly, when the amounts currently in AOCI are recycled to the income statement, they will be recycled at net of tax amounts even though they were initially established on a gross basis for the effects of the subsidy. This difference (sometimes referred to as a *residual tax effect*) is typically released from AOCI when the item giving rise to the tax effect is disposed of, liquidated, or terminated. The residual tax effect associated with an employer's benefit obligation generally would remain in AOCI at least until the plan is terminated. See Paragraphs 5.050 and 9.031 for additional discussion of residual tax effects and Paragraph 9.045 for additional discussion of deferred taxes for pensions and other postretirement benefit plans.

#### Example 9.42: Tax Effect of Patient Protection and Affordable Care Act

ABC Corp. sponsors a prescription drug benefit plan for retirees. As of the enactment of PPACA, ABC reported the following on the balance sheet (using its with-subsidy amounts):

APBO (reflects \$150 federal subsidy)	\$ 350
AOCI for actuarial losses	60
AOCI for prior service costs	20

Before the enactment of PPACA, ABC determined the following amounts for the calculation of deferred taxes (without subsidy):

APBO	\$ 500
AOCI for actuarial losses	195
AOCI for prior service costs	30

After the enactment of PPACA, ABC determined that it expected to receive \$120 of the expected \$150 subsidy after 2013. Accordingly, ABC's *without subsidy* amounts were adjusted to reduce the tax benefit for years after 2013, as follows:

APBO	\$ 380 <sup>1</sup>
AOCI for actuarial losses	75
AOCI for prior service costs	20

For ABC, the adjustment for the \$120 reduction in the APBO was reflected as a reduction in APBO and an actuarial loss in the without subsidy records. As this is an adjustment to the without subsidy records, it does not have a direct financial statement effect on the reported APBO. However, there is an indirect financial statement impact for the tax effects of this adjustment. Accordingly, ABC recorded a \$48 (\$120 of subsidy that will no longer be tax free  $\times$  40%) charge to income tax expense from continuing operations in the period that included March 23, 2010. This tax adjustment does not affect the without subsidy records.

Between the enactment date and December 31, 2012 (the date the federal subsidy becomes fully taxable), ABC continued to have a deductible temporary difference

related to the tax deduction for the subsidy in the intervening period. This amount reversed through December 31, 2012, at which time tracking the with subsidy and without subsidy for accounting for income taxes purposes was no longer necessary.

<sup>1</sup>\$30 of which represents the tax deductions for the subsidy that were received in 2010 through 2012. This was recognized in the financial statements as the subsidy was received in those years, resulting in the with- and without-subsidy amounts being equal as of December 31, 2012.

## ENDNOTES

<sup>1</sup> In December 2023, the FASB issued ASU 2023-09, *Improvements to Income Tax Disclosures*. The ASU enhances annual income tax disclosures to address investor requests for more information about the tax risks and opportunities present in an entity's worldwide operations.

The ASU is effective for PBEs for annual periods in fiscal years beginning after December 15, 2024. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2025. Early adoption is permitted for annual financial statements not yet issued or made available for issuance.

The ASU applies on a prospective basis to annual financial statements for periods beginning after the effective date. However, retrospective application in all prior periods presented is permitted.

See KPMG Hot Topic: Income tax disclosures, for additional discussion and KPMG observations.

<sup>2</sup> In August 2020, the FASB issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. Among other items, the ASU eliminates the accounting for beneficial conversion features embedded in convertible debt instruments. The ASU will result in fewer embedded conversion features being separately recognized from the host debt instrument, and therefore fewer temporary differences being identified at initial recognition of those instruments. Under the ASU, separation of a conversion feature from a convertible debt instrument will be required only if the (1) conversion feature is required to be separately accounted for under Topic 815, *Derivatives and Hedging*, based on amended conditions, or (2) convertible debt is issued at a substantial premium. The ASU is effective for PBEs that are SEC filers and are not eligible to be smaller reporting companies for annual and interim periods in fiscal years beginning after December 15, 2021. For all other entities, the ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2023. Early adoption is allowed no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. An entity should adopt the guidance at the beginning of its annual fiscal year. An entity that has not yet adopted the amendments to the guidance for accounting for certain instruments with down-round features (ASU 2017-11) may adopt the recognition and measurement amendments in ASU 2020-06 for any convertible security that includes a down-round feature in financial statements that have not yet been issued or made available for issuance for fiscal years (or interim periods) beginning after December 15, 2019.

<sup>3</sup> In August 2020, the FASB issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. Among other items, the ASU eliminates the accounting for beneficial conversion features embedded in convertible debt instruments. The ASU will result in fewer embedded conversion features being separately recognized from the host debt instrument, and therefore fewer temporary differences being identified at initial recognition of those instruments. Under the ASU, separation of a conversion feature from a convertible debt instrument will be required only if the (1) conversion feature is required to be separately accounted for under Topic 815, *Derivatives and Hedging*, based on amended conditions, or (2) convertible debt is issued at a substantial premium. The ASU is effective for PBEs that are SEC filers and are not eligible to be smaller reporting companies for annual and interim periods in fiscal years beginning after December 15, 2021. For all other entities, the ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2023. Early adoption

is allowed no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. An entity should adopt the guidance at the beginning of its annual fiscal year. An entity that has not yet adopted the amendments to the guidance for accounting for certain instruments with down-round features (ASU 2017-11) may adopt the recognition and measurement amendments in ASU 2020-06 for any convertible security that includes a down-round feature in financial statements that have not yet been issued or made available for issuance for fiscal years (or interim periods) beginning after December 15, 2019.

<sup>4</sup> ASU 2023-09 replaces the term ‘public entity’ used in the current income tax disclosure requirements with the term ‘public business entity’ as defined in the Master Glossary of the Codification. An entity that is not considered a public entity but meets the definition of a PBE is subject to the following upon adoption of the ASU:

- the enhancements and other changes in the ASU applicable to PBEs; and
- other income tax disclosure requirements not affected by the ASU that are only applicable to a public entity before adoption of the ASU, such as the requirements to disclose: 740-10-50-6 and 50-15A
- temporary differences and carryforwards that give rise to a significant portion of deferred tax liabilities and assets; and
- a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period.

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ENDNOTES

**10.000** The subjects covered in this section are:

- Temporary differences acquired other than in a business combination;
- Equity method investments;
- Testing goodwill for impairment;
- Goodwill Amortization for Private Companies and Not-For-Profit Entities;
- Intercorporate tax allocations;
- Interim period tax calculations;
- Pass-through subsidiaries (consolidated partnerships and other consolidated tax pass-through entities);
- Cooperatives;
- Regulated investment companies and real estate investment trusts;
- Regulated entities;
- Reorganizations and quasi-reorganizations;
- Tax credits and government grants; and
- Transactions among or with shareholders.

## **TEMPORARY DIFFERENCES AND CARRYFORWARDS ACQUIRED OTHER THAN IN A BUSINESS COMBINATION**

**10.001** Temporary differences and carryforwards can be acquired in purchase transactions that are not business combinations (and therefore not subject to the guidance provided in Section 6, *The Tax Effects of Business Combinations*). These transactions, whether in the form of the acquisition of the equity interest of a legal entity or the actual acquisition of the underlying assets, where the assets acquired and liabilities assumed do not constitute a business, as defined in the accounting literature, are commonly referred to as asset acquisitions. Temporary differences and carryforwards acquired in transactions that are not accounted for as business combinations should be accounted for using the guidance in ASC paragraphs 740-10-25-50 through 25-52. Accordingly, an entity acquiring temporary differences and carryforwards must distinguish whether the transaction is an asset acquisition or a business combination. ASC Topic 805, *Business Combinations*, provides guidance on determining whether acquired assets and liabilities constitute a business. Paragraph 4.144e has additional guidance on transactions resulting in differing amounts of deferred tax assets and liabilities notwithstanding that the related deductible and taxable temporary differences are the same amounts. ASC paragraphs 740-10-S99-3, 740-10-55-171 through 55-204, 805-10-25-1

**10.002** Recognizing deferred tax assets or liabilities for temporary differences for acquired assets and liabilities in a purchase transaction that is not a business combination

generally would not result in immediate income statement recognition. The tax effects of acquired temporary differences and carryforwards generally are identified and recognized in the following manner.

- (1) Determine the initial allocation of the consideration paid to assets acquired (including in-process research and development (IPR&D)) and liabilities assumed based on their fair values.
- (2) Identify the tax bases of assets acquired and liabilities assumed and identify the amount of carryforwards acquired based on applicable enacted tax laws and regulations (see Paragraph 10.006).
- (3) Recognize a deferred tax asset for the tax benefits of operating loss and tax credit carryforwards in the acquisition (Paragraphs 10.002a and 10.007). Method 2 in Example 10.1a illustrates this approach. An entity may also recognize a deferred tax asset or liability for assets and liabilities that are not eligible for adjustment (see Paragraph 10.002b) in this step. Method 1 in Example 10.1a illustrates this approach.
- (4) Compute the excess cost or bargain purchase amount as the difference between the consideration paid and the amounts identified in steps 1 and 3. Allocate that amount pro rata to eligible noncurrent assets (see Paragraphs 10.002b and 10.002c) and IPR&D (see Paragraph 10.007a) based on the initial fair values.
- (5) Expense the initial amount allocated to IPR&D from steps 1 and 4 (see Paragraph 10.007a) and recognize a related deferred tax benefit to the extent of tax basis in IPR&D from step 2, if any.
- (6) Compare the initial allocated amount of the assets acquired and liabilities assumed from steps 1 and 4 to their tax bases from step 2 to determine the initial amount of temporary differences under ASC Topic 740. If an entity elected to recognize a deferred tax asset or liability for assets and liabilities that are not subject to adjustment (see Paragraph 10.002b) in step 3, it excludes the temporary differences related to those assets and liabilities from steps 6 and 7.
- (7) Perform the simultaneous equation to determine the final carrying amount of eligible noncurrent assets and their related deferred tax assets and liabilities (see Paragraph 10.003). If an entity elected to not recognize a deferred tax asset or liability for assets and liabilities that are not eligible for adjustment (see Paragraph 10.002b) in step 3, it recognizes the amount in this step.
- (8) Recognize a residual debit as income tax expense or a residual credit as a deferred credit (see Paragraph 10.004).

**10.002a Acquired Future Tax Benefits.** Acquired future tax benefits, such as net operating loss carryforwards or the acquisition of additional tax basis either as part of an asset acquisition or through a transaction with a taxing authority, should be recorded at the amount of the deferred tax asset (or reduction of the deferred tax liability) measured in accordance with ASC Topic 740. See Paragraph 10.007.

**10.002b Financial Assets, Current Assets and Noncurrent Assets That Are Ineligible for Adjustment.** Financial assets (excluding equity method investments), current and certain noncurrent assets should be allocated cost in the purchase price allocation based on the amounts required by other U.S. GAAP – i.e., they are not subject to pro rata or simultaneous equation adjustments as discussed in steps 4 and 7 (or the adjustments are limited).

- Financial assets (excluding equity method investments) are recorded at fair value.
- Acquired assets to be disposed of (i.e., those that meet the held-for-sale criteria of ASC Topic 360, *Property, Plant, and Equipment*), should be recorded at fair value less cost to sell.
- While not addressed in ASC Topic 740, we believe that postretirement benefit plan assets, current assets, contract assets and indemnification assets should be recognized at fair value or the amounts required by other U.S. GAAP in an asset acquisition. In addition, we believe that indefinite-lived intangible assets should be recognized at fair value without an upward adjustment from the pro rata allocation or from applying a simultaneous equation if those steps would net to an upward adjustment. An upward adjustment to an indefinite-lived intangible asset could result in an immediate impairment loss related to that asset. However, we believe an indefinite-lived intangible would be subject to a downward adjustment from applying the pro rata allocation or from applying a simultaneous equation – i.e., the adjustment would result in an allocation of cost to that asset at an amount less than fair value.

If the transaction does not include any assets eligible for adjustment and a temporary difference or carryforward exists on acquisition that results in a difference between the consideration paid and the amount allocated to the assets acquired and the liabilities assumed, we believe the entity would generally recognize that difference as an immediate charge to income tax expense or a deferred credit (see Paragraph 10.004).

**10.002c Noncurrent Assets That Are Eligible for Adjustment.** Noncurrent assets acquired (excluding those assets not eligible for adjustment as discussed in Paragraph 10.002b) should be recorded at fair value plus or minus an allocated pro rata share of the difference between the amounts initially assigned to all the acquired assets and liabilities assumed and the consideration paid. After this pro rata allocation, an entity computes the initial amount of its deferred tax assets or liabilities and applies the simultaneous equation (see Paragraph 10.003). When an initial taxable temporary difference exists in an asset acquisition, the simultaneous equation would result in an allocation that increases the financial statement carrying amounts of the noncurrent assets acquired that are eligible for simultaneous equation adjustment. When an initial deductible temporary difference exists in an asset acquisition, the simultaneous equation would result in an allocation that reduces the financial statement carrying amount of the noncurrent assets acquired that are eligible for simultaneous equation adjustment. If the simultaneous equation results in the noncurrent assets being reduced to zero (or the assets acquired are entirely those that are ineligible for simultaneous equation adjustment, see Paragraph

10.002b), the remaining excess of the amounts assigned to acquired assets over the consideration paid is recorded as a deferred credit, which is not a temporary difference. The deferred credit arising from the application of ASC subparagraph 740-10-25-51(b) should be amortized into income tax expense as discussed in Paragraph 10.004.

**10.003 Calculating Deferred Tax Assets and Liabilities for Noncurrent Assets That Are Eligible for Adjustment.** Calculating deferred tax assets and liabilities for acquired noncurrent assets that are eligible for simultaneous equation adjustment becomes circular in these transactions, because when an entity changes the financial statement carrying amount of those assets as a result of the recognition of deferred taxes on a temporary difference that exists at the acquisition date, an incremental temporary difference arises that results in another adjustment to eligible noncurrent assets. For example, recognizing a deferred tax asset for an acquired asset with an excess tax basis will increase the excess of the amounts assigned to acquired assets (including the deferred tax asset) over the consideration paid (bargain purchase amount). The bargain purchase amount is allocated to the asset, reducing its assigned value. The reduction in turn increases the deferred tax asset, which increases the bargain purchase amount, and so on. This circular calculation is solved using the simultaneous equation as discussed in Paragraph 6.015.

#### **Example 10.1: Tax Basis Is Less Than Financial Statement Carrying Amount in Asset Acquisition**

ABC Corp. pays \$1,000 for the shares of DEF Corp. DEF's only asset is a patent with a tax basis of \$200. DEF has no operations, employees, or processes, and therefore the acquisition is not considered the acquisition of a business. Assume ABC's tax rate is 21%.

The simultaneous equation factor is 26.58% ( $21\% \div (1 - 21\%)$ ).

Using the simultaneous equation factor, the deferred tax liability and the increase to the initial asset value is calculated as follows.

Purchase price allocated to patent (steps 1 and 4)	\$	1,000
Less tax basis		(200)
Initial temporary difference (step 6)		<u>800</u>
Multiplied by simultaneous equation factor		<u>.2658</u>
Deferred tax liability and adjustment to patent asset	\$	<u><u>213</u></u>

The purchase price assigned to the patent in step 7 would be \$1,213, the total cash purchase price plus the simultaneous equation adjustment ( $\$1,000 + \$213$ ). The deferred tax liability would be \$213 (the  $\$1,013$  temporary difference  $(\$1,213 - \$200) \times 21\%$  tax rate).

ABC would record the following entry:

	Debit	Credit
Intangible asset - patent	1,213	
Cash		1,000
Deferred tax liability		213

### Example 10.1a: Asset Acquisition of a Group of Assets, Including Those Not Eligible for Adjustment

ABC Corp. acquires DEF Corp. in a nontaxable acquisition that is accounted for as an asset acquisition. ABC pays \$7,300,000 in cash for the stock of DEF. ABC and DEF are C corporations for tax purposes and the applicable tax rate is 20%.

As of the acquisition date, DEF determines it has the following net assets in steps 1 and 2.

	Tax basis	Fair value
Current assets	\$ 100,000	\$ 100,000
Financial assets	50,000	50,000
Assets held for sale	50,000	50,000
Indefinite-lived intangible asset	600,000	800,000
IPR&D	0 <sup>1</sup>	4,000,000
Other noncurrent assets	0 <sup>2</sup>	2,000,000
Deferred tax asset (net operating loss carryforward)		500,000 <sup>3</sup>
Liabilities	(800,000)	(800,000)
Fair value of acquired net assets		<u>6,700,000</u>
Cash consideration		<u>7,300,000</u>
Cost in excess of fair value		<u><u>\$ 600,000</u></u>

Notes:

<sup>1</sup> The tax basis of IPR&D at acquisition is zero because DEF deducted the associated costs on its pre-acquisition tax returns. Assume that the IPR&D has no alternative future use.

<sup>2</sup> The tax basis of other noncurrent assets at acquisition is zero because DEF elected to report bonus depreciation on its pre-acquisition tax returns.

<sup>3</sup> ABC measures acquired deferred tax assets for carryforwards at the amount of the deferred tax asset measured in accordance with ASC Topic 740 (see Paragraph 10.002).

Although the cost of \$7,300,000 is greater than the fair value of the net assets acquired (\$6,700,000), the excess is not recorded as goodwill. Instead, the excess is allocated only to DEF's other noncurrent assets and IPR&D (see Paragraph 10.002) on a relative fair value basis.

Two approaches that ABC could use to compute its pro rata and simultaneous equation adjustments are (see Paragraph 10.002):

- Method 1: Identify temporary differences for assets that are not eligible for adjustment before computing and allocating its excess cost (or bargain purchase amount), or
- Method 2: Identify temporary differences for assets that are not eligible for adjustment after computing and allocating its excess cost (or bargain purchase amount).

### Method 1

Under Method 1, ABC computes the excess cost as the consideration paid minus the fair value of acquired net assets, including the deferred tax liability in step 3 ( $\$40,000 = (\$800,000 - \$600,000) \times 20\%$ ) related to the indefinite-lived intangible asset (because that asset is not eligible for adjustment; see Paragraph 10.002b). The excess of  $\$640,000$  ( $\$7,300,000 - \$6,700,000 + \$40,000$ ) is allocated in step 4 as follows.

	Fair value	Relative fair value percentage	Allocated excess	Total allocated value
IPR&D	\$4,000,000	66.667%	\$ 426,667	\$ 4,426,667
Other noncurrent assets	2,000,000	33.333%	213,333	2,213,333
Total	\$6,000,000	100.0%	\$ 640,000	\$ 6,640,000

In step 5, ABC immediately expenses the  $\$4,426,667$  allocated to IPR&D because it has no alternative future use.

The last step to finalize the accounting for the asset acquisition is to recognize deferred taxes related to the remaining acquired assets and liabilities and to determine the final carrying amount of eligible noncurrent assets. As discussed in Paragraph 10.002a, ABC measures the deferred tax asset for the net operating loss carryforward equal to the  $\$500,000$  acquired benefit in step 3. Under Method 1, ABC measures the deferred tax liability related to the indefinite-lived intangible asset with no adjustment, equal to the  $\$40,000$  ( $\$200,000$  temporary difference  $\times$  the 20% tax rate). After recognizing these deferred tax amounts, there is one remaining taxable temporary difference of  $\$2,213,333$  related to the other noncurrent assets.

To determine the deferred tax liability and adjustment necessary to compute the final carrying amount of the eligible noncurrent assets, ABC applies the simultaneous equation factor of .25 ( $20\% \div (1 - 20\%)$ ) to the taxable temporary difference ( $\$2,213,333$ ). This results in a final deferred tax liability  $\$553,333$ . ABC must increase the initial carrying amount of other noncurrent assets by this amount. This results in a final carrying amount for the other noncurrent assets of  $\$2,766,666$  in step 7.



ABC checks its final computation of deferred taxes by multiplying the final temporary differences by the tax rate.

	<b>Tax basis</b>	<b>Final carrying amount</b>	<b>Final temporary difference</b>	<b>Tax rate</b>	<b>Deferred tax asset (liability)</b>
Current assets	\$ 100,000	\$ 100,000	\$ 0	20%	\$ 0
Financial assets	50,000	50,000	0	20%	0
Assets held for sale	50,000	50,000	0	20%	0
Indefinite-lived intangible asset	600,000	800,000	(200,000)	20%	(40,000)
IPR&D	0	0	0	20%	0
Other noncurrent assets	0	2,766,666	(2,766,666)	20%	(553,333)
Deferred tax asset (NOL)			N/A		500,000
Liabilities	(800,000)	(800,000)	0	20%	0

ABC records the asset acquisition with the following journal entry.

Current assets	100,000	
Financial assets	50,000	
Assets held for sale	50,000	
Indefinite-lived intangible asset	800,000	
Other noncurrent assets	2,766,666	
Deferred tax asset - NOL	500,000	
IPR&D expense	4,426,667	
Liabilities		800,000
Deferred tax liabilities		593,333
Cash		7,300,000

## Method 2

Under Method 2, ABC computes the excess cost as the consideration paid minus the fair value of acquired net assets, excluding the deferred tax liability related to the indefinite-lived intangible asset. The excess of \$600,000 (\$7,300,000 – \$6,700,000) is allocated in step 4 as follows.

	<b>Fair value</b>	<b>Relative fair value percentage</b>	<b>Allocated excess</b>	<b>Total allocated value</b>
IPR&D	\$ 4,000,000	66.667%	\$ 400,000	\$ 4,400,000
Other noncurrent assets	2,000,000	33.333%	200,000	2,200,000
<b>Total</b>	<b>\$ 6,000,000</b>	<b>100.0%</b>	<b>\$ 600,000</b>	<b>\$ 6,600,000</b>

The \$700,000 difference between the \$6,600,000 allocated in step 4 above and the total consideration paid of \$7,300,000 is the amount allocated to the remaining net assets acquired:

Current assets	\$ 100,000
Financial assets	50,000
Assets held for sale	50,000
Indefinite-lived intangible asset	800,000
Deferred tax asset - NOL	500,000
Liabilities	(800,000)
Total	<u>\$ 700,000</u>

In step 5, ABC immediately expenses the \$4,400,000 allocated to IPR&D because it has no alternative future use.

The last step to finalize the accounting for the asset acquisition is to recognize deferred taxes related to the remaining acquired assets and liabilities and to determine the final carrying amount of eligible noncurrent assets. As discussed in Paragraph 10.002a, ABC measures the deferred tax asset for the net operating loss carryforward equal to the \$500,000 acquired benefit in step 3. In addition, there are two taxable temporary differences of \$200,000 and \$2,200,000 for the indefinite-lived intangible asset and other noncurrent assets, respectively.

To determine the deferred tax liability and adjustment necessary to compute the final carrying amount of the eligible noncurrent assets, ABC applies the simultaneous equation factor of .25 ( $20\% \div (1 - 20\%)$ ) to the sum of the taxable temporary differences related to the other noncurrent assets (\$2,200,000) and the indefinite-lived intangible asset (\$200,000). This results in a total deferred tax liability for the two items of \$600,000. Because ABC must recognize its indefinite-lived intangible asset at fair value (see Paragraph 10.002b) and its related deferred tax liability at \$40,000 (equal to its initial temporary difference), ABC must increase the initial carrying amount of other noncurrent assets by \$600,000. This results in a final carrying amount for the other noncurrent assets of \$2,800,000 in step 7.

ABC checks its final computation of deferred taxes by multiplying the final temporary differences by the tax rate.

	Tax basis	Final carrying amount	Final temporary difference	Tax rate	Deferred tax asset (liability)
Current assets	\$100,000	\$ 100,000	\$ 0	20%	\$ 0
Financial assets	50,000	50,000	0	20%	0
Assets held for sale	50,000	50,000	0	20%	0
Indefinite-lived intangible asset	600,000	800,000	(200,000)	20%	(40,000)

IPR&D	0	0	0	20%	0
Other noncurrent assets	0	2,800,000	(2,800,000)	20%	(560,000)
Deferred tax asset (NOL)			N/A		500,000
Liabilities	(800,000)	(800,000)	0	20%	0

ABC's records the asset acquisition with the following journal entry.

Current assets	100,000
Financial assets	50,000
Assets held for sale	50,000
Indefinite-lived intangible asset	800,000
Other noncurrent assets	2,800,000
Deferred tax asset - NOL	500,000
IPR&D expense	4,400,000
Liabilities	800,000
Deferred tax liabilities	600,000
Cash	7,300,000

**10.004 Recognition of the Deferred Credit.** An excess of (a) the amounts allocated to the acquired assets, assumed liabilities and related deferred tax assets and liabilities in step 4, over (b) the consideration paid, reduces the value of the noncurrent assets that are eligible for the simultaneous equation adjustment (as discussed in Paragraph 10.002c). If the simultaneous equation adjustment reduces the eligible noncurrent assets to zero, the remainder is classified as a deferred credit. A deferred credit also arises in some situations where an entity acquires only assets that are not eligible for adjustment (as discussed in Paragraph 10.002b) that also have temporary differences or acquires only a deferred tax asset, such as a net operating loss carryforward (as discussed in Paragraph 10.002a). Those deferred credits are subsequently recognized as a reduction to income tax expense in proportion to the realization (or elimination, if the asset is sold) of the deferred tax asset that gave rise to the deferred credit. Deferred credits are not temporary differences under ASC Topic 740. Accordingly, they are not classified as deferred tax liabilities (or an offset to deferred tax assets), do not serve as a source of future taxable income, and are not adjusted for a change in tax law or rates. The example below illustrates the accounting for a purchase of a financial asset and the resulting deferred credit. ASC paragraphs 740-10-25-50 through 25-52, 740-10-35-5, 740-10-45-22 through 45-24

### Example 10.2: Calculating the Deferred Credit

ABC Corp. pays \$650 to acquire a financial asset in 20X7. The financial asset has a tax basis of \$1,000 and a fair value of \$600. ABC's tax rate is 21%. 50% of the financial asset is sold in 20X8.

The financial asset should be recorded by the acquiring entity at its \$600 fair value in step 1. A deferred tax asset of \$84  $(\$1,000 - 600) \times 21\%$  should be recognized for the difference between the \$600 financial statement carrying amount and the \$1,000 tax basis in step 3 or 7. Assuming this acquisition is not a business combination, a \$34 deferred credit should also be recognized in step 8 because the tax basis of the financial asset differs from the amount of consideration assigned to it in ABC's accounting for the purchase. The acquisition would be recorded as follows:

	Debit	Credit
Financial asset	600	
Deferred tax asset	84	
Cash		650
Deferred credit		34

The deferred tax effects of the partial sale in 20X8 would be recorded as follows:

Deferred tax expense	42	
Deferred tax asset		42
Deferred credit	17	
Income tax expense		17

**10.004a Examples of Asset Acquisitions.** Examples of acquisitions of eligible noncurrent assets (both with and without a resulting deferred credit), a financial asset, an acquisition of a net operating loss carryforward, and a transaction resulting in a step-up in tax basis are provided in ASC paragraphs 740-10-55-171 through 55-201.

**10.004b UK Super-deduction.** On June 10, 2021, the Queen provided royal assent to Finance Act 2021 thereby establishing the enactment date of this Act for ASC Topic 740 (see Paragraph 7.071). Included are new capital allowances reliefs, including a temporary 130% deduction for expenditures on new plant or machinery designed to promote productivity-enhancing capital investments, also referred to as the super-deduction. Expenditures incurred for qualifying new plant or machinery between April 1, 2021 and March 31, 2023 may benefit from this tax super-deduction. Those expenditures may result in a 130% first-year allowance; in other words, taxpayers may take an immediate deduction for 130% of the expenditure incurred. This relief is available only for taxpayers subject to corporation tax and applies only to expenditures incurred under contracts entered into on or after March 3, 2021. If a qualifying asset is sold in a period that begins prior to April 1, 2023, the sales proceeds would be deemed to be 130% of the lesser of the actual proceeds or the original acquisition price.

**10.004c** In the reporting period that includes the enactment date, an entity remeasures deferred taxes and adjusts current taxes to reflect the 130% first-year allowance related to qualifying expenditures that were incurred before the enactment date. The adjustment should be included in income from continuing operations and treated as a discrete event in the interim period that includes the enactment date. In determining the discrete amount

of deferred tax expense from a change in tax law, we believe it is acceptable to remeasure deferred taxes using either the enactment date temporary differences or beginning-of-year temporary differences (see discussion beginning in Paragraph 5.017a).

**10.004d** We believe the 30% deduction over an entity's purchase price generally is akin to additional tax basis. As a result, qualifying expenditures incurred after the enactment date result in an asset for financial reporting purposes whose measurement differs from its tax basis at initial recognition. We believe the asset and the related income tax effects generally should be accounted for following the simultaneous equation method as discussed beginning in Paragraph 10.003.

**10.004e** When it purchases a qualifying asset, an entity recognizes a deferred tax asset for the excess of the amount that will be allowed as a first-year allowance over the financial statement carrying amount of the asset. Immediately after purchase, the entity receives a tax deduction for the entire amount of the tax basis, which brings the tax basis of the asset to zero. As a result, the related deferred tax asset reverses and a taxable temporary difference originates for the excess of the financial statement carrying amount over the tax basis of zero.

**10.004f** Although we believe the 30% deduction over the entity's purchase price generally is akin to tax basis, we understand there is diversity in practice on this issue. Some entities believe the 30% excess portion of the deduction should be accounted for like a special deduction because, unlike traditional tax basis in the UK, it cannot be depreciated for tax purposes, it is elective, and it is subject to effective recapture (as opposed to being subject to the UK capital allowance disposal rules that apply to the first-year allowance up to the amount of the expenditure). Those entities also believe the 100% portion of the deduction is more like traditional tax basis and thus should be considered as such in accounting for the acquisition of the asset. Given the unique nature of the provision in the tax law, we believe this alternative view is also acceptable. An entity that accounts for the 30% excess deduction as a special deduction recognizes the related benefit in the period in which it is available for deduction on the tax return (see Paragraph 3.074).

**10.004g** The new law also increases the UK tax rate to 25%, effective April 1, 2023. Accordingly, any temporary difference scheduled to reverse after the increase in the tax rate should be measured at the enacted tax rate for the year of reversal. In this situation, the deferred tax liability arising after purchase will be established at a tax rate that is greater than the rate for the year of the immediate tax deduction. We believe an entity accounts for the tax effect of this difference in tax rates in earnings when the first-year allowance is permitted and includes the tax effect of the originating temporary difference when determining the estimated annual effective tax rate.

### **Example 10.2a: Purchase of an Asset Qualifying for the Super-deduction**

ABC Corp., a calendar year entity, purchases qualifying equipment on January 1, 2022 for \$1,000 that has a useful life of five years and expects to hold the asset throughout its

useful life. ABC concludes the super-deduction results in tax basis and an immediate deduction of \$1,300. ABC does not need a valuation allowance for any of its deferred tax assets. ABC has a 19% tax rate for 2022, 23.5% for 2023 and 25% for later years.

The amounts assigned to the equipment and the related deferred tax asset are determined using the simultaneous equation as follows.

Determine the amount assigned to the deferred tax asset:

$$\text{Preliminary temporary difference} \times (\text{tax rate} \div (1 - \text{tax rate})) = (\$1,300 - \$1,000) \times (0.19 \div (1 - 0.19)) = \mathbf{\$70}$$

Determine the financial statement carrying amount assigned to the equipment:

$$\text{Preliminary book basis} - \text{deferred tax asset} = \$1,000 - \$70 = \mathbf{\$930}$$

The following journal entry recognizes the asset purchase and related deferred tax asset.

	Debit	Credit
Equipment	930	
Deferred tax asset	70 <sup>1</sup>	
Cash		1,000

$$^1 \$1,300 - \$930 \times 19\%$$

After initially recognizing the purchase of the asset and the deferred tax asset related to the excess tax basis, ABC makes the following entry to recognize the tax effects of the current super-deduction and the originating taxable temporary difference.

Income taxes receivable	247 <sup>1</sup>	
Deferred tax expense	290	
Current tax benefit		247
Deferred tax asset		70 <sup>2</sup>
Deferred tax liability		220 <sup>3</sup>

$$^1 \$1,300 \times 19\%$$

<sup>2</sup> Reversal of deferred tax asset recognized at acquisition

<sup>3</sup> See below

The deferred tax liability is measured based on the scheduled reversal over five years of the \$930 taxable temporary difference (calculated as the difference between the \$930 financial statement carrying amount and zero tax basis) as shown in the following table.

Description	2022	2023	2024	2025	2026	Total
Scheduled reversal	\$186	\$186	\$186	\$186	\$186	\$930
Tax rate	19%	23.5% <sup>1</sup>	25%	25%	25%	
Deferred tax liability	<u>\$ 35</u>	<u>\$44</u>	<u>\$47</u>	<u>\$47</u>	<u>\$47</u>	\$220

$$^1 (19\% \times (90 \text{ days} \div 365 \text{ days})) + (25\% \times (275 \text{ days} \div 365 \text{ days}))$$

For the 2022 estimated annual effective tax rate, ABC includes the \$186 depreciation expense in pretax ordinary income and includes the \$247 current tax benefit and \$255 of deferred tax expense in the tax effect of ordinary income. The \$255 of deferred tax expense includes \$70 from the reversal of the deferred tax asset recognized when the asset was acquired and \$220 of deferred tax expense related to the establishment of the deferred tax liability, net of \$35 of deferred tax benefit on the 2022 tax effect of the change in the financial statement carrying amount of the asset.

#### **10.005 Reduction in the Acquiring Entity's Valuation Allowance at Acquisition.**

Reducing the acquiring entity's valuation allowance solely as a result of acquiring assets should be recognized separately from the asset acquisition, generally as an income tax benefit (or credited directly to contributed capital) in accordance with ASC paragraph 740-10-45-20. If an acquired deferred tax liability provides a source of future taxable income to support some of the acquiring entity's existing deferred tax assets, a valuation allowance previously recognized for those deferred tax assets may be reduced. See Paragraph 6.039 for additional discussion on measuring the acquirer's deferred tax consequence. ASC subparagraph 740-10-25-51(c) and paragraphs 805-740-30-3

**10.005a Valuation allowance for Acquired Deferred Tax Assets.** If the acquirer recognizes a valuation allowance on an acquired deferred tax asset at the time of the asset acquisition, we believe that the deferred tax asset and the related valuation allowance generally are recognized separately in the accounting for the purchase. Immediate income statement recognition resulting from tax effects of asset purchases (not business combinations) when basis differences exist is specifically prohibited in ASC 740-10-25-51. Rather than using a simultaneous equation to calculate the deferred tax asset and a corresponding adjustment to the assets purchased, we believe the deferred tax asset should be recorded based on the cost basis of the asset purchased along with a valuation allowance. The income tax benefit from the release of a valuation allowance established when the deferred tax assets were acquired should be recognized in accordance with ASC paragraphs 805-740-45-2. Therefore, a reduction in the valuation allowance would be recognized as a decrease to income tax expense or, if applicable, an adjustment to contributed capital. If a valuation allowance is necessary for an acquired tax benefit after the asset acquisition, the effect should be recognized in continuing operations as a part of income tax expense. If a deferred credit had been recognized in the transaction in accordance with Paragraph 10.004, a proportionate share of that deferred credit should be recognized as a credit to income tax expense on subsequent establishment of the valuation allowance. ASC paragraphs 805-740-25-3, and 45-2

#### **10.006 Income Tax Uncertainties Related to Acquired Temporary Differences.**

Consistent with the discussion in the context of business combinations (see Paragraph 6.044), the tax bases used in the computation of deferred tax assets and liabilities in an asset acquisition are determined pursuant to the provisions of ASC Subtopic 740-10, *Income Taxes - Overall* (FIN 48) on accounting for uncertainty in income taxes. Accordingly, deferred tax assets and liabilities should be calculated based on the

differences between the assigned amounts for financial reporting purposes (as previously discussed) and the tax bases as determined using the recognition and measurement principles of ASC paragraphs 740-10-25-6 and 30-7 (see Paragraph 3.015 for additional discussion of accounting for uncertainty in income taxes). The ongoing recognition and measurement of acquired tax positions with uncertainty will also be subject to the principles of ASC Subtopic 740-10. Accordingly, new information about the recognition and measurement of such positions should trigger a reevaluation. The reevaluation could lead an entity to derecognize a previously recognized tax position, recognize a previously unrecognized tax position, or remeasure a previously recognized tax position and would be recognized as part of income tax expense (see the discussion beginning in Paragraph 3.026 for additional information on reevaluation of uncertainty in income taxes). ASC paragraphs 740-10-45-22 through 45-23, 25-51

**10.007 Acquired Future Benefits.** Acquired deductible temporary differences and carryforwards should be measured using the applicable enacted tax rate in accordance with the provisions of ASC Topic 740 and therefore should not be discounted. Accordingly, if a deferred tax asset is the only asset acquired from a third party which is not a government acting in its capacity as a taxing authority and the purchase price is at fair value (e.g., based on the discounted present value of the future tax benefits), a difference will arise, similar to the difference arising in a purchase of a financial asset with a temporary difference at acquisition. The excess of an acquired deferred tax asset (measured under ASC Topic 740) over the purchase price should be recognized as a deferred credit that is amortized into income tax expense in proportion to the reversal of the associated deferred tax asset. An entity may enter into a transaction with a third party that results in an increase to the tax basis of goodwill. In those situations, we do not believe an entity should limit the deferred tax asset recognized to the amount that exceeds existing financial statement goodwill. See Paragraph 10.004.

### Example 10.3: Purchase of Future Tax Benefits

Target A, a foreign entity that has nominal assets other than net operating loss carryforwards, is acquired by ABC Corp. ABC has other profitable foreign operations in Target A's tax jurisdiction and can use Target A's net operating loss carryforwards to offset future taxable income of the combined entity under the provisions of the tax law in the foreign jurisdiction. Target A has no operations and the transaction does not constitute a business combination. ABC is able to acquire Target A for \$1.5 million, which is a discount from the amount corresponding to the deferred tax asset of \$4.5 million, primarily as a result of the time value of money. Assume ABC concludes it is more likely than not that the full benefit of the acquired net operating loss carryforwards will be realized.

The deferred tax asset would be measured in accordance with ASC Topic 740 in step 2 and the excess of the amount assigned to the deferred tax asset over the purchase price would be recorded as a deferred credit in step 8 as follows:



	Debit	Credit
Deferred tax asset	4,500,000	
Deferred credit		3,000,000
Cash		1,500,000

**10.007a Acquisition of In-Process Research and Development (IPR&D).** As discussed in Paragraph 10.002, when an entity acquires in-process research and development in a transaction that is not a business combination, the purchase price allocated to the IPR&D is expensed at acquisition unless it has an alternative future use. We believe the write-off of the allocated purchase price generally comes before the identification and measurement of deferred taxes because GAAP does not allow the acquirer to recognize an asset. Accordingly, the write-off would be recognized in pretax earnings and would only have an associated income tax effect if there is associated tax basis.

**10.008 Transactions with Governmental Taxing Authorities.** If the cash acquisition of a tax benefit is directly between a taxpayer and a government in its capacity as a taxing authority, the excess of the assigned value of the tax benefit over the amount paid generally is recognized directly as a reduction of income tax expense in a manner similar to accounting for a change in tax law or rates.

**10.008a Increasing the Basis of Tax-Deductible Goodwill in a Transaction Directly with the Taxing Authority.** An entity may enter into a transaction directly with a government in its capacity as a taxing authority to increase the tax basis of goodwill. An entity that increases the tax basis of goodwill in a transaction with the taxing authority must determine if the step-up relates to the business combination in which the financial statement goodwill was originally recognized or if it is a separate transaction. ASC paragraph 740-10-25-54 includes factors that may indicate a step-up in tax basis relates to a separate transaction. Although the scope of guidance is specific to transactions with governments, it may be appropriate to apply it by analogy to other transactions that result in the step-up in the tax basis of goodwill.

**10.008c** If the step-up is considered part of the business combination, the entity recognizes a deferred tax asset only to the extent that the newly deductible goodwill amount exceeds the remaining balance of financial statement goodwill. We believe that if a transaction is considered part of a business combination, its tax effects, including a liability for consideration to be paid to the taxing authority, is recognized in the acquisition accounting under ASC Topic 805.

**10.008d** If the step-up is considered a separate transaction, the entity recognizes a deferred tax asset for the newly created tax goodwill. If the consideration paid to the taxing authority differs from the amount of the deferred tax asset (if any), the entity recognizes that difference as part of income tax expense (as discussed in Paragraph 10.008).

**10.008e** Not used.

## EQUITY METHOD INVESTMENTS

**10.009** Investments accounted for under the equity method for financial reporting purposes in accordance with ASC Topic 323, *Investments—Equity and Joint Ventures*, generally are accounted for using the cost method for tax purposes and therefore give rise to two types of temporary differences:

- First, a temporary difference can arise between the tax basis and the financial statement carrying amount of the investment (outside basis difference) because of adjustments to the investor's financial statement carrying amount for equity in earnings or losses. The tax effect of the basis difference in the investment in the stock of the investee is recognized on the balance sheet of the investor as a deferred tax asset or liability. See Paragraphs 2.053, 7.013, and 9.164a.
- Second, temporary differences can arise between the investor's share of the investee's financial statement carrying amounts of its assets and liabilities and the investor's share of the fair values (assigned values) of the investee's individual assets and liabilities (inside basis differences that are incremental to the investee's inside basis differences) at the date of investment as a result of the application of acquisition accounting. These inside basis differences are identified at acquisition because they will affect the earnings recognized by the investor and therefore become a component of the net investment in the equity method investee for financial reporting purposes.

**10.010 Allocating the Cost of an Investment.** The investor is required to allocate the cost of the investment to the individual assets and liabilities of the investee in accordance with the purchase price allocation provisions of ASC Topic 805. Similar to the allocation process required for business combinations (see Paragraph 6.011), any differences between the value assigned to the investee's individual assets and liabilities by the investor and the investee's financial statement carrying amount of those assets and liabilities give rise to deferred tax effects, which are not separately recognized, but affect the calculation of the investor's share of the earnings or losses of the investee for financial reporting purposes. For example, if the value assigned by the investor to the investee's depreciable assets exceeds the investee's financial statement carrying amount of the depreciable assets, an incremental temporary difference (i.e., an incremental temporary difference beyond what has been considered and accounted for by the investee, which is included in the financial statement carrying amount of its net assets) will be identified in the purchase price allocation process. Deferred taxes attributable to these temporary differences and measured at the investee's tax rate become a component of the equity method investment but are not presented separately as individual deferred tax assets and liabilities, as equity method accounting is a one-line consolidation. However, changes in these temporary differences affect the determination of the investor's share of earnings or losses of the investee and consequently may also affect the outside basis difference of the investment. ASC paragraphs 323-10-35-8 and 35-13

**Example 10.4: Deferred Taxes of an Equity Method Investment**

On January 1, 20X7, ABC Corp. purchases 25% of DEF Corp. for \$1,000, which is equal to the tax basis of its investment. The investment is accounted for under the equity method. DEF's financial statement carrying amount and the fair value of its net assets are \$2,400 and \$4,000, respectively. The difference between the financial statement carrying amount and the fair value is attributed to appreciation in the fair value of depreciable assets that have a 10-year remaining useful life at the date ABC acquires its 25% interest. ABC's income tax rate is 21%. There are no intangible assets.

DEF's statutory income tax rate is 21%. During 20X7, DEF reported net income of \$400.

On January 1, 20X7, ABC recorded the investment in DEF as follows:

	Debit	Credit
Investment in DEF	1,000	
Cash		1,000

Separately, ABC identified the components of the net assets acquired in accordance with ASC Topic 805. The identified components will not be recorded separately in the financial statement accounts of ABC, but instead are used to determine ABC's reported amount of the earnings or losses of DEF. The purchase price is allocated as follows:

Net assets as reported in DEF's financial statements ( $\$2,400 \times 25\%$ )	\$	600
Additional amount assigned to fixed assets ( $25\% \times [\$4,000 - \$2,400]$ )		400
Deferred tax liability for fixed assets ( $\$400 \times 21\%$ )		(84)
Equity method goodwill (nondeductible)		84
		<hr/>
Total purchase price	\$	<u><u>1,000</u></u>

At the end of 20X7, ABC calculated its share of income from its investment in DEF. When determining the amount of earnings from the equity method investment in DEF, ABC considers the effect of the purchase price allocation and the related income tax effects. The income from the equity method investment is calculated as follows:

Total net income from DEF	\$	400
ABC's ownership of DEF		25%
ABC's share of DEF's net income		<hr/> 100
Additional depreciation expense on additional purchase price allocation to fixed assets ( $\$400 \div 10\text{-year remaining life}$ )		(40)
Change in related deferred tax liability from purchase price allocation ( $40 \times 21\%$ )		8
		<hr/>
Equity in earnings from investment in DEF	\$	<u><u>68</u></u>

The equity in earnings from the investment in DEF includes the deferred tax expense (benefit) attributable to the underlying operations of the investee. ABC will also recognize a \$14 ( $\$68 \times 21\%$ ) deferred tax liability and related income tax expense associated with the undistributed equity in earnings because the exceptions from the comprehensive recognition of deferred taxes provided in ASC paragraph 740-30-25-17 (see Paragraph 10.012) do not apply to the newly created outside basis difference in the investment in DEF (financial statement carrying amount of \$1,068 and tax basis of \$1,000).

**10.011** The excess of the purchase price paid for an equity method investment over the assigned values of the investee's individual assets and liabilities under the allocation provisions of ASC Topic 805 is equity method goodwill. This goodwill generally is nondeductible and therefore (similar to the provisions of ASC paragraphs 805-740-25-8 and 25-9 on business combinations – see Paragraph 6.012 for additional discussion), no deferred tax liability would be identified in the purchase price allocation related to the equity method goodwill. ASC paragraph 323-10-35-34

**10.011a Acquiring an Equity Method Investee That is Not a Business.** When an investor acquires an equity method interest in an investee that does not contain a business, it does not identify equity method goodwill in its purchase price allocation. As a result, when it identifies deferred taxes related to its basis differences in its purchase price allocation, there is no equity method goodwill to adjust. Rather, the investor offsets the amount that it identifies as deferred taxes on its basis differences with an increase or decrease to the amounts it initially allocated to its share of the investee's noncurrent assets. It allocates those amounts on a relative fair value basis, similar to the allocation in an asset acquisition (see Paragraph 10.002).

**10.011b** This calculation, like in other asset acquisitions, becomes circular. When the investor adjusts the amount it has allocated to its share of the investee's noncurrent assets, it changes the basis differences related to those noncurrent assets. Those changes in the basis differences result in changes to the related deferred taxes. The investor would need to account for those deferred tax changes by again adjusting its share of the investee's noncurrent assets, which would start the cycle again. This circular calculation is solved using the simultaneous equation as discussed in Paragraph 6.015.

**10.012 Temporary Difference at Investor Level (Outside Basis).** A difference between the investor's financial statement carrying amount and tax basis of an investment accounted for under the equity method (outside basis) results in a temporary difference for which deferred taxes should be recognized. Deferred taxes are measured based on the expected character of the taxable or deductible amounts when the deferred effects reverse. Future taxable amounts related to an equity method investment generally will result from either dividends or sale of the investment. An investor may measure deferred taxes based on the expected tax effects of a future sale of the equity method investment (e.g., at capital gains rates), when the investors cannot control receipt of future dividends. ASC paragraph 740-10-55-24

**10.012a** Deferred taxes generally should be recognized on the outside basis difference even if a portion of that basis difference arises from an item for which an exception to the recognition of deferred taxes applies – e.g., nondeductible financial statement goodwill. However, we believe it would be acceptable for an investor to exclude that portion if the investee is a partnership. See additional discussion beginning in Paragraph 10.098.

**10.012b** The ASC paragraph 740-30-25-17 (APB 23) exception to recognizing a deferred tax liability for a taxable outside basis difference generally does not apply to equity method investments except for equity method investments in certain foreign corporate joint ventures (see Paragraph 7.003).

**10.013** When a foreign subsidiary becomes an equity method investment, an entity that has not recognized a deferred tax liability on an excess of the financial statement carrying amount over the tax basis of an investment in a foreign subsidiary will recognize a deferred tax liability for the outside basis difference in its retained equity method investment if it deconsolidates the subsidiary (unless the equity method investee is a foreign corporate joint venture that itself would be eligible for application of the indefinite reversal criterion or the investment can be recovered tax-free).

**10.013a** There is no exception for an existing taxable outside basis difference of a domestic equity method investee that was previously unrecognized pursuant to ASC paragraphs 740-30-25-7 and 25-8 or for a deductible outside basis difference (excess of tax basis over the financial statement carrying amount). Accordingly, deferred taxes are provided for these outside basis differences if recovery of the investment would have tax consequences. Accounting for an outside basis difference when an equity method investment becomes a consolidated subsidiary is discussed in Paragraphs 2.060, 6.076, and 7.055.

**10.014** Not used.

**10.015 Equity Method Bargain Purchase.** A bargain purchase may arise in the acquisition of an investment accounted for under the equity method. Because an owner generally will not knowingly or willingly sell assets or businesses at prices below their fair value, this situation is expected to occur infrequently, other than when there may be a forced liquidation or distress sale. In a bargain purchase, the investor generally allocates the shortage to its share of the investee's nonfinancial assets on a relative fair value basis. This calculation then becomes circular. When the investor adjusts the amount it has allocated to its share of the investee's noncurrent assets, it changes the basis differences related to those noncurrent assets. Those changes in the basis differences result in changes to the related deferred taxes. The investor would need to account for those changes in deferred taxes by again adjusting its share of the investee's noncurrent assets, which would start the cycle again. This circular calculation is solved using the simultaneous equation as discussed in Paragraph 6.015.

**10.016 Changes in Equity Method Investee Tax Uncertainties.** An entity's acquisition of an investment accounted for under the equity method may include uncertainties at the acquisition date related to the tax bases of the equity method investee's assets and

liabilities or the sustainability of prior tax return positions. Subsequent changes in judgment relative to the ultimate resolution of those uncertainties should be accounted for under ASC Subtopic 740-10 (FIN 48) on uncertainty in income taxes. See Paragraph 3.015 for additional discussion of accounting for uncertainty in income taxes.

**10.017 Changes in an Equity Method Investee's Valuation Allowance.** A valuation allowance may be necessary on an investee's deferred tax assets or additional deferred tax assets identified in the purchase price allocation for the acquisition of an investment accounted for under the equity method. The ASC Topic 740 provisions related to changes in valuation allowances subsequent to business combinations would also apply to valuation allowances related to an equity method investee's deferred tax assets. If and when the benefit of a deferred tax asset is realized via a reduction in the valuation allowance that existed at the acquisition date, the investor's share of that benefit follows the ASC Topic 740 guidance about intraperiod tax allocation, which generally results in a reduction to the investee's income tax expense included in the investor's share of income from the investment. ASC Section 740-20-45, ASC paragraph 740-10-45-20

**10.018** Not used.

## ACCOUNTING FOR TAX GOODWILL AFTER ACQUISITION

### **10.018a Accounting for Tax Goodwill Amortization after the Acquisition Date.**

Deferred tax effects of goodwill basis differences arise after the acquisition when (a) the deferred tax asset associated with second component tax goodwill, if any, reverses or (b) a basis difference arises related to the first component of goodwill (see Paragraph 6.012 for additional information about the accounting for goodwill at acquisition). We believe there are two acceptable methods for recognizing the deferred tax effects that arise as tax deductible goodwill is amortized. The first method (Method A) allocates the amortization of tax goodwill first entirely to second component tax goodwill before any tax amortization is allocated to the first component of tax goodwill. When second component tax goodwill is fully amortized (and the related deferred tax asset reverses as that basis difference is eliminated), a new basis difference will start to arise in the first component of goodwill (i.e., first component financial statement goodwill will exceed the first component of tax goodwill assuming no disposal, impairment or amortization under the goodwill alternative available to private companies and not-for-profit entities; see Paragraph 10.040 for additional discussion). As that basis difference arises in first component goodwill, a deferred tax liability (for which the timing of reversal may be indefinite, see Paragraphs 4.017-4.018) is established. Alternatively, an entity may elect a policy to recognize the deferred tax effects of the amortization of tax-deductible goodwill on a pro rata basis between the first component and second component tax goodwill (Method B). If an entity has already made a policy election for allocating changes in tax goodwill resulting from a disposal, we generally would expect it to apply that existing policy for allocating tax goodwill amortization to first and second component tax goodwill (see Paragraph 10.037a). We believe the accounting election discussed in this paragraph is an accounting policy election that, once made, should be applied consistently to all acquisitions. Entities have a similar policy election for allocating

changes in financial statement goodwill resulting from impairment or amortization (see Paragraphs 10.038b and 10.042 for additional information).

### Example 10.4a: Tax Goodwill Exceeds Financial Statement Goodwill in a Taxable Business Combination—Part I

ABC Corp. completes a taxable business combination on January 1, 20X9 that results in tax-deductible goodwill exceeding the financial statement goodwill. At the acquisition date, the goodwill for financial reporting purposes is \$6,000,000 before computing any deferred taxes related to second component goodwill. The tax basis of goodwill is \$9,000,000 and ABC's tax rate is 21%.

After applying the simultaneous equation (see computations in Example 6.9), the goodwill for financial reporting is established at the acquisition date at \$5,202,532 and the deferred tax asset recognized for the second component tax goodwill is \$797,468 ( $\$3,797,468 \times 21\%$ ).

Below is a summary of allocation of the first and second component goodwill:

	<u>January 1, 20X9</u>	
	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$ 5,202,532	\$ 5,202,532
Second component	—	<u>3,797,468</u>
Total goodwill	<u>\$ 5,202,532</u>	<u>\$ 9,000,000</u>

ABC will amortize tax goodwill over three years. ABC elects to apply Method A for amortization of tax goodwill.

ABC records the following entries after the acquisition as tax goodwill amortizes:

#### December 31, 20X9

	<b>Debit</b>	<b>Credit</b>
Deferred tax expense	630,000	
Deferred tax asset		630,000

The tax goodwill of \$9,000,000 is amortized over three years and at a 21% tax rate results in an annual reduction of current tax expense of \$630,000 ( $\$3,000,000 \times 21\%$ ). When

ABC amortizes tax deductible goodwill, the deferred tax asset associated with the second component tax goodwill reverses first.

Below is a summary of allocation of the first and second component goodwill at the end of 20X9:

	<b>December 31, 20X9</b>	
	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$ 5,202,532	\$ 5,202,532
Second component	—	797,468
Total goodwill	<u>\$ 5,202,532</u>	<u>\$ 6,000,000</u>

A deferred tax asset of \$167,468 remains at December 31, 20X9 related to second component tax goodwill. There is no temporary difference or deferred taxes related to the first component of goodwill at December 31, 20X9.

#### December 31, 20Y0

	<b>Debit</b>	<b>Credit</b>
Deferred tax expense	630,000	
Deferred tax asset		167,468
Deferred tax liability		462,532

ABC recognizes a deferred tax liability for the basis difference of first component goodwill once the second component tax goodwill is fully amortized for tax purposes.

Below is a summary of allocation of the first and second component goodwill at the end of 20Y0:

	<b>December 31, 20Y0</b>	
	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$ 5,202,532	\$ 3,000,000
Second component	—	—
Total goodwill	<u>\$ 5,202,532</u>	<u>\$ 3,000,000</u>



There is a deferred tax liability of \$462,532 at December 31, 20Y0 for the temporary difference related to the first component of goodwill.

**December 31, 20Y1**

	<b>Debit</b>	<b>Credit</b>
Deferred tax expense	630,000	
Deferred tax liability		630,000

At the end of 20Y1, ABC amortizes the remaining \$3,000,000 of tax deductible goodwill for tax purposes. The deferred tax liability related to the goodwill is \$1,092,532 ( $\$5,202,532 \times 21\%$ ).

Below is a summary of allocation of the first and second component goodwill at the end of 20Y1:

	<u>December 31, 20Y1</u>	
	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$ 5,202,532	\$ —
Second component	<u>—</u>	<u>—</u>
Total goodwill	<u>\$ 5,202,532</u>	<u>\$ —</u>

**Example 10.4b: Tax Goodwill Exceeds Financial Statement Goodwill in a Taxable Business Combination—Part II**

Assume the same information as in Example 10.4a except ABC elects to apply Method B for amortization of tax goodwill.

The following entries will be recorded after the acquisition as tax goodwill is amortized:

**December 31, 20X9**

	<b>Debit</b>	<b>Credit</b>
Deferred tax expense	630,000	
Deferred tax asset		265,823
Deferred tax liability		364,177

Tax goodwill of \$9,000,000 is amortized over three years and at a 21% tax rate results in an annual reduction of current tax expense of \$630,000 ( $\$3,000,000 \times 21\%$ ). ABC amortizes tax deductible goodwill proportionally from first and second components. Therefore, the reduction of the deferred tax asset on second component goodwill is computed as:

$$[\$3,000,000 \times (\$3,797,468 / \$9,000,000)] \times 21\% = \$265,823$$

The establishment of the deferred tax liability on first component goodwill is computed as:

$$[\$3,000,000 \times (\$5,202,532 / \$9,000,000)] \times 21\% = \$364,177$$

Below is a summary of allocation of the first and second component goodwill at the end of 20X9:

	<b>December 31, 20X9</b>	
	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$ 5,202,532	\$ 3,468,355
Second component	—	2,531,645
Total goodwill	<u>\$ 5,202,532</u>	<u>\$ 6,000,000</u>

At December 31, 20X9, there is a \$364,177 deferred tax liability related to the first component of goodwill and a deferred tax asset of \$531,645 related to the second component tax goodwill. Thus, for balance sheet classification, there is a net deferred tax asset of \$167,468 assuming that the deferred tax asset is determined to be fully recoverable.

#### December 31, 20Y0

	<b>Debit</b>	<b>Credit</b>
Deferred tax expense	630,000	
Deferred tax asset		265,822
Deferred tax liability		364,178

Because the entity elected Method B, the result is the same as in 20X9.

Below is a summary of allocation of the first and second component goodwill at the end of 20Y0:

	<u>December 31, 20Y0</u>	
	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$ 5,202,532	\$ 1,734,177
Second component	—	1,265,823
Total goodwill	<u>\$ 5,202,532</u>	<u>\$ 3,000,000</u>

At December 31, 20Y0, there is a \$728,355 deferred tax liability related to the first component of goodwill and a deferred tax asset of \$265,823 related to the second component of tax goodwill. Thus, for balance sheet classification, there is a net deferred tax liability of \$462,532 assuming that the deferred tax asset is determined to be fully recoverable.

#### December 31, 20Y1

	<b>Debit</b>	<b>Credit</b>
Deferred tax expense	630,000	
Deferred tax asset		265,823
Deferred tax liability		364,177

At the end of 20Y1, ABC amortizes the remaining \$3,000,000 of tax deductible goodwill for tax purposes. The deferred tax liability related to the goodwill at the end of 20Y1 is \$1,092,532 ( $\$5,202,532 \times 21\%$ ) and the deferred tax asset established in acquisition accounting is reduced to \$0.

Below is a summary of allocation of the first and second component goodwill at the end of 20Y1:

	<u>December 31, 20Y1</u>	
	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$ 5,202,532	\$ —
Second component	—	—
Total goodwill	<u>\$ 5,202,532</u>	<u>—</u>

## TESTING GOODWILL FOR IMPAIRMENT

**10.019** Under ASC Topic 350, *Intangibles—Goodwill and Other*, goodwill for a public business entity<sup>1</sup> is required to be tested for impairment at least annually at the reporting unit level. ASC paragraphs 350-20-35-3 through 35-3B permit, but do not require, an entity to perform a qualitative assessment with respect to any of its reporting units to determine whether the quantitative impairment test is needed. Entities are permitted to assess based on qualitative factors whether it is more likely than not that a reporting unit's fair value is less than its carrying amount before applying the quantitative goodwill impairment test. If it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the entity would conduct the quantitative goodwill impairment test.

**10.019a** Not used.

**10.019b** Entities measure impairment using the difference between the carrying amount and the fair value of the reporting unit. The tax benefit of the impairment charge related to first component financial statement goodwill either creates a deferred tax asset or reduces an existing deferred tax liability, which increases the carrying amount of the reporting unit above its fair value. To address this additional impairment ASC Subtopic 350-20, *Intangibles—Goodwill and Other - Goodwill*, require an entity to calculate its recognized impairment loss and associated deferred tax effect using the simultaneous equation as used in business combinations and as discussed in Paragraph 6.015.

**10.019c** This subsection explains the income tax aspects resulting from goodwill impairment. A private company<sup>2</sup> or not-for-profit entity may make an accounting policy election to amortize goodwill on a straight-line basis over 10 years (or less if another useful life is more appropriate) and only requires goodwill to be tested for impairment when a triggering event occurs that indicates that the fair value of an entity (or a reporting unit) may be below its carrying amount (see additional discussion beginning in Paragraph 10.040).

## DETERMINING THE CARRYING AMOUNT OF A REPORTING UNIT

**10.020 Assigning Deferred Tax Assets and Liabilities.** Assets and liabilities are assigned to a reporting unit if (a) the asset will be employed in, or the liability relates to, the operations of the reporting unit, and (b) the asset or liability will be considered in determining the fair value of the reporting unit. Deferred tax assets and liabilities that relate to the assets and liabilities of the reporting unit should also be assigned to that reporting unit. The method used to assign deferred taxes should be consistent with how the underlying financial statement asset or liability is assigned. For example, if a production facility is included in a reporting unit, any related deferred tax asset or liability is included in the reporting unit. This assignment is made even if the deferred tax asset or liability will not be considered in determining the reporting unit's fair value. This follows the specific requirement in Subtopic 350-20, which overrides the general assignment principles discussed in Question 5.4.10 of KPMG Handbook, *Impairment of*

*nonfinancial assets*. ASC paragraphs 350-20-35-7 and 35-25 to 35-27, 55-10 through 55-23D

**10.021** Certain deferred tax assets and liabilities may relate to assets and liabilities that have been assigned to multiple reporting units. In that case, the deferred taxes should be assigned to those reporting units on the same basis as the related assets or liabilities were assigned. For example, a deferred tax asset for vacation pay accruals that relates to all of the entity's employees should be assigned to the reporting units in which the employees provide services, consistent with the method used to assign the vacation pay liability to reporting units.

**10.022 Deferred Taxes for Assets and Liabilities Not Assigned to a Reporting Unit.**

The deferred taxes related to assets and liabilities not assigned to a reporting unit should also not be assigned to a reporting unit. For example, an environmental liability related to a disposed business may not be assigned to any reporting unit because it does not relate to the operations of any existing reporting unit and would not be acquired by a purchaser of any reporting unit. ASC paragraphs 350-20-35-39 and 35-40

**10.023 Assigning Deferred Taxes When There Is No Corresponding Financial Statement Carrying Amount.**

Deferred tax assets and liabilities that exist because of a carryforward or tax basis that has no corresponding financial statement carrying amount should be assigned to one or more reporting units if the general assignment principles are met: (a) the deferred tax asset or liability relates to the operations of the reporting unit and (b) it will be considered in determining the fair value of the reporting unit. For example, if the deferred tax assets related to operating loss carryforwards and tax credit carryforwards that arise from the operations of a reporting unit are considered by market participants when determining the fair value of the reporting unit, those deferred tax assets should be assigned to the reporting unit. However, in many cases carryforwards are not reflected in the fair value of a reporting unit that is measured assuming a taxable transaction; therefore, they will not be included in the carrying amount of the reporting unit. See Paragraph 10.029 and KPMG Handbook, *Impairment of nonfinancial assets*, for additional discussion of how to determine the assumed tax structure in goodwill impairment tests.

**Example 10.5: Assigning Deferred Tax Assets Related to Net Operating Loss Carryforwards to a Reporting Unit**

ABC Corp. is testing Reporting Unit X for impairment at its annual impairment test date and concludes that qualitative factors indicate the quantitative goodwill impairment test should be performed. The carrying amount of assets and liabilities of Reporting Unit X are: identifiable assets, \$500,000; identifiable liabilities, \$200,000; goodwill, \$450,000. Additionally, there is a deferred tax asset associated with a net operating loss carryforward of \$75,000. In applying the quantitative goodwill impairment test, ABC must consider whether Reporting Unit X would be sold in a taxable or nontaxable transaction.

Case 1: ABC concludes that a nontaxable transaction is not feasible, in part because several reporting units are contained in a single legal entity. As a result, it concludes that a sale of the reporting unit would be structured as a taxable transaction.

In a taxable transaction, net operating loss carryforwards are not available to an acquirer and would not be reflected in the fair value of a reporting unit. As these items would not be considered in arriving at fair value, ABC should not assign deferred tax assets related to net operating loss carryforwards to the carrying amount of the reporting unit. Thus, the carrying amount of Reporting Unit X would be \$750,000 (identifiable assets of \$500,000 + goodwill of \$450,000 - identifiable liabilities of \$200,000).

Case 2: ABC determines that Reporting Unit X's value would be maximized through a nontaxable transaction and that it is feasible to sell the reporting unit in a nontaxable transaction. Thus, the fair value of Reporting Unit X would include the value of the tax benefit attributable to the net operating loss carryforward. As a result, the carrying amount of Reporting Unit X would be \$825,000 (\$750,000 from Case 1 + deferred tax asset of \$75,000).

**10.024** Assigning carryforwards to reporting units is a straightforward process when the carryforward is generated solely from the operations of a particular reporting unit (e.g., when the reporting unit is a consolidated subsidiary for financial reporting purposes but files its own tax return). However, in most situations the assignment process will be more difficult when a reporting unit is a component of a group that files a consolidated tax return. The method used to assign the deferred tax assets to reporting units should be reasonable and systematic. An approach similar to that used for intercorporate tax allocation is one method that may be appropriate. See Paragraph 10.043 for additional discussion of acceptable methods for intercorporate tax allocation.

**10.025 Assigning Deferred Tax Asset Valuation Allowances.** A deferred tax asset valuation allowance that is recognized for a specific deferred tax asset should be assigned to the reporting unit to which the specified deferred tax asset is assigned. However, valuation allowances are frequently not asset-specific. For example, an entity concludes that its only source of taxable income to support realization of its deferred tax assets is the reversal of existing taxable temporary differences. As a result, it recognizes a valuation allowance equal to the amount of its deferred tax assets that are not supported by the reversal of its deferred tax liabilities. The entity is not able to associate the valuation allowance with specific deferred tax assets. In this case, the valuation allowance should be assigned to deferred tax assets before assigning the deferred tax assets to the reporting units. Various methods may be appropriate in making that assignment, depending on facts and circumstances. For example, the valuation allowance could be assigned on a pro rata basis to all deferred tax assets. It may also be acceptable for an entity to assign the valuation allowance based on which deferred tax assets are more likely than not of being realized based on the entity's scheduling.

**10.026 Assigning Liabilities for Unrecognized Tax Benefits.** Liabilities for unrecognized tax benefits associated with a reporting unit should also be assigned to that reporting unit when determining its carrying amount. This assignment should be performed in a manner consistent with the entity's assignment methodology for other current tax items and consider whether the liability relates to the operations of the reporting unit and whether it will be considered in determining the fair value of the reporting unit. ASC paragraph 350-20-35-39

**10.027 Assigning Only Recognized Deferred Tax Assets and Liabilities.** Certain deferred tax assets and liabilities are not recognized in the financial statements. For example, they may not be recognized because they: (a) are subject to specific exceptions in ASC Topic 740 (see Section 2, *Temporary Differences*), (b) do not meet the recognition criteria for tax positions with uncertainties (see Section 3, *Tax Calculation*), or (c) are a deductible temporary difference related to an investment in a subsidiary (see Section 2, *Temporary Differences*). Deferred tax assets and liabilities that have not been recognized in the financial statements should not be included in the carrying amount of a reporting unit. This is because unrecognized assets and liabilities are neither employed in nor related to the operations of a reporting unit as reported in the financial statements.

**10.028 Assigning the Tax Basis of Goodwill.** The tax basis of goodwill should be assigned to reporting units as part of assigning deferred taxes for goodwill to reporting units (see Paragraph 10.020). The method used to assign the tax basis of goodwill among multiple reporting units should be consistent with the method used to assign the financial statement carrying amount of goodwill. For example, if \$60 of the financial statement carrying amount of goodwill from an acquisition is assigned to Reporting Unit A and \$20 of the goodwill from the same acquisition is assigned to Reporting Unit B and if the tax basis in goodwill is a single unit of account under the tax law, then 75% of the tax basis of the goodwill could be assigned to Reporting Unit A and 25% to Reporting Unit B. If reporting units are in multiple jurisdictions, or if within a reporting unit there are separate legal entities filing separate tax returns within one jurisdiction, the tax basis of goodwill should be determined based on the unit of account under the tax law for each tax jurisdiction (see Paragraph 6.019 for additional discussion).

## IMPAIRMENT TESTING

**10.029 Impairment Test– Assumed Tax Structure When Estimating the Fair Value of the Reporting Unit.** The tax structure assumed (taxable versus nontaxable exchange) when estimating the fair value of a reporting unit is the structure that (a) is feasible, (b) will result in the highest economic value (including consideration of the related taxes that would reduce the proceeds expected to be realized from the sale), and (c) has assumptions consistent with those that market participants would incorporate into their estimates of fair value. In determining the feasibility of a nontaxable transaction, an entity should consider (i) whether the reporting unit could be sold in a nontaxable transaction and (ii) whether there are any income tax laws and regulations or other corporate governance requirements that could limit an entity's ability to treat a sale of the unit as a nontaxable transaction. ASC paragraphs 350-20-35-25 through 35-27

**10.030** ASC Subtopic 350-20, *Intangibles—Goodwill and Other - Goodwill*, does not define what constitutes a taxable transaction or nontaxable transaction. We believe that use of the term *taxable transaction* describes transactions in which the tax bases of the assets acquired and liabilities assumed of the acquired entity are adjusted to their acquisition-date fair value. Similarly, we believe that use of the term *nontaxable transaction* describes transactions in which the acquiree’s tax bases of the individual assets acquired and liabilities assumed are carried over by the acquiring entity. For example, an exchange of the acquirer’s shares or cash for the acquiree’s shares generally results in a nontaxable transaction, while an acquisition of the assets and liabilities of an acquiree for cash generally results in a taxable transaction. In certain circumstances, a tax election may be available under section 338 of the Internal Revenue Code, whereby the acquirer can elect to have an acquisition of shares treated as a taxable transaction. Involvement of tax professionals may be necessary to determine if an assumed tax structure will result in a taxable or nontaxable transaction.

**10.031** Valuation professionals sometimes value businesses without regard to whether the structure of a possible sale transaction would be taxable or nontaxable. However, the assumed tax structure of a transaction can significantly affect the valuation of a reporting unit. Some of the differences (not all-inclusive) that may arise between an assumed taxable and nontaxable structure of a transaction include:

- Valuations prepared assuming a taxable transaction explicitly consider the tax benefits to an acquirer of a step-up in basis including the tax deduction (often referred to as a tax amortization benefit) available to an acquirer from the ability to write off intangible assets and goodwill, regardless of whether they are recognized in the reporting unit’s financial statements.
- Forecasts prepared by management for a reporting unit’s expected future performance often include the benefits of net operating loss carryforwards, if applicable. These benefits generally are not realizable by the acquirer in a taxable transaction.
- In a nontaxable transaction, the amount of net operating loss carryforwards and built-in losses, which can be used annually by the acquirer, would be limited. Section 382 of the Internal Revenue Code imposes limits on the amount of net operating losses and built-in losses that can be applied annually against income in the event of certain ownership changes.

#### **Example 10.6: Determining the Reporting Unit’s Fair Value – Assumed Tax Structure**

ABC Corp. believes it can sell Reporting Unit to market participants by receiving cash in exchange for:

- the shares in Reporting Unit (nontaxable transaction) for \$700; or
- the assets and liabilities of Reporting Unit (taxable transaction) for \$800.



Because either type of transaction is feasible, ABC needs to assume the method that results in the highest economic value to ABC. The tax basis of Reporting Unit's net assets is \$350, which is the same as the tax basis of Reporting Unit's shares (as a legal entity); the tax rate is 21%.

- If the shares in Reporting Unit were sold, ABC would have a current tax payable of \$74 because of the tax effect of the difference between the proceeds and the tax basis of the shares:  $(\$700 - \$350) \times 21\%$ .
- If the assets and liabilities of Reporting Unit were sold, ABC would have a current tax payable of \$95 on the sale:  $(\$800 - \$350) \times 21\%$ .

As shown in the table, this means that ABC should assume that Reporting Unit would be sold in a taxable transaction because the net economic value of the transaction is higher. Therefore, fair value for the purposes of impairment testing is \$800.

	<b>Nontaxable Transaction</b>	<b>Taxable Transaction</b>
Gross proceeds (fair value)	\$ 700	\$ 800
Less: taxes arising from transaction	(74)	(95)
Economic value to ABC	<u>\$ 626</u>	<u>\$ 705</u>

**10.032 – 10.033** Not used.

**10.033a Impairment Test.** An entity will initially measure impairment using the difference between the carrying amount and the fair value of the reporting unit and, if first component financial statement goodwill exists, calculate its recognized impairment loss and associated deferred tax effect using the simultaneous equation as used in business combinations.

### **Example 10.7: Calculating Goodwill Impairment When a Taxable Transaction Yields the Highest Economic Value**

ABC Corp. is performing a goodwill impairment test relative to Reporting Unit at December 31, 20X7. Reporting Unit has the following assets and liabilities:

- Net assets (excluding goodwill and deferred taxes) of \$60 with tax bases of \$35
- Nondeductible goodwill of \$40
- Net deferred tax liabilities of \$5

The fair value of the net tangible and identifiable intangible assets in Reporting Unit is \$65, before consideration of book/tax basis differences. ABC has a tax rate of 21%.

Management concluded that it would realize the highest economic value from Reporting Unit by selling it in a taxable transaction and that the fair value of the reporting unit in a taxable transaction was \$80.

Deferred taxes related to the net assets of Reporting Unit should be included in the carrying amount of Reporting Unit even though they would reverse to ABC and would not carryover to a buyer. Accordingly, ABC would determine the carrying amount of Reporting Unit as follows:

Net assets (excluding goodwill and deferred taxes)	\$ 60
Goodwill	40
Deferred taxes	<u>(5)</u>
Carrying amount	<u><u>\$ 95</u></u>

ABC measures the initial impairment as the difference between the carrying amount (\$95) and the fair value (\$80) of the reporting unit (\$15). Because ABC's goodwill is nondeductible goodwill, the impairment would be recognized with no related income tax effect.

If ABC instead had first component goodwill that was impaired, the related income tax benefit either creates a deferred tax asset or reduces an existing deferred tax liability, which would increase the carrying amount of the reporting unit above its fair value. To solve this circular equation, ABC would calculate its impairment loss and associated deferred tax effect using the simultaneous equation used in business combinations as discussed in Paragraph 6.015.

As discussed in Paragraph 10.019b and illustrated in Examples 10.9a and 10.9b, ABC uses the simultaneous equation to determine the adjustment to its (a) deferred taxes and (b) the initial \$15 impairment charge:

$$\text{Adjustment to deferred taxes/adjustment to the initial impairment charge} = (\text{tax rate} \div (1 - \text{tax rate})) \times \text{initial impairment charge}$$

Assuming ABC's goodwill is entirely first component goodwill, the adjustment to the existing deferred taxes related to that goodwill is \$4  $((21\% \div (1 - 21\%)) \times \$15)$  and its impairment charge is \$19  $(\$15 + \$4)$ .

### **Example 10.8: Calculating Goodwill Impairment When a Nontaxable Transaction Yields the Highest Economic Value**

Assume the same facts as in Example 10.7. The fair value of the net tangible and identifiable intangible assets in the reporting unit is \$65, before consideration of book/tax basis differences. ABC has a tax rate of 21%. Management concluded that it would realize the highest economic value from Reporting Unit by selling it in a

nontaxable transaction and that the fair value of the reporting unit in a nontaxable transaction was \$85.

Deferred taxes related to the net assets of Reporting Unit should be included in the carrying amount of Reporting Unit. Accordingly, ABC would determine the carrying amount of Reporting Unit as follows:

Net assets (excluding goodwill and deferred taxes)	\$	60
Nondeductible goodwill		40
Deferred taxes		<u>(5)</u>
Carrying amount	\$	<u><u>95</u></u>

ABC measures the initial impairment as the difference between the carrying amount (\$95) and the fair value (\$85) of the reporting unit (\$10). Because ABC's goodwill is nondeductible goodwill, the impairment would be recognized with no related income tax effect.

If ABC instead had first component goodwill that was impaired, the related income tax benefit either creates a deferred tax asset or reduces an existing deferred tax liability, which would increase the carrying amount of the reporting unit above its fair value. To solve this circular equation, ABC would calculate its impairment loss and associated deferred tax effect using the simultaneous equation used business combinations as discussed in Paragraph 6.015.

As discussed in Paragraph 10.019b and illustrated in Example 10.9b, ABC uses the simultaneous equation to determine the adjustment to its (a) deferred taxes and (b) the initial \$10 impairment charge:

$$\text{Adjustment to deferred taxes/adjustment to the initial impairment charge} = (\text{tax rate} \div (1 - \text{tax rate})) \times \text{initial impairment charge}$$

Assuming ABC's goodwill is entirely first component goodwill, the adjustment to the existing deferred taxes related to that goodwill is \$3  $((21\% \div (1 - 21\%)) \times \$10)$  and its impairment charge is \$13  $(\$10 + \$3)$ .

**10.034 - 10.035** Not used.

**Example 10.8a:** Not used.

**10.036 Tax Effects of Goodwill Remaining in a Reporting Unit on Disposal of a Business.** On the disposal of a business within a larger reporting unit, ASC paragraphs 350-20-35-51 to 35-57 require the seller to allocate the reporting unit's financial statement goodwill between the business that was disposed of and the remaining parts of

the reporting unit based on their relative fair values on the date of disposal. For tax purposes, the gain or loss considers specific tax goodwill associated with the disposed business. We believe first and second component financial statement goodwill is determined in the acquisition accounting and is not subsequently re-evaluated. Consequently, the financial statement goodwill that leaves the reporting unit will retain its acquisition date characterization as first component or second component.

**10.037** In some situations, when the allocation of financial statement goodwill is made to the disposed business, a new temporary difference may arise in the remaining reporting unit. We believe a change in the temporary difference due to the loss of tax basis in goodwill is akin to a change in the temporary difference arising from tax goodwill being reduced due to amortization. This would be true even if the operations that remain post-disposal were originally acquired in nontaxable transactions that generated only second component financial statement goodwill.

### Example 10.9: Tax Effects of Goodwill Remaining in a Reporting Unit on Disposal of a Business

On January 20X1, ABC Corp. purchases the stock of DEF Corp. in a taxable business combination. In acquisition accounting, ABC recognizes \$1,000 of financial statement goodwill and generates \$1,000 of tax goodwill. ABC integrates DEF into an existing reporting unit with \$1,000 of nondeductible (second component financial reporting) goodwill.

The reporting unit's post-acquisition goodwill for financial reporting and tax purposes is as follows:

	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>
First component	\$ 1,000	\$ 1,000
Second component	1,000	-
Total goodwill	<u>\$ 2,000</u>	<u>\$ 1,000</u>

On December 31, 20X3, ABC disposes of DEF's stock. The financial reporting and tax goodwill amounts pre-disposal are as follows:

	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>	<b>Temporary Difference</b>	<b>Deferred tax liability</b>
First component	\$ 1,000	\$ 800*	\$ 200	\$ 42 <sup>F</sup>
Second component	<u>1,000</u>	<u>-</u>		<u>-</u>
Goodwill at December 31, 20X3	<u>\$ 2,000</u>	<u>\$ 800</u>		<u>\$ 42</u>

\*ABC Corp. uses a 15-year tax amortization period resulting in \$200 of amortization  $((\$1,000 \div 15 \text{ years}) \times 3 \text{ years})$  of the first component of tax goodwill and a \$200 taxable temporary difference at December 31, 20X3.

T \$200 taxable temporary difference  $\times$  21% tax rate

DEF's fair value represents 15% of the reporting unit's fair value. As a result, ABC allocates to DEF \$300  $(\$2,000 \times 15\%)$  of the reporting unit's financial statement goodwill.

As discussed in Paragraph 10.036, because DEF's financial statement goodwill was entirely first component at acquisition, the \$300 of goodwill allocated to it in the disposal is also entirely first component.

The reporting unit's financial reporting and tax goodwill amounts post-disposal are as follows:

	<b>Financial Statement Carrying Amount</b>	<b>Tax Basis</b>	<b>Temporary Difference</b>
First component	\$ 700*	\$ 0	\$ 700
Second component	1,000	0	
Remaining GW	<u>\$ 1,700</u>	<u>\$ -</u>	

\*Calculated as the initial first component financial statement goodwill less the portion allocated to DEF  $(\$1,000 - \$300)$ .

Before the disposal, the reporting unit's taxable temporary difference related to first component goodwill was \$200. After the disposal, it is \$700. The change in the temporary difference is the net effect of (1) allocating \$300 first component financial statement goodwill to the disposal, and (2) losing \$800 of first component tax goodwill.

As discussed in Paragraph 10.037, we believe a change in the temporary difference due to the loss of tax basis in goodwill is akin to a change in the temporary difference arising from tax goodwill being reduced due to amortization. As a result, ABC must recognize an incremental deferred tax liability for the \$500  $(\$700 - \$200)$  increase in its first component taxable temporary difference.

	<b>Debit</b>	<b>Credit</b>
Gain or loss on disposal of DEF	105*	
Deferred tax liability		105

\*Calculated as  $(\$700 \times 21\% \text{ tax rate}) - \$42 \text{ existing deferred tax liability (or } \$500 \text{ incremental taxable temporary difference} \times 21\% \text{ tax rate)}$

**10.037a** Similarly, if there was second component tax goodwill in the reporting unit pre-disposal, entities have a policy choice between two acceptable methods for characterizing the reduction in tax goodwill. The first method would be to allocate the reduction in tax goodwill first to second component tax goodwill (which would reduce any existing deferred tax asset) until exhausted and then allocate the remaining reduction in tax goodwill to first component tax goodwill (which would generate an additional deferred tax liability). Alternatively, an entity may elect a policy to allocate the reduction on a pro rata basis between the first component and second component tax goodwill. Entities have a similar policy election for allocating tax goodwill amortization to first and second component tax goodwill (see Paragraph 10.018a for additional information). If an entity has already made a policy election for allocating tax goodwill amortization, we generally would expect it to apply that existing policy for allocating changes in tax goodwill resulting from disposals.

**10.038 Allocating Goodwill Impairment to Deductible and Nondeductible Goodwill.**

If the first component of financial statement goodwill becomes impaired such that first component tax goodwill exceeds the first component of financial statement goodwill, a deferred tax asset should be recognized. An impairment of first component financial statement goodwill may also result in a reduction of a deferred tax liability that was recognized for an excess of first component financial statement goodwill over first component tax goodwill before the impairment loss.

**10.038a** Not used.

**10.038b** If a reporting unit has both first and second component financial statement goodwill, the goodwill impairment could be allocated using the methods used to reflect amortization of tax-deductible goodwill as discussed at Paragraph 10.018a. The impairment could be allocated by either allocating the impairment first entirely to second component financial statement goodwill, if any, before any impairment is allocated to the first component financial statement goodwill (Method A) or allocating the impairment on a pro rata basis to the reporting unit's first component and second component financial statement goodwill (Method B). An offsetting deferred tax asset (or reduction in a deferred tax liability) should be recognized for the impairment allocated only to the reporting unit's first component financial statement goodwill. There is no tax effect from the impairment of nondeductible goodwill (second component financial statement goodwill). Therefore, an entity that has elected Method A would recognize \$0 tax effect if the goodwill impairment amount was less than or equal to the second component financial statement goodwill. In applying Method B, sometimes the calculated goodwill impairment loss (resulting from the simultaneous equation) exceeds first component financial statement goodwill when there is also second component financial statement goodwill. In that case, we believe the excess should be allocated to second component financial statement goodwill (see Paragraph 10.039a).

**10.038c** We believe the allocation of an impairment charge to first component and second component goodwill guidance in Paragraph 10.038b also applies to amortizing financial statement goodwill under the accounting alternative available to private companies and not-for-profit entities in ASC Subtopic 350-20, *Intangibles—Goodwill and Other—Goodwill*. We generally would expect an entity to apply the same policy for allocating financial statement goodwill amortization and financial statement goodwill impairment. See additional discussion and Examples in Paragraph 10.040.

**10.039** Not used.

**Example 10.9a:** Not used.

### Example 10.9b: Allocating Goodwill Impairment

ABC Corp. is testing Reporting Unit's goodwill for impairment at December 31, 20X9. ABC has initially determined that the carrying amount of Reporting Unit is \$350 greater than its fair value. ABC's tax rate is 21%.

#### Scenario 1

ABC's goodwill and related deferred taxes before the goodwill impairment are:

	<b>Financial Statement Carrying Amount</b>		<b>Tax Basis</b>		<b>DTA / (DTL)</b>
First component	\$ 600	\$	600	\$	—
Second component	—		300		63
Total goodwill	<u>\$ 600</u>	\$	<u>900</u>	\$	<u>63</u>

ABC uses the simultaneous equation to determine the amount of the deferred tax asset and the adjustment to the initial \$350 impairment charge:

Deferred tax asset/adjustment to the initial impairment charge = (tax rate ÷ (1 - tax rate)) × initial impairment charge

ABC's deferred tax asset is \$93 ((21% ÷ (1 - 21%)) × \$350) and its impairment charge is \$443 (\$350 + \$93). ABC's goodwill and related deferred taxes after the goodwill impairment are:

	<b>Financial Statement Carrying Amount</b>		<b>Tax Basis</b>		<b>DTA / (DTL)</b>
First component	\$ 157	\$	600	\$	93 (600-157) × 21%
Second component	—		300		63
Total goodwill	<u>\$ 157</u>	\$	<u>900</u>	\$	<u>156</u>

ABC records the following journal entries:

	<b>Debit</b>	<b>Credit</b>
Impairment loss	443	
Goodwill		443
Deferred tax asset	93	
Deferred tax benefit		93

### Scenario 2

ABC's goodwill and related deferred taxes before the goodwill impairment are:

	<b>Financial Statement Carrying Amount</b>		<b>Tax Basis</b>		<b>DTA / (DTL)</b>
First component	\$ 600	\$	200	\$	(84)
Second component	—		—		—
Total goodwill	<u>\$ 600</u>	\$	<u>200</u>	\$	<u>(84)</u>

ABC uses the simultaneous equation to determine the adjustment to (a) the existing deferred tax liability and (b) the initial \$350 impairment charge:

$$\text{Adjustment to the deferred tax liability/adjustment to the initial impairment charge} = (\text{tax rate} \div (1 - \text{tax rate})) \times \text{initial impairment charge}$$

ABC's adjustment (debit) to the existing deferred tax liability is \$93 ((21% ÷ (1 – 21%)) × \$350) and its impairment charge is \$443 (\$350 + \$93). ABC's goodwill and related deferred taxes after the goodwill impairment are:

	<b>Financial Statement Carrying Amount</b>		<b>Tax Basis</b>		<b>DTA / (DTL)</b>
First component	\$ 157	\$	200	\$	9 (200-157) × 21%
Second component	—		—		—
Total goodwill	<u>\$ 157</u>	\$	<u>200</u>	\$	<u>9</u>



ABC records the following journal entries:

	Debit	Credit
Impairment loss	443	
Goodwill		443
Deferred tax asset	9	
Deferred tax liability	84	
Deferred tax benefit		93

### Scenario 3

ABC's goodwill and related deferred taxes before the goodwill impairment are:

	Financial Statement Carrying Amount	Tax Basis	DTA / (DTL)
First component	\$ 900	\$ 800	\$ (21)
Second component	300	—	—
Total goodwill	<u>\$ 1,200</u>	<u>\$ 800</u>	<u>\$ (21)</u>

Because ABC has excess financial statement goodwill, it could allocate the impairment on a pro rata basis (Method B) to first and second component goodwill. See Paragraph 10.038b. In that situation, ABC would allocate the initial impairment charge (\$350) to first and second component financial statement goodwill. Using a pro rata calculation, ABC would allocate \$263 ( $\$350 \times (900/1,200)$ ) to first component and \$87 ( $\$350 \times (300/1,200)$ ) to second component.

ABC then uses the simultaneous equation to determine the adjustment to (a) the existing deferred tax liability and (b) the \$263 initial impairment charge that was allocated to first component goodwill:

Adjustment to the deferred tax liability/adjustment to the allocated initial impairment charge =  $(\text{tax rate} \div (1 - \text{tax rate})) \times \text{initial impairment charge allocated to first component}$

ABC's adjustment (debit) to the existing deferred tax liability is \$70 ( $((21\% \div (1 - 21\%)) \times \$263)$ ) and its impairment charge allocated to first component goodwill is \$333 ( $\$263 + \$70$ ). ABC's goodwill and related deferred taxes after the goodwill impairment are:

	<b>Financial Statement Carrying Amount</b>		<b>Tax Basis</b>		<b>DTA / (DTL)</b>
First component	\$ 567	\$	800	\$	49 (800-567) × 21%
Second component	<u>213</u>		<u>—</u>		<u>—</u>
Total goodwill	<u>\$ 780</u>	\$	<u>800</u>	\$	<u>49</u>

ABC records the following journal entries:

	<b>Debit</b>	<b>Credit</b>
Impairment loss	420	
Goodwill		420
Deferred tax asset	49	
Deferred tax liability	21	
Deferred tax benefit		70

Alternatively, ABC could have elected Method A, and allocated the initial impairment charge (\$350) first to the second component financial statement goodwill (reducing it to zero) and then allocating the remaining initial impairment charge of \$50 to first component goodwill.

ABC would then use the simultaneous equation to determine the adjustment to (a) the existing deferred tax liability and (b) the \$50 initial impairment charge that was allocated to first component goodwill:

Adjustment to the deferred tax liability/adjustment to the allocated initial impairment charge = (tax rate ÷ (1 - tax rate)) × initial impairment charge allocated to first component

ABC's adjustment (debit) to the existing deferred tax liability is \$13 ((21% ÷ (1 - 21%)) × \$50) and its impairment charge allocated to first component goodwill is \$63 (\$50 + \$13). ABC's goodwill and related deferred taxes after the goodwill impairment are:

	<b>Financial Statement Carrying Amount</b>		<b>Tax Basis</b>		<b>DTA / (DTL)</b>
First component	\$ 837	\$	800	\$	(8) (800-837) × 21%
Second component	<u>—</u>		<u>—</u>		<u>—</u>
Total goodwill	<u>\$ 837</u>	\$	<u>800</u>	\$	<u>(8)</u>

ABC records the following journal entries:

	Debit	Credit
Impairment loss	363	
Goodwill		363
Deferred tax liability	13	
Deferred tax benefit		13

**10.039a Full Impairment of First Component Financial Statement Goodwill.** In some cases, the calculated goodwill impairment charge (resulting from the simultaneous equation) exceeds (a) first component financial statement goodwill when there is also second component financial statement goodwill, or (b) the total amount of goodwill allocated to the reporting unit. When the calculated goodwill impairment charge exceeds first component financial statement goodwill and second component goodwill remains (because the entity applied the pro rata method to allocate the impairment; see Paragraph 10.038b), we believe an entity should reduce second component financial statement goodwill for the excess impairment. When the calculated goodwill impairment charge exceeds the total amount allocated to the reporting unit, a conflict arises because ASC paragraph 350-20-35-8 limits the impairment charge to the total amount of goodwill allocated to the reporting unit. We believe an entity in that circumstance should limit its recognized impairment charge to the financial statement carrying amount of goodwill allocated to the reporting unit and adjust the associated deferred tax benefit so that the ending deferred tax balance is equal to the post-impairment temporary difference times the tax rate. Example 10.9c illustrates this calculation.

### Example 10.9c: Full Goodwill Impairment

ABC Corp. is testing the goodwill of a reporting unit (RU A) for impairment at its annual impairment testing date. Assume that all other assets in RU A have already been tested for impairment (ASC paragraphs 350-20-35-31 and 35-32). For purposes of applying the goodwill impairment test, ABC has determined that the fair value of RU A is \$700, tax basis of the RU goodwill is \$825, and the applicable tax rate is 21%.

The following is ABC's preliminary impairment allocation:

	Carrying Amount	Fair Value	Preliminary Impairment	Preliminary Deferred Tax Adjustment	Carrying Amount after Preliminary Calculation
Goodwill	\$ 350		(300)		\$ 50
Deferred tax asset	100			63	163
Other net assets	550				550
	<u>\$1,000</u>	\$ 700			<u>\$ 763</u>

Because the carrying amount of RU A (\$763) exceeds its fair value (\$700) following the preliminary calculation, ABC next applies the simultaneous equation illustrated in ASC paragraph 350-20-55-23C.

The following is ABC's secondary allocation:

	Carrying Amount	Fair Value	Preliminary Impairment	Adjustment for Equation*	Carrying Amount after Equation
Goodwill	\$ 350		(300)	(80)	\$ (30)
Deferred tax asset	100			80	180
Other net assets	550				550
	<u>\$ 1,000</u>	\$ 700			<u>\$ 700</u>

\* Calculated as  $21\% / (1-21\%) \times \$300 = \$80$

However, applying the simultaneous equation results in an impairment charge (\$380) that exceeds the carrying amount of goodwill (\$350). Because ASC Topic 350, *Intangibles – Goodwill and Other*, limits the impairment charge to the reporting unit's goodwill, we believe ABC should limit its impairment charge to \$350 and adjust the associated deferred tax effect so that the ending deferred tax asset is equal to the post-impairment temporary difference times the tax rate.

The following is the final calculation:

	Carrying Amount	Fair Value	Impairment	Deferred Tax Adjustment	Carrying Amount after Impairment
Goodwill	\$ 350		(350)		\$ -
Deferred tax asset	100			73	173*
Other net assets	550				550
	<u>\$ 1,000</u>	<u>\$ 700</u>			<u>\$ 723</u>

\* Calculated as \$825 (tax basis of goodwill) - \$0 (book basis of goodwill) × 21% (tax rate) = \$173.

Though the resulting carrying amount of RU A (\$723) exceeds its fair value (\$700) post-impairment, no additional impairment (or impairment testing) is necessary because goodwill has been fully impaired and all of RU A's other assets have been assessed for impairment under their respective impairment models. The ending deferred tax asset should be assessed for realizability under ASC Topic 740.

**10.039b Allocating Goodwill Impairment to Multiple Tax Jurisdictions within a Reporting Unit.** As described beginning in Paragraph 10.038b, if a reporting unit has financial statement goodwill that is impaired, an entity may choose to allocate that impairment (a) first entirely to second component financial statement goodwill, if any, before any impairment is allocated to the first component goodwill (Method A), or (b) on a pro rata basis to the reporting unit's first component and second component financial statement goodwill (Method B). Where there is more than one separate legal entity or tax jurisdiction within the reporting unit, the entity may need to further allocate the impairment to those lower levels. For example, if the impairment amount is less than the total of all of the reporting unit's second component financial statement goodwill and the entity elects Method A (i.e., allocates the impairment first entirely to the second component financial statement goodwill), one acceptable method of allocation would be a pro rata allocation of the impairment at the reporting unit level to those lower levels that, pre-impairment, have second component financial statement goodwill. That allocation could be based on the proportion of pre-impairment second component financial statement goodwill at the jurisdictional/legal entity level to the total pre-impairment second component financial statement goodwill at the reporting unit level. An entity that elects Method B (i.e., allocates the impairment on a pro rata basis to the reporting unit's first component and second component financial statement goodwill) may apply the same principle by:

- (1) Determining how much impairment will be allocated to first and second component goodwill based on the pro rata calculation at the reporting unit level (i.e., apply Method B);

- (2) Determining each lower level's proportion of the reporting unit's total first and second components of goodwill; and
- (3) Taking the impairment amount attributed to each component at the reporting unit level (determined in (1)) and allocating it to the lower levels based on the proportions determined in (2).

These allocation processes should result in (a) none of the first component financial statement goodwill impairment being allocated to lower levels that, pre-impairment, have no first component financial statement goodwill, and (b) none of the second component financial statement goodwill impairment being allocated to lower levels that, pre-impairment, have no second component financial statement goodwill.

**10.039c Recoverability of Goodwill Impairment Deferred Tax Assets when the Simultaneous Equation Is Applied.** We believe an entity should assess the need for a valuation allowance related to a goodwill impairment deferred tax asset only after it has applied the simultaneous equation and recognized the deferred tax asset before valuation allowance. Once the impairment loss is recognized, the entity should consider the realizability of the deferred tax asset following the general principles of ASC Topic 740. This approach is consistent with the general principle in ASC Topic 740 of recognizing all deferred tax assets and only then determining the need for a valuation allowance. It also ensures that the full goodwill impairment loss is recognized in accordance with Subtopic 350-20.

**Example 10.9d:** Not used.

### Example 10.9e: Allocating Goodwill Impairment to Lower Levels

Reporting Unit comprises two subsidiaries (Sub A and B) of ABC Corp. that are located in different jurisdictions.

The following is the pre-impairment allocation of financial statement goodwill within Reporting Unit. The second component financial statement goodwill is nondeductible (i.e., nondeductible goodwill):

	Sub A	Sub B	Total Reporting Unit
First Component	\$ 100	\$ 50	\$ 150
Second Component	200	0	200
Total goodwill	\$ 300	\$ 50	\$ 350

ABC is performing a goodwill impairment test for Reporting Unit, and concludes that goodwill is impaired by \$100.

**Scenario 1: ABC elects Method A**

If ABC has elected Method A (i.e., it allocates the impairment first entirely to second component financial statement goodwill before allocating any impairment to first component goodwill), the entire \$100 impairment would be allocated to Sub A because Sub A's proportion of the total second component financial statement goodwill is 100% (Sub A's second component financial statement goodwill of \$200 ÷ Total Reporting Unit second component financial statement goodwill of \$200).

**Scenario 2: ABC elects Method B**

If ABC has elected Method B (i.e., it allocates the impairment on a pro rata basis to the reporting unit's first component and second component financial statement goodwill), the initial \$100 impairment would be allocated as follows:

*Step 1: Determine how much of the initial impairment charge will be allocated to first and second component goodwill based on the pro rata calculation at the reporting unit level*

Total Reporting Unit First Component Goodwill of \$150 ÷ Total Reporting Unit Goodwill of \$350 = 43%

$43\% \times \$100 = \mathbf{\$43}$  of initial impairment charge allocated to first component

$57\% \times \$100 = \mathbf{\$57}$  of initial impairment charge allocated to second component

*Step 2: Determine each lower level's proportion of the reporting unit's total first and second components of goodwill*

Total Sub A First Component Goodwill of \$100 ÷ Total Reporting Unit First Component Goodwill of \$150 = **67%** (Sub A's proportion of the Reporting Unit's First Component Goodwill)

Total Sub B First Component Goodwill of \$50 ÷ Total Reporting Unit First Component Goodwill of \$150 = **33%** (Sub B's proportion of the Reporting Unit's First Component Goodwill)

Total Sub A Second Component Goodwill of \$200 ÷ Total Reporting Unit Second Component Goodwill of \$200 = **100%** (Sub A's proportion of the Reporting Unit's Second Component Goodwill)

Total Sub B Second Component Goodwill of \$0 ÷ Total Reporting Unit Second Component Goodwill of \$200 = **0%** (Sub B's proportion of the Reporting Unit's Second Component Goodwill)

*Step 3: Multiply the impairment attributed to each component at the reporting unit level determined in Step 1 by each lower level's first and second component proportions determined in Step 2*

*Sub A*

Total First Component Initial Impairment Charge of \$43 × Sub A First Component Goodwill Proportion of 67% = **\$29 of initial impairment charge allocated to Sub A's first component goodwill**

Total Second Component Impairment Charge of \$57 × Sub A Second Component Goodwill Proportion of 100% = **\$57 of impairment charge allocated to Sub A's second component goodwill**

*Sub B*

Total First Component Initial Impairment Charge of \$43 × Sub B First Component Goodwill Proportion of 33% = **\$14 of initial impairment charge allocated to Sub B's first component goodwill**

Total Second Component Impairment Charge of \$57 × Sub B Second Component Goodwill Proportion of 0% = **\$0 of impairment charge allocated to Sub B's second component goodwill**

*Step 4: Use the simultaneous equation to determine the adjustment to deferred taxes and the initial impairment charge allocated to first component goodwill*

*Sub A*

In Step 3, Sub A was allocated \$29 of the initial impairment charge allocated to first component goodwill. The adjustment to its (a) deferred taxes and (b) initial impairment charge is equal to:

$$(\text{Tax rate} \div (1 - \text{Tax rate})) \times \text{initial impairment charge allocated to first component}$$

Sub A's adjustment to its deferred taxes (assuming a 21% tax rate) is \$8  $((21\% \div (1 - 21\%)) \times \$29)$  and its first component impairment charge is \$37  $(\$29 + \$8)$ . **Its total impairment charge (for both first and second component) is \$94  $(\$37 + \$57)$ .**

*Sub B*

In Step 3, Sub B was allocated \$14 of the initial impairment charge allocated to first component goodwill. The adjustment to its (a) deferred taxes and (b) initial impairment charge is equal to:

$$(\text{Tax rate} \div (1 - \text{Tax rate})) \times \text{initial impairment charge allocated to first component}$$



Sub B's adjustment to its deferred taxes (assuming a 21% tax rate) is \$4 ( $(21\% \div (1 - 21\%)) \times \$14$ ) and its first component impairment charge is \$18 ( $\$14 + \$4$ ). **Its total impairment charge (for both first and second component) also is \$18 because it has no second component goodwill.**

Goodwill impairment and related deferred taxes in the separate financial statements of Sub A and Sub B may differ from the amounts above depending on how those subsidiaries identify their reporting units.

## GOODWILL AMORTIZATION FOR PRIVATE COMPANIES AND NOT-FOR-PROFIT ENTITIES

**10.040** As discussed in Section 6, at the acquisition date, no deferred taxes are provided on (a) first component goodwill (because by definition no basis difference will exist at the acquisition date), or (b) nondeductible goodwill (i.e., second component financial statement goodwill). However, deferred taxes should be recognized at the acquisition date for basis differences related to second component tax goodwill. Deferred tax effects of goodwill basis differences arise after the acquisition when (a) the deferred tax asset associated with second component tax goodwill, if any, reverses, or (b) a basis difference arises related to first component goodwill.

**10.041** A deferred tax asset should be recognized when an entity's (or a reporting unit's) first component tax goodwill exceeds first component financial statement goodwill. This can result from impairing financial statement goodwill as discussed above, but can also result from amortizing financial statement goodwill. As discussed in Paragraph 10.038c, while financial statement goodwill typically is not amortized, Subtopic 350-20, *Intangibles—Goodwill and Other - Goodwill*, allows private companies and not-for-profit entities to amortize financial statement goodwill on a straight-line basis over 10 years (or less than 10 years if the entity demonstrates that a shorter useful life is more appropriate). Entities that amortize financial statement goodwill, which results in an expected reversal of the temporary difference, should also consider the effect of the amortization in the valuation allowance assessment. If an entity has first component financial statement goodwill that exceeds first component tax goodwill, a deferred tax liability should be recognized and considered as a source of taxable income on reversal of the deferred tax liability. See discussion of valuation of deferred tax assets including scheduling the reversal of existing temporary differences in Section 4.

**10.042** Paragraph 10.038b provides guidance about how to allocate a goodwill impairment charge if an entity has both first and second component financial statement goodwill. That guidance states that an entity can either allocate the financial statement impairment entirely to second component financial statement goodwill first (which results in no tax effect until the impairment exceeds the carrying amount of second component financial statement goodwill), or the financial statement impairment can be allocated on a pro rata basis to first component and second component financial statement goodwill. We believe similar guidance applies to the amortization of financial statement

goodwill under the accounting alternative. Accordingly, an entity can either allocate periodic amortization entirely to second component financial statement goodwill first (which results in no tax effect until the amortization exceeds the carrying amount of second component financial statement goodwill), or the periodic amortization can be allocated on a pro rata basis to first component and second component financial statement goodwill. The amortization of second component financial statement goodwill will generally result in a pretax expense with no related income tax benefit. We generally would expect an entity to apply the same policy for allocating financial statement goodwill amortization and financial statement goodwill impairment.

### Example 10.10: Tax Accounting Related to Goodwill Amortization – Part 1

ABC Corp. recognized \$1 million of financial statement goodwill and \$1 million of tax goodwill in a taxable acquisition of DEF Corp. on January 1, 20X2 and elects to amortize financial statement goodwill under the accounting alternative. The tax goodwill is amortized over 15 years and financial statement goodwill is amortized over 10 years. ABC has a 21% tax rate.

The deferred tax effects recognized for the year ended December 31, 20X2 are:

	Book	Tax	Temporary Difference	DTA (DTL)
Initial Carrying Amount	\$ 1,000,000	\$ 1,000,000	\$ 0	\$ 0
20X2 Amortization	<u>(100,000)<sup>1</sup></u>	<u>(66,667)<sup>2</sup></u>		
20X2 Carrying Amount	\$ 900,000	\$ 933,333	\$ 33,333	\$ 7,000 <sup>3</sup>

<sup>1</sup>\$1,000,000 (total financial statement goodwill) ÷ 10 years = \$100,000

<sup>2</sup>\$1,000,000 (total tax goodwill) ÷ 15 years = \$66,667

<sup>3</sup>\$33,333 (excess tax basis in first component goodwill) × 21% = \$7,000

Assuming ABC had net income of \$0 for both financial statement and tax purposes other than the \$100,000 and \$66,667 of financial statement and tax goodwill amortization, respectively, and ABC was able to carryback the loss generated by the goodwill amortization, its effective tax rate (before consideration of any valuation allowance) would be:

Current:

Taxable loss	\$66,667	
Tax rate	21%	
Current tax benefit		\$ 14,000

Deferred:

Deductible temporary difference	\$33,333	
Tax rate	21%	
Deferred tax benefit		<u>\$ 7,000</u>

Total tax benefit	\$ 21,000
Divided by financial statement loss	<u>÷\$100,000</u>
Effective tax rate	21%

### Example 10.11: Tax Accounting Related to Goodwill Amortization – Part 2

Assume the same facts as in Example 10.10 except that ABC Corp. recognized \$1 million of financial statement goodwill and \$750,000 of tax goodwill and has elected to allocate amortization to the first and second components of financial statement goodwill on a pro rata basis.

The deferred tax effects recognized for the year-ended December 31, 20X2 are:

	Book	Tax	Temporary Difference	DTA (DTL)
<b>First Component</b>				
Initial Carrying Amount	\$ 750,000 <sup>1</sup>	\$ 750,000	\$ 0	\$ 0
20X2 Amortization	<u>(75,000)<sup>2</sup></u>	<u>(50,000)<sup>3</sup></u>		
20X2 Carrying Amount	\$ 675,000	\$ 700,000	\$ 25,000	\$ 5,250 <sup>4</sup>
<b>Second Component</b>				
Initial Carrying Amount	\$ 250,000 <sup>1</sup>	\$ 0	\$ (250,000)	\$ 0
20X2 Amortization	<u>(25,000)<sup>2</sup></u>	<u>0</u>		
20X2 Carrying Amount	\$ 225,000	\$ 0	\$ (225,000)	\$ 0

<sup>1</sup>\$1,000,000 total financial statement goodwill; First component goodwill is equal to the lesser of the financial statement goodwill or the tax goodwill at the acquisition date.

<sup>2</sup>\$1,000,000 (total financial statement goodwill) ÷ 10 years = \$100,000 allocated pro rata (i.e., 75/25) to the first and second components of financial statement goodwill.

<sup>3</sup>\$750,000 (total tax goodwill) ÷ 15 years = \$50,000

<sup>4</sup>\$25,000 (excess tax basis in first component goodwill) × 21% = \$5,250

Assuming ABC had net income of \$0 for both financial statement and tax purposes other than the \$100,000 and \$50,000 of financial statement and tax goodwill amortization, respectively, and ABC was able to carryback the loss generated by the goodwill amortization, its effective tax rate (before consideration of any valuation allowance) would be:

Current:		
Taxable loss	\$50,000	
Tax rate	21%	
Current tax benefit		\$ 10,500

Deferred:	
Deductible temporary difference	\$25,000

Tax rate	21%	
Deferred tax benefit		<u>\$ 5,250</u>
Total tax benefit		\$ 15,750
Divided by financial statement loss		<u>÷\$100,000</u>
Effective tax rate		16%

The 5% difference between the statutory rate of 21% and the effective rate of 16% is attributable to the fact that no deferred taxes are initially or subsequently recognized for second component financial statement goodwill. Had a deferred tax benefit been recognized for the \$25,000 of second component financial statement goodwill amortization, ABC's effective rate would have been equal to the statutory rate of 21%.

### Example 10.12: Tax Accounting Related to Goodwill Amortization – Part 3

Assume the same facts as in Example 10.11 except that ABC Corp. has elected to allocate amortization first to second component financial statement goodwill.

The deferred tax effects recognized for the year-ended December 31, 20X2 are:

	Book	Tax	Temporary Difference	DTA (DTL)
<b>First Component</b>				
Initial Carrying Amount	\$ 750,000 <sup>1</sup>	\$ 750,000	\$ 0	\$ 0
20X2 Amortization	<u>0</u>	<u>(50,000)<sup>3</sup></u>		
20X2 Carrying Amount	\$ 750,000	\$ 700,000	\$ (50,000)	\$ (10,500) <sup>4</sup>
<b>Second Component</b>				
Initial Carrying Amount	\$ 250,000 <sup>1</sup>	\$ 0	\$ (250,000)	\$ 0
20X2 Amortization	<u>(100,000)<sup>2</sup></u>	<u>0</u>		
20X2 Carrying Amount	\$ 150,000	\$ 0	\$ (150,000)	\$ 0

<sup>1</sup>\$1,000,000 total financial statement goodwill; First component goodwill is equal to the lesser of the financial statement goodwill or the tax goodwill at the acquisition date.

<sup>2</sup>\$1,000,000 (total financial statement goodwill) ÷ 10 years = \$100,000 allocated first to second component financial statement goodwill until such goodwill is exhausted.

<sup>3</sup>\$750,000 (total tax goodwill) ÷ 15 years = \$50,000

<sup>4</sup>\$50,000 (excess tax basis in first component goodwill) × 21% = \$10,500

Assuming ABC had net income of \$0 for both financial statement and tax purposes other than the \$100,000 and \$50,000 of financial statement and tax goodwill amortization, respectively, and ABC was able to carryback the loss generated by the goodwill amortization, its effective tax rate (before consideration of any valuation allowance) would be:

Current:		
Taxable loss	\$50,000	
Tax rate	21%	
Current tax (benefit)		\$(10,500)
Deferred:		
Taxable temporary difference	\$50,000	
Tax rate	21%	
Deferred tax expense		<u>\$ 10,500</u>
Total income tax benefit		\$0
Divided by financial statement loss		<u>÷\$100,000</u>
Effective tax rate		0%

The 21% difference between the statutory rate of 21% and the effective rate of 0% is attributable to the fact that no deferred taxes are initially or subsequently recognized for second component financial statement goodwill. Had a deferred tax benefit been recognized for the \$100,000 of second component financial statement goodwill amortization, ABC's effective rate would have been equal to the statutory rate of 21%.

**10.042a Goodwill Amortization Policy with Multiple Acquisitions.** If a private entity that amortizes financial statement goodwill has multiple acquisitions, it amortizes the financial statement goodwill on an acquisition-by-acquisition basis – i.e., it creates a separate amortization schedule for each layer of goodwill regardless of whether (or how) that goodwill is allocated to reporting units. Likewise, tax goodwill is typically amortized on an acquisition-by-acquisition basis. As a result, entities generally apply their policy for allocating financial statement goodwill amortization to first component and second component financial statement goodwill (see Paragraph 10.042) on an acquisition-by-acquisition basis; however, there may be other acceptable approaches.

**10.042b** Not used.

## INTERCORPORATE TAX ALLOCATIONS

**10.043** Current and deferred taxes for a group that files a consolidated tax return (or other form of combined or group filing) should be allocated among the members of the group for their separate financial statements (intercorporate tax allocation) using a method that is systematic, rational, and consistent with the broad principles of ASC Topic 740. However, an entity is not required to allocate consolidated income taxes to a legal entity that is not subject to tax for purposes of that legal entity's separate financial statements, but entities may elect to allocate consolidated income taxes to a legal entity if it is not subject to income tax and is disregarded by the taxing authority. An entity may not choose to allocate consolidated income taxes to legal entities that are partnerships or are other pass-through entities that are not wholly owned. The election can be made on an entity-by-entity basis. ASC paragraphs 740-10-30-27 to 30-28

**10.043a** Not used.

**10.043b** Although ASC Topic 740 does not prescribe a single allocation method to apply when an entity allocates current and deferred income taxes, in practice, intercorporate tax allocations are generally calculated using the separate return method, the pro rata method, or the benefits for losses method. As further discussed in Paragraph 10.051, the SEC staff believes that the separate return method is the preferable method for determining income taxes in the stand-alone financial statements.

**10.043c** While ASC paragraph 740-10-30-27 specifically states that the consolidated amount of current and deferred tax expense for a group must be allocated to each member, we believe that the current and deferred tax assets and liabilities must likewise be allocated to each member. Based on discussions with the SEC and FASB staffs, we believe that a member should present on its separate financial statements an allocated amount of deferred tax assets and liabilities for temporary differences until those temporary differences reverse. It would not be appropriate for a member to combine individual deferred tax assets and liabilities for temporary differences and classify them in an intra-entity payable or receivable caption, regardless of which intercorporate tax allocation method it applies.

**10.044** This subsection discusses the intercorporate tax allocation provisions of ASC Topic 740 for members of the group that file a consolidated income tax return. A subsidiary that files a separate tax return (not part of a consolidated tax return) should determine income tax expense based on the separate tax return filed for that subsidiary.

**10.045 Separate Return Method.** The separate return method applies ASC Topic 740 to the stand-alone financial statements of each member of the consolidated group as if the group member were a separate taxpayer and a stand-alone entity. Calculations of current and deferred taxes should consider all applicable income tax laws for the relevant tax jurisdiction. In some cases, the sum of the amounts allocated to individual members may not equal the consolidated amount. Accordingly, the group member may have net operating loss carryforwards, or other carryforwards that do not exist in the parent entity's consolidated tax return. ASC paragraphs 740-10-30-27 and 30-28

**10.046** The need for a valuation allowance on deferred tax assets generally is assessed using the sources of future taxable income available only to the group member. Accordingly, the sum of the valuation allowance amounts allocated to each group member may not equal the consolidated amount. For example, even if future taxable income exclusive of reversing temporary differences expected to be generated by a profitable subsidiary supports the conclusion that the consolidated entity does not need a valuation allowance for the deferred tax assets of an unprofitable subsidiary, the financial statements of the unprofitable subsidiary may need a valuation allowance when applying the separate return method.

**10.047 Modifying the Separate Return Method: Benefits for Losses.** As discussed in Paragraph 10.043, ASC Topic 740 requires the method of allocation to be systematic, rational, and consistent with the broad principles established by ASC Topic 740. While

the separate return method is one such method, modifications to the separate return method may be acceptable if the method used is systematic, rational, and consistent with the broad principles established by ASC Topic 740. For example, assume a parent entity generally allocates current and deferred tax expense among the members (e.g., subsidiaries) of the group using the separate return method; however, the parent entity has modified that hypothetical *separate return* by considering the subsidiary's net operating losses and capital losses realized by the subsidiary in its separate financial statements when those losses are used by the parent in its consolidated tax return with a cash settlement at that time. The separate return method, modified in the manner described (sometimes referred to as the *benefits for losses* method), also is a systematic, rational approach to allocating current and deferred tax expense among the members of the group and is consistent with the broad principles established in ASC Topic 740. If the benefits for losses method is used, we believe that the subsidiary may consider the parent's sources of taxable income in evaluating whether the subsidiary's deferred tax assets are expected to be realized to the extent that those deferred tax assets would create net operating losses or capital losses recoverable in the consolidated tax return. However, disclosure about the modification to the separate return method would be appropriate.

### Example 10.13: Allocating Taxes Using the Separate Return Method

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

ABC Corp. has two subsidiaries, Subsidiary X and Subsidiary Y, both of which are included in the consolidated tax return of ABC. However, Subsidiaries X and Y prepare separate financial statements in accordance with generally accepted accounting principles. The following is a summary of financial statement data of ABC and its subsidiaries as of and for the year ended December 31, 20X7 (balance sheet amounts do not include deferred taxes):

		Subsidiary X		Subsidiary Y		Consolidated ABC Corp.
Tangible assets	\$	40	\$	60	\$	100
Intangible assets	\$	20	\$	800	\$	820
Goodwill						
(nondeductible)	\$	—	\$	200	\$	200
Net liabilities	\$	(50)	\$	(300)	\$	(350)
Pretax net income	\$	500	\$	(200)	\$	300

- Subsidiary X had deductible temporary differences of \$25 at December 31, 20X6. In 20X7 depreciation expense for financial statement purposes exceeded tax depreciation by \$125.
- Subsidiary Y had no temporary differences at December 31, 20X6. In 20X7 intangible amortization expense for income tax purposes exceeded financial statement expense by \$200.

- Subsidiary Y's pretax net income includes a goodwill impairment charge of \$100 taken in 20X7.
- ABC and its subsidiaries operate in one tax jurisdiction with an income tax rate of 21%.
- No valuation allowance is needed at the consolidated level of ABC.
- Subsidiaries X and Y recognized no valuation allowances in 20X6.
- Subsidiary Y was recently acquired and has no history of profitable operations.

ABC's consolidated taxable income and total tax expense are determined as follows:

Pretax net income	\$	300
Add-back nondeductible goodwill write-off		100
Deduct tax depreciation/amortization in excess of book (\$125 - \$200)		(75)
Taxable income	\$	325
		× 21%
Current tax expense	\$	68
Net change in deferred taxes (\$75 × 21%)		16
Total income tax expense	\$	<u>84</u>

Under the separate return method, income tax expense is allocated to Subsidiaries X and Y as if the subsidiaries file separate income tax returns. Following is the summary of the calculations of total income tax expense for Subsidiaries X and Y using the separate return approach.

	<b>Subsidiary X</b>	<b>Subsidiary Y</b>
Pretax net income (loss)	\$ 500	\$ (200)
Add-back nondeductible goodwill write-off	—	100
Add (deduct) tax depreciation/amortization less than (in excess) of book	125	(200)
Plus increase in net operating loss carryforward	—	300
Taxable income	\$ 625	\$ —
	× 21%	× 21%
Current tax expense (benefit)	\$ 131	\$ —
Net change in deferred taxes	(26)	(21)
Change in valuation allowance	—	21
Total income tax expense (benefit)	\$ <u>105</u>	\$ <u>—</u>

Subsidiary Y would recognize a valuation allowance for its net deferred tax assets as a result of its inability to project sufficient future taxable income. The valuation allowance



would be \$21 for the portion of the \$63 ( $\$300 \times 21\%$ ) deferred tax asset for the net operating loss carryforward that cannot be used to offset the future taxable income arising as a result of the reversal of existing \$42 of deferred tax liabilities ( $\$200 \times 21\%$ ) as of December 31, 20X7 (note that this example assumes that Subsidiary Y is able to use all of its NOL to offset the taxable income resulting from the reversal of its taxable temporary difference and that the NOL is not subject to the 80% annual limitation – see Paragraph 4.016a for additional discussion). Subsidiary Y recognizes a valuation allowance for this portion of its net operating loss carryforward even though ABC has no valuation allowance or net operating loss carryforward on a consolidated basis. Assuming the tax-sharing agreement between ABC and Subsidiaries X and Y provides for amounts payable/receivable to ABC based on the current payable/receivable calculated on a separate return basis (see Paragraph 10.054 for additional discussion of tax-sharing agreements), the journal entries for Subsidiaries X and Y in their separate financial statements would be as follows:

	Debit	Credit
<b>Subsidiary X</b>		
Current tax expense	131	
Due to parent (taxes payable)		131
Deferred tax asset	26	
Deferred tax benefit		26
<b>Subsidiary Y</b>		
Deferred tax asset	63	
Deferred tax benefit		63
Deferred tax expense	42	
Deferred tax liability		42
Deferred tax expense	21	
Valuation allowance		21

The \$21 valuation allowance in Subsidiary Y's separate financial statements would be reversed in consolidation resulting in consolidated income tax expense of \$84 (\$105 for Subsidiary X plus \$0 for Subsidiary Y less \$21 in consolidation).

### **Example 10.14: Allocating Net Operating Loss Carryforwards under the Separate Return Method**

Parent Company uses the separate return method to allocate income taxes to its subsidiaries. The consolidated financial statements of Parent Company as of December 31, 20X7 reflect deferred tax assets for unused net operating loss carryforwards that were

generated from 20X2-20X3 by Subsidiary A. While Subsidiary A has been profitable since 20X5 such that it would have fully used its net operating loss carryforwards by the end of 20X6 had it filed a separate tax return, the consolidated operations of Parent Company have been break-even.

During 20X7, Parent Company agrees to sell Subsidiary A in a transaction that is scheduled to close in 20X8. The terms of the sale are such that the unused net operating loss carryforwards not previously used in the consolidated tax return will be transferred with Subsidiary A upon sale.

In preparing its stand-alone financial statements for the year ended December 31, 20X7, Subsidiary A would not report the deferred tax assets associated with the net operating loss carryforwards because those deferred tax assets would have already been used by Subsidiary A in prior years had it filed a separate tax return. However, the financial statements of both Subsidiary A and the consolidated Parent Company should disclose the fact that the net operating loss carryforwards exist and will be transferred upon sale of Subsidiary A.

#### **Example 10.15: Tax Effect of Amounts Charged to Subsidiary by Parent under the Separate Return Method**

Parent has an other postemployment benefit plan (OPEB) in which employees of its subsidiaries participate. Parent charges a management fee to Subsidiary A, which includes Subsidiary A's allocable portion of the OPEB plus a fixed mark-up fee for recovery of general overhead. Subsidiary A settles the management fee by paying cash to Parent each reporting period.

In Parent's consolidated financial statements, the OPEB cost is a temporary difference because a liability exists that will result in a deduction on settlement. Therefore, Parent recognizes a deferred tax asset for the liability in its consolidated financial statements.

In Subsidiary A's financial statements, there is no temporary difference (and no deferred tax asset) because Subsidiary A does not carry the OPEB liability (as primary obligor) on its separate financial statements but instead pays the cost charged each period through its settlement of the management fee. If the OPEB amount is material, disclosure (e.g., as part of the related party note) that the cost was treated as currently deductible in applying the separate return method would be appropriate.

**10.048 Pro Rata Method.** Under the pro rata method, current and deferred income taxes are allocated to members of the group based on each member's relative contribution to the group's consolidated income tax expense or benefit. Unlike the separate return method, the sum of the amounts allocated to individual members should equal the amounts reported in the consolidated financial statements. For example, group members

generally would not recognize net operating loss carryforwards, or other carryforwards that do not exist in the parent entity's consolidated tax return.

**10.049** The consolidated valuation allowance on deferred tax assets generally is allocated to the group members pro rata based on the members' relative share of the consolidated deferred tax assets. However, it may be appropriate to specifically allocate a valuation allowance to a particular member when it clearly relates to a specific deferred tax asset of that member. As discussed above, because the sum of the amounts allocated to individual members should equal the consolidated amount, group members generally would not record a valuation allowance if the consolidated group does not record a valuation allowance. Accordingly, the amount of income tax expense allocated to profitable members of a profitable consolidated group that does not have a valuation allowance will generally be similar under either the separate return method or pro rata method; however, amounts allocated to unprofitable members could be significantly different because of differences in assessing the need for a valuation allowance under the two methods. For example, an unprofitable member of a profitable consolidated group may be required to recognize a valuation allowance on a separate return basis, but recognize no valuation allowance under a pro rata method as the consolidated group has no valuation allowance.

**10.050** When applying the pro rata method, each component of income tax expense and each deferred tax asset and liability generally should be allocated to the group members rather than simply allocating total income taxes. As discussed in Paragraph 10.043c, it would not be appropriate for a member to combine individual deferred tax assets and liabilities for temporary differences and classify them in an intra-entity payable or receivable caption in periods before the related temporary differences reverse for the consolidated group. An approach that separately allocates each component of the income taxes will result in an allocation that is consistent with the broad principles of ASC Topic 740.

### Example 10.16 Allocating Taxes Using the Pro Rata Method

ABC Corp. has two subsidiaries, Subsidiary X and Subsidiary Y, both of which are included in the consolidated tax return of ABC. However, Subsidiaries X and Y prepare separate financial statements in accordance with generally accepted accounting principles. The following is a summary of financial statement data of ABC and its subsidiaries as of and for the year ended December 31, 20X7 (balance sheet amounts do not include deferred taxes):

	Subsidiary X		Subsidiary Y		Consolidated ABC Corp.
Tangible assets	\$	40	\$	60	\$ 100
Intangible assets	\$	20	\$	800	\$ 820
Goodwill (nondeductible)	\$	—	\$	200	\$ 200
Net liabilities	\$	(50)	\$	(300)	\$ (350)
Pretax net income	\$	500	\$	(200)	\$ 300

- Subsidiary X had deductible temporary differences of \$25 at December 31, 20X6. In 20X7, depreciation expense for financial statement purposes exceeded tax depreciation by \$125.
- Subsidiary Y had no temporary differences at December 31, 20X6. In 20X7, intangible asset amortization expense for income tax purposes exceeded financial statement expense by \$200.
- Deferred taxes at the subsidiaries are calculated based on the financial carrying amount of the subsidiary's individual assets and liabilities.
- Subsidiary Y's net income includes a goodwill impairment charge of \$100 taken in 20X7.
- ABC and its subsidiaries operate in one tax jurisdiction with an income tax rate of 21%.
- No valuation allowance is needed at the consolidated level for ABC for 20X6 or 20X7.
- Subsidiary Y was recently acquired and has no history of profitable operations.

ABC's consolidated taxable income and total tax expense are determined as follows:

Pretax net income	\$	300
Add-back nondeductible goodwill write-off		100
Deduct tax depreciation/amortization in excess of book (\$125 - \$200)		(75)
Taxable income		<u>325</u>
		× 21%
Current tax expense		<u>68</u>
Net change in deferred taxes (\$75 × 21%)		<u>16</u>
Total income tax expense	\$	<u><u>84</u></u>

Under the pro rata method, the components of income tax expense are allocated to Subsidiaries X and Y based on each subsidiary's relative contribution to the entity's consolidated income tax expense or benefit. Accordingly, 100% of the goodwill write-off is allocated to Subsidiary Y, 100% of the decrease in net deferred taxes (related to the excess tax amortization of intangible assets) is allocated to Subsidiary Y, and 100% of the increase in net deferred taxes (related to the excess book amortization of tangible assets) is allocated to Subsidiary X. The following is the summary of the calculations of total income tax expense for Subsidiaries X and Y using the pro rata approach.

	<b>Subsidiary X</b>	<b>Subsidiary Y</b>
Pretax net income (loss)	\$ 500	\$ (200)
Add-back goodwill write-off	—	100
Deduct tax depreciation/amortization in excess of book	125	(200)
Taxable income (loss)	\$ 624	\$ (300)
	<small>× 21%</small>	<small>× 21%</small>
Current tax expense/(benefit)	\$ 131	\$ (63)
Net change in deferred taxes	(26)	42
<b>Total income tax expense/(benefit)</b>	<b>\$ 105</b>	<b>\$ (21)</b>

The calculation of income tax expense or benefit results in the same total income tax expense for Subsidiaries X and Y as under the separate return method with the exception of the net operating loss carryforward and the valuation allowance. No net operating loss carryforward and valuation allowance are allocated to Subsidiary Y, because ABC did not recognize a net operating loss carryforward and valuation allowance in its consolidated financial statements. A similar allocation between Subsidiary X and Subsidiary Y would result from allocating consolidated income tax expense to the subsidiaries on a pro rata basis based on pretax income adjusted for permanent differences.

Assuming the tax-sharing agreement between ABC and Subsidiaries X and Y provides for amounts payable/receivable to ABC based on the current payable/receivable calculated on a pro rata basis (see Paragraph 10.054 for additional discussion of tax-sharing agreements), the journal entries for Subsidiaries X and Y in their separate financial statements would be as follows:

	<b>Debit</b>	<b>Credit</b>
<b>Subsidiary X</b>		
Current tax expense	131	
Due to parent (taxes payable)		131
Deferred tax asset	26	
Deferred tax benefit		26
<b>Subsidiary Y</b>		
Due from parent (taxes receivable)	63	
Current tax benefit		63
Deferred tax expense	42	
Deferred tax asset		42

This is one example of the pro rata method. Other allocation methods may also be acceptable.

**10.051 Considerations for SEC Registrants.** The SEC staff believes that it is material to investors to know what the effect on income would have been if the reporting entity had not been eligible to be included in a consolidated tax return with its parent and therefore believes that the separate return method is preferable. However, the SEC will accept other methods (e.g., pro rata, benefits for losses) if the reporting entity presents a pro forma income statement for the most recent year and interim period reflecting income tax expense or benefit calculated on a separate return basis. This guidance is equally applicable to both separate legal entities filing financial statements with the SEC as well as divisions or branches that prepare carve-out financial statements. See Paragraph 10.060. ASC paragraph 220-10-S99-3; June 12, 2001 AICPA/SEC Regulations Committee Minutes

**10.052 Unacceptable Allocation Methods.** There is no single required method for allocating income tax expense to members of a consolidated group. However, the method used should be systematic, rational, and consistent with the broad principles of ASC Topic 740. The following methods are not consistent with the broad principles of ASC Topic 740 and, therefore, are not acceptable:

- A method that allocates only current taxes payable to members of the group when the members have taxable temporary differences; ASC subparagraph 740-10-30-28(a)
- A method that allocates deferred taxes to members of the group using a method fundamentally different from the asset and liability method of ASC Topic 740 (e.g., the former APB Opinion No. 11, *Accounting for Income Taxes*, deferred method that was used before 1989); ASC subparagraph 740-10-30-28(b)
- A method that allocates no current or deferred tax expense to members of the group that have taxable income because the consolidated group has no current or deferred tax expense; ASC subparagraph 740-10-30-28(c)
- A method that allocates a consolidated entity's income tax expense to members in different tax jurisdictions who are not included in the consolidated tax return.

In addition, as discussed in Paragraph 10.043c, it would not be appropriate for a member to combine individual deferred tax assets and liabilities for temporary differences and classify them in an intra-entity payable or receivable caption in periods before the related temporary differences reverse for the consolidated group, regardless of which intercorporate tax allocation method it applies. We believe entities generally should use the same allocation methodology for all members of a consolidated group unless a disregarded member qualifies for and has elected not to recognize its share of the income taxes of the consolidated group as discussed beginning in Paragraph 10.055.

**10.053 Uncertainty in Income Taxes in Separate Financial Statements.** Because the application of the broad principles of ASC Topic 740 requires consideration of the guidance on accounting for uncertainty in income taxes, an entity's allocation method similarly should consider how the parent's income tax uncertainties affect its subsidiaries' separate financial statements. In some cases, tax uncertainties in the consolidated tax return may result directly from activity at the subsidiary and in other cases, the uncertainties may result from the activities of several members of the consolidated group. Allocation of tax uncertainties should be performed in a manner consistent with the entity's allocation methodology for other current and deferred income taxes as discussed above. We would also expect the subsidiary to make disclosures that are consistent with the requirements of ASC paragraphs 740-10-50-15 and 15A (FIN 48) based on the amounts allocated to the subsidiary. In some cases, additional disclosure with respect to a parent entity's tax uncertainties may be appropriate, even if such amounts are not directly allocated to the subsidiary. A tax-sharing agreement with the parent does not obviate the need to apply ASC Subtopic 740-10 (FIN 48) on accounting for uncertainty in income taxes or provide the required disclosures in the subsidiary's stand-alone financial statements.

**10.054 Tax-Sharing Agreements.** Tax-sharing agreements may provide a reasonable basis on which to allocate income taxes among members of a consolidated group; however, such agreements must be systematic, rational, and consistent with the broad principles of ASC Topic 740. When tax-sharing agreements are not consistent with an allocation methodology that is acceptable for financial statement purposes, differences may arise between the amounts reported in the financial statements (e.g., as computed using the separate return method or the pro rata method) and the amounts actually payable or receivable under the tax-sharing agreement. These differences generally should be reported as adjustments to capital (as contributed capital or dividends) in the separate financial statements of the subsidiaries.

**10.054a** In some cases, an intercorporate tax allocation policy may not allocate current and deferred tax assets and liabilities in an acceptable manner. This can occur when a tax-sharing agreement requires the member to periodically settle its deferred tax assets or liabilities for temporary differences before those temporary differences have reversed for the consolidated group. This arrangement may suggest that the member should derecognize those deferred tax assets or liabilities in its separate financial statements on settlement with the parent and report a single intra-entity payable or receivable. As discussed in Paragraph 10.043c, we believe that a member should recognize individually allocated deferred tax assets and liabilities for temporary differences until those temporary differences reverse for the consolidated group, regardless of whether it periodically settles those deferred tax assets or liabilities with its parent. If the member exchanges cash with its parent based on the amounts of deferred tax assets or liabilities before the related temporary differences reverse for the consolidated group, the member should recognize the cash exchanged directly in equity.

**10.054b** Unlike the agreements discussed in Paragraph 10.054a, some tax-sharing agreements require the member to periodically settle its deferred tax assets for operating loss or tax credit carryforwards, but not for deductible temporary differences. In those

situations, we believe it is acceptable for the member to derecognize the deferred tax assets for the carryforwards, even if those attributes have not been used by the parent in the consolidated tax return.

### **Example 10.17: Law-Imposed Tax-Sharing Limitation**

Parent operates wholly owned Subsidiaries A, B, and C in a foreign tax jurisdiction and files a consolidated return. Subsidiaries A, B, and C use the separate return method to recognize income taxes in their stand-alone financial statements. The tax-sharing agreement requires that Parent and Subsidiaries A, B, and C exchange cash based on the current tax payable/receivable calculated on a separate return basis.

The foreign income tax system requires taxpayers to pay a trade tax in addition to the corporate income tax. Parent's consolidated group has not incurred trade tax due to large trade tax losses in Subsidiaries B and C. Because Subsidiary A would be subject to trade tax if it were to file a separate return in the foreign tax jurisdiction, trade taxes are provided in the stand-alone financial statements of Subsidiary A and such amounts have been paid to Parent in accordance with the tax-sharing agreement through December 31, 20X6.

In 20X7, the foreign tax courts made a decision that it was inappropriate for a parent entity to charge a subsidiary a trade tax if the consolidated group did not pay the trade tax. Accordingly, Parent is required by law to reimburse Subsidiary A for the trade taxes paid to Parent through December 31, 20X6. Reimbursement of the trade tax to Subsidiary A by its parent should be recognized as contributed capital rather than as a reduction of income tax expense. On an ongoing basis, if the trade tax were assessed if Subsidiary A were a stand-alone entity, Subsidiary A would continue to recognize income tax expense for the trade tax and an equal amount of contributed capital for the amount of income tax expense related to the trade tax that will not be paid to Parent under the tax-sharing agreement.

**10.055 Separate Financial Statements of LLCs and Other Eligible Entities.** U.S. entities organized as corporations are automatically classified as corporations for U.S. federal income tax purposes under the check-the-box regulations and may not elect to be treated as any other kind of entity. Other U.S. entities, including limited liability companies (LLCs), that are not required to be treated as corporations may choose their own classification and are referred to as eligible entities. While the check-the-box regulations permit an LLC to elect to be classified as an association taxed as a corporation, LLCs are generally classified as partnerships (if the LLC has two or more members) or as disregarded entities (if the LLC has a single member).

**10.056** Whether or not an LLC provides taxes in its separate financial statements largely depends on its tax status. For example, LLCs (multi-member and single-member) that are taxed as corporations would provide taxes like any other tax-paying entity under ASC Topic 740. Conversely, income taxes are not presented in the financial statements of



multi-member LLCs treated as partnerships for tax purposes. However, in some situations income-based taxes may be assessed by a jurisdiction on LLCs that are treated as partnerships for tax purposes in other jurisdictions. In these situations, it is important to determine whether the imposed tax is attributed to the LLC or whether the LLC is being used as a vehicle to withhold taxes from the members to whom those taxes are attributed under laws and regulations of the taxing authority. The presence of certain factors may indicate that the payments to the tax jurisdiction are a withholding tax on behalf of specific members, rather than attributed to the LLC. When only certain members are subject to the tax, it may suggest that the tax payment is a withholding tax on behalf of specific members, rather than a tax on the LLC itself. This may also be true if the payment must be reported on an individual member's federal Form K-1 as a distribution made on behalf of the member rather than a reduction of income when calculating the member's share of earnings. An indication that the payment may be a tax on the LLC itself would be a requirement for the LLC to file a tax return and pay taxes on all of its taxable income in a jurisdiction, even though the federal Form K-1 allocates the tax to the individual members for consideration in their federal tax returns. After assessing all relevant facts, if it is determined that a multi-member LLC is subject to incomes taxes, regardless of whether such income taxes are federal, state, or local, the LLC would be required to provide for income taxes under ASC Topic 740 for the jurisdictions in which it is subject to income taxes. ASC paragraphs 740-10-55-226 to 55-228

**10.057 - 10.059a** Not used.

**10.059b** As discussed previously, for an LLC to be treated as a partnership for tax purposes, it must have more than one member. Single-member LLCs are taxed as disregarded entities. Disregarded entities do not have individual tax status but rather are treated as a division of the single member for federal income tax purposes.-An entity is not required to allocate consolidated income taxes to a legal entity that is not subject to tax for purposes of that legal entity's separate financial statements, but may elect to allocate consolidated income taxes to a legal entity if it is not subject to income tax and is disregarded by the taxing authority. Therefore, an entity will be able to elect not to allocate consolidated income taxes to its single-member LLCs and make that election on an entity-by-entity basis.

**10.060 Separate Branch or Division Financial Statements.** Current and deferred income taxes generally should be reflected in the separate financial statements of a branch or division of a taxable entity using an acceptable intercorporate tax allocation method. Although a branch or division is not a separate legal entity and does not have individual tax status, its operations are similar to those of a wholly owned corporate subsidiary included in the consolidated return of a taxable entity for U.S. federal tax purposes. The SEC staff believes that registrants preparing carve-out financial statements in SEC filings generally should provide for income taxes in the carve-out in a manner consistent with the requirements for subsidiaries; however, we are aware of exceptions granted by the SEC staff when the carved-out entity will not be taxable post-public offering. See Paragraph 10.051.

**10.060a Abbreviated Financial Statements Under S-X Rule 3-05(e).** A registrant may present audited abbreviated financial statements for an acquired business when it is not practicable to provide full financial statements or carve-out financial statements of the acquired business and when certain other conditions are met. It is permissible to omit income tax expense when presenting abbreviated financial statements under this rule. See 10.3.30 in KPMG Handbook, *SEC Reporting Requirements for Business Combinations*, for discussion of when abbreviated financial statements under S-X Rule 3.05(e) may be presented.

### **Example 10.17a: Preparing Carve-out Financial Statements Using the Separate Return Method**

ABC Corp. is preparing carve-out financial statements of Business X, which is included in ABC's consolidated financial statements through a series of wholly owned foreign entities that are disregarded for U.S. tax purposes.

Assume the following facts relating to the legal structure of ABC and Business X.

- ABC is a U.S. entity;
- ABC owns 100% of a Canadian holding company (hereafter referred to as Canada Holdco);
- Canada Holdco owns 100% of a Canadian operating company (hereafter referred to as Canada Opco);
- Canada Opco owns Business X;
- Canada Holdco and Canada Opco each file separate corporate tax returns in Canada; and
- Canada Holdco and Canada Opco are both disregarded entities for U.S. tax purposes and therefore their taxable income is included in ABC's consolidated U.S. tax return.

Business X earned \$100 of pretax income (and all other businesses of Canada Holdco and Canada Opco were break-even). If the U.S. corporate tax rate was 21% and the Canadian corporate tax rate was 15%:

- \$15 of income tax was owed in Canada ( $\$100 \times 15\%$ ).
- \$6 of income tax was owed in the U.S. ( $\$100 \times 21\%$  minus the \$15 foreign tax credit for taxes payable in Canada).

The carve-out financial statements of Business X should reflect the income taxes that it would owe if it were truly a separate entity in Canada, irrespective of its current status as a disregarded entity for U.S. tax purposes. Therefore, using the amounts above and assuming the carve-out financial statements are prepared under the separate return method, the carve-out financial statements should reflect \$15 in income tax expense (i.e.,

the amount owed in Canada) and not \$21 (i.e., the amount owed in Canada and the U.S. under its current structure).

**10.061 Effects of Push-Down Accounting Adjustments.** As discussed above, current and deferred income taxes generally should be recognized for temporary differences arising related to the assets and liabilities included in the stand-alone financial statements of a subsidiary of a tax-paying entity. Accordingly, if debt is pushed down to the subsidiary as a result of the business combination, the tax basis of that debt likewise should be considered pushed down for computing deferred taxes in the stand-alone financial statements even if the subsidiary does not have tax basis in the debt for U.S. federal income tax purposes. See Paragraph 10.148 for additional discussion of the effects of push-down accounting to the separate financial statements of the acquired subsidiary.

**10.061a Tax Effects of Transactions Recorded on the Black Line.** If the effects of a transaction triggered by the consummation of a business combination (e.g., the acquiree's payment and acquirer's reimbursement of certain acquisition-specific costs) are initially recognized on the black line that separates the predecessor and successor financial statements (i.e., there is no effect to the income statement of either the predecessor or successor), the income tax effects associated with that transaction generally should be recognized on the black line. However, if the transaction affects the financial statement carrying amount or tax basis of an existing (pre-acquisition) asset or liability of the acquiree, the current and deferred tax effects generally are recognized in the acquiree's predecessor financial statements (see Example 6.20 for illustration).

**10.062 Intercorporate Tax Allocation Disclosures.** An entity that is a member of a group that files a consolidated tax return is required to disclose the following:

- (1) The aggregate current and deferred tax expense for each year a statement of earnings is presented.
- (2) Tax-related balances due to or from affiliates as of each balance sheet date presented. (A group member consolidated in its parent's tax return assumes for financial statement purposes that it files a tax return to its parent. Accordingly, the group member generally will present current taxes payable and receivable as amounts due to or due from its parent.)
- (3) A description of the method used to allocate the consolidated amount of current and deferred taxes to members of the group and the nature and effect of any changes in that method. ASC paragraph 740-10-50-17

If an entity is both not subject to tax and is disregarded by the taxing authority and has elected to recognize an allocated amount of current and deferred tax expense in its separate financial statements under the election provided in ASC paragraph 740-10-30-27A, the entity should disclose that fact and make the above disclosures. ASC paragraph 740-10-50-17A

**10.063** The above disclosure requirements are significantly less detailed than the disclosures required of separate tax-paying entities. However, additional disclosures, consistent with those separate tax-paying entities, would be appropriate. Furthermore, when an entity is included in a consolidated tax return, the entity is jointly and severally responsible for the income tax obligations of the consolidated group. Additional disclosures for these potential liabilities may be required. For example, as discussed in Paragraph 10.053, we would expect a subsidiary to make disclosures related to uncertainty in income taxes that are consistent with the requirements of ASC paragraphs 740-10-50-15 and 15A (FIN 48) based on the amounts allocated to the subsidiary. Additionally, while the income tax obligations arising from an intercorporate tax allocation are outside the scope of ASC Subtopic 405-40, *Liabilities – Obligations Resulting from Joint and Several Liability Arrangements*, subsidiaries may consider whether some or all of the disclosure content in ASC paragraph 405-40-50-1 would be useful to users of the stand-alone financial statements.

**10.064 Changes in Intercorporate Tax Allocation Method.** A change in intercorporate tax allocation method from one acceptable method to another acceptable method, such as from the pro rata method to the separate return method or to follow a revised tax-sharing agreement, is a change in accounting principle in the separate financial statements of the members of the consolidated group. Such changes are subject to the requirements of ASC Topic 250, *Accounting Changes and Error Corrections*. Accordingly, a change in method of allocating income taxes to members of a group that file a consolidated tax return would require an assessment as to whether the new method is preferable and a preferability letter if the member is an SEC registrant. The separate return method (see Paragraph 10.045) generally is considered preferable to other methods and therefore a change from the separate return method to the benefits for losses method, for example, generally would not be considered preferable. ASC paragraphs 250-10-45-1 and 45-2

**10.064a** Not used.

## INTERIM PERIOD TAX CALCULATIONS

**10.065** The accounting requirements for recognizing income tax expense in interim periods are based on the view that each interim period is an integral part of the annual period. Accordingly, income tax expense for interim periods is based on an annual effective tax rate for the full year. ASC Subtopic 740-270, *Income Taxes - Interim Reporting*, provides the primary guidance on accounting for income taxes in interim periods. This subsection discusses the allocation of income tax expense among interim periods and provides some illustrative examples.

**10.065a** Income tax expense recognized as of an interim period is generally based on:

- the tax (benefit) related to worldwide ordinary income (loss) that is recognized through the use of an estimated annual effective tax rate applied to year-to-date results (see discussion beginning in Paragraph 10.066); and

- the tax (benefit) related to specific events that are discretely recognized in the period in which they occur (see Paragraph 10.065b).

**10.065b** Examples of common discrete items to be excluded from the estimated annual effective tax rate calculation include:

- Effect of change in laws or rates on existing deferred tax assets and liabilities (see Paragraph 10.083);
- Retroactive change on current taxes payable or refundable for that prior annual period (see Paragraph 10.083);
- Effect of a change in tax status on existing deferred tax assets and liabilities (see Paragraph 10.084);
- Excess tax benefits (windfalls) and shortfalls from the exercise of share options (see Paragraph 8.030);
- Effect of a disqualifying disposition (see Paragraph 8.031);
- Changes in an indefinite reinvestment assertion (see Paragraph 10.085a);
- Changes in the recognition of a deferred tax asset associated with an outside basis difference at the beginning of the year (see Paragraph 10.086a);
- Change in judgment that results in change in a tax position taken in a prior annual period (see Paragraph 10.087);
- Interest and penalties related to income taxes (see Paragraph 10.090);
- Judgments about beginning of the year valuation allowance (see Paragraph 10.078);
- Valuation allowance release as a result of a business combination (may be discrete, see Paragraph 10.078);
- Effects of transaction gains and losses on withholding tax liabilities (see Paragraph 10.094c);
- Tax in a jurisdiction that anticipates or has an ordinary loss computes its own separate estimated annual effective tax rate (see Paragraph 10.092);
- Tax in a jurisdiction that is unable to make reliable estimates (see Paragraph 10.092);
- Effects of items excluded from continuing operations or presented below income tax expense (see Paragraphs 10.071a and 10.073); and
- Effects of significant unusual or infrequently occurring items when they are separately reported or disclosed (see Paragraph 10.074), including significant unusual or infrequently occurring tax only items (see Paragraph 10.074a).

**10.066 Estimated Annual Effective Tax Rate.** The estimated *annual effective tax rate* is used to allocate expected annual income tax expense related to ordinary income to

interim periods. The rate is the ratio of estimated annual income tax expense to estimated pretax *ordinary income*, with ordinary income defined as pretax income from continuing operations excluding significant unusual or infrequently occurring items. Accordingly, discontinued operations and cumulative effects of changes in accounting principles are excluded from the definition. This rate is applied to the year-to-date interim period's ordinary income to determine the income tax expense allocated to the year-to-date period. The income tax effects of the income items excluded from ordinary income are determined separately and recognized in the interim period in which the income items arise. Ordinary income, as used to estimate the annual effective tax rate for financial statement purposes, does not have the same meaning as the term used for income tax purposes in the context of ordinary income versus capital gains. ASC paragraphs 740-270-25-2, 740-270-30-2 through 30-3, and 30-5

**10.067** The annual income tax expense used to derive the entity's estimated annual effective tax rate generally should include all events expected to occur in the fiscal year affecting income tax expense for which reliable estimates can be made (see Paragraph 10.077 for additional discussion). Although there are certain exceptions to this general rule, the income tax expense estimate should include the expected benefits from anticipated tax credits, statutory depletion, and other tax planning alternatives, in addition to the tax effect of foreign tax rates, capital gains rates, Subpart F income, (see Paragraph 7.077), GILTI inclusions (see Paragraph 7.087a for additional discussion), alternative tax systems (e.g., BEAT in the United States – see Paragraph 3.072b for additional discussion) and in some circumstances the effect of tax holidays. In addition, the benefits of investment tax credits generally are included in the estimated annual effective rate. However, an entity may elect to exclude the net benefit from investment tax credits if it is using the deferral method (see discussion beginning in Paragraph 10.126) and recognizing the benefit in income tax expense.

**10.067a** The estimated annual income tax expense should also include the effect of any valuation allowance expected to be necessary at the end of the year for originating deferred tax assets or reductions in beginning-of-year valuation allowances due to realization of the related deferred tax assets as a result of current year ordinary income (see Paragraph 10.078 for additional discussion of changes in valuation allowances) as well as the effect of tax positions with uncertainty expected to be taken in the current year (see Paragraph 10.087 for additional discussion of the application of ASC Subtopic 740-10 (FIN 48) on accounting for uncertainty in income taxes to interim period calculations).

**10.067b** Prior to determining the estimated annual effective tax rate, an entity also would perform its intraperiod tax allocation (i.e., the process of allocating income tax expense or benefit to components of comprehensive income and directly to shareholders' equity, etc. – see Paragraph 9.020 for additional discussion). ASC paragraphs 740-270-30-4 through 30-8, and 30-14 through 30-19, 718-740-35-2

**10.068** Calculating the estimated annual effective tax rate requires an entity to estimate annual income tax expense (current and deferred) and annual ordinary income. The estimate of current tax expense for the year is the estimated amount of income taxes payable for the year as determined by applying the provisions of enacted tax law and

considering the guidance in ASC Subtopic 740-10 (FIN 48) on accounting for uncertainty in income taxes (see Paragraph 3.015 for additional discussion) to estimated annual taxable income related to ordinary income for that year. The estimate of deferred tax expense for the year attributable to ordinary income is based on an estimate of the net deferred tax asset or liability at the end of the year. This estimate requires an entity to estimate temporary differences at the end of the year, as well as determine whether a valuation allowance will be necessary for its originating deferred tax assets.

**10.069** To calculate current and deferred tax expense and related balance sheet accruals, the estimated annual current effective tax rate and estimated annual deferred effective tax rate can be calculated separately, and separately applied to interim period ordinary income.

### Example 10.18: Calculating the Estimated Annual Effective Tax Rate

At March 31, 20X7, ABC Corp. estimates that ordinary income for the year will be \$30,000. The estimated ordinary income for 20X7 includes \$2,000 of expenses that will not be deductible for income tax purposes. ABC estimates that its taxable temporary differences will increase \$10,000 during 20X7 as a result of tax depreciation in excess of book depreciation. Assume no valuation allowance for deferred tax assets is expected to be necessary as of December 31, 20X7 and the enacted tax rate is 21%.

ABC calculated its estimated annual effective tax rate as follows:

	Current	Deferred	Combined
Estimated annual ordinary income	\$ 30,000	\$ —	\$ 30,000
Nondeductible expenses	2,000	—	2,000
Change in temporary differences	(10,000)	10,000	—
Estimated annual taxable income	\$ 22,000	\$ 10,000	\$ 32,000
Multiplied by enacted tax rate	21%	21%	21%
Estimated annual income tax expense	\$ 4,620	\$ 2,100	\$ 6,720
Divided by estimated annual ordinary income	30,000	30,000	30,000
Estimated annual effective tax rate	<u>15.4%</u>	<u>7%</u>	<u>22.4%</u>

ABC earns \$7,000 of ordinary income in the fiscal quarter ending March 31, 20X7. Using the estimated annual effective tax rate, the entity calculated current tax expense of \$1,078 ( $\$7,000 \times 15.4\%$ ) and deferred tax expense of \$490 ( $\$7,000 \times 7\%$ ). ABC will record the following journal entry to record income tax expense for the three-month period ended March 31, 20X7:

	Debit	Credit
Current tax expense	1,078	
Deferred tax expense	490	
Current taxes payable		1,078
Deferred tax liability		490

The calculation of income tax expense for the quarter ended March 31, 20X7 does not depend on either the amount of nondeductible expenses that were incurred in the quarter or the actual change in the temporary differences during the quarter.

### Example 10.18a: Calculating the Estimated Annual Effective Tax Rate – Investment Tax Credit Under the Deferral Method

ABC Corp. receives investment tax credits for development of clean hydroelectric power facilities in the amount of 30% of eligible property. ABC accounts for the investment tax credits using the deferral method and has elected to recognize the benefit of the ITC in income tax expense. ABC operates in a tax jurisdiction with a statutory tax rate of 25%.

On January 1, 20X2 ABC placed in service \$2,000,000 in qualifying property. ABC receives \$2,000,000 of tax basis in the asset. ABC elected to account for the \$600,000 investment tax credit as a reduction to the financial statement carrying amount of the asset and recognized the \$150,000 ( $\$600,000 \times 25\%$ ) tax effect of the resulting temporary difference in income tax expense as a discrete item in Q1 20X2.

The eligible property has a productive life of 6 years for both book and tax purposes. Pretax ordinary income for 20X2 is forecasted to be \$5,000,000 and Q1 year-to-date pretax ordinary income is \$1,500,000.

If ABC elects to include the ITC in its estimated annual effective tax rate (see Paragraph 10.067), its income tax expense for Q1 20X2 (excluding the \$150,000 discrete tax effect discussed above) is calculated as follows:

Full-year forecasted pretax ordinary income	\$ 5,000,000
Statutory tax rate	<u>× 25%</u>
Expected tax at 25%	1,250,000
Net annual benefit from investment tax credit	<u>(75,000)<sup>1</sup></u>
Forecasted tax expense	\$ <u>1,175,000</u>
Estimated annual effective tax rate	<u>23.5%<sup>2</sup></u>
Year-to-date pretax ordinary income	\$ 1,500,000
Estimated annual effective tax rate	<u>× 23.5%</u>
Q1 income tax expense	\$ <u>352,500</u>



<sup>1</sup> \$2,000,000 qualified property × 30% credit rate = \$600,000 investment tax credit recognized over 6-year productive life, minus the related deferred tax expense of \$25,000. The deferred tax expense of \$25,000 is calculated by applying the tax rate of 25% to the benefit from the investment tax credit for the year of \$100,000.

<sup>2</sup> \$1,175,000 ÷ \$5,000,000.

If ABC elects not to include the ITC in the estimated annual effective tax rate, the effect of the amortization of the credit is recognized discretely each quarter. For 20X2 Q1, ABC calculates its interim period income tax expense as follows (excluding the \$150,000 discrete tax effect discussed above):

Full-year forecasted pretax ordinary income	\$ 5,000,000
Statutory tax rate	× 25%
Expected (and forecasted) tax at 25%	<u>\$ 1,250,000</u>
Estimated annual effective tax rate	× 25% <sup>3</sup>
Year-to-date pretax ordinary income	\$ 1,500,000
Estimated annual effective tax rate	× 25%
Year-to-date income tax expense	\$ 375,000
Net tax benefit from amortization of ITC	(18,750) <sup>4</sup>
Q1 income tax expense	<u>\$ 356,250</u>

<sup>3</sup> \$1,250,000 forecasted income tax expense ÷ \$5,000,000.

<sup>4</sup> Net annual benefit from investment tax credit of \$75,000 (see above) ÷ four quarters.

### Example 10.18b: Calculating the Estimated Annual Effective Tax Rate – Investment Tax Credit Under the Flow-Through Method

ABC Corp. receives investment tax credits in the amount of 30% of eligible property placed in service. ABC accounts for the investment tax credits using the flow-through method.

On January 1, 20X2 ABC placed in service \$2,000,000 in qualifying property. ABC receives \$2,000,000 of tax basis in the asset. The eligible property has a productive life of 6 years for both tax and book purposes.

Pretax ordinary income for 20X2 is forecasted to be \$5,000,000 and Q1 year-to-date pretax ordinary income is \$1,500,000. ABC operates in a tax jurisdiction with a statutory tax rate of 25%.

ABC includes the ITC in its estimated annual effective tax rate as follows:

Full-year forecasted pretax ordinary income	\$ 5,000,000
Statutory tax rate	× 25%
Expected tax at 25%	<u>1,250,000</u>
Investment tax credit	(600,000) <sup>1</sup>
Forecasted tax expense	<u>\$ 650,000<sup>2</sup></u>

Estimated annual effective tax rate		13% <sup>3</sup>
Year-to-date ordinary pretax income	\$	1,500,000
Estimated annual effective tax rate		× 13%
Q1 income tax expense	\$	<u>195,000</u>

<sup>1</sup> \$2,000,000 qualifying property × 30% ITC rate = \$600,000 investment tax credit.

<sup>2</sup> Investment tax credits accounted under the flow-through method are generally reflected in the estimated annual effective tax rate (see Paragraph 10.067).

<sup>3</sup> \$650,000 forecasted tax expense ÷ \$5,000,000 full year forecasted pretax ordinary income.

**10.070** The annual effective tax rate is revised, if necessary, at the end of each interim period based on the entity's most current best estimate. Revisions to the estimated annual effective tax rate are frequently caused by changes in estimates of the tax effects of items that lack temporary income tax consequences. These items include, but are not limited to, permanent items (i.e., nondeductible expenses), effects of BEAT, changes in estimated GILTI inclusions, changes in the mix of income among tax jurisdictions, changes in estimated pretax annual income, changes in the ratio of anticipated credits to income tax computed at the statutory rate, and changes in the expectations about the need for a valuation allowance for deferred tax assets. Additionally, changes in the annual effective tax rate applicable to ordinary income may arise as a result of changes in the intraperiod allocation of total income tax expense or benefit during the year (see the discussion beginning in Paragraph 10.075 for additional information on changes to intraperiod allocation in interim periods). While these estimates are, by their nature, subject to change, if a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be used as the best estimate of the annual effective tax rate. Similarly, if ordinary income for a particular item cannot be reliably estimated, but the entity can otherwise make a reliable estimate, the tax effect of that item may be reported in the period in which the item is reported. See Paragraph 10.077 for additional discussion. ASC paragraphs 740-270-35-2 and 35-3; 740-270-30-6, and 30-14 through 30-18

**10.071 Estimating an Annual Effective Tax Rate with Noncontrolling Interests.** As discussed in Paragraphs 10.066 and 10.092, estimated ordinary income is pretax income from continuing operations excluding significant unusual or infrequent items from all consolidated entities. Income attributable to noncontrolling interest would therefore be included in the definition of ordinary income. When determining the annual effective tax rate for the interim periods, entities should include ordinary income attributable to noncontrolling interest in the estimate of pretax ordinary income.

### **Example 10.19: Calculating the Estimated Annual Effective Tax Rate with a Noncontrolling Interest**

ABC Corp. consolidates Subsidiary DEF, a 60% owned subsidiary. ABC would include ordinary income attributable to noncontrolling interest in its estimate of pretax ordinary income when determining its estimated annual effective tax rate for the interim periods. To determine the interim period net income attributable to the noncontrolling interest in DEF, ABC would determine DEF's income tax expense based on DEF's estimated

annual effective tax rate and apply that rate to determine the interim period tax allocable to DEF.

ABC first determines, based on its estimated pretax ordinary income (including 100% of DEF's pretax ordinary income), that its consolidated estimated annual effective tax rate to be applied in determining its interim period income tax expense is 26% as follows:

	<b>For the year ended 12/31/X1</b>
Estimated annual income tax expense ABC, excluding DEF	\$ 39,000
Estimated annual income tax expense DEF	<u>37,889</u>
Total estimated annual income tax expense for ABC Corp.	<u>\$ 76,889</u>
Estimated annual ordinary income for ABC Corp. (consolidated, includes 100% of DEF's operations)	\$ <u>300,000</u>
Estimated annual effective tax rate for ABC Corp.	<u><u>26%</u></u>

ABC then determines DEF's pretax ordinary income for the interim period, applies DEF's estimated annual effective tax rate of 31% and then computes the net income amount (after-tax) attributable to noncontrolling interest. Net income attributable to noncontrolling interests (after tax) is deducted from consolidated ABC net income to arrive at net income attributable to ABC. Assuming DEF reports \$25,000 of year-to-date pretax income, the net income attributable to ABC is:

	<b>For the quarter ended 3/31/X1</b>
ABC revenues	\$ 395,000
ABC expenses	<u>(330,000)</u>
Income before income taxes (also ordinary income)	\$ 65,000
Income tax expense (\$65,000 × 26%)	<u>(16,900)</u>
Net income	\$ 48,100
Less: Net income attributable to the noncontrolling interest in DEF <sup>1</sup>	<u>(6,900)</u>
Net income attributable to ABC Corp.	<u><u>\$ 41,200</u></u>

<sup>1</sup> Calculated as (\$25,000 pretax income - \$7,750 of income tax expense (\$25,000 ordinary income × 31%)) × 40%

**10.071a Estimating an Annual Effective Tax Rate When Equity in Earnings Is Presented Net of Investor Tax.** If equity in earnings is presented below income tax expense in the income statement, we believe the equity in earnings generally would be presented net of investor tax; therefore the investor's income tax expense associated with the equity in earnings would be reflected in the equity in earnings line item. (See Paragraph 9.164a for additional discussion.) A portion of the investor's total income tax expense must therefore be allocated to equity in earnings. We believe the equity in earnings and related investor tax would be excluded from the calculation of the estimated

annual effective tax rate on ordinary income as an item reported net of its related tax effect. ASC paragraphs 740-270-30-8 and 30-12

**10.071b** We believe the investor could measure the amount of total annual income tax expense to allocate to equity in earnings by identifying the rate specific to its equity in earnings and applying that rate to those earnings for the period or by applying a with-and-without approach. For example, assume a U.S. investor's overall estimated annual effective tax rate (including consideration of its equity in earnings) is 25% because it operates in a number of states with income taxes. However, its equity method investment is held by a subsidiary that operates in a state with no income tax and therefore the investor expects to pay only 21% on its equity in earnings. The investor could apply a tax rate of 21% to its equity in earnings for the period when determining how much of its total income tax to allocate to the equity in earnings, net of tax income statement caption. The investor would then compute an estimated annual effective tax rate on ordinary income that excludes the equity in earnings and related investor tax.

**10.072 Applying the Estimated Annual Tax Rate to Interim Period Ordinary Income (Loss).** The estimated annual effective tax rate is applied to year-to-date ordinary income (or loss – see Paragraph 10.079 for additional discussion of losses in interim periods). The income tax expense or benefit allocated to an interim period is the difference between the year-to-date amount computed and the year-to-date amounts reported for the previous interim period. This approach recognizes the effect of changes in the estimated annual effective tax rate on the year-to-date amounts in the interim period in which such changes arise. The year-to-date effect of a change in the estimated annual effective tax rate on the year-to-date amounts should not be spread among future interim periods.

#### **Example 10.20: Recognizing a Change in Effective Tax Rate in an Interim Period**

ABC Corp. earns \$10,000 of ordinary income in the fiscal quarter ending March 31, 20X7. At March 31, 20X7, the entity estimates that ordinary income for the year will be \$50,000. The estimated ordinary income for 20X7 includes \$5,000 of expenses that will not be deductible for income tax purposes.

The entity estimated that the annual effective tax rate will be 23.1%. The estimated annual effective tax rate was estimated as follows:

Estimated annual ordinary income	\$	50,000
Plus nondeductible expenses		5,000
Estimated annual taxable income	\$	55,000
Multiplied by enacted tax rate		21%
Estimated annual income tax expense	\$	11,550
Divided by estimated annual ordinary income		50,000
Estimated annual effective tax rate		<u>23.1%</u>

Using the estimated annual effective tax rate, the entity calculated income tax expense for the three-month period ended March 31, 20X7 at \$2,310 ( $23.1\% \times \$10,000$ ). The calculation of income tax expense for the quarter ended March 31 does not depend on the amount of the nondeductible expenses that were incurred in the quarter then ended.

For the fiscal quarter ended June 30, 20X7, ABC had ordinary income of \$5,000. Furthermore, the entity revised their estimate of the annual ordinary income downward to \$30,000 for the year; however, ABC still estimates \$5,000 of nondeductible expenses for 20X7.

The entity revises the estimate of the annual effective tax rate as follows:

Estimated annual ordinary income	\$	30,000
Plus nondeductible expenses		5,000
Estimated annual taxable income	\$	<u>35,000</u>
Multiplied by enacted tax rate		<u>21%</u>
Estimated annual income tax expense	\$	7,350
Divided by estimated annual ordinary income		30,000
Estimated annual effective tax rate		<u><u>24.5%</u></u>

Total income tax expense for the six-month period ended June 30, 20X7 is \$3,675 (income for the six-month period  $(\$10,000 + \$5,000) \times 24.5\%$ ). Total income tax expense recognized in the quarter ended March 31, 20X7 was \$2,310, resulting in \$1,365 to be recognized in the quarter ending June 30, 20X7.

**10.073 Tax Effects of Items Excluded from Ordinary Income.** Ordinary income excludes discontinued operations, other comprehensive income, cumulative effects of changes in accounting principles, and significant unusual or infrequently occurring items. Unusual or infrequently occurring items are those events or transactions that are unusual in nature, occur infrequently or both. If unusual or infrequently occurring items are material, they are required to be reported as a separate component of income from continuing operations. The tax effect of separately reported significant unusual items or significant infrequently occurring items, discontinued operations, and the cumulative effects of changes in accounting principles should be excluded from the estimated annual effective tax rate and instead recognized in the interim period in which the transaction arises. The tax effect of those items should be allocated consistent with the intraperiod tax allocation approach discussed beginning in Paragraph 9.020. ASC Section 740-20-45, ASC paragraphs 220-20-50-1, 740-270-30-11 through 30-13

**10.074** We believe *significant* unusual or infrequently occurring items should be excluded from the estimated annual effective tax rate only when they are separately reported. While there is no explicit guidance on what constitutes separate reporting when identifying discrete items to be excluded from the estimated annual effective tax rate

calculation, we believe the item must be subject to the separate disclosure requirements of ASC paragraph 220-20-50-1 and separately presented either on the face of the financial statements or in the notes to the financial statements.

**10.074a** We also believe significant unusual or infrequently occurring *tax-only* items should be excluded from the estimated annual effective tax rate as long as they are separately reported in the notes to the financial statements. We believe this is supported by the guidance in ASC paragraph 740-270-30-8 that requires an entity not include excess tax benefits and shortfalls from an equity classified share-based payment award in the estimated annual tax rate. We also believe it is consistent with the discussion in the Basis for Conclusions (paragraph BC13) of ASU 2016-16 in which the Board agreed that the tax impact of many intra-entity transfers other than inventory, which are tax-only items, would be reported as discrete items.

### Example 10.21: Effect of Discontinued Operations on Estimated Effective Tax Rate

ABC Corp. estimated that it will generate ordinary income for fiscal year 20X7 of \$200,000 and expects to generate tax credits of \$20,000. ABC expects to have income in all interim periods and is taxed at a 21% statutory rate. ABC's estimated annual effective tax rate is computed as follows:

Estimated ordinary income for 20X7	\$ 200,000
Tax at 21%	\$ 42,000
Less credits	<u>(20,000)</u>
Total tax	\$ 22,000
Estimated annual effective tax rate (ETR)	11%

Actual results from the first two quarters and estimated amounts for the third and fourth quarters are as follows:

Quarter	Ordinary Income			Income Tax		
	Period	YTD	ETR	YTD	Previously Provided	Period
First	\$ 45,000	45,000	11%	4,950	—	\$ 4,950
Second	\$ 40,000	85,000	11%	9,350	4,950	\$ 4,400
Third	\$ 55,000	140,000	11%	15,400	9,350	\$ 6,050
Fourth	\$ 60,000	200,000	11%	22,000	15,400	\$ 6,600

During the third quarter, ABC commits to a plan to dispose of a component of its business (DEF Corp.) that qualifies for discontinued operations presentation. DEF has historically had operating losses and is expected to continue to incur losses until the sale is expected to be completed in 20X8. ABC's revised estimates of ordinary income as of

the end of the third quarter (reflects actual results through the third quarter and estimated results for the fourth quarter) are as follows:

Quarter	Ordinary Income		Discontinued
		Continuing	
First	\$	53,000	\$ (8,000)
Second	\$	45,000	\$ (5,000)
Third	\$	60,000	\$ (5,000)
Fourth	\$	65,000	\$ (5,000)

Tax credits attributable to DEF total \$4,000 of the total \$20,000. ABC's revised estimated annual effective tax rate attributable to continuing operations is computed as follows (excludes DEF):

Estimated ordinary income for 20X7	\$	<u>223,000</u>
Tax at 21%	\$	46,830
Less credits		<u>(16,000)</u>
Total tax	\$	30,830
Estimated annual effective tax rate (ETR)		13.83%

ABC's revised quarterly income tax expense attributable to continuing operations are as follows (first and second quarters are presented as if DEF's operations had been discontinued effective January 1, 20X7):

Quarter	Period	Ordinary Income		Income Tax		
		YTD	ETR	YTD	Previously Provided	Period
First	\$ 53,000	53,000	13.83%	7,330	—	\$ 7,330
Second	\$ 45,000	98,000	13.83%	13,553	7,330	\$ 6,223
Third	\$ 60,000	158,000	13.83%	21,851	13,553	\$ 8,298
Fourth	\$ 65,000	223,000	13.83%	30,841	21,851	\$ 8,990

The income tax benefits attributable to losses from DEF are as follows:

Quarter	Tax Previously Computed	Tax as Revised	Income tax benefit of DEF Corp.
First	\$ 4,950	\$ 7,330	\$ (2,380)
Second	4,400	6,223	(1,823)
Third	6,050	8,298	(2,248)
Total			<u>\$ (6,451)</u>

ABC would report its three- and nine-month financial results for the third quarter as follows:

	<b>Three-month</b>	<b>Nine-month</b>
Income from continuing operations before income taxes	\$ 60,000	\$ 158,000
Income taxes	8,298	21,851
Income from continuing operations	\$ 51,702	\$ 136,149
Discontinued operations		
Loss from operations of discontinued DEF	(5,000)	(18,000)
Income tax benefit	2,248	6,451
Loss on discontinued operations	(2,752)	(11,549)
Net income	\$ 48,950	\$ 124,600

See also ASC paragraph 740-270-55-29 for additional examples.

### **Example 10.22: Effect of Business Combination on Estimated Effective Tax Rate**

ABC Corp. is a profitable U.S. corporation with several profitable foreign subsidiaries that are not consolidated in the U.S. consolidated federal tax return. Historically, approximately 95% of ABC's consolidated ordinary income was generated in the United States, subject to a 21% statutory rate, while the remaining 5% was generated by its foreign subsidiaries that operate in low tax-rate jurisdictions resulting in the overall estimated annual tax rate approximating 20% (see Paragraph 10.092 for additional discussion of considerations for entities operating in multiple tax jurisdictions). On June 30, 20X7, ABC closed on the acquisition of DEF Corp., a U.S. subsidiary in the start-up phase that will be included in ABC's consolidated U.S. tax return for 20X7. Because DEF is expected to generate significant losses during the last half of 20X7, ABC expects that operations in the United States will generate only small ordinary income for fiscal 20X7 in comparison to the ordinary income generated by its foreign subsidiaries in lower tax rate jurisdictions. Including the expected losses of DEF in ABC's computation of the overall consolidated estimated annual effective tax rate for fiscal 20X7 (as computed at June 30, 20X7) results in a lower estimated effective rate to be applied to year-to-date income as of June 30, 20X7, resulting in an income tax benefit for the quarter ended June 30, 20X7.

Assuming the business combination does not qualify as a significant unusual or infrequently occurring item, the effect of DEF's expected U.S. losses on the overall estimated annual effective tax rate should be considered as of June 30, 20X7 (the date the acquisition closed).



### **Example 10.22a: Tax Deductible Acquisition-Related Costs Associated with a Failed Business Combination**

ABC Corp. has a fiscal year ending December 31 and initiated a merger with XYZ Corp. during 20X1. ABC determined that the merger with XYZ was likely to be consummated in a nontaxable transaction and therefore did not recognize a deferred tax asset for acquisition-related costs expensed as incurred during 20X1 (see Paragraphs 6.088 and 6.089 for additional discussion of the available policy elections for acquisition-related costs). Because the acquisition-related costs were significant, separately reported, and ABC has neither a history of acquisitions nor current expectations of other significant future acquisitions, the acquisition-related costs were treated as discrete items and excluded from the 20X1 estimated annual effective tax rate.

On March 31, 20X2, the merger was terminated and all acquisition-related costs became deductible for tax purposes, resulting in an income tax benefit for the quarter ended March 31, 20X2. Because the acquisition-related costs were excluded from the 20X1 annual estimated tax rate, we believe the 20X2 tax deduction resulting from those acquisition-related costs should also be excluded from the 20X2 estimated annual effective tax rate.

If the acquisition-related costs did not qualify as discrete items in 20X1, ABC generally would have included the related 20X2 tax deduction in the overall estimated annual effective tax rate as of March 31, 20X2.

### **Example 10.23: Effect of a Non-Recognized Subsequent Event on an Entity's Estimated Effective Tax Rate**

ABC Corp. settled a legal dispute during the second quarter of its fiscal year ended December 31, 20X4 and will recognize a significant gain on the transaction. The gain contingency was resolved before issuance of the first quarter financial statements. The gain will be prominently disclosed on the face of ABC's second quarter statement of operations and in the notes to the financial statements.

In this situation, the gain would not be considered part of ordinary income. Accordingly, ABC should report the tax effect of the gain as a discrete item in the second quarter.

If the gain does not qualify as a discrete item in the second quarter, we believe ABC has a policy choice relative to considering it in its estimated annual effective tax rate:

- (a) ABC could incorporate the gain's effects when estimating the annual effective tax rate as of the end of the first quarter. We believe this policy is acceptable because the information used in estimating the annual effective tax rate at the end of a period generally should be based on information available up to the

date on which the financial statements are issued or available to be issued (even if the information might include factors or information that was not available until after the balance sheet date).

- (b) ABC could also incorporate the gain's effects when estimating the annual effective tax rate beginning in the second quarter. We believe this policy is also acceptable because the gain contingency is a non-recognized subsequent event, so the guidance in ASC paragraph 855-10-25-3 generally would preclude incorporating it into the recognition and measurement of the financial statements at the balance sheet date.

Whichever policy ABC elects, it should be consistently applied.

**10.075 Changes to Intraproduct Tax Allocation in Interim Periods** ASC Subtopic 740-270, *Income Taxes - Interim Reporting*, requires an entity, at the end of each interim period, to make its best estimate of the effective tax rate expected to be applicable for the full fiscal year as each interim period is viewed as an integral part of an annual period. Accordingly, an entity should perform its intraproduct tax allocation based upon its best estimate of ordinary income for the entire fiscal year together with items outside of ordinary income for the year-to-date period. This allocation is performed before determining the estimated annual effective tax rate related to ordinary income. If changes in estimates result in a change to the allocation in a subsequent interim period within the same fiscal year, the year-to-date intraproduct tax allocation is recast in the period of change. For example, assume a valuation allowance had been established in the first quarter for a deferred tax asset resulting from an unrealized loss on an available-for-sale security. Because the unrealized loss is an item recorded in other comprehensive income, the tax effect of both the deferred tax asset and the valuation allowance initially were allocated to other comprehensive income. If the valuation allowance was eliminated in the third quarter of the same fiscal year, the release would be recorded as a credit to other comprehensive income in order to adjust the year-to-date intraproduct tax allocation as if no valuation allowance was necessary for the originating deferred tax asset. This adjustment to the annual intraproduct tax allocation only applies to changes made in a subsequent interim period within the same fiscal year. In the above example, if the release of the valuation allowance was made in a subsequent *fiscal year* (e.g., in the annual period after origination), the credit generally would be recognized in continuing operations (see Paragraph 9.065 for additional discussion). See Paragraph 10.078 for additional discussion of allocating changes in valuation allowances in interim periods. ASC paragraph 740-270-45-2

**10.076** Recasting the intraproduct tax allocation from a previously reported interim period generally is not appropriate when the recast affects non-income tax accounts. For example, if a deferred charge was established in an interim period as a result of an intra-entity transfer of inventory (see additional discussion beginning in Paragraph 2.063), and in a later interim period within the same fiscal year there is a change in a valuation allowance that would have affected the amount of the deferred charge had the change occurred before the transaction, the entity would not recast the amount of the previously recognized deferred charge because it is not a deferred tax asset (and therefore is not

subject to a valuation allowance assessment in a subsequent interim period). See Paragraph 2.070 for additional discussion.

**10.077 Inability to Make Reliable Estimates.** If the annual effective tax rate cannot be reliably estimated (e.g., if an entity expects near break-even operations such that a small change in the entity's estimated ordinary income could result in a large change in the estimated annual effective tax rate), the actual effective tax rate for the year-to-date period may be used as the best estimate of the annual effective tax rate. Similarly, if an entity is unable to reliably estimate individual items within ordinary income or loss (e.g., the receipt of tax-exempt interest income, foreign exchange gains and losses), the tax (or benefit) related to those items would be recognized in the interim period in which the items are reported. We believe an entity should disclose if it cannot reliably estimate its overall annual effective tax rate in the current reporting period but could reliably estimate it in the past. See Example 10.30 for an illustration. ASC paragraphs 740-270-30-18 and 30-19 and ASC paragraph 740-270-25-3

**10.078 Changes in Valuation Allowance in Interim Periods.** The income statement effect of a change in a valuation allowance should be recognized in interim periods as described below. Refer also to the discussion beginning in Paragraph 10.075 for additional information on changes in intraperiod allocation in interim periods. ASC paragraphs 740-270-25-7, 30-7

- The effect of a change in the valuation allowance expected to be necessary at the end of a year for deductible temporary differences and carryforwards originating during the year and related to ordinary income generally should be included in the estimated annual effective tax rate.
- The effect of a change in the beginning-of-the-year valuation allowance as a result of a change in judgment about the realizability of the deferred tax asset in future years (e.g., deferred tax assets will reduce taxable income in a period after the current fiscal period) should be recognized as a discrete item in the interim period in which the change in judgment occurs. The effect of these changes in beginning-of-the-year valuation allowance should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate for the remainder of the year.
- The income tax benefit of a change in the beginning-of-the-year valuation allowance as a result of ordinary income in the current year generally should be included in the computation of the estimated annual effective tax rate to the extent associated with ordinary income.
- Changes to the acquirer's valuation allowance on its deferred tax assets that result from acquisition accounting generally are recognized as an increase or decrease to income tax expense or contributed capital in the period of the business combination. We believe an entity may elect to recognize changes related to deductible temporary differences and carryforwards originating during the year either as discrete items or through a revision to its estimated annual effective tax rate. See Paragraph 6.040 for additional discussion.

**Example 10.24: Interim Effect of a Change in Valuation Allowance**

As of January 1, 20X7, ABC Corp. had net deferred tax assets of \$10,000 and a full valuation allowance. The \$10,000 valuation allowance was established because ABC could not demonstrate that it was more likely than not that the deferred tax assets would be realized.

During the second quarter of 20X7, ABC signed a significant new contract that caused the entity to change its judgment about the realizability of the deferred tax assets. Based on current estimates, the entity expects that \$2,000 of the net deferred tax assets that existed at January 1, 20X7 will be used to reduce income tax expense attributable to 20X7 ordinary income. Furthermore, ABC determined that it is more likely than not that the remaining \$8,000 of net deferred tax assets will be realized in future periods.

ABC should record an income tax benefit in the second quarter (as a discrete item) to reduce the valuation allowance related to the \$8,000 of deferred tax assets that are expected to be realized in future periods. The benefit from the release of \$2,000 of the valuation allowance for deferred tax assets expected to be realized in the current year should be recognized as an adjustment to the annual effective income tax rate used to calculate income tax expense for 20X7.

**Example 10.25: Zero Effective Tax Rate**

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

ABC Corp. has a deferred tax asset consisting entirely of net operating loss carryforwards and has recorded a full valuation allowance as of December 31, 20X6. In the quarter ended March 31, 20X7, ABC has pretax profit. While ABC expects to record losses for the remainder of 20X7, it does expect to report overall pretax profit and thus plans to use a portion of its net operating loss carryforwards to offset income taxes payable. However, ABC is unable to demonstrate that the net operating loss carryforwards expected to remain as of December 31, 20X7 (i.e., those in excess of the amount permitted to offset current year ordinary income) are more likely than not of being realized.

Because the partial release of the valuation allowance in the current year relates to the expected current year use of some of the net operating loss carryforwards, the income tax benefit should be considered as part of ABC's estimated annual effective tax rate for 20X7. For example, if ABC expects to be able to offset 100% of its taxable income in 20X7 (i.e., its net operating loss carryforwards arose in tax years beginning before December 31, 2017 so that their utilization is not limited to 80% of taxable income – see Paragraph 4.016a for additional information), it would have a zero annual effective tax rate in 20X7 and therefore would recognize no income tax expense for the quarter ended

March 31, 20X7 (and no income tax benefit for the remaining quarters in which losses are expected).

### **Example 10.26: Changes in Valuation Allowance Due to Discontinued Operations**

ABC Corp. has a deferred tax asset with a full valuation allowance for capital loss carryforwards as of its fiscal year-end December 31, 20X1. During the second quarter of fiscal 20X2, ABC enters into a definitive sale agreement to sell one of its major subsidiaries. In accordance with ASC Subtopic 205-20, *Presentation of Financial Statements - Discontinued Operations*, the results of operations for the subsidiary for the current and prior periods will be recorded in discontinued operations beginning in the second quarter.

#### **Scenario 1**

The actual sale of the subsidiary is expected to occur during the third quarter and management projects a substantial capital gain on the sale which will allow ABC to fully use the capital loss carryforwards.

ASC paragraph 740-270-45-4 requires that the manner of reporting the tax benefit of an operating (capital) loss carryforward in a subsequent year generally is determined by the source of the income in that year and not by (a) the source of the operating (capital) loss carryforward or (b) the source of expected future income that will result in realization of a deferred tax asset for the operating (capital) loss carryforward. In this fact pattern, the source of income in the current year is from the sale of the subsidiary that is classified as discontinued operations in accordance with ASC Subtopic 205-20.

ASC paragraph 740-270-25-4 typically requires the tax benefit of an operating (capital) loss carryforward from prior years to 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. However, it also states that if the tax benefit is not expected to be realized as a result of ordinary income, the tax benefit should be recognized in each interim period to the extent that income in that period (and for the year to date) is available to offset the operating (capital) loss carryforward.

Therefore, if the more-likely-than-not criterion for the reversal of the valuation allowance is based on the income generated from the current year sale of the subsidiary that will be classified in discontinued operations, ABC should allocate the benefit to discontinued operations in the interim period that the income is included or recognized in the financial statements, or the third quarter of 20X2 for this situation.

**Scenario 2**

Assume the same facts as described above, except that the sale of the subsidiary will not occur until fiscal year 20X3.

ASC paragraphs 740-270-25-4 and 25-7 state that for a change in judgment about realizability of a deferred tax asset in future years, the effect shall be recognized in the interim period in which the change occurs. Accordingly, if the change in judgment in the second quarter of 20X2 is made with the expectation of realization in 20X3, the valuation allowance release would be recognized entirely in the second quarter of 20X2.

In this scenario where the sale is expected to occur in 20X3, in addition to the benefit being recognized in a different period (second quarter of 20X2) than if the sale had been expected to close in the third quarter of 20X2 (third quarter of 20X2), it will also be allocated differently in the statement of operations. ASC paragraph 740-10-45-20 states that the effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related DTA in future years ordinarily shall be included in income from continuing operations.

The conclusion to recognize the release in the valuation allowance to continuing operations when the realization is expected in a future year is also supported by ASC paragraph 740-20-45-8. This paragraph requires that the amount allocated to continuing operations is the tax effect of income or loss from continuing operations that occurred during the year plus or minus the income tax effects of changes in circumstances that caused a change in judgment about the realization of deferred tax assets in future years.

**10.079 Losses in Interim Periods.** The tax effects of losses that arise in early interim periods should be recognized only if the tax benefits are more likely than not of being realized during the year (i.e., through ordinary income expected to be generated in later interim periods) and/or in a future year (i.e., through recognition of a deferred tax asset with no valuation allowance). The tax benefits of such losses would be considered when estimating the annual effective tax rate.

**10.080** An historical pattern of losses in early interim periods offset by income in later interim periods due to the seasonal nature of an entity's business may provide evidence that realization of the tax benefit in subsequent interim periods is more likely than not (see Example 10.27 for illustration). If the tax effects of losses that arise in early interim periods are not recognized in those interim periods because their realization was not more likely than not, the tax effects of income arising in later interim periods should not be recognized until the tax effects of the previous interim losses are used. Tax benefits associated with early interim period losses that have not been recognized in those interim periods may be recognized in a later interim period if it becomes more likely than not that such losses will be realized as a result of current or future year ordinary income. Such changes are generally treated as an adjustment to the estimated annual effective tax rate.

See Paragraph 10.075 for additional discussion of changes to intraperiod allocation in interim periods. ASC paragraphs 740-270-25-8 through 25-11, 35-5, 45-5

**Example 10.27: Calculation of Interim Period Income Taxes When There Is Ordinary Loss at an Interim Date and Ordinary Income Is Estimated for the Full Year (Established Seasonal Pattern of Ordinary Income and Loss)**

ABC Corp. estimates that it will generate ordinary income for fiscal year 20X7 of \$60,000 and ordinary income and loss in interim periods, as noted in the table below. ABC has a 21% statutory rate and there are no permanent differences arising in the year; therefore, the estimated effective tax rate for the year is 21%. Assuming there are no changes during the year in ABC's estimated annual effective tax rate and established seasonal patterns provide evidence that the realization of the tax benefit for the year-to-date loss in the early interim periods is more likely than not, the quarterly tax computations are as follows:

Quarter	Ordinary Income (Loss)			Income Tax		
	Period	YTD	ETR	YTD	Previously Provided	Period
First	\$ (20,000)	(20,000)	21%	(4,200)	-	\$ (4,200)
Second	(15,000)	(35,000)	21%	(7,350)	(4,200)	(3,150)
Third	40,000	5,000	21%	1,050	(7,350)	8,400
Fourth	55,000	60,000	21%	12,600	1,050	11,550
Fiscal year	\$ 60,000					\$ 12,600

In this example, an established seasonal pattern of ordinary losses early in the year with ordinary income in the second half of the year in excess of year-to-date cumulative losses provides support for the realization of the tax benefits recorded in the first and second quarters. Had ABC been unable to conclude that it was more likely than not that the tax benefits of the year-to-date losses would be realized during the year (or recognized as a deferred tax asset at the end of the year), no benefit would have been recognized in the first and second quarters.

Refer also to ASC Section 740-270-55 for additional examples.

**Example 10.28: Calculation of Interim Period Income Taxes When There Is Ordinary Loss at an Interim Date and Ordinary Income Is Estimated for the Full Year (No Established Seasonal Pattern of Ordinary Income and Loss)**

Assume the same facts as Example 10.27 except that ABC Corp. has not established a seasonal pattern to provide evidence that the realization of the tax benefit for the year-to-date loss is more likely than not. Additionally, ABC is unable to conclude that realization of the tax benefits is more likely than not in a future year. Quarterly tax computations are as follows:

Quarter	Ordinary Income (Loss)			Income Tax		
	Period	YTD	ETR	YTD	Previously Provided	Period
First	\$ (20,000)	(20,000)	- <sup>1</sup>	-	-	\$ -
Second	(15,000)	(35,000)	- <sup>1</sup>	-	-	-
Third	40,000	5,000	21%	1,050	-	1,050
Fourth	55,000	60,000	21%	12,600	1,050	11,550
Fiscal years	\$ 60,000					\$ 12,600

<sup>1</sup> ABC is unable to recognize the tax benefit of its year-to-date losses because those benefits are not expected to be realized either (a) during the current year through ordinary income generated in the third and fourth quarters, or (b) in a future year through recognition of a deferred tax asset at the end of the year. If ordinary income in the third quarter was \$35,000 or less, no income tax expense would have been provided.

Refer also to ASC Section 740-270-55 for additional examples.

**10.081 Losses Expected for the Fiscal Year.** As discussed in Paragraph 10.080, tax benefits related to a year-to-date ordinary loss would only be recognized if it is more likely than not that the benefit will be realized in the current or future year. Accordingly, when a loss is expected for the full fiscal year, the effect of the necessary valuation allowance expected at the end of the fiscal year should be considered in determining (a) the estimated tax benefit of the expected ordinary loss for the year, (b) the estimated annual effective tax rate, and (c) the year-to-date tax benefit of a loss in an interim period. ASC paragraphs 740-270-25-8 through 25-11, 30-7, 30-28 through 30-31, 35-5

#### **Example 10.29: Limited Recognition of Tax Benefits on Losses in an Interim Period When There Is an Ordinary Loss Estimated for the Full Year**

ABC Corp. estimates that it will generate an ordinary loss for fiscal year 20X7 of \$100,000 and ordinary income and loss in interim periods, as noted in the table below.

ABC has \$50,000 of taxable temporary differences as of December 31, 20X6 and does not have carryback availability or the ability to rely on projections of future income. ABC determines that it is more likely than not to realize only \$50,000 of the 20X7 loss requiring a \$10,500 ( $\$50,000 \times 21\%$  statutory rate) valuation allowance for the remaining \$50,000 of ordinary loss that will result in a deductible temporary difference as of December 31, 20X7. Both the taxable temporary difference of \$50,000 and the deductible temporary difference of \$50,000 will reverse in 20X8. Therefore, the estimated annual effective tax rate is 10.5% ( $\$10,500$  benefit for the amount realizable divided by  $\$100,000$  estimated fiscal year ordinary loss).

ABC is not able to rely on projections of ordinary income during the third and fourth quarter of the year for purposes of determining whether it is more likely than not to realize the benefit of year-to-date losses.



Quarterly tax computations are as follows:

Quarter	Ordinary Income (Loss)				Income Tax		
	Period	YTD	ETR	YTD	Limited to	Previously Provided	Period
First	\$ (20,000)	(20,000)	10.5%	(2,100)		-	\$ (2,100)
Second	(120,000)	(140,000)	10.5%	(14,700)	(10,500) <sup>1</sup>	(2,100)	(8,400)
Third	70,000	(70,000)	10.5%	(7,350)		(10,500)	3,150
Fourth	(30,000)	(100,000)	10.5%	(10,500)		(7,350)	(3,150)
Fiscal year	\$ (100,000)		10.5%				\$ (10,500)

<sup>1</sup> The calculated tax benefit for cumulative losses at the second quarter of \$14,700 exceeds the total benefit that will be realized for the year of \$10,500. Accordingly, under ASC paragraph 740-270-30-31, ABC would be limited to recording a tax benefit for the second quarter such that the cumulative benefit for the six-month period does not exceed \$10,500. As a result of applying this limitation in the example above, the actual effective tax rates for the second and third quarters will be less than the full year effective tax rate.

Refer also to ASC Section 740-270-55 for additional examples.

**10.081a** If the year-to-date ordinary loss exceeds the anticipated ordinary loss for the year, there will be no further limitation when the interim losses are more likely than not to be realized. In that case, an entity will recognize the tax benefit of a year-to-date loss based on the estimated annual effective tax rate. ASC paragraph 740-270-30-28

### Example 10.29a: Limited Recognition of Tax Benefits on Losses in an Interim Period When the Interim Period Loss Exceeds the Loss Estimated for the Full Year

ABC Corp. estimates that it will generate an ordinary loss for fiscal year 20X7 of \$100,000 and ordinary income and loss in interim periods, as noted in the table below.

ABC determines that it will be able to realize the full amount of its year-to-date losses at each interim date. ABC's statutory income tax rate is 21% and it expects to generate \$3,000 in tax credits for the year. ABC estimates its annual effective tax rate as follows:

Income tax benefit at the statutory rate (\$100,000 × 21%)	\$	21,000
Tax credits		3,000
Total income tax benefit	\$	<u>24,000</u>
Estimated annual effective tax rate		24%

Quarter	Ordinary Income (Loss)			Income Tax			
	Period	YTD	ETR	YTD	Limited to	Previously Provided	Period
First	\$ (20,000)	(20,000)	24%	(4,800)		-	\$ (4,800)
Second	(120,000)	(140,000)	24%	(33,600)		(4,800)	(28,800)
Third	70,000	(70,000)	24%	(16,800)		(33,600)	16,800
Fourth	(30,000)	(100,000)	24%	(24,000)		(16,800)	(7,200)
Fiscal year	\$ <u>(100,000)</u>		24%				\$ <u>(24,000)</u>

If the year-to-date ordinary loss exceeds the anticipated ordinary loss for the year, the year-to-date income tax benefit for interim period losses is no longer limited to the amount that could be recognizable if the year-to-date loss was the expected annual loss.

**10.082 Calculating a Negative Estimated Annual Effective Tax Rate.** A negative annual effective tax rate can happen, for example, when nondeductible expenses exceed pretax loss. Calculating a negative estimated annual effective tax rate may, however, be an indication that reliable estimates of the annual effective tax rate cannot be made as the calculated rate in these situations is often sensitive to minor fluctuations of total estimated income. See Paragraph 10.077 for additional discussion.

### Example 10.30: Calculating a Negative Estimated Annual Effective Tax Rate

ABC Corp. has year-to-date pretax income of \$60,000 through the first three fiscal quarters and estimates that there will be a pretax loss of \$65,000 in the fourth quarter resulting in a net pretax loss of \$5,000 for year. The pretax income recognized in the first three quarters included a \$30,000 impairment loss related to nondeductible goodwill. ABC determined the impairment loss is not a significant unusual or infrequently occurring item. The following is a summary of the quarterly income and forecasted loss:

	1Q	2Q	3Q	Year-to-Date through 3Q	Est. 4Q	Est. Fiscal Year
Pretax income (loss)	\$ 20,000	\$ 20,000	\$ 20,000	\$ 60,000	\$ (65,000)	\$ (5,000)
Add back write-off of nondeductible goodwill	-	30,000	-	30,000	-	30,000
Taxable income (loss)	\$ <u>20,000</u>	\$ <u>50,000</u>	\$ <u>20,000</u>	\$ <u>90,000</u>	\$ <u>(65,000)</u>	\$ <u>25,000</u>

The enacted tax rate is 21%. The estimated annual effective tax rate would be a negative 105% ( $(\$25,000 \times 21\%) / -\$5,000$ ). However, due to the near break-even situation and the large nondeductible item, relatively small changes in estimates of pretax income would result in significant effects on the estimated annual effective tax rate.

As a result, ABC may conclude that it cannot make a reasonable estimate of the annual effective tax rate, and therefore, ABC should use the year-to-date effective tax rate as the estimated annual effective tax rate in determining the amount of income tax expense to recognize. Under this method, ABC would recognize income tax expense of \$18,900

(\$90,000 × 21%) through the third quarter (resulting in an effective rate of approximately 31.5%).

**10.083 Enacted Changes in Tax Laws or Rates.** The effect of a change in tax laws or rates on existing deferred tax assets and liabilities should be recognized as a discrete event in income from continuing operations in the interim period that includes the enactment date of the change. The effect of a change in tax laws or rates on deferred tax assets and liabilities at the enactment date should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate for the remainder of the year. Similarly, the tax effect of a retroactive change in tax laws or rates on income taxes currently payable or refundable for a prior year should be recognized as a discrete event as of the enactment date as income tax expense or benefit of the current year. The effect of these changes results in a catch-up adjustment as of the date of the change. In addition to the catch-up adjustments at the enactment date for existing deferred tax assets and liabilities (and the effect on income taxes payable or receivable for retroactive changes in tax law), entities would need to evaluate the effect of the change on the estimated annual effective tax rate. Entities account for the effect of a change in tax law or rate on taxes currently payable for the current year in the estimated annual effective tax rate in the period that includes the enactment date, even if the change is effective in a later reporting period. Refer also to Paragraph 5.017 for additional discussion, policy choices and examples of interim accounting for changes in tax laws and rates. ASC paragraphs 740-270-25-5 and 25-6, 740-10-25-47 and 25-48, 30-26, 45-16 and 45-17, and ASC paragraphs 740-270-55-44 to 55-51

**10.083a** Not used.

### Example 10.30a: Changes in Tax Law in Interim Periods

At January 1, 20X7, ABC Corp. expects \$250 of ordinary income in each of its 20X7 fiscal quarters—a total \$1,000 of ordinary income for the year. ABC's statutory tax rate is 21% and taxable income is expected to equal ordinary income and its estimated annual effective tax rate for the year is 21%.

On April 1, 20X7, a tax law change is enacted that makes certain expenses no longer deductible. The law change is effective on October 1, 20X7 and although ABC's ordinary income is still expected to be \$1,000, ABC is expected to have \$1,500 of taxable income in 20X7. The \$500 increase in taxable income is solely the result of expenses expected to be incurred between October 1, 20X7 and December 31, 20X7 that will no longer be deductible as a result of the law change. ABC's effective tax rate after the law change will be 31.5% (\$315 of income tax expense [ $\$1,500 \times 21\%$ ] / \$1,000 of ordinary income).

The amount of income tax expense that ABC should record every quarter is shown in the following table. The tax rate change is reflected in the estimated annual effective tax rate in the interim period that includes the enactment date (April 1, 20X7).

Reporting Period	Ordinary income	YTD ordinary income	ETR	YTD income tax	Previously provided	Reporting period income tax expense
Q1	\$ 250	\$ 250	21.0%	\$ 52.50	—	\$ 52.50
Q2	250	500	31.5%	157.50	52.50	105.00
Q3	250	750	31.5%	236.25	157.50	78.75
Q4	250	1,000	31.5%	315.00	236.25	78.75
Fiscal year	\$ 1,000					\$ 315.00

### Example 10.31: Recognizing the Effect of a Change in Tax Law in Interim Periods

This example does not reflect the temporary changes made to U.S. federal tax law under the CARES Act. See Paragraphs 1.022 and 4.016aa for additional discussion.

At January 1, 20X7, ABC Corp. expected a \$250 loss in each of its 20X7 fiscal quarters—a total \$1,000 loss for the year. As of December 31, 20X6, ABC had no net deferred tax asset or liability and no valuation allowance for existing deferred tax assets because its deferred tax assets were related to pre-2018 net operating loss carryforwards that were expected to be recovered against the reversal of taxable temporary differences (net operating loss carryforwards that arise in tax years beginning after December 31, 2017 may offset only 80% of taxable income in a given year – see Paragraph 4.016a for additional discussion). Without any additional reversing taxable temporary differences or any estimated taxable income, the entity is unable to demonstrate that it is more likely than not that the deferred tax asset associated with the 20X7 losses will be realized. Accordingly, ABC expects that a valuation allowance will be necessary for any net operating loss generated in 20X7 and thus its estimated annual effective tax rate for the year is expected to be 0%. ABC's statutory tax rate is 21%.

On April 1, 20X7, there was a tax law change that makes certain expenses no longer deductible. The law change is effective January 1, 20X8 and is expected to result in \$500 of taxable income in 20X8. Accordingly, after the tax law change, ABC will be able to realize \$105 of income tax benefit associated with \$500 of its 20X7 operating losses. Through March 31, 20X7, the entity incurred a \$250 loss. Assuming the entity incurs a \$250 loss in each of the three remaining quarters, the entity should record the following income tax benefit in each quarter.

#### Quarter 1

As of March 31, 20X7, ABC had a \$250 net operating loss for which it did not expect to realize the benefit either through current or future year ordinary income. In applying its estimated annual effective tax rate of 0% (based on enacted tax law as of March 31, 20X7), ABC would recognize no income tax expense or benefit in the first quarter.

## Quarter 2

At April 1, 20X7, ABC has a \$250 net operating loss carryforward related to losses for the first quarter of the year and a full valuation allowance. The change in tax law allows ABC to realize that loss in 20X8 due to a revised estimate of future taxable income. This benefit would not have been realizable if the change in tax law did not occur. ABC uses an enactment date approach (see Paragraph 5.017a) and recognizes a \$53 benefit ( $\$250 \times 21\%$ ) in the second quarter as a result of the change in tax law.

ABC also reassesses its estimate of the annual effective tax rate. Of the \$1,000 loss expected for 20X7 (\$250 in each quarter), \$500 will be realizable in 20X8, resulting in a total income tax benefit of \$105. Accordingly, ABC expects it will realize \$52 of additional income tax benefit during the year after considering the \$53 of benefit recognized discretely as a result of the change in tax law.

The estimated annual tax rate based on this reassessment is calculated as 5.2% (\$52 divided by \$1,000). Assuming ABC does incur a loss of \$250 during the second quarter, it would recognize an additional \$26 ( $\$500 \times 5.2\%$ ) income tax benefit. The total income tax benefit for the second quarter would be \$79 (\$53 due to the change in tax law for losses incurred through April 1, 20X7 plus \$26 of benefit for losses incurred year to date using the estimated annual effective tax rate revised for the change in tax law).

## Quarters 3-4

In each of the two remaining quarters, assuming the loss is incurred as expected, an income tax benefit of \$13 will be recognized ( $\$250 \times 5.2\%$ ).

Refer also to ASC Section 740-270-55 for additional examples.

### Example 10.31a: Recognizing the Effect of the Expiration of a Tax Holiday in Interim Periods

ABC Corp. was previously granted a tax holiday by a foreign government to reduce its income tax rate from 25% to 15%. The agreement contractually ends on December 31, 20X3, when the tax rate increases to 25%, the statutory rate. ABC has a September 30 year-end, so the expiration of the tax holiday occurs at the end of ABC's first quarter in its 20X4 fiscal year.

We believe ABC should account for the expiration of its tax holiday as part of estimating its annual effective rate. As a result, ABC develops one annual blended rate by including the holiday rate (15%) for the first three months of the year and the statutory rate (25%) for the last nine months of the year.

We believe ABC should use a blended rate because a change in tax rate due to the expiration of an existing tax holiday is not specifically identified by ASC Topic 740 as an

item that would be excluded from the estimated annual effective rate. Moreover, ASC paragraphs 740-270-25-5 and 25-6 focus on the effects of new tax legislation/changes in tax laws on taxes payable or refundable, not on changes in tax rates due to the expiration of holidays. In this situation, there has been no tax law change or change in the enacted tax rate, as the movement in rate from 15% to 25% is solely due to the expiration of a previously established income tax holiday. ASC paragraph 740-270-25-2 requires an entity to make its best estimate of the effective tax rate expected to apply for the full fiscal year, which we believe could take into account the tax rate both before and after the expiration of a tax holiday.

**10.084 Effect of Changes in Tax Status in Interim Periods.** The effect of a change in tax status on existing deferred tax assets and liabilities is a discrete event and should be recorded in the interim period that includes the date that the election is filed if approval from the taxing authority is not required. The effect of the change in tax status should be recognized as of the date that the taxing authority approves the change if approval from the taxing authority is required.

**10.085 Changes in ASC Paragraph 740-30-25-17 (APB 23) Assessment of Indefinite Reversal Criterion.** A deferred tax liability may not be recognized for an excess of the financial statement carrying amount over the tax basis of an investment in the stock of a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration. If taxation of the outside basis difference is indefinitely postponed and the entity meets the indefinite reversal criterion of ASC paragraph 740-30-25-17 (see Paragraph 7.004 for additional discussion), a deferred tax liability is not recognized.

**10.085a** The income tax effect of a change in an entity's assessment of the indefinite reversal criterion (resulting in the need to recognize a deferred tax liability or the need to eliminate a previously recognized deferred tax liability) should be recognized in the interim period of the change measured based on the temporary difference as of the date of the change in facts. We believe an entity that changes its indefinite reinvestment assertion in an interim period should recognize the liability entirely as a discrete item in that period. Those deferred tax effects generally are allocated entirely to net income, including amounts attributable to the cumulative translation adjustment (i.e., the portion of the liability associated with the cumulative translation adjustment generally would not be backwards traced to other comprehensive income).

**10.085b** It is also acceptable for an entity to recognize or derecognize the liability as a discrete item in the interim period of the change for the portion of the liability associated with its outside basis difference at the beginning of the year, and as an adjustment to the estimated annual effective tax rate for the portion of the liability associated with earnings in the current year. Under this approach, the income tax expense associated with earnings in the current year would be allocated in accordance with a step-by-step approach (see Paragraph 9.021 for additional discussion). For example, if an entity was establishing a deferred tax liability for a taxable outside basis difference in the third quarter as a result of a change in its ASC paragraph 740-30-25-17 assessment, the portion of the deferred tax liability arising during the first three quarters may be recognized as an adjustment to

the estimated annual effective tax rate (with the amount related to the first three quarters' translation adjustment being allocated to other comprehensive income) if it is associated with ordinary income and the portion existing at the beginning of the year would be recognized as a discrete charge to income tax expense from either continuing operations or discontinued operations (including the amount attributable to prior years' cumulative translation adjustment).

**10.085c** If the subsidiary's operations are later classified in discontinued operations, it would be acceptable for the entity to reclassify the deferred tax expense from continuing operations to discontinued operations or leave the amount in continuing operations (see Paragraph 9.170 for additional discussion). ASC paragraphs 740-30-25-17, 25-19, 45-2

**10.085d** As discussed in Paragraph 7.007d, U.S. tax law (after the 2017 tax reforms) allows a U.S. shareholder of a specified 10% foreign corporation a 100% dividends received deduction for the foreign-source portion of dividends received. However, U.S. shareholders may still assert indefinite reinvestment with respect to undistributed earnings that may be taxed in the future on repatriation (e.g., currency gain or loss on PTEP, section 965(b) PTEP, state income taxes, withholding). Changes to that assertion would be accounted for as described in Paragraphs 10.085 to 10.085c and the liability measurement would be based on the expected manner of recovery (e.g., remission of dividends, liquidation or sale) and consider the tax effects associated with that manner of recovery, if any. See Paragraph 7.007c for additional discussion.

**10.086 Recognizing a Benefit for a Deductible Outside Basis Difference.** A deferred tax asset should only be recognized for the excess of the tax basis of an investment in a subsidiary over its financial statement carrying amount (deductible outside basis difference) when it becomes apparent that the difference will become deductible in the foreseeable future (see Paragraphs 2.047, 7.021 and 9.170 for additional discussion). Those benefits may relate to discontinued operations and in that case would be excluded from the estimated annual effective tax rate calculation. If the subsidiary is reported as a discontinued operation, the benefit recognized for the deductible outside basis difference generally would be accounted for as a discrete event and generally is recognized in discontinued operations, including the portion associated with the beginning-of-year cumulative translation adjustment.

**10.086a** However, we believe it is also acceptable to recognize the income tax benefit in continuing operations. If the benefit is recognized in continuing operations either because that is where the entity chooses to classify it, or the disposal does not qualify as a discontinued operation, the entity generally would recognize as a discrete item in the interim period of the change the portion of the benefit associated with its outside basis difference at the beginning of the year; and as an adjustment to the estimated annual effective tax rate the portion of the benefit associated with earnings in the current year unless it is the tax effect of a significant unusual or infrequently occurring item that is separately reported (see Paragraph 10.074). Under this approach, the total income tax expense or benefit would be allocated in accordance with a step-by-step approach (see Paragraph 9.021 for additional discussion).

**10.086b** As discussed in Paragraph 10.086, it is not appropriate to recognize the benefit for a deductible outside basis difference until it becomes apparent that the difference will become deductible in the foreseeable future. We believe an entity analyzes whether the exception to the recognition of deferred taxes for an outside deductible temporary difference is met based on the facts and circumstances that exist at the reporting date. For example, assume a calendar year-end entity has a subsidiary with a deductible outside basis difference and has not recognized a related deferred tax asset. In February (after its year-end but before the annual financial statements are issued), the entity receives and accepts an unsolicited offer to buy the subsidiary and closes the sale in the second quarter. In this situation, we believe the entity recognizes the deferred tax asset for the deductible basis difference in its first quarter (assuming that the entity has a relatively high level of assurance that it will close the sale) rather than in its previous annual financial statements, because it was not apparent that the deductible basis difference would reverse in the foreseeable future based on conditions existing at December 31. Alternatively, consider another example in which an entity decides (as part of preparing its December 31 financial statements in February), to make a check-the-box election that will trigger only the reversal of its deductible outside basis difference. If the entity commits to that election during the subsequent events period, the election is entirely in its control, and it does not have a previous policy to treat such changes as a change in tax status, the entity recognizes the resulting deferred tax asset in the December financial statements. See Paragraph 5.022a for additional discussion of check-the-box elections. As discussed in Paragraph 2.049, it may be useful to use the held-for-sale criteria of ASC paragraph 360-10-45-9 to determine whether it is apparent that a deductible outside basis difference will reverse in the foreseeable future.

**10.087 Subsequent Recognition, Derecognition, or Remeasurement of Tax Positions.**

A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) should be recognized as a discrete item in the interim period in which the change occurs. Subsequent recognition of a tax position that originated in a prior year through effective settlement or expiration of the statute should also be recognized as a discrete item in the interim period in which the settlement occurs (i.e., the interim period in which effective settlement has been reached or the statute expires). The resulting financial statement effects of such changes should not be considered in estimating the annual effective tax rate to be applied to year-to-date ordinary income. See Section 3, *Tax Calculation*, for additional information on the more-likely-than-not recognition threshold and the related measurement guidance.

**10.088** In contrast, a change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior interim period within the same fiscal year should be considered in estimating the annual effective tax rate to be applied to year-to-date ordinary income (consistent with the initial treatment of the effects of the tax position). ASC paragraph 740-270-35-6

**10.089** For example, assume an entity took a tax position on its prior year tax return. The tax position was recognized and measured under ASC Subtopic 740-10 (FIN 48). In the second quarter of the current year, management determines that the tax position should be



remeasured based on the results of recent tax cases. Later, in the third quarter of the current year, the results of newer tax cases indicate that the tax position should be remeasured yet again. In this example, both changes (i.e., both the second quarter change and the third quarter change) should be reflected as discrete items in the respective quarters in which the changes in judgment occurred. Both changes relate to a tax position that was taken in a prior year. The determination of whether a change is a discrete item is made relative to the period in which the tax position was taken, not the last time it was recognized, derecognized, or remeasured.

**10.090 Interest and Penalties Accrued on Income Taxes.** Interest and penalties are not considered in determining the estimated annual effective tax rate pursuant to ASC Subtopic 740-270, even if an entity's accounting policy is to record such amounts in income tax expense. Interest and penalties related to income taxes are accounted for in accordance with ASC paragraphs 740-10-25-56 and 25-57; 30-29 and 30-30; and 45-25 as discussed in Paragraph 3.120. Excluding interest and penalties from the estimated annual effective tax rate may result in more volatility in reported income tax expense in interim periods. Disclosure in Management's Discussion and Analysis may be appropriate pursuant to Item 303 of Regulation S-K for SEC registrants.

**10.091 Anticipating Future Events.** ASC paragraph 740-270-30-8 requires that the estimated annual effective tax rate reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, future events, such as tax-planning strategies that are not primarily within management's control generally should not be anticipated when determining the estimated annual effective tax rate. This guidance is consistent with the treatment of tax-planning strategies when determining the appropriate amount of a valuation allowance. See additional discussion of tax-planning strategies beginning in Paragraph 4.057. It may, however, be appropriate in some circumstances to consider information that arises after the balance sheet date but before the financial statements are issued. See Example 10.23.

**10.091a** In addition, entities should not anticipate changes in tax laws and rates. For example, while some states' income tax laws automatically conformed entirely to the U.S. federal tax code on enactment of U.S. tax reform in 2017, others did not. Many entities expected that those states that did not automatically conform likely would enact some changes to their tax laws through legislation in 2018 or later. However, entities had to prepare their state and local income tax calculations based on enacted state and local tax law at the reporting date and account for changes to state legislation in the period those changes were enacted.

**10.092 Operations Taxable in Multiple Jurisdictions.** An entity subject to tax in multiple jurisdictions should generally compute one overall estimated annual effective tax rate related to consolidated ordinary income. However, the ordinary income (or loss) and related income tax (or benefit) in a jurisdiction should be excluded from the overall estimated annual effective tax rate computation if:

- An ordinary loss is anticipated for the fiscal year, or has an ordinary loss year-to-date in a separate jurisdiction for which no tax benefit can be recognized, or

- The 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 of the related tax in a jurisdiction (including the tax assessed in that jurisdiction as well as taxes or benefits in other jurisdictions such as the taxes on unremitted earnings or foreign tax credits).

**10.093** If an entity anticipates an ordinary loss for the fiscal year, or has an ordinary loss year-to-date, in a tax jurisdiction for which no tax benefit can be recognized, a separate effective tax rate should be calculated for that jurisdiction and applied to the ordinary loss of that jurisdiction. ASC paragraphs 740-270-30-36, 55-41

### **Example 10.32: Foreign Subsidiary Losses in Calculation of Estimated Annual Effective Tax Rate**

ABC Corp. is a U.S. corporation with several foreign subsidiaries that are not consolidated in the U.S. consolidated federal tax return. ABC's foreign subsidiaries, which operate in multiple tax jurisdictions, have historically been profitable, with the exception of the German subsidiary. ABC continues to anticipate losses in its German subsidiary and concludes that it is not more likely than not that the deferred tax assets related to net operating losses in Germany will be realized.

Because ABC's German subsidiary operates in a separate jurisdiction from the reporting entity and anticipates an ordinary loss for the year for which no tax benefit may be recognized, ASC subparagraph 740-270-30-36(a) requires that the German earnings and related income tax expense or benefit should be excluded in ABC's overall annual effective rate calculation. An annual effective tax rate should be computed on a stand-alone basis for the German jurisdiction and applied only to year-to-date German earnings (loss). Similarly, the overall annual effective tax rate applicable only to the non-loss jurisdictions should be applied to only the year-to-date earnings of those non-loss jurisdictions.

See also ASC Section 740-270-55 for additional examples.

**10.094** As discussed in Paragraph 10.092, 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 the related tax in a jurisdiction, the income tax related to ordinary income in that jurisdiction should be recognized in the interim period in which the ordinary income is reported. ASC paragraphs 740-270-30-36, 55-42 and 55-43

**10.094a Whether to Exclude a Loss Jurisdiction When it Results in a Benefit In Another Jurisdiction.** We believe there are two acceptable interpretations of ASC Topic 740's requirement to exclude from the overall estimated annual effective tax rate loss jurisdictions for which no benefit can be recognized when the loss jurisdiction provides a benefit in another jurisdiction, such as a reduction in the U.S. shareholder's GILTI

inclusion (see Paragraph 7.087a for additional discussion of GILTI). One interpretation (method A) is that a loss jurisdiction is excluded from the overall estimated annual effective tax rate if no benefit can be realized in any jurisdiction. Under method A, a U.S. parent includes in its overall estimated annual effective tax rate a foreign loss jurisdiction that reduces its GILTI inclusion or another tax in another jurisdiction, even if it cannot realize the benefits of its losses in the foreign jurisdiction.

**10.094b** A second interpretation (method B) is that a loss jurisdiction is excluded from the overall estimated annual effective tax rate if no benefit can be realized in the foreign jurisdiction. Under method B, a U.S. parent excludes from its overall estimated annual effective tax rate a foreign loss jurisdiction if it cannot realize the benefits of its losses in the foreign jurisdiction, even if its losses reduce the U.S. parent's GILTI inclusion. An entity's choice of method will affect the rate it applies to year-to-date ordinary income at its interim periods but will not affect total income tax expense for the year.

### **Example 10.32a: Estimating the Annual Effective Tax Rate – Loss Jurisdiction That Reduces GILTI**

#### **Background**

ABC Corp. is a U.S. parent entity with two foreign subsidiaries (Country A and Country B). Country A has historically been profitable, while Country B has not. Other than deemed repatriation as a result of U.S. tax reform in 2017, ABC historically was indefinitely reinvested in its foreign subsidiaries and did not recognize any U.S. taxes associated with its foreign subsidiaries. Historically, ABC has excluded Country B's ordinary loss when estimating its annual effective tax rate under ASC Topic 740 because it concluded that it is not more likely than not to realize the tax benefits of its losses and did not recognize a benefit for those losses.

In 2018, ABC continues to expect Country B to incur an ordinary loss for which it is not more likely than not to realize the benefits in Country B's local tax jurisdiction. However, Country B's ordinary loss will provide tax benefits for US tax purposes because its ordinary loss is expected to reduce ABC's worldwide GILTI inclusion.

The illustrations assume the following:

- U.S. domestic ordinary income: \$100,000
- U.S. domestic tax rate: 21%
- Country A's ordinary income: \$70,000
- Country A's tax rate: 5%
- Country B's ordinary loss: \$40,000
- Country B's tax rate (after considering its valuation allowance): 0%

- GILTI rate: 10.5%
- Foreign tax credit rate: 80%
- Foreign tax credit inclusion percentage resulting from tested losses reducing tested income: 43% (\$30,000 of net tested income ÷ \$70,000 of tested income).

For simplicity, the example ignores the deduction of foreign taxes in determining tested income, the section 78 gross-up, and U.S. expense allocations. It also assumes that all of the income or loss of the foreign subsidiaries is tested income or tested loss included in ABC's net tested income for GILTI purposes, and there is no deduction for qualified business asset investment (QBAI).

Method A: Include Country B

	<b>Ordinary income: all jurisdictions</b>	<b>Income tax expense (benefit): all jurisdictions</b>	<b>Tax rate</b>
ABC domestic operations (21%)	\$100,000	\$21,000	21%
GILTI (net tested income of Country A and Country B taxed at 10.5%, less 80% of 43% of the foreign taxes paid)		1,950	
Total United States	<u>100,000</u>	<u>22,950</u>	
Country A (local income tax expense: \$70,000 × 5%)	70,000	3,500	5%
Country B (local income tax benefit: \$40,000 × 0%)	<u>(40,000)</u>	<u>-</u>	<u>0%</u>
Total worldwide	<u><u>\$130,000</u></u>	<u><u>\$26,450</u></u>	<u><u>20.3%</u></u>

Under Method A, ABC applies a 20.3% estimated annual effective tax rate to its worldwide consolidated ordinary income (loss) each quarter.

If through its first quarter, ABC's US domestic operations and Country A collectively earned \$30,000 and Country B incurred a \$12,000 ordinary loss, ABC's consolidated income tax expense would be \$3,654  $[(30,000-12,000) \times 20.3\%]$ .

## Method B: Exclude Country B

	<b>Ordinary income: US plus Country A</b>	<b>Income tax expense (benefit): all jurisdictions</b>	<b>Tax rate</b>
ABC domestic operations (21%)	\$100,000	\$21,000	21%
GILTI (net tested income of Country A and Country B taxed at 10.5%, less 80% of 43% of the foreign taxes paid)		1,950	
Total United States	100,000	22,950	
Country A (local income tax expense: $\$70,000 \times 5\%$ )	70,000	3,500	5%
Total worldwide without Country B	\$170,000	\$26,450	15.6%
	<b>Ordinary loss: Country B</b>	<b>Local tax (benefit): Country B</b>	<b>Tax rate</b>
Country B (local income tax benefit: $\$40,000 \times 0\%$ )	\$40,000	\$0	0%
Total worldwide	\$130,000	\$26,450	20.3%

Under Method B, ABC applies a 15.6% estimated annual effective tax rate to the sum of its domestic and Country A ordinary income (loss) each quarter and separately applies a 0% rate to Country B's ordinary income (loss) each quarter.

If through its first quarter, ABC's U.S. domestic operations and Country A collectively earned \$30,000 and Country B incurred a \$12,000 ordinary loss, ABC's consolidated income tax expense would be \$4,680 ( $(30,000 \times 15.6\%) + (12,000 \times 0\%)$ ).

**10.094c Effect of Transaction Gains and Losses on Withholding Tax Liabilities.** As discussed in Paragraph 7.046a, we believe that a U.S. parent that recognizes a liability for withholding taxes should recognize in earnings changes to that liability attributable to changes in exchange rates under ASC Topic 830. Under ASC Topic 830, an entity recognizes these transaction gains (losses) discretely in the interim period in which they arise regardless of whether it elects to present them in pretax income or income tax expense (benefit). All entities should include these gains/losses in the aggregate transaction gain or loss disclosed under ASC Topic 830.

**10.095 Reporting Entities with a Nontaxable Parent or Nontaxable Subsidiaries.** As discussed in Paragraph 10.092, an entity subject to tax in multiple jurisdictions generally should compute one overall effective tax rate related to consolidated ordinary income unless certain conditions are met. We believe the same is true for reporting entities that have one or more nontaxable components (e.g., a REIT with one or more taxable REIT

subsidiaries). The reporting entity applies a single estimated annual effective tax rate to the consolidated ordinary income (rather than applying an estimated annual effective tax rate to the ordinary income of only the tax-paying components). If an entity cannot estimate part of its ordinary income (or loss) or the related tax (or benefit) but otherwise can make a reliable estimate, the tax (or benefit) that applies to that item (or jurisdiction) that cannot be estimated should be reported in the interim period in which the item is reported (see discussion in Paragraphs 10.077 and 10.094). The question of whether interim income taxes should be computed at a level lower than the consolidated entity was considered and rejected for all but a few instances when FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods: an interpretation of APB Opinion No. 28*, was deliberated. Diversity in practice exists on this issue, particularly in the REIT industry.

### **Example 10.33: Interim Tax Determination When a Hospitality REIT Has a Taxable Subsidiary**

Hospitality REIT owns hotel properties and, as required under the Internal Revenue Code, it must earn at least 75% of its gross income from rent and sales of real property. Accordingly, Hospitality REIT leases its owned hotel properties to its wholly owned subsidiary (a taxable REIT subsidiary, or TRS) for both fixed and variable rental payments. TRS earns income by operating the hotels (operating income) through third-party operating agreements and Hospitality REIT earns income from the rental payments received from TRS (rental income). The rental income of Hospitality REIT and the rental expense of TRS eliminate in consolidation.

While hospitality REITs in general expect TRS income to be modest relative to the consolidated entity's income over time, there can be unusual volatility in the consolidated effective tax rate for individual periods. This volatility is caused in part by the relationship of TRS income to REIT income, individual hotel performance and the hotel-specific intra-entity lease, seasonal fluctuations in hotel performance, and industry-wide cycles. For example, it is not unusual in certain business cycles for the taxable income of a TRS to be a significant portion of the overall income of the consolidated entity resulting in effective tax rates that run from very high (e.g., in excess of 70% when the TRS has income and the nontaxable entities in the consolidated entity have losses) to negative (e.g., when the TRS has income when the consolidated entity has a loss).

As discussed in Paragraph 10.095, an entity generally should recognize interim income taxes under Subtopic 740-270, whereby the income tax expense (or benefit) related to ordinary income (or loss) should be computed at an estimated annual effective tax rate for the consolidated entity. However, if an entity cannot estimate a part of its ordinary income (or loss) or the related tax (or benefit) but otherwise can make a reliable estimate, the tax (or benefit) that applies to the item that cannot be estimated should be reported in the interim period in which the item is reported. If the entity cannot reliably estimate an annual effective tax rate for the consolidated entity, such as may occur when the rate moves drastically based on changes in the business environment as described above, the actual effective tax rate year-to-date may be the best estimate of the annual effective tax

rate (as discussed in Paragraphs 10.077). Accordingly, it may be appropriate to reflect income tax expense for the consolidated Hospitality REIT on a year-to-date basis if the consolidated estimated annual effective tax rate cannot be reliably estimated.

**10.096 Changes in Estimates and Error Corrections.** ASC Topic 250 defines a change in accounting estimate as a change that results from new information and an error in previously issued financial statements as a change that results from mathematical mistakes, mistakes in applying GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. Changes in estimates are accounted for in the period of change (or in the period of change and future periods if the change affects both) while material errors are corrected through restatement of prior periods. Recognizing income taxes in interim and annual periods requires an entity to make a series of judgmental estimates that may change in future periods.

**10.096a** When those changes arise (e.g., through preparing the tax return, interacting with the taxing authority, evolving tax law interpretations, or identifying items in the course of other activities within the organization), an entity needs to evaluate whether the change results from new information or information that existed and was reasonably knowable at the time the financial statements were prepared. Determining whether information was ‘reasonably knowable’ at the time the financial statements were prepared can be highly judgmental. We believe information is ‘reasonably knowable’ if it can be identified by making a reasonable effort. Determining the income tax effect of many transactions is straightforward – i.e., the information and analysis necessary for a detailed estimate generally is available through making a reasonable effort. Other determinations are difficult because developing a best estimate requires considerable judgment and specialized tax technical expertise. This is often the case when income tax laws and regulations are new or the interpretations of them are evolving (see Paragraph 3.116a), and when an entity’s business operations and tax profile are changing. In those situations, the information and analysis necessary to narrow the range of possible outcomes to the same level of precision may not be available through reasonable effort. We believe that as the imprecision and complexity of the estimate increases, so does the likelihood that adjustments are appropriately accounted for as changes in estimates.

**10.097** If an entity concludes that a change is a change in estimate relative to a prior year transaction, that change in estimate would be recognized in the period of change, and not through the estimated annual effective tax rate. If the change in estimate relates to the prior year and current year ordinary income, the effect related to the prior year would be recognized in the period of change and the current year effect would be considered in estimating the annual effective tax rate. If a change is the correction of an immaterial error for which the entity has concluded that no restatement is necessary, the change would be recognized in the period of change.

## **PASS-THROUGH INVESTMENTS (PARTNERSHIPS AND OTHER TAX PASS-THROUGH ENTITIES)**

**10.098** When an entity is treated as a partnership or other pass-through entity (e.g., limited liability corporations taxed as partnerships or subchapter S Corporations) in one tax jurisdiction, but is directly taxed on income in another tax jurisdiction, the entity should apply the provisions of ASC Topic 740 for that jurisdiction where it is taxed. However, these entities are not directly subject to income taxes in many tax jurisdictions. If an entity is not subject to income taxes directly, differences between the financial statement carrying amounts and tax bases of assets and liabilities are not temporary differences because there are no future tax consequences to the entity. Accordingly, the stand-alone financial statements of such entities do not present deferred tax assets, deferred tax liabilities, or income tax expense related to those tax jurisdictions (unless the entity is a disregarded entity that has income taxes allocated to it, see additional discussion beginning in Paragraph 10.055). Taxable income and losses flow through the nontaxable entity to the owners of the entity and are reported with the respective owners' taxable income or loss and cannot be allocated to the separate financial statements of an entity that is not a disregarded entity (see Paragraph 10.043). Because these entities are not subject to income taxes directly, questions arise as to how a consolidating investor should account for the tax consequences of its investment in such entities.

**10.099 Application of ASC Topic 740 to Investments in Pass-Through Subsidiaries.** Deferred taxes should be recognized for the outside basis differences of investments in pass-through subsidiaries. An outside basis difference for a pass-through subsidiary is generally the difference between the financial statement carrying amount of the investment in the subsidiary (which is generally the investor's share of the net carrying amounts of the subsidiary's assets and liabilities; in other words, the amount the parent would report if the pass-through entity had been accounted for under the equity method) and the corresponding tax basis. Deferred taxes are recognized for the outside basis difference because the difference will generally have a future tax consequence to the parent either when the investment in the subsidiary is sold or when the inside basis differences of the subsidiary reverse and flow-through to the parent. We believe the ASC Topic 740 exceptions to recognizing deferred taxes for outside basis differences do not apply to the outside basis difference of the investment in pass-through subsidiaries, including any residual outside temporary difference that may remain after temporary differences inside the pass-through subsidiary reverse. See Paragraph 2.102 for additional discussion.

**10.100** The exceptions in ASC paragraphs 740-10-25-3 and 740-30-25-9 generally will apply to the portion of the temporary difference related to a pass-through subsidiary to the extent it relates to the pass-through subsidiary's inside temporary differences that qualify for the exceptions. For example, if a corporate parent has a consolidated partnership that consolidates a foreign corporation, a deferred tax liability for future taxes on the undistributed earnings of the consolidated foreign corporation (e.g., foreign withholding taxes and state income taxes) should not be recognized in the consolidated financial statements if the partnership (the parent in this case) is able to meet the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23). Accordingly, if a



pass-through subsidiary has an investment in a corporate subsidiary, the outside basis difference of the investment in the pass-through subsidiary by the ultimate corporate parent entity should be bifurcated into two components: (a) the outside basis difference related to the investment in the second tier corporate subsidiary, and (b) the remaining outside basis difference. Deferred taxes generally should not be recognized for the portion of the outside basis difference that relates to the pass-through subsidiary's investment in the second-tier corporate subsidiary that meets one of the exceptions to recognizing deferred taxes for outside basis differences. Similarly, an ultimate corporate parent entity may not recognize deferred taxes on the portion of its outside basis difference for its investment in a pass-through subsidiary attributable to nondeductible goodwill inside the pass-through subsidiary as deferred taxes are not provided for nondeductible goodwill under ASC subparagraph 740-10-25-3(d). However, we acknowledge diversity in practice where some recognize deferred taxes for the entire basis difference, including the portion attributable to nondeductible goodwill. We would not object to either practice provided it is consistently applied. Further, we would not object to a consistently applied policy (by nature of investment) either to (a) look through the outside basis difference and exclude all items for which ASC Topic 740 provides an exception to recognition, or (b) record deferred taxes on the entire outside basis difference. Entities can have differing policy elections based on the nature of the investment (i.e., consolidated subsidiary or equity method investment). See additional discussion of the exceptions to the recognition of deferred taxes for investments in subsidiaries beginning in Paragraph 2.033. ASC paragraphs 740-10-25-3, 740-30-25-9, 25-17 and 25-18, 805-740-25-3

**10.100a Application of ASC Topic 740 to Pass-Through Investments Accounted for Under the Equity Method.** We believe the guidance in Paragraph 10.100 about excluding portions of the outside basis difference (e.g., nondeductible goodwill) when recognizing deferred taxes for the outside basis difference in a consolidated partnership investment is also generally acceptable for other investments in partnerships, including those accounted for under the equity method. However, we believe the only portions of the outside basis difference that may be excluded are those for which an exception to the recognition of deferred taxes would apply if the ultimate tax-paying parent entity held its proportion of the underlying asset or liability directly. As a result, if a partnership investment is accounted for by the parent entity under the equity method, we believe it is generally not appropriate for that parent entity to exclude the portion of the outside basis difference that relates to the partnership's investment in another entity (i.e., the second-tier investment) even if the partnership itself would be able to apply an exception to the recognition of deferred taxes on the outside basis difference related to the investment in its subsidiary. We believe this is the case because the second-tier investment would not be a consolidated subsidiary of the ultimate tax-paying parent entity if that parent entity held it directly.

**Example 10.34: Application of ASC Topic 740 to Pass-Through Subsidiaries**

On January 1, 20X7, ABC Corp. and DEF Corp. form a partnership, with ABC contributing \$100 for four partnership units (80%) and DEF contributing \$25 for one partnership unit (20%). On the same day, the partnership acquires 100% of the outstanding stock of a foreign corporation for \$125. ABC will consolidate the partnership. ABC records its investment in the partnership with the following journal entry:

	Debit	Credit
Investment in partnership	100	
Cash		100

In 20X7 the foreign corporation earns \$200 of net income, which is not distributed to its owner. A deferred tax liability for foreign withholding was not recognized by the partnership because it was able to demonstrate that the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) was met with respect to its investment in the foreign corporation.

In 20X7 the partnership earns \$200 of net income (equal to the earnings of the foreign corporation), which is not distributed to its partners. ABC records the following journal entry to recognize its \$160 ( $\$200 \times 80\%$ ) equity in earnings of the partnership (before consolidation of the partnership):

Investment in partnership	160	
Equity in partnership earnings		160

At December 31, 20X7, ABC consolidates the investment in the partnership with the following consolidation entry:

Net assets (various accounts)	325	
Noncontrolling interest		65
Investment in partnership		260
Net income attributable to noncontrolling interest	40	
Equity in partnership earnings	160	
Net income (various accounts)		200

None of the earnings of the foreign corporation generated GILTI or Subpart F income and therefore did not change ABC's tax basis in the partnership. Instead, all of the earnings of the foreign corporation are eligible for a 100% dividends received deduction that would apply for federal income tax purposes, but not for state income tax purposes, based on ABC's expected manner of recovery. At December 31, 20X7, the financial statement carrying amount of ABC's investment in the partnership is \$260, while ABC's

tax basis of the investment in the partnership remains \$100 (ABC's initial investment). The \$160 basis difference is entirely due to the undistributed earnings of the partnership's investment in the foreign corporation. No federal deferred tax liability would be required due to the expectation of recovering in a tax-free manner. A deferred tax liability for state taxes would not be recognized for this basis difference because ABC was able to demonstrate that the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB 23) was met with respect to the partnership's investment in the foreign corporation.

DEF accounts for its investment in the partnership using the equity method. At December 31, 20X7, the financial statement carrying amount of DEF's investment in the partnership is \$65, while DEF's tax basis of the investment in the partnership is \$25. The \$40 basis difference is due to the undistributed earnings of the partnership's investment in the foreign corporation. In accordance with ASC paragraph 740-30-25-5, a state deferred tax liability should be recognized for this basis difference because the ASC paragraph 740-30-25-17 (APB 23) exception would not apply if DEF held its 25% proportionate interest in the foreign corporation directly – i.e., DEF's indirect investment in the foreign corporation is not an investment in a foreign subsidiary or foreign corporate joint venture. No liability would be required to be recorded by DEF with respect to withholding on distributions from the foreign corporation to the partnership because the withholding tax is attributable to the partnership and is not a tax of DEF.

However, no federal deferred tax liability would be required to the extent the investment is expected to be recovered in a manner that does not result in federal income taxes.

**10.101** An entity scheduling the reversal of existing temporary differences to determine whether a valuation allowance is needed for its deferred tax assets may need to separately schedule the components of a temporary difference related to an outside basis difference of an investment in a pass-through subsidiary. For example, the component of an outside basis difference that is due to differences between the financial statement carrying amount and the tax basis of fixed assets within the pass-through subsidiary should be scheduled to reverse over the depreciation period of the assets. However, the component of the outside basis difference that relates to an indefinite life identifiable intangible asset or goodwill generally should be scheduled to reverse in an indefinite future period (see Paragraph A.028 for additional discussion).

**10.102 Centralized Partnership Audit Regime.** As discussed in Paragraph 9.118, the centralized partnership audit regime applies to all partnerships, except for (a) qualifying partnerships that affirmatively elect out for a tax year, and (b) other partnerships that elect an alternative mechanism, in accordance with rules to be established by the Secretary of the Treasury.

**10.102a** The centralized partnership audit regime generally provides for assessment and collection of an imputed underpayment of tax, interest, and penalties at the partnership level. As a result, certain payments may be made by the partnership itself even though it continues to be a pass-through entity for income tax purposes. We believe that taxes on partnership income should continue to be attributed to the partners. Accordingly, an

investor in a partnership would need to evaluate such potential taxes in recognizing income taxes associated with an investment in a partnership. See additional discussion at Paragraph 9.118.

## COOPERATIVES

**10.103 Nonexempt Cooperatives.** Internal Revenue Code sections 1381 through 1388 impose a tax on all cooperative net earnings that are not distributed to patrons in cash or qualified written notices of allocation (collectively, patronage-sourced earnings). These sections enable exempt and nonexempt cooperatives to take tax deductions for patronage distributions and also allow exempt cooperatives (i.e., those cooperatives that meet the criteria necessary for an organization to qualify as exempt under section 521 of the Internal Revenue Code) to deduct distributions of nonpatronage income and dividends on capital in addition to the additional deductions permitted under section 521. The recipient of the distribution (generally the patron) is responsible for the income tax on the distributed patronage-sourced earnings.

**10.104** ASC Topic 740 does not directly address cooperatives and does not provide clear guidance on whether or not the patronage deductions are special deductions as discussed in ASC paragraphs 740-10-25-37 and 740-10-30-13. As further discussed in Paragraph 3.074, special deductions are taken into account in determining the current tax expense and are not anticipated for offsetting a deferred tax liability. However, ASC paragraphs 740-10-25-30, and 740-30-25-14 provide rationale for using a pro rata approach to tax – affecting only the portion of a cooperative’s temporary differences expected to have a tax consequence to the cooperative. See Paragraph 10.107 for discussion of nonqualified notices of allocation.

**10.105** Under the pro rata approach, the proration is based on a determination as to which source of future earnings (patronage or nonpatronage) the temporary difference relates and measures the related deferred tax asset or liability accordingly. To the extent a temporary difference relates solely to future nonpatronage source earnings, the applicable enacted tax rate would generally be used to determine the deferred tax liability or asset. If the temporary difference relates to future patronage source earnings that will be distributed, a zero percent tax rate would be used. The zero percent tax rate for patronage-sourced earnings is appropriate only if the cooperative has the ability and intent to distribute future patronage-sourced earnings and, therefore, will receive a tax deduction for the future distribution.

**10.106** Temporary differences that are related to both patronage and nonpatronage source earnings should be prorated based on an estimate of the relative magnitude of the two sources of earnings in the future periods that the temporary differences are expected to reverse. The estimate should take into account historical relationships of patronage and nonpatronage source earnings supplemented by all currently available information about future years. If patronage earnings are not to be distributed, they should be treated as nonpatronage earnings.

**Example 10.35: Prorated Approach for Cooperatives**

Assume the following with respect to the operations of a nonexempt cooperative:

- Historical earnings have been 10% nonpatronage-sourced and the relationship of patronage- to nonpatronage-sourced earnings is expected to continue into the foreseeable future;
- The cooperative's policy is to make qualified allocations of 100% of patronage-sourced earnings and the allocation policy is expected to continue into the foreseeable future;
- A taxable temporary difference of \$1,000 exists related to an asset used solely in an activity that results in nonpatronage-sourced earnings;
- A taxable temporary difference of \$5,000 cannot be specifically related to future patronage- or nonpatronage-source earnings.
- The tax rate is 21%.

A deferred tax liability of \$600 would be established, computed as follows:

Nonpatronage:

\$ 1,000 × 21%	\$	210
5,000 × 10% × 21%		105

Patronage:

\$ 5,000 × 90% × 0%		—
	\$	<u>315</u>

**10.107 Nonqualified Written Notices.** A nonexempt cooperative may also issue nonqualified written notices of allocation to members for patronage-sourced earnings. Unlike qualified notices of allocation, a cooperative does not receive a current deduction for nonqualified written notices of allocation. The cooperative pays current taxes on the earnings for which nonqualified notices were issued and the cooperative will receive a tax deduction for the distributions when nonqualified notices are redeemed. It is acceptable to recognize a deferred tax asset, subject to any necessary valuation allowance, for the taxes paid on nonqualified written notices of allocation if the cooperative has the expressed intent and ability to redeem the nonqualified notices.

**10.108** In situations where the cooperative does not have the intent and ability to redeem the nonqualified notices, the related patronage-sourced earnings are considered not distributed and should be treated the same as nonpatronage-sourced earnings in the determinations of deferred taxes. In that situation, (a) taxes paid on the unqualified allocations are included in current tax expense, (b) a deferred tax asset is not recognized for the tax payments, and (c) the benefit of the tax deduction received upon redemption of

nonqualified notices is recognized as a reduction of income tax expense in the period that the benefit of the deduction is realized.

## REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS

**10.109** Similar to cooperatives, certain entities (such as Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)) that meet specified criteria under the U.S. Internal Revenue Code may elect to qualify for special income tax treatment, which allows a deduction for dividends paid to shareholders. Qualification under these special rules allows the entity to avoid taxes on earnings distributed to shareholders. Failure to meet the qualification tests results in the entity being taxed as a C Corporation.

**10.110** In deliberating FASB Statement No. 109, *Accounting for Income Taxes*, the Board indicated in paragraph 145 of its Basis for Conclusions that a tax deduction for dividend payments represents an exemption from taxation. Accordingly, RICs and REITs do not recognize deferred taxes on basis differences if the entity:

- Is appropriately organized and structured to qualify as a RIC or REIT;
- Has met the appropriate qualifications to be treated as a RIC or REIT;
- Expects to make any required elections under the tax law to obtain such treatment (see Paragraph 5.026 for additional discussion on electing REIT or RIC status);
- Intends to continue to meet the requirements under the tax law for RICs or REITs, including the distribution of substantially all of its income that would otherwise be taxable;
- Expects to meet the foregoing requirements in all future periods; and
- There is no indication that the entity will fail to meet those requirements.

A tax-exempt or pass-through entity's assertion that it is not subject to tax is a tax position (e.g., the entity qualifies as a REIT) that should be evaluated for recognition and measurement in accordance with ASC Subtopic 740-10 (FIN 48) in the same manner as other tax positions. See Paragraphs 3.015 and 3.098 for additional discussion.

**10.111 Investor Accounting for an Investment in a RIC or REIT.** An investor in a RIC or REIT would recognize deferred taxes for its investment in a manner consistent with its expected manner of recovery. See Paragraphs 2.053 and 10.009 for additional discussion of accounting for the tax effects of investments accounted for under the equity method and Paragraphs 2.102 and 10.098 for additional discussion of investments in consolidated pass-through entities.

## REGULATED ENTITIES

**10.112** Regulated entities that meet the criteria to apply ASC Topic 980, *Regulated Operations*, are not exempt from the requirements to recognize deferred taxes for differences between the financial statement carrying amounts and tax bases of assets and liabilities. However, in applying the provisions of ASC Topic 980, a regulatory asset or liability may also be recognized when the deferred taxes are recognized if certain criteria are met such that the amount is considered to be a flow-through to the customers. ASC paragraphs 980-740-25-1 and 25-2

**10.113 Flow-Through Deferred Taxes.** Regulatory assets are recognized for the probable future recovery (from customers through increases in regulated rates) of higher taxes payable caused by the settlement of a deferred tax liability. Regulatory liabilities are recognized for the probable future payment (to customers through decreases in regulated rates) of lower taxes payable caused by the settlement of a deferred tax asset. This regulatory asset or liability should not be classified as a deferred tax asset or liability for financial reporting purposes or otherwise offset the reported amounts of deferred tax assets or liabilities. Furthermore, deferred taxes should be recognized for the temporary differences arising as result of establishing these regulatory assets and liabilities for financial reporting purposes, as such amounts will have zero tax bases. ASC paragraphs 980-740-55-8 through 55-14

**10.114 Simultaneous Equation for Regulatory Assets and Liabilities.** The calculation of deferred tax assets and liabilities becomes circular when regulatory assets and liabilities are recognized for deferred tax assets and liabilities. For example, recognizing a regulatory asset for a deferred tax liability creates a financial statement asset in excess of the tax basis for which a deferred tax liability is recognized. That recognized deferred tax liability then results in an increase to the regulatory asset to the extent such amount will flow through to the customer. This increase in the balance of the regulatory asset then results in an increase to the temporary difference, and so on. This phenomenon is similar to situations involving the reduction of first component financial statement goodwill upon recognition of a deferred tax asset for second component tax goodwill (see Paragraph 6.015). In a manner similar to those fact patterns, a simultaneous equation may be used in order to determine the deferred tax and regulatory asset (and/or liability) balances such that the deferred tax assets or liabilities appropriately reflect the tax effect of the difference between the final financial statement assigned amounts and tax bases of the regulatory assets and liabilities.

**10.115** The simultaneous equation can be summarized as follows:

$$\text{Regulatory Asset (and Total Deferred Tax Liability)} = \\ \text{Temporary Difference Originally Calculated} \times (\text{Tax Rate} \div (1 - \text{Tax Rate}))$$

The first step in solving the simultaneous equation is to calculate the last element of the equation ( $\text{Tax Rate} \div (1 - \text{Tax Rate})$ ). For example, assuming that the tax rate is 21% for all future years, the calculation would be as follows:

$$.21 \div (1 - 0.21) = 0.26582$$

The second step, which calculates the appropriate amount of regulatory asset (and the total amount of the deferred tax liability), is to multiply the result from the first step (26.582%) by the initial temporary difference (calculated as the initial financial statement assigned amount less the tax basis). Example 10.36 provides an illustration.

### Example 10.36: Calculation of Regulatory Asset and Related Deferred Tax Liability Using the Simultaneous Equation Method

ABC Corp. has a taxable temporary difference of \$100,000 in which the related deferred tax liability will entirely flow through to customers resulting in recognition of a regulatory asset under ASC Topic 980. Assume ABC's tax rate is 21%.

The simultaneous equation is applied in the following manner:

Temporary difference originally calculated	\$ 100,000
Simultaneous equation factor (0.21 ÷ (1 - 0.21))	<u>0.26582</u>
Regulatory asset and total deferred tax liability	<u>\$ 26,582</u>

The total deferred tax liability can be reconciled as follows:

Flow-through taxable temporary difference	\$ 100,000
Regulatory asset taxable temporary difference	<u>26,582</u>
Total taxable temporary difference	<u>126,582</u>
Tax rate	<u>21%</u>
Total deferred tax liability	<u><u>\$ 26,582</u></u>

**10.116 Change in Applicable Enacted Tax Rate for Regulated Entities.** Deferred tax assets and liabilities should be adjusted for the effect of a change in tax rates or laws when the change is enacted. If, as a result of an action by a regulator, it is probable that the change in tax rates or laws will flow-through to customers through future rates, the effect of the change will also result in recognition of a regulatory asset or liability. If the effect will not flow-through to customers, it should be recognized in the income statement at the date of enactment (with no offsetting increase or decrease to regulatory assets or liabilities). ASC paragraphs 980-740-25-1 and 25-2, 980-740-55-12 through 55-14

## REORGANIZATIONS AND QUASI-REORGANIZATIONS

**10.117** An entity emerges from Chapter 11 of the U.S. Bankruptcy Code once the bankruptcy courts confirm its reorganization plan. The entity should adopt fresh-start reporting upon its emergence if (1) the pre-reorganization assets are less than the total of all post-petition liabilities and allowed claims, (2) the holders of existing voting shares immediately before confirmation receive less than 50% of the voting shares of the



emerging entity, and (3) the loss of control by the majority shareholders is substantive and not temporary. Fresh-start reporting requires an entity to record assets and liabilities in a manner consistent with ASC Topic 805, as if the emerged entity was acquired for fair value. See Section 5, *Emerging from Chapter 11 bankruptcy*, of KPMG Handbook, *Accounting for bankruptcies*. ASC paragraphs 852-10-45-19 and 45-20

**10.118** The reorganization value (the fair value of an entity's assets immediately before emergence), is allocated to the tangible and intangible assets of the entity based on their fair values. In addition, liabilities of the emerged entity are recognized at fair value. Deferred tax assets and liabilities should be recognized in accordance with ASC Topic 740 for differences between the assigned reorganization value of assets and liabilities and the corresponding tax bases. Any reorganization value in excess of the recognized assets and deferred taxes (deferred tax assets and liabilities) is excess reorganization value, which is reported as goodwill. See paragraph 9.064 for additional discussion. ASC subparagraphs 852-10-45-20(a) and 45-20(c)

**10.118a Attribute Reduction Resulting from Emergence from Bankruptcy.** For U.S. federal income tax purposes, section 108 of the Internal Revenue Code provides that no taxable income is recognized by reason of debt discharged in a chapter 11 reorganization. As a result, cancellation of debt (COD) income realized by a taxpayer is excluded from taxable income. However, sections 108 and 1017 require an entity to reduce the amount of carryforwards and the tax basis of assets, subject to certain limitations and according to prescribed ordering rules, based on the amount of COD income excluded from taxable income. Although the debt is discharged at the emergence date (which may be in the middle of a tax year), the reduction of attributes occurs after the determination of tax for the year of discharge.

**10.118b** If there is COD income in excess of the amount used to reduce tax attributes, the excess is commonly referred to as "black hole" COD income. This excess amount that does not reduce tax attributes, is not later recaptured as a reduction of attributes or taxable income and is not currently recognized as taxable income. Instead, it represents COD income that will never be recognized as taxable income and is effectively a permanent benefit to the taxpayer. As a result of the timing of attribute reduction, the final amount of COD income that results in attribute reduction versus the amount representing black hole COD income depends on events that occur after the emergence date and before the end of the tax year.

**10.118c** As discussed in Paragraph 10.118, entities recognize deferred tax assets and liabilities for temporary differences and carryforwards that exist as of the emergence date. As this will be after the discharge of indebtedness, but prior to attribute reduction, the discharged debt will be excluded from the balance sheet at the date of fresh-start reporting, but some or all of the related COD income will be applied to reduce tax attributes in the future. Therefore we believe a deferred tax liability should be recognized as of the date of fresh-start reporting for the future attribute reduction, if any. We believe an acceptable approach to estimating the deferred tax liability is to determine the attributes that would be reduced if the reduction were to occur based on the facts and

circumstances at the emergence date, including consideration of the elections that management would expect to make based on those facts and circumstances.

**10.118d** Some common events that are considered in the measurement of the deferred tax liability include:

- *Future taxable income or loss exclusive of reversing temporary differences:* We believe taxable income occurring between the emergence date and the attribute reduction date that is not the reversal of an existing temporary difference (including, but not limited to, taxable income associated with pretax financial statement income during that period) is not a fact or circumstance that exists at the emergence date. Accordingly, the measurement of the deferred tax liability for attribute reduction at the emergence date would not consider these amounts.
- *Reversal of existing taxable temporary differences:* We believe the existence of a taxable temporary difference is part of the facts and circumstances at the emergence date and management's estimate of the amount that is scheduled to reverse prior to attribute reduction should be considered when measuring the deferred tax liability related to the attribute reduction.
- *Tax basis in acquired assets:* An entity may receive no benefit of tax basis in assets acquired between the emergence date and the attribute reduction date if it had COD income that would have resulted in black hole COD income had the asset not been acquired; instead, attributes associated with the acquired asset are reduced. We believe this attribute reduction is the result of post-emergence events and should not be forecasted when measuring the deferred tax liability for attribute reduction at the emergence date. We believe the use of the simultaneous equation approach should be used to determine the financial statement carrying amount of assets acquired in this situation.
- *Discharge of contingent or nondeductible liabilities:* Some entities may have liabilities accrued as of the end of the period immediately preceding the emergence date that have not been deducted for income tax purposes. A deferred tax asset typically also has been recognized for these liabilities as of the end of the period immediately preceding the emergence date. We would expect that deferred tax asset to reverse as part of the discharge of those liabilities on emergence and thus it will not affect attribute reduction.

**10.118e** In some instances, an entity may have enough tax attributes so that it would not have black hole COD income if it considered either only the facts and circumstances at the emergence date or the facts and circumstances at the attribute reduction date. For these entities, the deferred tax liability recognized at the emergence date may be unaffected by the activity between the emergence date and attribute reduction date.

**10.118f** Unlike business combinations, there is no measurement period concept for fresh-start reporting. As a result, the financial statement carrying amount of assets and liabilities, including any goodwill, recognized at the emergence date should not be

adjusted for new information or later events. The tax effects of the remeasurement of the deferred tax liability for attribute reduction as a result of post-emergence events should be considered part of income tax expense (benefit) and allocated through the intraperiod tax allocation guidance and should not be allocated to goodwill (see Paragraph 9.064). ASC paragraphs 852-10-45-21 and 852-740-45-1

**10.118g** An entity typically discloses a table of deferred tax assets and liabilities as of the end of each annual reporting period. Accordingly, a table of deferred tax assets and liabilities that considers the effects of attribute reduction may only be disclosed after attribute reduction has occurred. As a result, we believe it would be acceptable to net the deferred tax liability for attribute reduction against the deferred tax assets for the attributes that actually have been reduced as of the end of the annual period. See Paragraph 9.082 for additional discussion of the disclosure requirements.

### **Example 10.36a: Accounting for Attribute Reduction**

ABC Corp. has a December 31 year-end and previously filed for bankruptcy protection. ABC's plan of reorganization was confirmed by the bankruptcy court and ABC emerged from bankruptcy and applied fresh-start reporting on September 15, 20X1. ABC has a tax rate of 25%.

At emergence, ABC had no tax attributes other than net operating loss carryforwards of \$320. ABC also had \$400 of debt forgiveness. If ABC had no further activity from emergence at September 15 through December 31, 20X1, its \$320 of carryforwards would be reduced to zero and it would have \$400 of tax-exempt debt forgiveness income, of which \$80 would be considered black hole COD and reflected as non-taxable income within the rate reconciliation.

#### **September 15, 20X1**

Although a table of deferred tax assets and liabilities typically is not disclosed as of the emergence date, we believe that if one were prepared an acceptable approach would be for ABC to:

- Measure its deferred taxes for carryforwards and tax basis in assets without an adjustment for attribute reduction, and
- Separately recognize a deferred tax liability for the attribute reduction that would occur if the reduction were based on the facts and circumstances at the emergence date.

Using this approach, ABC recognizes both a deferred tax asset (for the carryforwards) and a deferred tax liability (for the attribute reduction) of \$80 ( $\$320 \times 25\%$ ) at the emergence date.

**December 31, 20X1**

During the period between September 15 and December 31, 20X1, ABC generates \$100 of pretax and taxable income, which is fully offset with available net operating loss carryforwards. The remaining \$220 of carryforwards were reduced to zero and ABC had \$400 of tax-exempt debt forgiveness, leaving \$180 of black hole COD.

	<b>Hypothetical at Emergence</b>	<b>Actual at December 31, 20X1</b>
Net operating loss reduction	\$ 320	220
Black hole COD	\$ 80	180

At December 31, 20X1, the \$220 of actual attribute reduction is known. Accordingly, the \$80 deferred tax liability is reduced by \$25 to \$55 ( $\$220 \times 25\%$ ).

Because the \$100 reduction in the amount of carryforwards that are subject to attribute reduction and corresponding increase in the black hole COD amount resulted from post-emergence activity, the related \$25 tax effect is recognized in income tax expense.

As of December 31, 20X1, ABC recognizes:

- \$100 of post-emergence pretax income;
- Deferred tax expense of \$25 for the reversal of the deferred tax asset related to the utilization of \$100 of carryforwards;
- An offsetting deferred tax expense of \$55 for the reversal of the remaining deferred tax asset for the carryforwards and a deferred tax benefit of \$55 for the reversal of the deferred tax liability related to the actual attribute reduction; and
- Deferred tax benefit of \$25 to write-off the remaining deferred tax liability related to the anticipated attribute reduction that ultimately resulted in \$100 in additional black hole COD.

In summary, ABC recognizes \$100 of post-emergence pretax income and zero income tax expense. At December 31, 20X1, ABC discloses no deferred tax asset for NOL carryforwards.

**10.119 Quasi-reorganizations.** Quasi-reorganizations are reorganizations that are effected from an event other than an emergence from bankruptcy. In quasi-reorganizations, adjustments to the assets and liabilities of an entity are recorded directly to equity as an adjustment to contributed capital. Similarly, the related adjustments to deferred taxes are reported as an adjustment to contributed capital. ASC subparagraph 740-20-45-11(f), and paragraphs 852-20-25-2 through 25-6, 852-740-45-3, 852-20-S99-2, 220-10-45-10B

**10.120 Post-emergence Tax Benefits from Reorganization Deferred Tax Assets.** As discussed in Paragraph 9.064, the income tax benefit from the release of a valuation allowance established at the date of reorganization for deferred tax assets of pre-reorganization deductible temporary differences and carryforwards should be reported as a reduction to income tax expense. ASC paragraph 852-740-45-1

**10.121 Deferred Taxes for Nondeductible Excess Reorganization Value.** As discussed above, entities that adopt fresh-start reporting in accordance with ASC Subtopic 852-10, *Reorganizations - Overall*, allocate the reorganization value to the entity's assets and liabilities in accordance with ASC Topic 805, with the excess of the reorganization value over the separately identifiable assets and liabilities identified as goodwill. Because this excess reorganization value is akin to goodwill, if it exceeds the carryover tax basis in goodwill (if any) and thus is not deductible for income tax purposes, no temporary difference should be recognized (similar to second component goodwill as discussed in Paragraph 6.013). For example, an entity with tax-deductible goodwill of \$400 at the fresh-start date and excess reorganization value of \$470 does not recognize a deferred tax liability for the \$70 excess reorganization value. This exception to the recognition of a temporary difference for excess reorganization value should not be applied by analogy to other assets with excess book basis.

**10.122 Tax-Deductible Goodwill Greater Than Excess Reorganization Value.** If the carryover tax-deductible goodwill is greater than the excess reorganization value at the date an entity applies fresh-start accounting, the excess tax-deductible goodwill is akin to second component tax goodwill. Accordingly, as further discussed beginning in Paragraph 6.015 in the context of business combinations, a deferred tax asset should be recognized for the excess tax basis using the simultaneous equations approach. For example, an entity with tax-deductible goodwill of \$470 at the fresh-start date and excess reorganization value of \$400, recognizes a deferred tax asset for the \$70 excess tax-deductible goodwill and further adjusts the amounts for the result of the simultaneous equation. ASC paragraphs 852-10-45-20, 852-740-45-1

**10.122a** To the extent that sufficient excess reorganization value is not available to recognize the deferred tax asset, an entity may either recognize the difference as a credit to opening additional paid-in capital or allocate the difference to certain nonfinancial assets on a relative fair value basis. See further discussion at Question 5.3.70 of KPMG Handbook, *Accounting for bankruptcies*.

**10.123 Tax Uncertainties Existing at the Time of Reorganization.** An entity that emerges from bankruptcy and applies fresh-start accounting under the provisions of ASC Topic 852, *Reorganizations*, may encounter uncertainties about (1) the tax bases of assets and liabilities, (2) the existence of preconfirmation carryforwards, and (3) the sustainability of prior tax return positions. Income tax uncertainties, including the effect on deferred tax assets and liabilities, should be accounted for at the date an entity applies fresh-start accounting pursuant to ASC Subtopic 740-10 (FIN 48) on accounting for uncertainty in income taxes. The accounting for income tax uncertainties while an entity is in bankruptcy depends on whether the underlying obligation meets the definition of a claim – i.e., if it represents the right to payment to the taxing authority at the filing date.

If a position with uncertainty meets the definition of a claim, it should be evaluated to determine if it is a liability subject to compromise. Unrecognized tax benefits that have a priority status (as provided by the Bankruptcy Code) generally are not considered to be subject to compromise. Regardless of the classification of the liability, the entity is still required to include all required disclosures of ASC Topic 740 in its financial statements. See further discussion in Section 4.10 of KPMG Handbook, *Accounting for bankruptcies*. See Paragraph 3.015 for additional discussion of the application of ASC Subtopic 740-10 (FIN 48) on uncertainty in income taxes.

**10.124** The ongoing recognition and measurement of uncertainties in preconfirmation/reorganization tax positions will also be subject to the principles of ASC Subtopic 740-10 (FIN 48). Accordingly, new information about the recognition and measurement of such positions should trigger a reevaluation. The reevaluation could lead an entity to derecognize a previously recognized tax position, recognize a previously unrecognized tax position, or remeasure a previously recognized tax position (see the discussion beginning in Paragraph 3.026 for additional information on reevaluation of uncertainty in income taxes). As a result of these subsequent reevaluations, changes in income taxes payable and/or deferred tax assets or liabilities that existed as of the fresh-start date are recognized as an adjustment to income tax expense. See additional discussion beginning in Paragraph 6.051. ASC paragraphs 852-10-45-20, 852-740-45-1

**10.124a Selection of Accounting Policies on Emergence from Bankruptcy.** An entity that emerges from bankruptcy is considered a new reporting entity for financial reporting purposes. Accordingly, the emerging entity's accounting policies are not required to be consistent with those of the predecessor entity. For example, an entity that elected an accounting policy to record deferred taxes for GILTI prior to entering into bankruptcy does not need to continue that accounting policy election after applying fresh-start accounting. Further, we do not believe the emerged entity needs to assess whether any newly applied accounting policy is preferable under ASC Topic 250, *Accounting Changes and Error Corrections*, or make the change in accounting policy disclosures required by ASC Topic 250 as long as the change occurs as part of fresh-start accounting. See further discussion in Section 5.3 of KPMG Handbook, *Accounting for bankruptcies*.

**10.124b** The net impact of changing any accounting policies on emergence from bankruptcy would be considered as part of fresh-start accounting. Accordingly, the net impact of the accounting policy changes related to income taxes would be reported within income tax expense within the predecessor entity's financial statements.

**10.125 Quasi-Reorganization Temporary Differences and Carryforwards.** As discussed in Paragraphs 9.063 and 9.067, tax benefits for deductible temporary differences and carryforwards that exist at the date of a quasi-reorganization should be initially recognized (either due to utilization or through the reduction of a valuation allowance) as an adjustment to contributed capital. ASC paragraphs 852-740-45-3, 220-10-45-10B

## INVESTMENT TAX CREDITS, GOVERNMENT GRANTS AND AFFORDABLE HOUSING PROJECTS

**10.126** See KPMG Handbook, *Tax Credits* for detailed discussion of the accounting for tax credits and government grants and applying the proportional amortization method.

**10.127 – 10.145** Not used.

**Examples 10.36b – e; 10.37; 10.37a – e; 10.38:** Not used.

## TRANSACTIONS AMONG OR WITH SHAREHOLDERS

**10.146** As discussed in Paragraph 9.070, certain transactions among or with shareholders may change the tax basis of assets and liabilities or may restrict the use of deferred tax assets. For example, a change of control occurs when shareholders sell more than 50% of the stock of an entity within a specified period of time. Such a change of control may limit the amount of existing net operating loss carryforwards that are available to be used in future years. Other common transactions among or with shareholders that have tax consequences include initial public offerings or subsequent share issuances, conversion of convertible debt, major stock purchases by new investors, sales of stock by major shareholders, common control mergers (see additional discussion of common control mergers beginning in Paragraphs 6.094 and 9.052), and similar transactions.

**10.147 Recognizing Changes to Deferred Tax Assets and Liabilities.** The tax effects of changes in the tax bases of assets and liabilities caused by transactions among or with shareholders are generally recognized as adjustments to equity. If these transactions result in recognizing additional deferred tax assets and it is determined at the date of the transaction that a valuation allowance is needed for those new deferred tax assets, the initial recognition of the valuation allowance should also be recognized in equity as discussed in Paragraph 9.051. However, subsequent increases or decreases in the valuation allowance should be included in income tax expense and the direct effects of changes in tax status (see Paragraphs 5.028a and 10.155 for additional information) may be included in income tax expense. In addition, a transaction with or among shareholders that results in a change in an existing valuation allowance due to changes in expectations about the realization of existing deferred tax assets or a write-off of a preexisting deferred tax asset that an entity can no longer realize should be reported in income.

**10.148** Certain transactions that are among or with shareholders of a subsidiary are intra-entity transactions for the consolidated group. The pretax profit or loss of an intra-entity inventory transaction is eliminated in the consolidated financial statements of the group even though the income is recognized in the seller's separate financial statements (see Paragraph 2.063 for additional discussion of intra-entity transactions). In addition, entities defer the tax effects of these inventory transactions in the consolidated financial statements. If the intra-entity transaction is for an asset other than inventory, the tax effects to the buyer and seller are recognized in income tax expense or benefit in the

consolidated financial statements. Nevertheless, the pretax effect of most transfers of assets other than inventory, should be recognized with an adjustment to equity in the stand-alone financial statements of the subsidiaries. The tax effect of the buyer's change in tax bases of assets and liabilities and any income taxes incurred by the seller are also recognized in equity in the subsidiaries' financial statements. A similar concept applies in the separate financial statements of an acquired subsidiary when push-down accounting has not been elected for financial statement purposes, but the acquisition is a taxable transaction. In those cases, while the step-up in basis of the financial statement carrying amount is not reflected in the subsidiary's financial statements, the change in the temporary difference due to the change in tax basis is recognized as an adjustment to equity. ASC paragraph 740-10-45-21, subparagraph 740-20-45-11(g), paragraph 805-740-25-3 and paragraph 805-50-S99-4

### **Example 10.39: Changing Deferred Taxes as a Result of an Acquisition**

ABC Corp. acquired Subsidiary S in a business combination in 20X7. For income tax purposes, ABC and the seller jointly elected to make a section 338(h)(10), election which permitted a step-up in the tax bases of the individual assets and liabilities of Subsidiary S to fair values at the date of acquisition. However, there is no change in the financial statement carrying amount of Subsidiary S's assets and liabilities because push-down accounting was not elected for financial reporting purposes.

Even though the acquisition accounting was not pushed down to Subsidiary S for purposes of preparing its separate financial statements, Subsidiary S should adjust deferred tax assets and liabilities to reflect the future tax consequences of existing temporary differences based on the stepped-up tax bases. The tax effect of the adjustments to deferred tax assets and liabilities caused by the change in the tax bases of the assets and liabilities should be charged or credited directly to equity. If the transaction resulted in a deferred tax asset from changes in the tax bases of assets and liabilities, the effect of a valuation allowance initially required on recognition of those deferred tax assets should also be included in equity. Changes in the valuation allowance occurring in subsequent periods (or a change in the valuation allowance existing at the date of the acquisition transaction due to a change in expectations about the realization of existing deferred tax assets, see Paragraphs 10.147 and 10.149) should be included in income.

**10.149 Changes in Valuation Allowance and Write-Off of Deferred Tax Assets.** A change in valuation allowance due to changes in expectations about the realization of existing deferred tax assets should be reported in income. Accordingly, if an entity needs to recognize a valuation allowance for its existing deferred tax assets because of a transaction with or among shareholders (such as a spin-off), the valuation allowance should be recognized with a charge to income from continuing operations. Similarly, because a write-off of previously existing deferred tax assets has the same effect as an increase in a valuation allowance, a write-off of an existing deferred tax asset as a result



of a transaction with or among shareholders would also be charged to income. ASC paragraph 740-10-45-21, and subparagraph 740-20-45-11(g)

### **Example 10.40: Write-off of Deferred Tax Assets**

Due to the level of sales of DEF Corp.'s stock among or with shareholders, DEF's ability to use its existing net operating loss carryforward is limited under the tax law. No valuation allowance had previously been recognized on the deferred tax asset related to the carryforward. As a result of the limitation on the use of the carryforward, DEF will write-off a portion of the deferred tax asset. The write-off of the deferred tax asset should be charged to income tax expense attributable to continuing operations.

### **Example 10.40a: Disallowance of Tax Basis after Spin-Off**

In 20X7, JKL Corp. obtained an asset from its parent in a spin-off transaction. At the spin-off date, JKL concluded that it was more-likely-than-not that the entire transferred asset basis would be tax deductible. In 20X9, new information about the tax deductibility of the asset became available. The reevaluation of the tax position resulted in JKL concluding it was not more-likely-than-not that the asset basis was tax deductible.

**Question:** Should JKL record a charge to equity to derecognize its previously recognized tax position because the asset was obtained as part of the spin-off?

**Answer:** No. The derecognition of the previously recognized tax position should be charged to income, not equity. The reevaluation was caused by a change in available facts after the spin-off date and the charge to income is consistent with the guidance discussed in Paragraph 10.149, which indicates that a write-off of a preexisting deferred tax asset as a result of a transaction with or among shareholders should be charged to the income statement.

The answer would not change if an indemnification agreement had existed between JKL and its former parent. JKL would recognize in the income statement both the charge to derecognize the tax position and the benefit from the indemnification agreement.

### **Example 10.41: Subsidiary's Increase in a Valuation Allowance**

GHI Corp. distributes the stock of its previously wholly owned subsidiary, JKL Corp., to its shareholders in a spin-off transaction. There is no change in the financial statement carrying amounts or tax bases of the assets and liabilities of JKL. Prior to the

spin-off, JKL, in its separate financial statements, did not recognize a valuation allowance for its deferred tax assets based on the anticipation that those benefits would be realized in the consolidated tax return of GHI and the deferred tax asset was realizable via the tax-sharing agreement (income tax expense was allocated among members of the consolidated group using the pro rata method – see Paragraph 10.048).

As a result of the spin-off, JKL concludes that a valuation allowance should be recognized in its separate financial statements. The valuation allowance established at the time of the spin-off for JKL's beginning-of-the year deferred tax assets is charged to income tax expense allocated to income from continuing operations in both JKL's separate financial statements and prior to the spin-off in GHI's consolidated financial statements.

Example 9.22a illustrates an example of an entity that changes its judgment about the realizability of its originating deferred tax assets as a result of a spin-off.

#### **Example 10.42: Parent Entity's Increase in a Valuation Allowance**

GHI Corp. distributes the stock of its previously wholly owned subsidiary, JKL Corp., to its shareholders in a spin-off transaction. GHI and JKL file a consolidated tax return. There is no change in the financial statement carrying amount or tax basis of the assets and liabilities of JKL. However, prior to the spin-off, GHI did not recognize a valuation allowance for its deferred tax assets solely because the taxable income generated by the deferred tax liabilities of JKL on reversal was sufficient to realize its deferred tax assets. GHI should reschedule the reversal of JKL's deferred tax liabilities based on the expected spin-off date and recognize a valuation allowance in its consolidated financial statements prior to the spin-off for the amount of deferred tax assets that are no longer more likely than not to be realized because of the change in the reversal period of JKL's deferred tax liabilities. GHI recognizes the valuation allowance, if any, with a charge to income tax expense allocated to income from continuing operations.

**10.150 Subsequent Period Change in Valuation Allowance.** If a transaction with or among shareholders results in recognizing deferred tax assets, and it is determined at the date of the transaction that a valuation allowance is needed for those new deferred tax assets, the initial recognition of the valuation allowance should also be recognized in equity. However, subsequent increases or decreases in the valuation allowance generally should be included in income tax expense. That is, an income tax benefit recognized on the release of a valuation allowance established when a deferred tax asset resulting from a transaction with or among shareholders was recognized would be included in income tax expense. ASC paragraph 740-10-45-21 and subparagraph 740-20-45-11(g)

**10.151 Taxable Spin-Offs.** Certain spin-offs result in the parent entity paying a tax. The tax liability resulting from the spin-off of assets and liabilities should be separated into

two parts: the excess of the financial statement carrying amount of the parent's investment in the spun-off entity (spinee) and its tax basis (i.e., the outside basis difference) and the excess of the fair value of the spinee over the financial statement carrying amount of the parent's investment in the spinee. The tax effects for previously unrecognized tax consequences of taxable outside basis differences (such as a tax charge to recognize the previously unrecognized tax effect of undistributed earnings of a subsidiary), should be charged to income tax expense from continuing operations. This tax effect is not a result of the spin-off but rather is the result of either a change in intent to indefinitely reinvest the earnings of a foreign subsidiary or change in intent to liquidate a domestic subsidiary tax-free. Because the recognition of the deferred taxes on the outside basis difference is not directly a result of the spin-off and timing of recognition is largely based on intent (and expected timing of the transaction in the case of a deductible outside basis difference), the tax effect is often recognized prior to the actual spin-off transaction. If the subsidiary's operations are later classified in discontinued operations, it would be acceptable for the entity to reclassify the deferred tax expense from continuing operations to discontinued operations (see Paragraph 9.170 for additional discussion). The incremental tax effect related to the excess of the fair value over the financial statement carrying amount would be recognized as a component of shareholders' equity and is generally recognized at the date of the spin-off. See Paragraph 9.036a for additional discussion of the tax effects of items recognized in shareholders' equity.

**10.152 Contingent Taxes Payable of a Spin-Off.** In a spin-off, the parent entity spinning off assets may be taxed on the built-in gain (fair value in excess of tax basis) unless certain conditions are met, including maintaining over 50% of the same shareholders and the receiving shareholders holding the assets for a specific period of time. Violating these conditions causes the parent entity to pay tax on the built-in gain that existed at the time of the spin-off. Uncertainty associated with this potential tax liability should be evaluated and accounted for in accordance with ASC Subtopic 740-10 (FIN 48). See the discussion beginning in Paragraph 3.015 for additional information on accounting for uncertainty in income taxes.

**10.152a Deferred Taxes for Spin-Off Related Costs.** In some tax jurisdictions, spin-off related costs are capitalized into the tax basis of the spinee's shareholders' equity (and therefore never deductible) if the spin-off occurs or are deductible in the period in which the spin-off is abandoned if the spin-off does not occur. When determining the pre-spin tax effects of these costs, we believe the entity should consider the likelihood that the spin-off transaction will be consummated – i.e., it should consider the expected manner of recovery. If the entity expects the spin-off transaction will be consummated, it should not recognize a deferred tax asset for the spin-off related costs in the pre-spin period. However, if the entity does not expect the spin-off transaction to be consummated, it should recognize a deferred tax asset for the spin-off related costs in the pre-spin period.

**10.153 Anticipating Future Transactions among or with Shareholders.** Transactions among or with shareholders should not be anticipated when determining the need for a valuation allowance. Although ASC Topic 740 requires an entity to consider all available evidence when determining the need for a valuation allowance, events among or with shareholders generally are not within an entity's control and, therefore, should not be

considered. For example, transactions that occur before the financial statements are issued but after the fiscal period end may restrict the use of net operating loss carryforwards. The income statement charge for the write-off of the carryforwards or increase in valuation allowance generally should be recognized in the period the event occurs. See Paragraph 4.031 for additional discussion.

**10.154 Tax-Deductible Goodwill.** Tax-deductible goodwill may result from a transaction among or with shareholders that triggers a step-up of the tax bases of a subsidiary's assets and liabilities without a corresponding adjustment to the financial statement carrying amount of the assets and liabilities of the subsidiary (see Paragraph 6.013 for additional discussion). ASC paragraph 740-10-45-21 and ASC subparagraph 740-20-45-11(g) require the tax effects of changes in the tax bases of assets and liabilities caused by transactions among or with shareholders to be recognized with a corresponding adjustment to equity when the transaction occurs. This includes recognition of a deferred tax asset for tax-deductible goodwill but only the amount that is in excess of financial statement goodwill.

**10.154a** An entity that increases the tax basis of goodwill in a transaction with the taxing authority must determine if the step-up relates to the business combination in which the financial statement goodwill was originally recognized or if it is a separate transaction. ASC paragraph 740-10-25-54 includes factors that may indicate that a step-up in tax basis relates to a separate transaction. Although the scope of guidance is specific to transactions with governments, it may be appropriate to apply it by analogy to other transactions that result in the step-up in the tax basis of goodwill, including an increase in tax goodwill that results from a transaction among or with shareholders. As a result, if an entity concludes that the step-up in tax basis relates to a separate transaction, it would recognize a deferred tax asset for the entire amount of the newly created tax goodwill.

#### **Example 10.43: Tax-Deductible Goodwill**

ABC Corp. distributes the stock of its wholly owned subsidiary, DEF Corp., to its shareholders in a taxable spin-off transaction. There is a step-up in tax basis of DEF's assets and liabilities but there is no change in the financial statement carrying amounts of DEF's assets and liabilities, resulting in an increase to tax goodwill of DEF upon the spin-off. ABC settles its related tax liability by paying cash, sacrificing existing tax attributes (e.g., net operating loss carryforwards), or both.

DEF should record the adjustments to deferred tax assets and liabilities, including the deferred tax asset for the entire amount of the tax-deductible goodwill, with a corresponding adjustment to equity.

**10.155 Changes in Tax Status Caused by a Transaction among or with Shareholders.** ASC paragraphs 740-10-45-21 and subparagraph 740-20-45-11(g) do not address transactions that involve a change in an entity's tax status. Accordingly, the income tax effects of a change in tax status caused by a transaction among or with

shareholders generally should be recognized in continuing operations as a part of income tax expense on the approval date of the change in tax status or on the filing date if approval is not necessary. This approach is consistent with ASC Topic 740's provisions about changes in tax status. However, in some transactions with or among shareholders, there is a change in status and a step-up in the tax bases of the newly taxable entity. As discussed in Paragraphs 5.028a-5.028b, the increase in tax basis generally is accounted for through continuing operations as part of accounting for the change in status. However, we believe it is also acceptable for the new corporation to recognize the change in its deferred taxes resulting from the step-up as an adjustment to equity. See the discussion beginning in Paragraph 5.019 for additional information on changes in tax status. ASC paragraphs 740-10-25-32 and 25-33, 40-6, 45-19

**10.156 Recognition and Measurement of Indemnified Unrecognized Tax Benefits after a Spin-off.** As part of a spin-off of a subsidiary previously included in a consolidated tax return, the spinee may contractually agree to indemnify the parent for income tax liabilities, including any unrecognized tax benefits, that it generated prior to the spin-off. If the subsidiary generated the obligations and is liable to the taxing authority as part of its joint and several liability, it accounts for those obligations, including unrecognized tax benefits, under ASC Topic 740.

**10.157** After the spin-off, the parent generally deals with the taxing authority regarding the former subsidiary's tax positions as agent for the group and remains a primary obligor for the subsidiary's obligations. As a result, we believe the parent's income tax exposure related to the former subsidiary's operations continues to be in the scope of ASC Topic 740 in the parent's financial statements post-spin. The parent also accounts for the indemnification asset from the former subsidiary under other applicable literature (see Paragraph 6.045). Although the indemnification agreement may reduce the parent's total exposure, the indemnification asset is accounted for separately from the income tax obligation and should not be offset for balance sheet presentation or disclosure purposes with the obligation under ASC Subtopic 740-10. If there are no collectibility or contractual limitations, equal and offsetting adjustments to the indemnification asset and the obligation to the taxing authority as a result of changes in the recognition and measurement of an obligation would not be recognized in the income statement. Similar accounting may be appropriate for disposals other than through a spin-off. See Paragraph 3.129 for further discussion on the accounting for indemnification of income tax uncertainties and Paragraph 10.053 for accounting for the uncertainty in income taxes in the separate financial statements of the subsidiary.

## ENDNOTES

<sup>1</sup> A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC

(including other entities whose financial statements or financial information are required to be or are included in a filing).

- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

<sup>2</sup> A private company is an entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of FASB ASC Topics 960 through 965 on plan accounting.

# Appendix A - Examples of Scheduling Temporary Differences

## Detailed Contents

Example A.1: Scheduling Temporary Differences for Depreciable Assets

Example A.2: Scheduling Temporary Differences for Mortgage Loans Acquired in Business Combinations

Example A.3: Scheduling Temporary Differences for Finance Leases by Lessee

**A.000** This Section provides a general description of a number of typical temporary differences and general guidance for determining the periods in which existing temporary differences will result in taxable or deductible amounts based on applicable U.S. federal income tax law. The guidance provided is for illustrative purposes only; it is not intended to prescribe the extent of scheduling necessary or the method that must be used to determine the pattern of reversal of existing temporary differences. The extent of scheduling required will depend on the specific facts and circumstances in each situation. Other acceptable methods of determining reversal patterns for existing temporary differences in addition to those discussed in this appendix may be appropriate. ASC paragraph 740-10-55-18

**A.000a** Scheduling may be necessary in assessing the need for a valuation allowance for deferred tax assets, measuring deferred taxes when there is a phased-in change in tax rates, and other circumstances. Scheduling generally only considers the reversal of existing temporary differences and does not include the future origination of temporary differences. However, if an entity is forecasting future taxable income exclusive of reversing items (see ASC subparagraph 740-10-30-18(b)), future originating differences and their subsequent reversals are implicit in the estimates of future taxable income. See Paragraphs 4.048a and 4.048b for additional information on whether to include future originating *deductible* temporary differences in such estimates. ASC paragraph 740-10-55-14 and 55-16

**A.000b** When scheduling for the purposes of determining the extent to which the future reversals of existing taxable temporary differences or carryback availability will support the recognition of deferred tax assets and the entity expects future temporary differences will originate, we believe a first-in first-out (FIFO) approach is generally appropriate for determining when the existing temporary differences will reverse. When scheduling for purposes of determining the appropriate tax rate to use to measure deferred tax assets and liabilities when an entity expects future temporary differences will originate, we believe either a FIFO or a last-in first-out (LIFO) approach may be used. See Example 3.8 for additional information on the FIFO and LIFO approaches.

**A.001 Investments in Trading Securities.** Trading securities are reported at their fair value with unrealized holding gains and losses included in earnings in accordance with ASC Topic 320, *Debt Securities*; however, securities may have a tax basis equal to the original cost of the security. The basis difference resulting from reporting the securities at fair value for financial reporting purposes and at cost for tax purposes is a temporary difference that should be scheduled to reverse in the year of the expected sale of the security, generally the year following the balance sheet date for trading securities.

**A.002** The reversal of temporary differences related to securities may result in a capital gain or loss for tax purposes. Depending on the applicable provisions of the tax law, temporary differences that will result in future capital gains and losses should be segregated from temporary differences that will result in ordinary income or deductions in the deferred tax calculation and the assessment of the need for a valuation allowance.



**A.003 Investments in Available-for-Sale Debt Securities.** Available-for-sale debt securities, those investments not classified as either trading or held-to-maturity, are reported at their fair value with unrealized holding gains and losses excluded from earnings and reported in other comprehensive income under ASC Topic 320; however, the securities may have a tax basis equal to the original cost of the security. The basis difference resulting from reporting the securities at fair value for financial reporting purposes and at cost for tax purposes is a temporary difference (the effect of which should be charged or credited to other comprehensive income – refer to Paragraph 9.046 for additional discussion) that should be scheduled to reverse in the years that management expects to sell the securities.

**A.004** The reversal of temporary differences related to debt securities may result in a capital gain or loss for tax purposes. Depending on the applicable provisions of the tax law, temporary differences that will result in future capital gains and losses should be segregated from temporary differences that will result in ordinary income or deductions in the deferred tax calculation and the assessment of the need for a valuation allowance.

**A.004a Investments in Equity Securities.** Equity securities are reported at their fair value (or using the measurement alternative) with unrealized holding gains and losses included in earnings under ASC Topic 321, *Investments – Equity Securities*. However, the securities may have a tax basis equal to the original cost of the security. The basis difference resulting from reporting the securities at fair value (or the measurement alternative) for financial reporting purposes and at cost for tax purposes is a temporary difference that should be scheduled to reverse in the years that management expects to sell the securities.

**A.004b** The reversal of temporary differences related to equity securities may result in a capital gain or loss for tax purposes. Depending on the applicable provisions of the tax law, temporary differences that will result in future capital gains and losses should be segregated from temporary differences that will result in ordinary income or deductions in the deferred tax calculation and the assessment of the need for a valuation allowance.

**A.005 Allowance for Credit Losses.** Because deductions for bad debts generally occur when a receivable is specifically charged-off, a deductible temporary difference generally will exist for the financial statement carrying amount of the allowance for credit losses. This temporary difference should be scheduled to result in deductible amounts based on management's estimate of the years that the entity will take the related tax deduction. Allowances recognized for specific accounts receivable should be scheduled with reference to the related receivable. The reversal of allowances not attributable to specific accounts receivable should be estimated based on historical trends and other information used to calculate that portion of the allowance for credit losses.

**A.006 Inventories.** Differences between the financial statement carrying amounts and the tax bases of inventories may exist for a number of reasons. For example, differences may be caused by differences in inventoriable costs for financial reporting and tax purposes or by adjustments made as a result of business combinations. If inventory is estimated to turn over at least once a year, the related temporary differences generally should be

scheduled to result in taxable or deductible amounts in the first year subsequent to the balance sheet date. However, a temporary difference related to inventory that is valued using the LIFO method should be scheduled to reverse in the period that the inventory is expected to be liquidated and not replaced.

**A.007 Reserves for Obsolete Inventory.** For financial reporting purposes, reserves for inventory obsolescence may be established. For tax purposes, deductions for obsolete inventory generally are not allowed until disposition of the inventory. The deductible temporary difference related to the reserve for inventory obsolescence generally should be scheduled to result in deductible amounts in the periods in which the tax deductions are expected to be claimed, irrespective of the overall inventory turnover ratio.

**A.008 Cash Surrender Value of Life Insurance.** As discussed in Paragraph 2.023, under current U.S. tax law, proceeds received on a life insurance policy on the death of the insured are not taxable under certain conditions. Accordingly, deferred taxes would not be recognized on the excess of the financial statement carrying amount over cumulative premiums paid (the tax basis) for a life insurance policy if the entity expects to recover the financial statement carrying amount by holding the policy until the death of the insured. However, if the entity expects to surrender the policy before the death of the insured or if the policy is not eligible for the tax benefit under the tax law, a deferred tax liability should be recognized because the basis difference would be subject to tax. This temporary difference should be scheduled to result in taxable income in the year that the entity expects to surrender the policy.

**A.009 Land.** The value assigned to land in a nontaxable business combination may exceed its tax basis. In addition, the financial statement carrying amount of land for financial reporting purposes may differ from its tax basis for other reasons, such as differences in capitalized costs. Regardless of the origin of the differences, if the entity expects to sell the land, the temporary difference should be scheduled to reverse in the expected year of sale; otherwise, the timing of the reversal of the taxable or deductible amount would be indefinite. Deferred taxes would be recognized on the differences even if the timing of reversal is indefinite.

**A.010 Plant and Equipment.** The method of scheduling the reversal of temporary differences related to plant and equipment depends on the facts and circumstances surrounding an entity's need for a valuation allowance.

If an entity must consider the likelihood of sufficient future taxable income to enable the entity to realize deferred tax assets (i.e., reversal of existing taxable temporary differences and carryback availability, if any, are not sufficient), the entity should consider future originating differences for existing depreciable assets (assets in use at the end of the current year), because those future originating differences and their reversals will affect future taxable income.

If a deferred tax asset is fully supported by offsetting taxable amounts related to existing taxable temporary differences, it generally is appropriate to use a first-in first-out (FIFO) pattern to schedule the reversal of existing temporary differences without considering

future originating differences. That is, the future originating differences should not increase the amount of the valuation allowance required when the reversal of existing taxable temporary differences support the realization of deferred tax assets. ASC paragraphs 740-10-55-14 through 55-17

**A.011** The following example illustrates the scheduling of temporary differences for depreciable assets.

**Example A.1: Scheduling Temporary Differences for Depreciable Assets**

ABC Corp. purchased equipment and placed it in service on January 1, 20X6. The cost of the equipment was \$10,000 for both financial reporting and tax purposes. For financial reporting purposes, the equipment is depreciated straight-line over five years. For tax purposes, the equipment is depreciated under the modified accelerated cost recovery system using the mid-quarter convention. Depreciation schedules for financial reporting and tax purposes are shown below:

Year	Financial Reporting	Tax	Tax Over (Under)	
			Year	Cumulative
20X6	\$ 2,000	\$ 3,500	\$ 1,500	\$ 1,500
20X7	2,000	2,600	600	2,100
20X8	2,000	1,560	(440)	1,660
20X9	2,000	1,101	(899)	761
20Y0	2,000	1,101	(899)	(138)
20Y1	—	138 <sup>1</sup>	138	—
	<u>\$ 10,000</u>	<u>\$ 10,000</u>		

At December 31, 20X6 the temporary difference of \$1,500 (financial statement carrying amount of \$8,000 less tax basis of \$6,500) will result in a future net taxable amount. If the originating differences are considered, the temporary difference of \$1,500 should be scheduled to reverse in the following manner as of December 31, 20X6:

Temporary difference at December 31, 20X6	Future Years					
	20X7	20X8	20X9	20Y0	20Y1	
Future taxable (deductible) amounts	\$ 1,500	\$ (600)	\$ 440	\$ 899	\$ 899	\$ (138)

If future originating differences are not considered, a FIFO pattern would be used and the \$1,500 taxable temporary difference would be scheduled as follows at December 31, 20X6:

	<b>Temporary difference at December 31, 20X6</b>	<b>20X7</b>	<b>20X8</b>	<b>20X9</b>	<b>20Y0</b>	<b>20Y1</b>
Future taxable amounts	\$ 1,500	\$ —	\$ 440	\$ 899	\$ 161	\$ —

<sup>1</sup> This example assumes that it is not more likely than not that ABC can support taking the \$138 tax deduction in an earlier period - e.g., in 20Y0 when the equipment is fully depreciated for financial reporting purposes. Under other circumstances, an entity may expect to (a) abandon or scrap its equipment at the end of its book life, and (b) sustain a position to take the remaining tax deduction in the same period.

**A.012 Assets under Construction.** The financial statement carrying amount and tax basis of an asset under construction for an entity's own use may differ due to differences in capitalized costs. For example, interest capitalized for financial reporting purposes may differ from the amount capitalized for tax purposes, or costs required to be capitalized for tax purposes under the uniform capitalization rules may not be capitalized for financial reporting purposes. The difference between the financial statement carrying amount and the tax basis of the construction in progress generally should be scheduled to reverse over the expected depreciable life of the asset, beginning in the period the asset is expected to be ready for service.

**A.013 Assets with an Amortizable (or Depreciable) Carrying Amount for Financial Reporting Purposes but No Amortizable or Depreciable Tax Basis.** Differences between the financial statement carrying amount and tax basis of certain assets give rise to temporary differences even if the asset has no tax basis or amortization of the asset is not currently deductible for tax purposes.

**A.014** Temporary differences associated with assets that have no tax basis should be scheduled to reverse in the periods the asset is depreciated or amortized for financial statement purposes. If the asset is not depreciated or amortized for financial reporting purposes, temporary differences would be scheduled to reverse in the expected year of disposition, similar to the discussion above with respect to reversal of temporary differences associated with land. If there is no intention to dispose of the asset, for example, if the asset were an indefinite-lived intangible asset, the temporary difference generally should be scheduled to reverse in the indefinite period. See Paragraphs 4.017a, 6.016 and 6.123 for additional discussion.

**A.015 Investments in Common Stock Accounted for under the Equity Method.** A difference between the investor's financial statement carrying amount and tax basis of an investment in common stock accounted for under the equity method results in a basis difference that should be analyzed. To the extent a basis difference is expected to reverse without tax consequences, no temporary difference exists. However, if recovery of the

investment at its carrying amount, based on the expected manner of recovery, would have income tax consequences, a temporary difference does exist. Deferred taxes must be recognized on this temporary difference irrespective of how the cost of the investment was allocated to the investee's net assets. In other words, even if the investor allocates a portion of the cost of the investment to equity method goodwill, the investor would recognize deferred taxes for the tax effect of the entire difference between its financial statement carrying amount and tax basis of the common stock of the investee. If the financial statement carrying amount of the investment exceeds its tax basis, a temporary difference may exist that will result in future taxable amounts. This temporary difference should be scheduled to reverse based on the expected type of taxable amounts in future years (e.g., reversal may result from receipt of dividends, liquidation of investee, sale of the investment). For example, if a taxable temporary difference is expected to reverse through dividends, the calculation of deferred taxes should consider the effect of any dividends-received deductions or foreign tax credits, and taxes that would be withheld from the dividend. If the tax basis exceeds the financial statement carrying amount of the investment, the deductible temporary difference generally should be scheduled to reverse in the year in which the investor expects to sell the investment or in the indefinite column when there are no current plans to dispose of this investment.

**A.016** The reversal of a temporary difference related to the difference between an investor's financial statement carrying amount and tax basis of an equity-method investment may result in a capital gain or loss for tax purposes. It may be necessary to segregate temporary differences that will result in capital gains and losses from temporary differences that will result in ordinary taxable income and deductions.

**A.017 Temporary Difference in the Equity Method Investee's Net Assets.** When an investor acquires an interest in an entity accounted for under the equity method, it is required to allocate the cost of that investment to the underlying net assets of the investee in accordance with the accounting requirements of ASC Subtopic 805-50, *Business Combinations-Related Issues*. Because temporary differences identified as a result of this allocation process are not recognized in the investor's financial statements for a corporate investment, the related deferred taxes in and of themselves generally are not scheduled to assess the investor's need for a valuation allowance. However, these deferred taxes do affect the calculation of the investor's share of the earnings and losses of the corporate investee and should therefore be considered in estimating the investor's future taxable income when circumstances necessitate that analysis. In these situations, the temporary differences would be scheduled to reverse based on the reversal pattern of the investee's underlying asset or liability that gave rise to the temporary difference. See also Paragraph A.025 for discussion of investments in partnerships accounted for under the equity method.

**A.018 Investments in Foreign Subsidiaries.** Deferred taxes may not be recognized on unremitted earnings of foreign subsidiaries based on the indefinite reversal criterion of ASC paragraph 740-30-25-17 (APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*). However, if deferred taxes are recognized (e.g., for foreign withholding taxes payable by U.S. parent entities, see Paragraphs 7.007a through 7.007d for additional discussion) because the requirements of the indefinite reversal criterion have

not been met, scheduling should be based on the expected timing of the transaction giving rise to the taxable event (e.g., the expected timing of repatriation of previously unremitted earnings).

**A.019 Investments in Partnerships and Other Pass-through Entities.** Depending on the facts and circumstances, a partner may account for an investment in a partnership for financial reporting purposes at fair value (or the measurement alternative) under ASC Topic 321, *Investments – Equity Securities*, the equity method, or by consolidating the partnership. In addition, in certain industries, the partner’s pro rata share of the assets, liabilities, revenues, and expenses of the partnership may be included in the partner’s consolidated financial statements. For tax purposes, investments in partnerships and other entities treated as partnerships for tax purposes (regardless of how they are characterized for financial reporting purposes) are generally accounted for with (a) the partner’s share of taxable income and losses of a partnership being reported in the partner’s tax return, (b) distributions from a partnership reducing the partner’s tax basis of the investment, and (c) undistributed earnings of a partnership resulting in an increase in the partner’s tax basis of its investment.

**A.020** Differences may arise between the financial statement carrying amount and the tax basis of an investment in a partnership due to (a) differences between the partner’s methods of accounting for the investment for financial reporting and tax purposes and (b) differences between the financial statement carrying amounts and tax bases of the individual assets and liabilities of the partnership.

**A.021 Investments in Partnerships and Other Pass-Through Entities Accounted for Under ASC Topic 321.** An investor with equity securities in the scope of ASC Topic 321 adjusts its financial statement carrying amount to reflect the investment at fair value (or for other reasons under the measurement alternative) but adjusts the tax basis of the investment to reflect its share of the partnership’s taxable income when the income is earned and distributions of that taxable income. The basis difference is a temporary difference that should be scheduled to reverse based on management’s expectations of the timing of partnership cash distributions, and ultimate recovery through sale of the investment, or liquidation (or termination) of the partnership.

**A.022** The reversal of temporary differences related to equity securities of pass-through entities may result in some amount of capital gain or loss for tax purposes. Depending on the applicable provisions of the tax law, temporary differences that will result in future capital gains and losses may need to be segregated from temporary differences that will result in ordinary income or deductions in the deferred tax calculation and the assessment of the need for a valuation allowance.

**A.023 - A.024** Not used.

**A.025 Investments in Partnerships and Other Pass-Through Entities Accounted for Using the Equity Method.** When a partner uses the equity method of accounting for an investment in a partnership for financial reporting purposes, the partner recognizes its share of the partnership’s income or loss for financial reporting purposes with a

corresponding increase in the financial statement carrying amount of the investment. Distributions of partnership assets would then reduce the carrying amount of the partner's investment.

**A.026** A temporary difference between the tax basis and the financial statement carrying amount of an investment in a partnership that is accounted for using the equity method for financial reporting purposes that arises as a result of basis differences attributable to the partnership's assets and liabilities should be scheduled to reverse in the same manner as the basis differences on the individual underlying assets and liabilities of the partnership. The following approach could be used to identify and schedule these temporary differences:

- (1) Determine the net amount of the taxable or deductible temporary difference attributable to the partner's investment in the partnership.
- (2) Calculate the difference between the financial statement carrying amount and tax basis of each asset and liability of the partnership.
- (3) Determine the periods in which each of the partnership's basis differences will result in future taxable or deductible amounts.
- (4) Calculate the partner's share of the future taxable or deductible amounts resulting from the reversal of each of the partnership's basis differences. Generally, this procedure should be performed for each basis difference because a partner will report its share of certain taxable and deductible amounts (such as capital gains and losses) in its tax return.
- (5) Include the partner's share of the partnership's future taxable or deductible amounts in the partner's schedule of temporary differences along with any other residual outside basis differences in the partner's investment in the partnership that are not related to the basis differences at the partnership level.

**A.027** This approach also may be followed for other partnership investments.

**A.028 Consolidated Partnerships and Tax Pass-Through Entities.** In some instances, a partner may include the individual assets and liabilities of a partnership in its consolidated financial statements and recognize a noncontrolling interest for the interests in the partnership that are held by third parties. Only the net interest in the partnership (one amount) will be reported on the partner's tax-basis balance sheet. The temporary difference related to the partnership is the difference between the financial statement carrying amount and the tax basis of the investment. See Paragraphs 2.102 and 10.098 for additional discussion of partnership and other pass-through investments.

**A.029** However, for purposes of scheduling the reversal of that temporary difference, the partner may need to look through the tax basis in the net interest in the partnership to the tax bases of the individual assets and liabilities of the partnership. Differences between the financial statement carrying amounts and tax bases of the assets and liabilities of a partnership will affect the timing of the reversal of the partner's temporary difference in the investment in the partnership. Identifying the basis differences of the partnership and

scheduling the partner's future taxable and deductible amounts relating to those differences could be accomplished in the same manner as discussed above for investments accounted for using the equity method.

**A.030 Equity Method for Partnerships and Other Pass-Through Entities That Are Consolidated on a Pro Rata Basis.** In certain industries, such as the oil and gas industry, it is acceptable practice for a partner to include its pro rata share of the individual assets, liabilities, revenues, and expenses of the partnership in the partner's financial statements. In these cases, the scheduling of temporary differences relating to the partner's interest in the partnership would be performed in the same manner as if the partnership were fully consolidated in the partner's financial statements.

**A.031 Organization and Start-Up Costs.** Organization and start-up costs generally are expensed as incurred for financial reporting purposes. For tax purposes, such costs are deferred and amortized, generally over fifteen years, using the straight-line method. The deductible temporary difference related to organization costs should be scheduled to result in future deductible amounts based on the future amortization of the tax basis of the asset.

**A.032 Warranty Reserves and Estimated Volume Discounts and Returns.** Tax deductions for warranty reserves and estimated volume discounts and returns generally are not allowed until the liability is settled. A deductible temporary difference will exist in the amount of the liability for financial reporting purposes. The temporary difference related to these reserves should be scheduled to result in deductible amounts in the years that the tax deductions are expected to be claimed (generally, the period in which the financial statement liability will be settled). Historical trends and the terms of the arrangements should be considered in estimating the pattern of reversal.

**A.033 Interest Accrued for Underpayments of Income Taxes.** Generally, the interest accrual for financial reporting purposes is not deductible for tax purposes until paid to the taxing authority. Accordingly, the deductible amount attributable to this temporary difference should be scheduled to reverse in the year in which payment is expected.

**A.034 Installment Gain Receivables and Contract Assets.** Some types of revenue or gain may be included in taxable income at a different time than recognized for financial reporting purposes and thus result in temporary differences. For example, section 453 installment sales may result in a gain and a receivable (or contract asset) that is recognized for financial reporting purposes before it is recognized for tax purposes. In these transactions, taxable income will be recognized as the receivable is collected. The taxable amounts attributable to this temporary difference should be scheduled based on the contract's payment terms and the character of the income when it reverses (it may be necessary to segregate temporary differences that will result in capital gains from temporary differences that will result in ordinary income for those installment sales that include both ordinary income and capital gain).

**A.035 Contract or Deposit Liabilities.** In other arrangements, revenue or gain may be included in taxable income before revenue or gain is recognized for financial reporting



purposes. Although the contract or deposit liability for financial reporting purposes will not be reported on future tax returns because the revenue was included in taxable income in prior years, its recognition for financial reporting purposes creates a deductible temporary difference because the financial statement liability has no tax basis. Temporary differences attributable to revenues deferred for financial reporting purposes, but not for tax purposes, should be scheduled to result in deductible amounts when the revenue is expected to be recognized and the financial statement liability is expected to be settled).

**A.036** Profit recognition for financial reporting purposes follows a five-step model to determine when to recognize revenue (or profit), and at what amount. The model specifies that revenue (or profit) is recognized when or as an entity transfers control of goods or services at the amount to which the entity expects to be entitled.

**A.036a** IRC section 451 addresses the interaction between financial reporting revenue or gain and taxable income. Section 451 generally requires accrual method taxpayers to recognize taxable income no later than the tax year in which the item is recognized as revenue in its financial statements (i.e., that the all events test is satisfied no later than the year in which the revenue is recognized for financial reporting purposes). This book conformity requirement has some exceptions and leaves in place certain other provisions of the code.

**A.037** Not used.

**A.038 Self-Insurance Reserves.** The temporary difference attributable to self-insurance reserves recognized for financial reporting purposes, but not for tax purposes, should be scheduled to result in deductible amounts in the years that the entity expects to settle the liability and claim the tax deduction. Historical trends and other information used to compute the liability should be used in estimating the periods of reversal.

**A.039 Accrual of Loss Contingencies and Recognition of Guarantees.** Generally, accruals of loss contingencies (such as pending litigation) that are recognized in accordance with ASC Topic 450, *Contingencies*, or recognition of guarantees that are recognized in accordance with ASC Topic 460, *Guarantees*, are not deductible for tax purposes until paid. Accordingly, the related deductible temporary difference should be scheduled to result in a deductible amount in the year that the deduction is expected to be taken for tax purposes.

**A.040 – A.042** Not used.

**A.043 Issuances of Stock by a Subsidiary.** Issuances of stock by a subsidiary will generally result in temporary differences because such transactions result in a change in the financial statement carrying amount of the parent's investment in the subsidiary without a change to the tax basis. This results in a change to the outside basis difference in the parent's investment in the subsidiary. Deferred taxes may not be recognized on outside basis differences related to certain subsidiaries based on the provisions of ASC paragraphs 740-10-25-3 and 740-30-25-5 through 25-19. However, if deferred taxes are recognized, scheduling should be based on the expected timing of the transaction giving

rise to the taxable event (e.g., sale of the subsidiary). See Paragraph A.018 for additional information about investments in foreign subsidiaries.

**A.044 Assets and Liabilities Recognized at Amortized Cost.** Acquired financial assets and liabilities, like other assets and liabilities, are generally recognized for financial reporting purposes at fair value upon acquisition. Certain financial assets (e.g., loans) are accounted for post-acquisition at amortized cost and therefore have financial statement carrying amounts that change over the life of the related asset or liability, for example as payments are received and discounts or premiums are amortized. Temporary differences frequently arise between the financial statement carrying amounts and tax bases of these assets and liabilities, both at acquisition and on an ongoing basis. For example, a commercial loan receivable acquired in a nontaxable business combination is recorded at fair value using a discount rate commensurate with risk at the time the loan receivable was acquired; however, the tax basis will be the historical amortized basis of the receivable using the discount rate appropriate when the loan receivable was initially executed. This difference is a temporary difference at acquisition that will eventually reverse as the financial statement carrying amount is eventually adjusted to the remaining principal amount.

**A.045** The following alternatives are available for scheduling the reversal of temporary differences related to assets and liabilities measured at amortized cost:

- A. The temporary difference may be scheduled to reverse based on the future reductions in the principal balance of the asset or liability. This approach is referred to as the loan amortization method, or
- B. The temporary difference may be scheduled to reverse based on the present value of future cash flows. This approach is referred to as the present value method.

**A.046** These two approaches were provided as alternatives in the FASB's Special Report on Statement 96. Although neither ASC Topic 740 nor the Special Report on Statement 109 specifically address the pattern of reversals of assets and liabilities accounted for at amortized cost, these two methods continue to be acceptable alternatives.

**A.047** The following example illustrates the application of both methods.

### **Example A.2: Scheduling Temporary Differences for Mortgage Loans Acquired in Business Combinations**

ABC Corp. acquired a mortgage loan with the following terms in a business combination on January 1, 20X6:

- Principal balance at date of business combination – \$100,000
- Remaining term – five years

## Appendix A – Examples of Scheduling Temporary Differences

- Stated interest rate – 8%
- Payment due the end of each year – \$25,046

At January 1, 20X6, the current interest rate for a mortgage loan with similar terms was 12%. For financial reporting purposes, the mortgage loan was assigned a fair value of \$90,285 at January 1, 20X6, based on the contractual future cash receipts discounted at a 12% interest rate. For tax purposes, the loan has a basis of \$100,000. The difference of \$9,715 between the assigned financial statement carrying amount and the tax basis represents future deductible amounts.

The reduction of the principal balance based on annual payments of \$25,046 each year assuming a 12% discount rate for financial statement purposes and an 8% discount rate for tax purposes is scheduled as follows:

	<b>20X6</b>	<b>20X7</b>	<b>20X8</b>	<b>20X9</b>	<b>20Y0</b>	<b>Total</b>
Financial reporting	\$ 14,212	15,916	17,827	19,967	22,363	\$ 90,285
Tax	<u>17,044</u>	<u>18,410</u>	<u>19,882</u>	<u>21,473</u>	<u>23,191</u>	<u>100,000</u>
Difference	\$ (2,832)	(2,494)	(2,055)	(1,506)	(828)	\$ (9,715)

The fair value at January 1, 20X6 of each of future cash receipts (using an interest rate of 12%) and tax purposes (using an interest rate of 8%) are as follows:

	<b>20X6</b>	<b>20X7</b>	<b>20X8</b>	<b>20X9</b>	<b>20Y0</b>	<b>Total</b>
Financial reporting	\$ 22,363	19,967	17,827	15,916	14,212	\$ 90,285
Tax	<u>23,191</u>	<u>21,473</u>	<u>19,882</u>	<u>18,410</u>	<u>17,044</u>	<u>100,000</u>
Difference	\$ (828)	(1,506)	(2,055)	(2,494)	(2,832)	\$ (9,715)

Using the amounts from the schedules above, the reversal of the deductible temporary difference of \$9,715 should be scheduled to result in future deductible amounts in the following manner under Approach A (loan amortization method) and Approach B (present value method) as of January 1, 20X6.

	Temporary Difference at December 31, 20X6	Future Years				
		20X7	20X8	20X9	20Y0	20Y1
Future taxable (deductible) amounts:						
Approach A (loan amortization method)	\$ (9,715)	(2,832)	(2,494)	(2,055)	(1,506)	(828)
Approach B (present value method)	\$ (9,715)	(828)	(1,506)	(2,055)	(2,494)	(2,832)

**A.048** As illustrated in the previous example, the two approaches result in dramatically different effects on the pattern of the record of future deductible or taxable amounts. Whichever approach is selected, it should be applied consistently from year to year. Although it would be desirable to use the same approach for all assets and liabilities accounted for at amortized cost, different approaches may be used for different categories of temporary differences. However, the same approach should be used for all assets and liabilities within a category.

**A.049 Lessee.** For financial reporting purposes, the lessee records a right-of-use asset and a lease liability at the inception of the lease at an amount equal to the present value of lease payments not yet paid. In many instances, no related asset or liability exists for tax purposes. These temporary differences should be scheduled to reverse using an approach similar to those discussed for assets and liabilities with amortizing bases as discussed above (see Paragraphs A.013 and A.044 for additional discussion).

**A.050** Not used.

### Example A.3: Scheduling Temporary Differences for Finance Leases by Lessee

JKL Corp., as lessee, enters into a finance lease at the beginning of 20X6 with the following terms:

- Fair value of the underlying asset is \$5,000.
- The non-cancellable lease term is 60 months. There are no renewal options.
- \$100 is payable at the end of each month. No amounts were prepaid by JKL and there were no initial direct costs or lease incentives.

- The right-of-use asset is amortized straight-line over five years (the lease term) for financial reporting purposes.
- The lessee’s incremental borrowing rate is 9.15%.

At lease commencement, JKL recognizes a right-of-use asset and a lease liability, both in the amount of \$4,800, which is the present value of the unpaid lease payments at commencement. For tax purposes, the lease is accounted for as an operating lease. For financial reporting purposes, JKL will recognize annual amortization of the right-of-use asset of \$960 in 20X6 through 20Y0. The annual amounts related to the lease liability are as follows:

	Commencement	20X6	20X7	20X8	20X9	20Y0
Lease payments	\$	1,200	1,200	1,200	1,200	1,200
Interest		407	331	248	157	57
Lease liability (end of year)	\$	4,800	4,007	3,138	2,186	1,143
						-

A finance lease gives rise to two separate temporary differences. At the end of 20X6, there is a right-of-use asset recognized for financial reporting purposes, but not for tax purposes, of \$3,840 (\$4,800 less amortization of \$960) and a lease liability recognized for financial reporting purposes, but not for tax purposes, of \$4,007 (\$4,800 plus interest of \$407 less payment of \$1,200). The temporary difference attributable to the right-of-use asset would be scheduled to result in future taxable amounts based on future amortization for financial reporting purposes. The temporary difference attributable to the lease liability may be scheduled to result in future deductible amounts based on the present value of the payments to be made in each future year (present value method) or based on the future reductions of the lease liability (loan amortization method). See Paragraph A.045 for additional discussion of the present value and loan amortization methods.

Using the loan amortization method, these temporary differences would be scheduled to reverse based on the expected amortization of the right-of-use asset and forecasted reductions to the lease liability. The following table illustrates this method as of December 31, 20X6:

	Temporary Difference at December 31, 20X6	Future Years			
		20X7	20X8	20X9	20Y0
Future taxable amounts attributable to right-of-use asset	\$ 3,840	960	960	960	960
Future deductible amounts attributable to lease liability	(4,007)	(869)	(952)	(1,043)	(1,143)
Future net taxable (deductible) amount	\$ (167)	91	8	(83)	(183)

Using the present value method, these temporary differences would be scheduled to reverse based on the expected amortization of the right-of-use asset and forecasted changes to the present value of the future cash flows for the lease liability. The following table illustrates this method as of December 31, 20X6:

	Temporary Difference at December 31, 20X6	Future Years			
		20X7	20X8	20X9	20Y0
Future taxable amounts attributable to right-of-use asset	\$ 3,840	960	960	960	960
Future deductible amounts attributable to lease liability	(4,007)	(1,143)	(1,043)	(952)	(869)
Future net taxable (deductible) amount	\$ (167)	(183)	(83)	8	91

**A.051 Lessor.** Certain lease agreements that are treated as operating leases for tax purposes are classified by a lessor as direct-financing or sales-types leases for financial reporting purposes. Generally, the present value of the lease payments during the lease term and the residual value of the leased asset at the end of the lease term are recognized for financial reporting purposes as the net investment in the lease.

**A.052** The deductible amount scheduled in each future year should be based on the depreciation to be recognized for tax purposes in those future years. The taxable amount scheduled in each future year generally should be based on the present value of amounts to be received in each future year or on the future principal reductions in the lease receivable. See Example A.2.

**A.053 Failed Sale and Leaseback Transactions.** Under ASC Topic 842, *Leases*, an entity entering into a sale-leaseback transaction will apply the specific requirements of Topic 606 (and other sale-leaseback specific considerations, such as whether the leaseback would be classified as a finance/sales-type lease) to determine whether the transfer of the asset is a sale. This may result in sale-leaseback transactions where the form of the transaction is respected for tax purposes, but is a failed sale under Topic 842 resulting in deferred tax items. For example, while the seller-lessee may be considered to have sold the asset for tax purposes, it may still have the asset, as well as a financing liability, for book purposes. The taxable amounts scheduled in each future year should be based on the expected pattern of reversal of book depreciation. The deductible amounts scheduled in each future year should be based on the expected pattern of reversal through deductible lease payments using one of the methods described in A.044. See section 10.1.5 of KPMG Handbook, *Leases*, for further discussion and examples of the tax impacts of sale-leaseback transactions.

**A.054 Defined Pension and Other Postretirement Benefits.** Under ASC Topic 715, *Compensation--Retirement Benefits*, employers are required to recognize on the balance sheet the net amount by which a defined-benefit-postretirement obligation is over- or

underfunded. The funded-status amount will be measured as the difference between the fair value of plan assets and the benefit obligation. If the benefit obligation is larger than the fair value of plan assets, the plan would be underfunded, and a net liability would be reported. Conversely, if the fair value of the plan assets is larger, the plan would be overfunded, and a net asset would be reported on the balance sheet. Temporary differences frequently will arise as a result of the recognition of such assets and liabilities. In addition, settlement or curtailment gains and losses recognized under ASC Topic 715 may create temporary differences because the transactions generally are not taxable or deductible at the date recognized for financial reporting purposes.

**A.055** Due to the complexities of pension and postretirement benefit accounting and the various ways temporary differences could arise, a number of different alternative methods for scheduling the reversal of temporary differences may be acceptable. Whichever approach is used, it should be applied consistently from year to year and for all of the entity's pension plans. The following two approaches were included in the FASB Staff's Special Report on Statement 96 and continue to be acceptable methods under ASC Topic 740.

- (1) The future taxable amount related to a pension or postretirement benefit asset is scheduled to occur in the period of an expected asset reversion or in an indefinite period. The temporary difference attributable to a pension or postretirement benefit liability recognized for financial reporting purposes would be scheduled to result in deductible amounts based on the present value of the estimated deductible contributions (based on current plan participants and assumptions) to the benefit plan in future years, limited to the amount of the pension or postretirement benefit liability.
- (2) The future taxable amount related to a pension or postretirement benefit asset is scheduled to occur based on the estimated plan expense for financial reporting purposes in future years, limited to the amount of the postretirement benefit asset. The temporary difference attributable to a pension or postretirement benefit liability recognized for financial reporting purposes would be scheduled to result in deductible amounts based on estimated future tax-deductible contributions to the plan in excess of interest on the pension liability, limited to the amount of the pension liability.

**A.056** In addition to the methods described above, other more practical approaches may also be acceptable. For example, the taxable temporary difference related to a postretirement benefit asset could be scheduled to result in taxable amounts in future years when plan expense for financial reporting purposes is expected to exceed the tax-deductible contributions. Deductible temporary differences related to a postretirement benefit liability could be scheduled to result in deductible amounts in future years when the tax-deductible contributions are expected to exceed plan expense for financial reporting purposes.

**A.057 Deferred Investment Tax Credits.** The temporary difference related to investment tax credits that are deferred for financial reporting purposes should be

scheduled to result in future deductible amounts in the periods in which the deferred credits will be recognized for financial reporting purposes.

**A.058 Share-Based Compensation.** The cumulative amount of compensation cost recognized for equity or liability classified share-based compensation awards that are expected to result in a future tax deduction (e.g., NSOs) are considered a temporary difference. The deductible temporary difference is measured based on the compensation cost recognized for financial reporting purposes under ASC Topic 718, *Compensation--Stock Compensation*, and is not adjusted for changes in the intrinsic value of the award. This temporary difference should be scheduled to result in future deductible amounts in the periods that the related tax deductions are estimated to be taken, which may not be until the award vests or, if the award is an option, until it is exercised by the employee. Judgment may be required when scheduling the reversals of such temporary differences, particularly those associated with options because exercise generally is not in the employer's control. Because tax deductions available for share-based compensation awards generally are based on the intrinsic value of the award, whereas ASC Topic 718 requires compensation expense to be measured at an award's fair value, such deductions will often be in different amounts and in different periods from the compensation cost recognized in the financial statements. The scheduling of the reversal of the deductible temporary difference (see additional discussion in Paragraphs 4.006(1) and 4.108) should be based on the amount of the temporary difference.

**A.059** The estimated income tax deduction from the exercise of share options reduces the amount of otherwise available future taxable income. In situations where entities are forecasting future taxable income exclusive of reversing temporary differences (see additional discussion in Paragraph 4.006(2)) in the assessment of the need for a valuation allowance for deferred tax assets, it generally would be appropriate for projections of future taxable income to include consideration of future excess tax deductions associated with share options for which no deferred tax asset is recognized in the financial statements. Estimates of such excess future deductions should be based on the entity's best estimate of the future deduction from share option exercises. This estimate will generally consider existing options, expected future options, turnover, and other subjective factors (see additional discussion in Paragraph 4.047).

**A.060 Asset Retirement Obligations.** ASC Subtopic 410-20, *Asset Retirement and Environmental Obligations - Asset Retirement Obligations*, requires an entity to recognize a liability for legal obligations associated with the retirement of a tangible long-lived asset. These liabilities generally will not be deductible for income tax purposes when accrued for financial reporting. Accordingly, a deferred tax asset should be recognized for the difference between the financial statement carrying amount and the corresponding tax basis (which generally will be zero). The offset to the liability established will be an increase in the carrying amount of the respective asset. This additional asset amount will result in a separate temporary difference for which a deferred tax liability should be recognized.

**A.061** The deferred tax liability associated with the increase in the asset amount will reverse as the asset is depreciated for financial statement purposes. However, because



many of the asset retirement liabilities will be long-term, an entity may not be able to estimate when the liability will be settled and it may be after operations have ceased. Accordingly, a valuation allowance may be needed for the deferred tax asset related to the asset retirement obligation. While the deferred tax liability associated with the incremental asset amount may not provide a source of taxable income (due to a mismatch in the periods in which the deferred effects reverse) to support the deferred tax asset, other sources of taxable income, such as a tax-planning strategy or future taxable income exclusive of reversing temporary differences, may enable an entity to demonstrate that it is more likely than not the deferred tax asset related to the asset retirement obligation will be realized. Entities may consider many of the same factors as discussed in the context of defined pension and other postretirement benefits. Refer to Paragraph A.054.

**A.062 In Process Research & Development (IPR&D).** In a business combination, an entity recognizes deferred taxes for IPR&D if the amount recorded for financial statement purposes differs from the tax basis. While the IPR&D is still being developed and considered to be an indefinite-lived intangible asset, the reversal period of the related deferred tax liability may be difficult to predict as it is based on the estimated remaining development period plus the estimated useful life after completion. See discussion beginning at Paragraph 6.120.

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