KPMG

Recent SEC comments on accounting for income taxes

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Representatives of the U.S. Securities and Exchange Commission (SEC) made comments about accounting for income taxes during the 2024 AICPA[1] & CIMA[2] Conference on Current SEC and PCAOB[3] Developments. This article summarizes certain comments made at the conference and provides examples of comments related to income taxes recently issued by the SEC to registrants. Recent comments from regulators and standard setters may help registrants identify areas for improvements in existing income taxes disclosures in order to provide more robust and relevant information to investors and users of the financial statements.

2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments

The 2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments (the Conference) was held December 9–11, 2024, in Washington, D.C. The speakers and panelists included representatives of the SEC, the Financial Accounting Standards Board (FASB), and the PCAOB, who shared views on various accounting, financial reporting, auditing, and regulatory issues. SEC representatives reiterated recent themes and concerns, in particular the need for registrants to focus on quality in the current economic environment. Refer to KPMG's Executive Highlights from the 2024 Conference for additional details.

With year-end quickly approaching, Staff in the SEC's Division of Corporation Finance (Corp Fin) touched on several Form 10-K disclosure topics at the Conference. While Management Discussion and Analysis (MD&A) disclosures are featured every year at the Conference, some of this year's reminders touched on emerging issues, including the following MD&A disclosures that apply to Pillar Two developments.

- Looking back, if reported income tax is materially affected by tax law changes due to Pillar Two, companies are required to describe the economic change and the effect it had on income.

[1] American Institute of Certified Public Accountants
[2] Chartered Institute of Management Accountants
[3] Public Company Accounting Oversight Board

- Looking forward, companies must describe, quantitatively and qualitatively, any reasonably likely effects on future operations, to the extent they are material.

Corp Fin expects 'warning disclosures' about the likely impact of known regulation changes, and Pillar Two is not an exception. The SEC Staff (the Staff) emphasized that Pillar Two–related disclosures in MD&A should continue to evolve as more information becomes available. For example, a company might not be able to initially quantify the potential impact of Pillar Two, but in a later period will have sufficient information to estimate a range of reasonably likely outcomes.

Additionally, the Conference closed out the technical discussions with a Pillar Two implementation session, where the common theme between the panels was the need for robust controls and proactive collaboration with your auditor. The panelists acknowledged that Pillar Two presents significant implementation challenges for multinational companies.

The panelists stressed that companies need to assess their systems and processes, identify constituent entities, evaluate safe harbors and design new internal controls for compliance, including:

- Controls around country-by-country reporting that serves as a basis to evaluate the safe harbors.
- Controls around computing global anti-base erosion (GloBE) income.
- Controls around models and technology solutions that are being implemented.
- Controls over the completeness and accuracy of the information used in the processes and the operation of the new controls.

In addition, because the entries and disclosure elements for the accounting may be coming from different people and parts of the organization, there may be a need to revisit the operation of existing controls.

Lastly, effective communication with your auditors is crucial for resolving issues on a timely basis and ensuring the completeness and accuracy of information used in Pillar Two processes. Open communication helps in planning for information needs, ensuring that all adjustments are accurately and timely reflected in the financial statements.

For implementation steps and how accounting and finance may be impacted, download our executive summary, Pillar Two Gameplan. And for the latest on implementation, read our Hot Topic, Checking in on Pillar Two.

Examples of recent SEC comment letters

The following selection of SEC comment letters specific to income taxes is provided to illustrate areas in which the Staff questioned whether the disclosures provided adequate insight for investors to understand a company's income taxes environment or when the Staff wanted a better understanding of the basis for management's judgments. The comments below highlight common findings that are representative of the Staff's areas of recent focus associated with income taxes.

Example 1: Effective tax rate reconciliation

The Staff may request additional detail on fluctuations in and any ongoing impact of specific items in the effective tax rate reconciliation:

> We note your discussion and analysis of the changes in your income tax on page X. Based on your effective tax rate reconciliation within Note X, it appears there are other material factors impacting your income tax benefit/(expense) that should be included in MD&A so that readers can fully understand the variances and assess the continuing impact. For example, it appears that the differences on rates of foreign operations changed from a X% decrease to your effective tax rate in 2022 to a X% decrease to the effective tax rate in 2023 while the proportion of income before income taxes for your international operations remained fairly consistent at approximately X% of total income before operations for 2022 and X% in 2023. To the extent material factors in your foreign operations including changes in your jurisdictional mix of income may be impacting your effective tax rate, please explain the changes and factors including whether you may expect these changes to continue. Given the materiality of your foreign operations and impact on your effective tax rate, please also tell us your consideration of including a discussion of the primary taxing jurisdictions where your foreign earnings are derived, the location of tax holidays and the relevant statutory rates in those jurisdictions in order for readers to better understand the material impacts such factors have on your effective tax rate. Please refer to Item 303 of Regulation S-K and Sections 501.12.b.3 and 501.12.b.4. of the Financial Reporting Codification for guidance.

Example 2: Effective tax rate reconciliation

The Staff may request additional detail on specific items in the effective tax rate reconciliation:

> We note your tax rate reconciliation table on page F-X. Please clarify for us and in your filing the nature of the return-to-provision true-up line item. In addition, please clarify for us your basis in U.S. GAAP for recording this item.

Example 3: Effective tax rate reconciliation

The Staff may request additional disclosure of each component of the effective tax rate reconciliation within Management's Discussion and Analysis (MD&A):

> We note your income tax expense for the year ended March 31, 2023 has significantly increased as compared to the amount for the year ended March 31, 2022. Please revise your discussion of income tax expenses to provide robust discussions to address each of the components of the effective tax rate disclosed on page F-X.

Example 4: Valuation allowances

The Staff may request additional detail on the change in the valuation allowance, the stated impact of the valuation allowance in the effective tax rate reconciliation and the relationship between the amounts presented:

> Your disclosure on page X indicates that you have charged approximately $X billion to costs and expenses to increase your tax valuation allowance to approximately $X billion as of

> December 31, 2023. We also note that your effective tax rate reconciliation on page X shows an adjustment of only $X million for the fiscal year ended December 31, 2023. Please reconcile for us the material difference between these amounts.

Example 5: Valuation allowances

The Staff may request additional detail on the valuation allowance judgment:

> It is unclear why you cite "cumulative losses in the U.S. during the prior three years" as a justification for your decision to continue to carry a full valuation allowance against your U.S. deferred tax assets as of December 31, 2022 when you report income before income taxes in the U.S. in each of the past three years. Please revise.

Example 6: Unrecognized tax benefits

The Staff may request additional detail on an entity's recognition of a tax position with uncertainty:

> You disclose as of June 30, 2023 the total amount of gross unrecognized tax benefits was $X million, $X million of which was subject to a full valuation allowance. ASC 740-10-40-2 states use of a valuation allowance is not a permitted substitute for derecognizing the benefit of a tax position when the more-likely-than-not recognition threshold is no longer met. Please explain to us how your treatment complies with the noted guidance.

Example 7: Section 174 capitalization

The Staff may request additional detail on the description of deferred taxes related to section 174 capitalization:

> Refer to your table presentation of deferred income tax assets and liabilities where we note the line item Section 174 Capitalization, resulting in a deferred tax asset of approximately $X million at April 30, 2023. Please expand your disclosures to explain the meaning of this new deferred tax asset and its treatment for income tax accounting purposes. We note that revisions to Section 174 of the Internal Revenue Code, as part of the 2017 Tax Cuts and Jobs Act, went into effect for tax years beginning after December 31, 2021 and pertains to eliminating the immediate expensing of research and experimental expenditures ("R&E") and require taxpayers to capitalize their R&E expenditures and software development cost over a period of years. Refer to ASC 740-10-50-14.

Example 8: Indefinite reinvestment

The Staff may request missing disclosures related to indefinite reinvestment assertions:

> We note that you have material foreign income and, based on your disclosure on page X, that your cash balance is primarily located outside of the United States. Please disclose in future filings the amount of unremitted foreign earnings and the unrecognized deferred tax liability on unremitted foreign earnings, if practicable, or a statement that such determination is not practicable. See ASC 740-30-50-2b and 2c.

Example 9: Intra-entity transfers of assets other than inventory

The Staff may request additional detail on intra-entity asset transfers:

> We note from your disclosure in Note X, that the intra-entity asset transfer of intellectual property had a significant effect on your effective tax rate in both 2021 and 2022. Additionally, you disclose that the increase in intangible deferred tax assets relates to the intra-entity asset transfer of certain intangible assets between two of your foreign subsidiaries Please tell us, and revise future filings to disclose, the details of this IP transfer, including the nature of any estimates and assumptions related to the valuation of this transaction.

Example 10: Non-GAAP financial measures

The Staff may request additional detail on the tax rate applied to non-GAAP financial measures:

> **Initial comment:**
>
> We note your measure of non-GAAP net income does not appear to include the income tax impact of your non-GAAP adjustments. Please revise to include a separate income tax adjustment commensurate with your non-GAAP measure of profit or alternatively, to explain why you do not believe an income tax expense adjustment is necessary. Refer to non-GAAP C&DI Question 102.11.
>
> **Follow-up comment:**
>
> You state in your response to prior comment X that in order to determine the appropriate tax rate to apply to your non-GAAP net income, you need to take into account the company's specific situation of net operating loss carryforwards and tax credit carryforwards as well as the fact that you have not recorded, and do not expect to record or pay significant taxes in the near term. This statement appears to be referring to your GAAP tax position. However, the non-GAAP tax adjustment should include tax expense commensurate with your non-GAAP measure of profitability. In this regard, you appear to have reported significant cumulative non-GAAP net income before taxes in recent years, which suggests that from a non-GAAP perspective, loss carryforwards may not be available and therefore, should not be considered in determining your non-GAAP income tax adjustment. It further suggests that on a non-GAAP basis, you may have recorded and paid significant taxes. To the extent you continue to disclose non-GAAP net income, please revise to also include an adjustment for income tax expense that is commensurate with your non-GAAP measure of profitability.

Example 11: Tax credits

The Staff may request additional detail on the accounting policy established for refundable credits:

> We note that by analogizing to International Accounting Standards 20, Accounting for Government Grants and Disclosure of Government Assistance, you recognized Ireland-related research and development tax credits of $X as a reduction to research and product development expense. Tell us how you consider US GAAP accounting literature, including ASC 450, when evaluating the accounting for this transaction.

Conclusion

In summary, as demonstrated in recent comment letters, accounting for income taxes continues to be an area of focus for the SEC. Consequently, financial statement preparers may decide to consider the recent comments from regulators and standard setters to identify areas for improvements in existing income taxes related disclosures.

Related content

For additional information and background on the Conference, refer to the KPMG executive highlights. For additional information on the disclosure requirements related to income taxes, refer to section 9 of the KPMG Handbook: *Accounting for income taxes*.

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