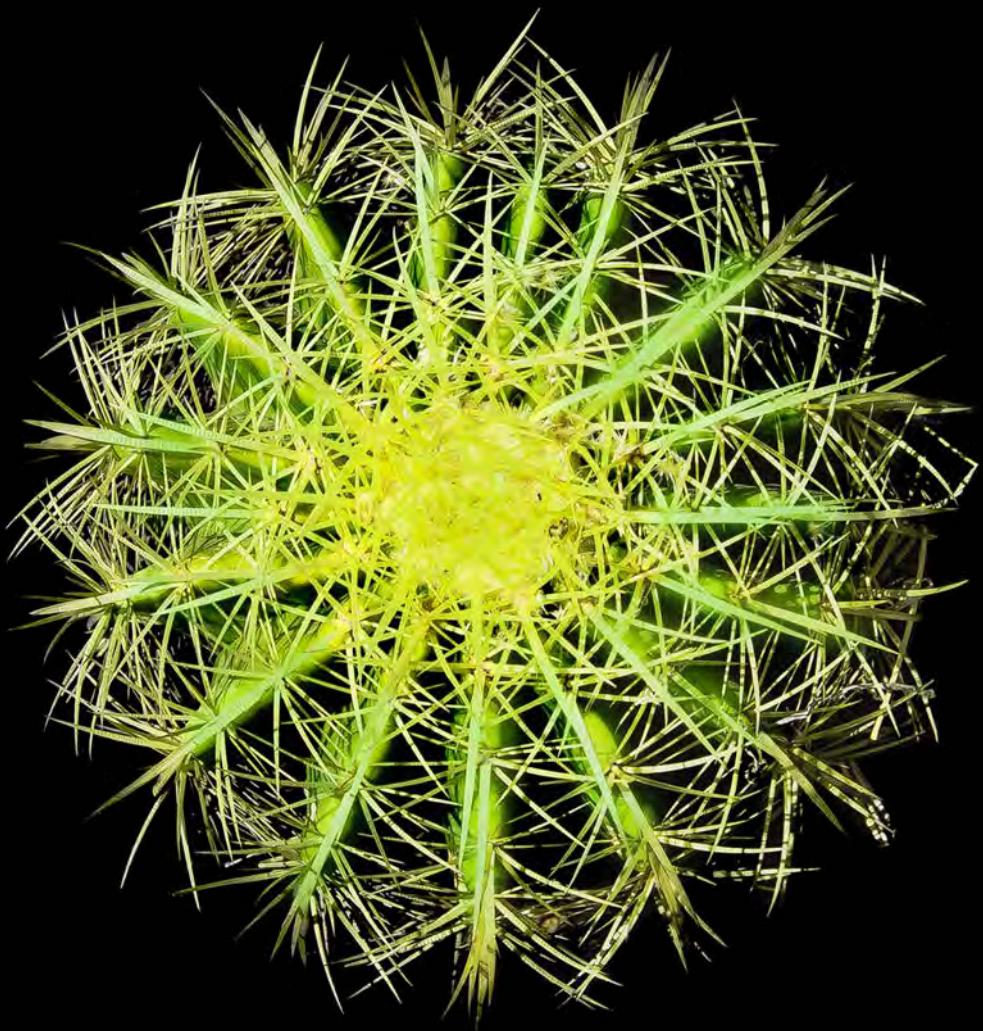


# Deloitte.



## A Roadmap to Accounting for Income Taxes

2018

The *FASB Accounting Standards Codification®* material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, and is reproduced with permission.

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2018 Deloitte Development LLC. All rights reserved.

# Other Publications in Deloitte's Roadmap Series

## Roadmaps are available on these topics:

*Asset Acquisitions*

*Business Combinations — SEC Reporting Considerations*

*Carve-Out Transactions*

*Common-Control Transactions*

*Consolidation — Identifying a Controlling Financial Interest*

*Contracts on an Entity's Own Equity*

*Discontinued Operations*

*Distinguishing Liabilities From Equity*

*Earnings per Share*

*Environmental Obligations and Asset Retirement Obligations*

*Equity Method Investments and Joint Ventures*

*Equity Method Investees — SEC Reporting Considerations*

*Foreign Currency Transactions and Translations*

*Initial Public Offerings*

*Leases*

*Noncontrolling Interests*

*Non-GAAP Financial Measures*

*Pushdown Accounting*

*Revenue Recognition*

*SEC Comment Letter Considerations, Including Industry Insights*

*Segment Reporting*

*Statement of Cash Flows*

## Roadmaps on these topics will be available soon:

*Business Combinations*

*Convertible Debt*

# Acknowledgments

Matt Himmelman and Steve Barta supervised the overall preparation of the 2018 edition of this Roadmap and extend their deepest appreciation to all professionals who helped in its development, but in particular the other core members of the working group, which included Jeff Jenkins, Patrice Mano, and Paul Vitola. The 2018 edition would not have been possible without the numerous contributions of the following professionals in the Accounting Services group of Deloitte & Touche LLP's National Office and the Washington National Tax group of Deloitte Tax LLP who were instrumental in developing the updated guidance contained herein:

Chris Ahl	Peggy Cullen
Chris Barton	Jeff Fitzgerald
David Brown	Krystle Kort
Ryan Caldwell	Alice Loo
Chris Chiriatti	Nikki Nikizad

Special thanks to our Production group who worked tirelessly to make this Roadmap a reality.

Teri Asarito  
Lynne Campbell  
Sandy Cluzet  
Amy Davidson  
Geri Driscoll  
David Frangione  
Michael Lorenzo  
Peter McLaughlin  
Jeanine Pagliaro  
Joseph Renouf  
Lora Spickler-Alot

# Contents

Preface	xix
Contacts	xx
Executive Summary	xxi
<b>Chapter 1 — Overview</b>	<b>1</b>
1.01    Overview of ASC 740	4
1.02    Objectives of ASC 740	5
<b>Chapter 2 — Scope</b>	<b>6</b>
2.01    Taxes Within the Scope of ASC 740	7
2.02    Hybrid Taxes	8
2.03    Accounting for Taxes Assessed on the Payor of a Dividend	9
2.03A   Accounting for Taxes Withheld on Certain Payments (e.g., Dividend, Interest, Royalty, or License)	10
2.04    Refundable Tax Credits	11
2.05    Income Tax Indemnifications Upon Sale of a Subsidiary That Previously Filed a Separate Tax Return	12
<b>Chapter 3 — Recognition and Derecognition</b>	<b>14</b>
General Recognition Approach	14
3.01    Exceptions to Recognition of Deferred Taxes	19
3.02    Definition of Subsidiary and Corporate Joint Venture	19
3.03    Definition of Foreign and Domestic Investments	20
3.04    Definition of “Inside” and “Outside” Basis Differences	21
3.05    Recognition of Deferred Taxes for Inside Basis Differences	22
3.06    Deferred Tax Considerations Related to Withholding Taxes Imposed on Distributions From Disregarded Entities and Foreign Subsidiaries	22
3.07    Recognition of Deferred Taxes for Temporary Differences Related to the CTA	24
3.08    Hedge of a Net Investment in a Foreign Subsidiary	25
3.09    Deferred Taxes Recorded Through the Currency Translation Adjustment	26
3.10    Whether a Change in Management’s Plans for Reinvestment or Repatriation of Foreign Earnings Is a Recognized or Nonrecognized Subsequent Event	26
3.11    Tax Consequences of a Change in Intent Regarding Remittance of Pre-1993 Undistributed Earnings	27
3.12    Tax Consequences of Bad-Debt Reserves of Thrift Institutions	28

3.13	Tax Consequences of a Reduction of the Tax Base-Year Bad-Debt Reserve in an Annual Period	30
3.14	Tax Consequences of a Reduction of the Tax Base-Year Bad-Debt Reserve in an Interim Period	30
3.15	Realization of a DTA of a Savings and Loan Association: Reversal of a Thrift's Base-Year Tax Bad-Debt Reserve	31
3.15A	Regulated Entities Subject to ASC 980	31
3.15B	Construction in Progress and Plant in Service Recorded Net-of-Tax	32
3.16	Intra-Entity Transactions Between Different Tax-Paying Components	32
3.17	Subsequent Changes in Tax Rates Involving Intra-Entity Transactions	33
3.18	Indexing of the Tax Basis of Assets and Liabilities	34
<b>Tax Positions</b>		<b>34</b>
3.19	Consideration of Tax Positions Under ASC 740	37
3.20	Considerations of Tax Positions by Tax-Exempt or Pass-Through Entities	38
3.20A	Unrecognized Tax Benefits and Spin-Off Transactions	38
3.21	Accounting for the Tax Effects of Tax Positions Expected to Be Taken in an Amended Tax Return or Refund Claim or to Be Self-Reported Upon Examination	40
3.22	Recognition and Measurement — Assumptions to Be Used	41
3.23	Decision Tree for Recognizing Benefits of a Tax Position	42
3.24	Legal Tax Opinions Not Required to Support a Tax Position	43
3.25	Meaning of the Court of Last Resort and Its Impact on Recognition	43
3.26	Impact of the Likelihood of the U.S. Supreme Court's Hearing the Case	44
3.27	Consideration of Widely Understood Administrative Practices and Precedents	44
3.28	Applying ASC 740 to Questions About Economic Nexus	45
3.29	Lookback Period for Accruing a State Income Tax Liability for UTBs	45
3.30	Determining the Unit of Account	46
3.31	Whether Determination of the Unit of Account Is an Accounting Policy Choice	47
3.32	Applying the Unit of Account	47
3.33	Decision Tree for the Subsequent Recognition, Derecognition, and Measurement of Benefits of a Tax Position	48
3.34	Evaluating the Recognition Threshold After Examination of a Tax Year	49
3.35	Effectively Settled Tax Positions	49
3.36	Finality or Certainty of Outcome in Subsequent Recognition, Derecognition, or Measurement of a Tax Position	50
3.37	New Information Obtained After the Balance Sheet Date Concerning Uncertain Tax Positions	51
3.38	Interim Accounting for a Change in Judgment	52
3.39	Changes in Judgment Regarding a Tax Position Taken in the Current Year	52
3.40	Changes in Judgment Regarding a Tax Position Taken in the Prior Year	53
3.41	Distinguishing a Change in Estimate From a Correction of an Error	54
3.42	Deferred Tax Consequences of UTBs	56
<b>Temporary Differences</b>		<b>57</b>
3.43	Tax Bases Used in the Computation of Temporary Differences	61
3.44	Temporary Differences	61
3.45	Income Tax Consequences of Issuing Debt With a Conversion Feature Accounted for Separately as a Derivative	62
3.46	Income Tax Effects on Medicare Part D Subsidy Receipts	64

3.47	Recognizing Deferred Taxes for Indefinite-Lived Assets	65
3.48	Deferred Tax Considerations When Goodwill Becomes a Finite-Lived Asset	66
3.49	Deferred Tax Consequences of Synthetic Leases	66
3.50	Considering the Impact of Tax Method Changes	67
3.51	When to Recognize the Impact of Tax Method Changes	70
3.51A	Accounting for Foreign Branch Operations	71
3.51B	Deferred Income Taxes Related to a Foreign Branch: Accounting for Changes in a Parent's Deferred Taxes Due to Changes in Exchange Rates	75
<b>Basis Differences That Are Not Temporary Differences</b>		<b>77</b>
3.52	Permanent Differences	78
3.53	Examples of Basis Differences That Are Not Temporary Differences	80
<b>Change in Tax Status</b>		<b>81</b>
3.54	Change in Tax Status of an Entity	81
3.54A	Tax Effects of a "Check-the-Box" Election	83
3.55	Recognition Date for Conversion to a REIT	84
3.56	Loss of Nontaxable Status as a Result of Acquisition	85
3.57	Successor Entity's Accounting for the Recognition of Income Taxes When the Predecessor Entity Is Nontaxable	86
3.58	Accounting for the Elimination of Income Taxes Allocated to a Predecessor Entity When the Successor Entity Is Nontaxable	88
3.59	Voluntary Change in Tax Status of an Acquired Entity	89
3.60	Change in Tax Status as a Result of a Common-Control Merger	89
3.61	Change in Tax Status to Taxable: Accounting for an Increase in Tax Basis	89
3.62	Built-in Gain: Recognition and Measurement	90
<b>Tax Holidays</b>		<b>92</b>
3.63	Tax Consequences of Tax Holidays	92
3.63A	Accounting for Temporary Differences Related to Investment Tax Credits	92
<b>Effect of Anticipated Future Special Deductions, Losses, and Tax Credits</b>		<b>97</b>
<b>Alternative Minimum Tax</b>		<b>98</b>
<b>Investment Tax Credits</b>		<b>99</b>
<b>Changes in Laws or Rates</b>		<b>99</b>
3.64	Retroactive Changes in Tax Laws or Rates and Expiring Provisions That May Be Reenacted	99
3.65	Enacted Changes in Tax Laws or Rates That Affect Items Recognized in OCI	99
3.66	Reporting Tax Effects of a Change in Tax Law in Discontinued Operations	101
<b>Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations</b>		<b>102</b>
<b>Interest and Penalties</b>		<b>103</b>
3.67	Recognition and Measurement of Interest and Penalties	104
3.68	Interest Income on UTBs	105
3.69	Capitalization of Interest Expense	106
3.70	Recognition of the Accrual for Penalties	106

<b>Chapter 4 — Measurement</b>	<b>107</b>
<b>General Measurement Approach</b>	<b>107</b>
4.01 Measuring Deferred Taxes in Consolidated Financial Statements When a Foreign Subsidiary Uses a Local Statutory Basis of Accounting to Prepare Its Financial Statements	109
<b>Applicable Tax Rate Used to Measure Deferred Taxes</b>	<b>110</b>
4.02 Tax Rate Used in Measuring Operating Losses and Tax Credits	112
4.03 Determining the Applicable Tax Rate on a Loss Carryback	112
4.04 Measuring Deferred Taxes for Indefinite-Lived Intangible Assets When Different Tax Rates May Apply	113
4.05 Use of a Blended Rate to Measure Deferred Taxes	113
4.06 Effect of Tax Holidays on the Applicable Tax Rate	114
4.07 Consideration of Certain State Matters, Including Optional Future Tax Elections, in the Measurement of DTAs and DTLs	114
4.08 Situations in Which Determining the Applicable Tax Rate May Be Complex	116
4.09 Graduated Tax Rates	118
4.10 Measurement When Graduated Tax Rates Are a Significant Factor	119
4.11 Measurement When Future Tax Losses Are Expected in a Graduated Tax Rate Structure	120
4.12 Measurement When Phased-In Changes in Tax Rates Are Enacted	121
4.13 Measurement When Contingent Phased-In Changes in Tax Rates Are Enacted	122
4.14 Consideration of U.S. AMT Credit Carryforwards	123
4.15 AMT Rate Not Applicable for Measuring DTLs	123
4.16 Example Illustrating the Application of ASC 740 to the AMT System in the U.S. Federal Jurisdiction	124
4.17 Consideration of Special Deductions That Are Permitted Under the Tax Law	125
4.18 Measurement of Basis Differences in an Adjusted Gross Receipts Tax Regime	128
4.19 Deferred Tax Treatment of Hybrid Taxes	129
4.20 Applicability of Pushdown Accounting to Income Taxes and Foreign Currency Translation Adjustments	133
<b>Establishment of a Valuation Allowance for Deferred Tax Assets</b>	<b>135</b>
4.21 Consideration of Future Events	137
4.22 Sources of Taxable Income	138
4.23 Examples Illustrating Sources of Taxable Income	138
4.24 Evaluating a DTA (for Realization) of a Debt Security Attributed to an Unrealized Loss Recognized in OCI	139
4.25 Determining the Pattern of Reversals of Temporary Differences	142
4.26 Examples Illustrating the Determination of the Pattern of Reversals of Temporary Differences	143
4.27 Using the Reversal of a DTL for an Indefinite-Lived Asset as a Source of Taxable Income	150
4.28 AMT Valuation Allowances	151
4.28A Assessing Realization of a DTA for Regular Tax NOL Carryforwards When an Entity Anticipates Paying AMT Perpetually	152
4.29 Definition of a Tax-Planning Strategy	154
4.30 Examples of Qualifying Tax-Planning Strategies	156
4.31 Examples of Nonqualifying Tax-Planning Strategies	157
4.32 Recognition and Measurement of a Tax-Planning Strategy	159

4.33	The "More-Likely-Than-Not" Standard	160
4.34	Examples Illustrating the Measurement of Valuation Allowances When Tax-Planning Strategies Are Involved	160
4.35	Determination of the Need for a Valuation Allowance Related to FTCs	164
4.36	Definition of "Cumulative Losses in Recent Years"	166
4.37	Consideration of Negative Evidence in the Determination of Whether a Valuation Allowance Is Required	167
4.38	Cumulative Losses: An Objectively Verifiable Form of Negative Evidence	168
4.39	Going-Concern Opinion as Negative Evidence	169
4.40	Estimates of Future Income	169
4.41	Effect of Nonrecurring Items on Estimates of Future Income	170
4.42	Example Illustrating the Estimation of Future Taxable Income When Negative Evidence in the Form of Cumulative Losses Exists	171
4.43	Positive Evidence Considered in the Determination of Whether a Valuation Allowance Is Required	173
4.44	Additional Examples of Objectively Verifiable Positive Evidence	174
4.45	Example Illustrating the Determination of a Valuation Allowance When It Is More Likely Than Not That a Portion of Existing Tax Benefits Will Not Be Realized	175
4.46	Reduction of a Valuation Allowance When Negative Evidence Is No Longer Present	177
4.47	Valuation Allowances: Time Frame for Assessing Future Taxable Income	179
	<b>Tax Rates Applicable to Items Not Included in Income From Continuing Operations</b>	179
	<b>Allocation of Consolidated Tax Expense to Separate Financial Statements of Members</b>	180
4.48	Subsidiary Financial Statements [Deleted]	180
4.49	Acceptable Methods of Allocating Tax to Separate Financial Statements	180
4.50	Preferable Allocation Method for Public Entities	184
4.51	Change in Application of Tax Allocation Methods	184
4.52	Valuation Allowance in the Separate Financial Statements of a Consolidated Group Member	184
4.52A	Accounting for Income Taxes in the Balance Sheet of Separate Financial Statements: DTAs Related to Tax Attributes	185
4.53	Tax Consequences of Tax-Sharing Agreements That Are Not Acceptable for Financial Reporting Purposes	187
4.54	Reporting Acquisition Debt in Separate Financial Statements	188
4.55	Tax Benefit of the Deductible Interest in the Separate Financial Statements	189
4.56	Application of the Separate Return Method in Combined or Carve-Out Financial Statements of Multiple Legal Entities, Multiple Divisions, or Both	189
4.57	Allocating Income Taxes to Nonmembers in Carve-Out Financial Statements	190
4.57A	Accounting for Taxable Temporary Differences Resulting From Investments in Foreign Subsidiaries and Foreign Corporate Joint Ventures in Separate Financial Statements Prepared by Using the Separate Return Method	191
4.57B	Accounting for Income Taxes in the Balance Sheet of Separate Financial Statements: Unrecognized Tax Benefits and Current Taxes Payable or Receivable	193
4.58	Disclosure Requirements When an Unincorporated Division's Statement of Revenues and Expenses Is Presented in a Public Filing [Deleted]	194
4.59	Single Member LLC Tax Allocation	194
4.60	Change From Single Member LLC to Multiple Member LLC (or Vice Versa)	195
4.61	Publicly Held Single Member LLC	195

<b>Interest and Penalties on Unrecognized Tax Benefits</b>	<b>195</b>
<b>Information Affecting Measurement of Tax Positions</b>	<b>196</b>
4.62 Use of Aggregation and Offsetting in Measuring a Tax Position	196
4.63 Measurement: Weighing of Information	196
4.64 Measuring a Tax Position — Assigning Probabilities in a Cumulative-Probability Assessment	196
4.65 Cumulative-Probability Table	197
4.66 Cumulative-Probability Approach Versus Best Estimate	197
4.67 Example Illustrating the Measurement of the Benefit of an Uncertain Tax Position	198
4.68 Measurement of Tax Positions That Are Considered Binary	198
4.69 Uncertainty in Deduction Timing	199
4.70 Measurement of Uncertain Tax Positions in Transfer Pricing Arrangements	201
<b>Changes in Tax Laws or Rates</b>	<b>204</b>
4.71 Change in Tax Law That Allows an Entity to Monetize an Existing DTA or Tax Credit in Lieu of Claiming the Benefit in the Future	205
<b>Deferred Credit Arising From Asset Acquisitions That Are Not Business Combinations</b>	<b>205</b>
<b>Chapter 5 — Presentation</b>	<b>206</b>
<b>Statement of Financial Position Classification of Income Tax Accounts</b>	<b>206</b>
5.01 Current/Noncurrent Classification of DTLs and DTAs	209
5.02 Presentation of Deferred Federal Income Taxes Associated With Deferred State Income Taxes	210
5.03 Recognition of Changes in Indemnification Assets Under a Tax Indemnification Arrangement	211
5.04 Valuation Allowance: Classification in a Classified Balance Sheet	212
5.05 Accounting for the Tax Effects of a Change in Tax Accounting Method	214
5.06 Balance Sheet Classification of the Liability for UTBs	215
5.07 Financial Statement Display of Future Obligations to Tax Authorities Under Regulation S-X, Rule 5-02	216
5.08 Interaction of UTBs and Tax Attributes	216
5.09 Balance Sheet Presentation of UTBs Resulting From Transfer Pricing Arrangements	217
5.10 Presentation of Professional Fees	218
<b>Income Statement Presentation of Certain Measurement Changes to Income Tax Accounts</b>	<b>219</b>
<b>Income Statement Classification of Interest and Penalties</b>	<b>220</b>
5.11 Classification of Interest and Penalties in the Financial Statements	220
<b>Investment Tax Credits Under the Deferral Method</b>	<b>221</b>
<b>Chapter 6 — Disclosure</b>	<b>222</b>
<b>Statement of Financial Position-Related Disclosures</b>	<b>222</b>
6.01 Required Level of Detail	223
6.02 Definition of "Significant" With Respect to Disclosing the Tax Effect of Each Type of Temporary Difference and Carryforward That Gives Rise to DTAs and DTLs	223
6.03 Disclosure of Worthless Tax Benefits	223
6.04 Change in Tax Status to Taxable: Financial Reporting Considerations	224
<b>Income-Statement-Related Disclosures</b>	<b>225</b>
6.05 Disclosure of the Components of Deferred Tax Expense	225
6.06 Disclosure of the Tax Effect of a Change in Tax Law, Rate, or Tax Status	226

<b>Income Tax Expense Compared to Statutory Expectations</b>	<b>226</b>
6.07    Evaluating Significance of Reconciling Items in the Rate Reconciliation	227
6.07A   Appropriate Federal Statutory Rate for Use in the Rate Reconciliation of a Foreign Reporting Entity	228
6.07B   Computing the "Foreign Rate Differential" in the Rate Reconciliation	228
<b>Unrecognized Tax Benefits-Related Disclosures</b>	<b>229</b>
6.08    Periodic Disclosures of UTBs	230
6.09    Disclosure of Expiration of Statute of Limitations	230
6.10    Disclosure Requirements for Effectively Settled Tax Positions	230
6.11    Disclosure of UTBs That Could Significantly Change Within 12 Months of the Reporting Date	231
6.12    Interim Disclosure Considerations Related to UTBs That Will Significantly Change Within 12 Months	232
6.13    Amounts Included in the Tabular Reconciliation of UTBs	232
6.14    Separate Disclosure of Interest Income, Interest Expense, and Penalties	232
6.15    Disclosure of Interest and Penalties Recorded in the Tabular Reconciliation of UTBs	233
6.16    Presentation of Changes Related to Exchange Rate Fluctuations in the Tabular Reconciliation	233
6.17    Disclosure of Fully Reserved DTAs in the Reconciliation of UTBs	233
6.18    Items Included in the Tabular Disclosure of UTBs From Uncertain Tax Positions May Also Be Included in Other Disclosures	234
6.19    Disclosure of the Settlement of a Tax Position When the Settlement Amount Differs From the UTB	234
6.20    Consideration of Tabular Disclosure of UTBs in an Interim Period	235
6.21    Presentation in the Tabular Reconciliation of a Federal Benefit Associated With Unrecognized State and Local Income Tax Positions	235
6.22    Disclosure of UTBs That, If Recognized, Would Affect the ETR	235
6.23    Example of UTBs That, If Recognized, Would Not Affect the ETR	235
6.24    Disclosure of Liabilities for UTBs in the Contractual Obligations Table	236
<b>Public Entities Not Subject to Income Taxes</b>	<b>236</b>
6.25    Tax Bases in Assets	236
<b>Entities With Separately Issued Financial Statements That Are Members of a Consolidated Tax Return</b>	<b>237</b>
6.26    Disclosures Required in the Separate Financial Statements of a Member of a Consolidated Tax Return	237
6.26A   Disclosure Requirements When Abbreviated Financial Statements Are Presented in a Public Filing	238
<b>Policy-Related Disclosures</b>	<b>238</b>
<b>Other Disclosures</b>	<b>239</b>
6.27    Disclosing the Effects of Income Tax Uncertainties in a Leveraged Lease	239
<b>SEC Staff Disclosure Guidance</b>	<b>240</b>
6.27A   Disclosure of the Components of Income (or Loss) Before Income Tax Expense (or Benefit) as Either Foreign or Domestic — Branches and Intra-Entity Transactions	243
<b>Non-GAAP Measures — Treatment of Tax Adjustments</b>	<b>245</b>

<b>Chapter 7 — Intraperiod Tax Allocation</b>	<b>248</b>
<b>Allocation of Income Tax Expense or Benefit for the Year</b>	<b>248</b>
7.01    Intraperiod Tax Allocation: General Rule	249
7.02    Intraperiod Tax Allocation: Application Level	250
<b>Allocation to Continuing Operations</b>	<b>250</b>
7.03    Intraperiod Tax Allocation: Application of the "With" and "Without" Rules	251
7.04    Intraperiod Tax Allocation of Changes in Valuation Allowances	252
7.05    Changes in Valuation Allowances Resulting From Items Other Than Continuing Operations	254
7.06    Intraperiod Tax Allocation When There Is a Loss From Continuing Operations in the Current Period	255
7.06A   Application of ASC 740-20-45-7 to Amounts Credited Directly to APIC	257
7.06B   Application of ASC 740-20-45-7 to Foreign Currency Exchange Gains	258
7.07    Consideration of Credit Entries for Reclassification Adjustments That Are Recorded in OCI During the Reporting Period When the General Intraperiod Tax Allocation Rule Is Applied	259
7.08    Implications of the Character of Income (or Loss) When the Exception to the General Intraperiod Tax Allocation Rule Is Applied	260
7.09    Intraperiod Tax Allocation: Treatment of Certain Out-of-Period Adjustments	261
7.10    Intraperiod Tax Allocation: Tax Benefit From a Worthless Stock Deduction	262
7.11    Intraperiod Allocation of "Out-of-Period" Tax Effects of UTBs That Originated in Discontinued Operations	263
7.12    Tax Benefits for Dividends Paid to Shareholders: Recognition	265
7.13    Income Tax Accounting Considerations Related to When a Subsidiary Is Deconsolidated	265
7.14    Fresh-Start Accounting: Subsequent Increase or Decrease in a Valuation Allowance	267
7.15    Subsequent Changes in Valuation Allowances for Pre-Quasi-Reorganization Tax Benefits	267
7.16    Subsequent Recognition of Tax Benefits From a Quasi-Reorganization	268
<b>Allocations to Items Other Than Continuing Operations</b>	<b>268</b>
7.17    Tax Consequences of Securities Classified as Held to Maturity, Trading, and Available for Sale	273
7.18    AFS Securities: Methods of Accounting for Deferred Taxes	275
7.19    AFS Securities: Valuation Allowance for Unrealized Losses	276
7.20    AFS Securities: Valuation Allowance Changes Not Recorded Directly in Shareholders' Equity	276
7.21    Assessing Realization of Tax Benefits From Unrealized Losses on AFS Securities	277
7.21A   Application of ASC 740-20-45-7 to Recoveries of Losses in Accumulated OCI	278
7.22    Holding Gains and Losses Recognized for Both Financial Reporting and Tax Purposes	280
7.23    Treatment of Tax Benefit for Dividends Paid on Shares Held by an ESOP	282
7.24    Tax Consequences of Transactions Among (and With) Shareholders	283
7.25    Accounting for the Tax Effects of Contributions to Pass-Through Entities in Control-to-Control Transactions*	284

\* Items that are new or have been significantly amended since the previous edition.

<b>Chapter 8 — Other Considerations or Special Areas</b>	<b>289</b>
<b>Background and Scope</b>	<b>289</b>
<b>Undistributed Earnings of Subsidiaries and Corporate Joint Ventures</b>	<b>290</b>
8.01 Definition of Foreign and Domestic Investments	291
8.02 Accounting for Temporary Differences Related to an Investment in a Corporation	292
8.03 Unremitted Earnings of a Foreign Subsidiary When There Is an Overall Deductible Outside Basis Difference	294
8.03A Outside Basis Difference in a Foreign Subsidiary — Subpart F Income	295
8.03B Outside Basis Difference in a Foreign Subsidiary — “Deferred” Subpart F Income	296
8.04 “Unborn” Foreign Tax Credits	297
8.05 Consideration of the VIE Model in ASC 810-10 in the Evaluation of Whether to Recognize a DTL	299
8.06 Tax Consequences of Investments in Pass-Through or Flow-Through Entities	300
8.07 Parent’s Deferred Tax Considerations When Intra-Entity Loans That Are of a Long-Term-Investment Nature Are Not Denominated in the Functional Currency	302
<b>Equity Method Investee Considerations</b>	<b>303</b>
8.08 Tax Effects of Investor Basis Differences Related to Equity Method Investments	303
8.09 Deferred Tax Consequences of an Investment in an Equity Method Investment (a 50-Percent-or-Less-Owned Investee)	304
8.10 Tax Consequences From Sales of Stock by Equity Method Investees [Deleted]	305
8.11 Presentation of Tax Effects of Equity in Earnings of an Equity Method Investee	305
8.12 Noncontrolling Interests in Pass-Through Entities: Income Tax Financial Reporting Considerations	305
8.13 Accounting for the Tax Effects of Transactions With Noncontrolling Shareholders	306
8.13A Accounting for an Investment Tax Credit Received From an Investment in a Partnership Accounted for Under the Equity Method	308
<b>Other Considerations Related to Foreign and Domestic Subsidiaries</b>	<b>310</b>
8.14 Deferred Tax Consequences of an Investment in a More-Than-50-Percent-Owned Subsidiary	311
8.15 Tax-Free Liquidation or Merger of a Subsidiary	312
8.16 Exception to Deferred Taxes for an Investment in a More-Than-50-Percent-Owned Domestic Subsidiary [Deleted]	313
8.17 Tax Consequences of Business Combinations Achieved in Stages: Other Tax Considerations	313
8.18 State Tax Considerations in Connection With the Assessment of Outside Basis Differences Under ASC 740-30-25-7	314
8.19 Realization of a DTA Related to an Investment in a Subsidiary: Deferred Income Tax Exceptions Not a Source of Income	315
8.20 Recognition of a DTA Related to a Subsidiary Classified as a Discontinued Operation	316
8.21 Change in Investment From a Subsidiary to an Equity Method Investee	317
<b>Exceptions to Comprehensive Recognition of Deferred Income Taxes for Outside Basis Differences</b>	<b>318</b>
8.22 Evidence Needed to Support the Indefinite Reinvestment Assertion	319
8.23 DTL for a Portion of an Outside Basis Difference	319
8.24 Ability to Overcome the Presumption in ASC 740-30-25-3 in the Future After a Change in Management’s Plans for Reinvestment or Repatriation of Foreign Earnings	320
8.25 Whether a Change in Management’s Plans for Reinvestment or Repatriation of Foreign Earnings Is a Recognized or Nonrecognized Subsequent Event	321
<b>Presentation and Disclosure Considerations</b>	<b>322</b>
8.26 Disclosure of Outside Basis Differences	323

<b>Chapter 9 — Interim Reporting</b>	<b>324</b>
Background and Scope	324
Recognition	325
9.01 Estimating the AETR for Interim Reporting of Income Taxes	327
9.02 Tax-Exempt Interest in the Calculation of the Estimated AETR	330
9.03 Impact of Changes in an Indefinite Reinvestment Assertion for Interim-Period Tax Purposes	330
9.04 Balance Sheet Effects of the Interim Provision for Income Taxes	331
9.05 Interim Implications of Intraperiod Tax Allocation for Discontinued Operations When There Is a Loss From Continuing Operations	332
9.06 Calculating an Interim Tax Provision When a Portion of Ordinary Income Cannot Be Reliably Estimated	335
9.06A Calculating an Interim Tax Provision When the AETR Is Highly Sensitive to Changes in Estimates of Ordinary Income or Loss	336
9.07 Interim-Period Treatment of a Nonrecognized Subsequent Event With Respect to the Estimated AETR	336
9.08 Adjustments of Intraperiod Tax Allocation Made in a Prior Interim Period	336
9.09 Changes in the Valuation Allowance in an Interim Period	337
9.10 Changes in Tax Laws and Rates Occurring in Interim Periods	340
9.11 Interim Income Tax Accounting for Significant Unusual or Infrequently Occurring Items	344
Measurement	346
9.12 Recognition of the Tax Benefit of a Loss in an Interim Period	352
9.13 Intraperiod Tax Allocation in Interim Periods	352
9.14 Recognizing Interest Expense for Interim-Period Reporting When Interest Is Classified as Income Tax Expense	353
9.15 Computing an Interim Tax Provision for an Entity Subject to Tax in Multiple Jurisdictions	354
9.16 Impact of Zero-Tax-Rate Jurisdictions and Nontaxable Entities on an Entity's AETR	356
Presentation and Disclosure Considerations	357
<b>Chapter 10 — Share-Based Compensation</b>	<b>359</b>
Background and Scope	360
Recognition	360
10.01 Tax Effects of Share-Based Compensation	363
10.02 Incentive Stock Options	363
10.03 Nonqualified Stock Options	364
10.04 Change in Tax Status of an Award	364
10.05 "Recharge Payments" Made by Foreign Subsidiaries	365
10.06 Impact of Research and Development Cost-Sharing Arrangements	366
10.07 The Effect of UTB Liabilities on Realization of Excess Tax Benefits	367
10.08 Permanent Differences Related to an Exchange of Awards	368
10.09 Accounting for Excess Tax Benefits Included in an NOL Carryforward Acquired in a Business Combination	368
10.10 Accounting for Income Taxes Related to Capitalized Share-Based Payment Compensation Cost	369

<b>Measurement</b>	<b>372</b>
10.11 Measuring DTAs in Reference to the Current Stock Price	375
10.12 Basic Income Tax Effects of Share-Based Payment Awards	376
10.13 Tax Effects of Awards With Graded Vesting	377
10.14 Recognizing Income Tax Effects on an Award-by-Award Basis	378
10.15 Income Tax Effects of "Early Exercise" of Restricted Stock Awards	381
10.16 Measuring the Excess Tax Benefit Associated With Share-Based Compensation: Tax Credits and Other Items That Affect the ETR	381
10.17 Change in Tax Rates	382
10.18 Amounts Included in the Excess Tax Benefits Available for Offset ("APIC Pool")	383
10.19 Realization of Excess Tax Benefits	383
10.20 Tax Effects of Expiration of a Vested Award	385
10.21 Combining Employee and Nonemployee APIC Pools	386
10.22 Effect of Acquisitions, Sales, Spin-Offs, and Investments in Equity Method Investees on the APIC Pool — Parent-Company Awards	386
10.23 Computing the APIC Pool in Interim Financial Statements	387
10.24 Interim Financial Statements — Anticipating the Tax Effects of Share-Based Payment Awards	388
10.25 Recording Tax Benefits of Awards Granted Before the Adoption of Statement 123(R)	389
10.26 Effect on the APIC Pool When the Full Corresponding DTA Does Not Exist Upon Exercise	390
10.27 Valuation Allowances on Excess Tax Benefits Established Before the Adoption of Statement 123(R)	393
10.28 Application of the Prospective Application Method to Nonpublic Entities' APIC Pool	393
10.29 Calculating the APIC Pool When a Company Becomes Public After Adopting Statement 123	394
<b>Presentation Considerations</b>	<b>396</b>
10.30 Balance Sheet Classification of DTAs Related to Nonqualified Stock Options	399
10.31 ESOP: Income Tax Accounting Example	400
10.32 Tax Benefit of ESOP Dividends	401
<b>Earnings per Share Considerations</b>	<b>402</b>
10.33 Inclusion of "Out-of-the-Money" Share-Based Payment Awards With a Dilutive Effect Under the Treasury Stock Method Because of Tax Benefit Deficiencies	402
10.34 Tax Benefit Component of Assumed Proceeds	403
10.35 Realization of Excess Tax Benefits in the Calculation of the Tax Benefit Component of Assumed Proceeds	404
10.36 Estimating Expected Disqualifying Dispositions in the Calculation of the Tax Benefit Component of Assumed Proceeds	405
10.37 Earnings-per-Share Treatment of the Tax Benefits of Dividends on Unallocated Stock	406
<b>Statement of Cash Flows</b>	<b>406</b>
10.38 Presentation in the Statement of Cash Flows of the Income Tax Effects of Share-Based Payment Awards	406
10.39 Tax Benefit Deficiencies of Share-Based Payment Awards	407
<b>ASU 2016-09 FAQs</b>	<b>408</b>

<b>Chapter 11 — Business Combinations</b>	<b>412</b>
Background and Scope	412
Recognition	412
11.01 Tax Consequences of Business Combinations	415
11.01A Determining Whether Income Tax Elections, Tax Planning, or Subsequent Business Integration Steps Should Be Included in the Application of the Acquisition Method of Accounting to a Business Combination	416
11.02 Recognition of an Acquiring Entity's Tax Benefits Not Considered in Acquisition Accounting	417
11.02A Considering Whether Acquired Deferred Tax Liabilities Support the Realization of Acquired or Acquirer Deferred Tax Assets	417
11.03 Recognition of an Acquiring Entity's Tax Benefits After the Acquisition Date	419
11.04 Accounting for Uncertainty in Income Taxes in Business Combinations	420
11.05 Deferred Taxes Associated With Acquired Intangible Assets	420
11.06 Recording Deferred Taxes in a Business Combination on "Inside" and "Outside" Basis Differences	420
11.07 Accounting for the Settlement of a Preexisting Relationship	423
11.08 Reacquired Rights	425
11.09 Income Tax Accounting for Transaction Costs in a Business Combination	427
11.10 Income Tax Accounting for Acquisition-Related Costs Incurred in a Period Before Consummation of a Business Combination	428
11.11 Income Tax Accounting for Acquisition-Related Costs Incurred in a Business Combination	429
11.12 Tax Consequences of Business Combinations Achieved in Stages: Remeasurement of the Original Investment	431
11.13 Tax Consequences of Business Combinations Achieved in Stages: Other Tax Considerations	433
11.14 Accounting for Income Taxes in a Business Combination That Resulted in a Bargain Purchase	435
11.15 Accounting for the Tax Effects of Contingent Environmental Liabilities Assumed in a Business Combination	437
11.16 Research and Development Assets Acquired in a Business Combination	439
11.17 Obtaining Tax Basis Step-Up of Acquired Net Assets Through Payment to a Tax Authority	440
11.18 Income Tax Accounting for Assets Acquired in a Business Combination That Were Subject to an Intra-Entity Sale	440
11.19 Tax Considerations Related to Leveraged Leases Acquired in a Business Combination	440
11.19A Income Tax Benefits From Amortization of Intangible Assets in Fair Value Measurements	441
11.20 Deferred Taxes Associated With Goodwill	442
11.21 Allocation of Tax Amortization of Goodwill	445
11.22 Deferred Taxes Associated With Goodwill in Pre-Statement 141(R) Acquisitions	446
11.23 Tax Benefits of Tax-Deductible Share-Based Payment Awards Exchanged in a Business Combination	449
11.23A Settlement of Share-Based Payment Awards Held by the Acquiree's Employees	457
11.24 Tax Benefits Received From the Disqualifying Disposition of Incentive Stock Options Exchanged in a Business Combination	458
11.25 Revisions to Accounting for a Business Combination After the Measurement Period	461

<b>Measurement</b>	<b>463</b>
11.26 Initial Measurement of the Income Tax Consequences of Contingent Consideration in a Business Combination	464
11.27 Subsequent Measurement of the Income Tax Consequences of Contingent Consideration in a Business Combination	465
11.28 Applicable Tax Rates: Business Combination Accounting	468
11.29 Initial Measurement of the Tax Effects of Contingencies Assumed in a Business Combination	469
11.30 Subsequent Measurement of the Tax Effects of Contingencies Assumed in a Business Combination	470
11.31 Impact of Indefinite-Lived Intangible Assets on Accounting for Income Taxes [Deleted]	474
11.32 Goodwill Impairment Test — Tax Considerations*	474
11.33 Determining the Deferred Tax Effects of a Goodwill Impairment*	477
11.34 Tax Effects of Goodwill Remaining in a Reporting Unit Upon Disposal of a Subsidiary That Was Previously Integrated Into the Reporting Unit*	480
11.35 Accounting for Changes in Forfeiture Estimates Affecting Share-Based Payment Awards Exchanged in a Business Combination	482
<b>Presentation and Disclosure Considerations</b>	<b>486</b>
11.36 Accounting for Changes in the Acquirer's and Acquiree's Valuation Allowances as of and After the Consummation or Acquisition Date	487
11.37 Changes in Uncertain Income Tax Positions Acquired in a Business Combination	488
11.38 Uncertainty in Income Taxes in a Business Combination — Measurement Period	489
<b>Chapter 12 — Foreign Currency Matters</b>	<b>490</b>
12.01 Price-Level-Adjusted Financial Statements	493
12.02 Accounting for Deferred Taxes Related to Nonmonetary Assets and Liabilities When the Functional Currency Is Not the Local Currency	493
12.03 Change in the Functional Currency When an Economy Ceases to Be Considered Highly Inflationary	495
12.04 Deferred Income Tax Effects When the Functional Currency Changes From the Local Currency to the Reporting Currency	496
12.05 Accounting for Deferred Taxes Related to Monetary Assets When the Reporting Currency Is the Functional Currency	500
12.06 Deferred Tax Considerations Related to a Foreign Subsidiary When Intra-Entity Loans That Are of a Long-Term-Investment Nature Are Denominated in the Parent's Currency	503
<b>Chapter 13 — Qualified Affordable Housing Project Investments</b>	<b>506</b>
13.01 Tax Benefits Resulting From Investments in Affordable Housing Projects (Before the Adoption of ASU 2014-01 [Deleted])	506
13.02 Tax Benefits Resulting From Investments in Affordable Housing Projects	511
13.02A Determining Whether an Investor Has the Ability to Exercise Significant Influence Over an Entity That Invests in Qualified Affordable Housing Projects	513
13.03 Applicability of the Proportional Amortization Method to a Qualified Affordable Housing Project Investment That Generates Other Tax Credits in Addition to Affordable Housing Credits	514
13.04 Recognizing Deferred Taxes When the Proportional Amortization Method Is Used to Account for an Investment in a Qualified Affordable Housing Project	515

<b>Appendix A — Implementation Guidance and Illustrations</b>	<b>519</b>
<b>Appendix B — Frequently Asked Questions About Tax Reform*</b>	<b>592</b>
B.1 Introduction	592
B.2 SAB 118	592
B.3 FASB ASU and Staff Q&As	593
B.4 Change in Corporate Tax Rate	593
B.5 Modification of Carryforwards and Certain Deductions	596
B.6 Deemed Repatriation Transition Tax (IRC Section 965)	597
B.7 Global Intangible Low-Taxed Income	602
B.8 Foreign-Derived Intangible Income	608
B.9 Base Erosion Anti-Abuse Tax	609
B.10 Corporate AMT	610
B.11 Non-ASC 740 Topics Affected by Tax Reform	611
B.12 Separate-Company Financial Statements	620
B.13 Disclosure Considerations	620
B.14 IFRS Considerations	625
B.15 Interim Reporting Considerations	625
B.16 ASU 2018-02	631
<b>Appendix C — Glossary of Terms in the ASC 740 Topic and Subtopics</b>	<b>638</b>
<b>Appendix D — Sample Disclosures of Income Taxes</b>	<b>648</b>
<b>Appendix E — Sample SEC Comments: Income Taxes</b>	<b>671</b>
<b>Appendix F — Differences Between U.S. GAAP and IFRS Standards*</b>	<b>695</b>
<b>Appendix G — Titles of Standards and Other Literature</b>	<b>707</b>
<b>Appendix H — Abbreviations</b>	<b>714</b>

# Preface

To our friends and clients:

We're pleased to present the 2018 edition of *A Roadmap to Accounting for Income Taxes*. This Roadmap provides Deloitte's insights into and interpretations of the income tax accounting guidance in ASC 740<sup>1</sup> and the differences between that standard and IFRS® Standards (in [Appendix F](#)). The income tax accounting framework has been in place for many years; however, views on the application of that framework to current transactions continue to evolve because structures and tax laws are continually changing. Therefore, use of this Roadmap, though it is intended as a helpful resource, is not a substitute for consultation with Deloitte professionals on complex income tax accounting questions or transactions.

The body of this Roadmap combines the income tax accounting rules from ASC 740 with Deloitte's interpretations and examples in a comprehensive, reader-friendly format. The Roadmap's organization mirrors the order of ASC 740 and reflects ASUs issued through September 30, 2018. Each chapter of this publication typically starts with a brief introduction and includes excerpts from ASC 740, Deloitte's interpretations of those excerpts, and examples to illustrate the relevant guidance. The Roadmap includes pending content from recently issued ASUs, some of which may already apply to some entities or for which early adoption may be permitted. Readers should refer to the transition guidance in the ASC or in the relevant ASU to determine the effective date(s) of the pending guidance.

Throughout the Roadmap, new guidance has been added and minor edits have been made to existing guidance to improve its clarity. The numbering of items within each chapter is unchanged from the numbering used in the 2017 edition of the Roadmap; items that are new to the Roadmap have been inserted in a logical sequence in the appropriate chapter and assigned an item number with a letter suffix. An asterisk in the section title in the table of contents denotes items that are new or have been significantly amended since the previous edition of the Roadmap. Items without asterisks are unchanged from the previous edition. In addition, [Appendix B](#) has been added and contains responses to frequently asked questions (FAQs) about how an entity should account for the tax effects of the Tax Cuts and Jobs Act (the "Act"), signed into law by the president in December 2017, in accordance with ASC 740. However, the content in Chapters 1 through 13 has not been updated to address the impact of the legislation's provisions on the accounting for income taxes under ASC 740. The updated content will be included in a subsequent edition.

Where applicable, we also include cross-references linking to other Roadmap paragraphs (links are in blue; as a reminder, use [alt] and [left arrow] to return to the paragraph you were originally reading).

Subscribers to the [Deloitte Accounting Research Tool \(DART\)](#) may access any interim updates to this publication by selecting the document from the "Roadmaps" tab on DART's home page. If a "Summary of Changes Since Issuance" displays, subscribers can view those changes by clicking the related links or by opening the "active" version of the Roadmap.

We hope that you find this Roadmap a useful tool when considering the income tax accounting guidance.

Sincerely,

Deloitte & Touche LLP

<sup>1</sup> For the full titles of standards, topics, and regulations, see [Appendix G](#). For the full forms of abbreviations, see [Appendix H](#).

# Contacts

If you have questions about the information in this publication, please contact any of the following Deloitte professionals:



**Matt Himmelman**  
Partner  
Deloitte & Touche LLP  
+1.714.436.7277  
[mhimmelman@deloitte.com](mailto:mhimmelman@deloitte.com)



**Steve Barta**  
Partner  
Deloitte & Touche LLP  
+1.415.783.6392  
[sbarta@deloitte.com](mailto:sbarta@deloitte.com)



**Paul Vitola**  
Partner  
Deloitte Tax LLP  
+1.602.234.5143  
[pvitola@deloitte.com](mailto:pvitola@deloitte.com)



**Patrice Mano**  
Partner  
Deloitte Tax LLP  
+1.415.783.6079  
[pmano@deloitte.com](mailto:pmano@deloitte.com)

# Executive Summary

The following is a brief summary of the Roadmap's 13 chapters and 8 appendixes, which includes guidance that has been amended or added to this edition. Further, this edition includes FAQs and interpretive guidance related to the Act in [Appendix B](#). The content in Chapters 1 through 13 has not been updated to address the impact of the legislation's provisions on the accounting for income taxes under ASC 740. The updated content will be included in a subsequent edition.

- [Chapter 1, "Overview"](#) — Includes excerpts from the overview and objectives subsection of ASC 740 as well as a brief summary of the evolution of the income tax accounting guidance.
- [Chapter 2, "Scope"](#) — Discusses the differences between taxes that are within the scope of ASC 740 (i.e., income taxes) and taxes that are not considered income taxes and therefore are accounted for under other U.S. GAAP.
- [Chapter 3, "Recognition and Derecognition"](#) — Contains comprehensive recognition guidance on all transactions that are within the scope of ASC 740 as well as on the exceptions to the recognition criteria. Specific topics covered include when a tax position taken or expected to be taken on a tax return meets the ASC 740 recognition criteria; determining the unit of account to use in applying those criteria; when recognition or derecognition is warranted after the original assessment of the criteria; examples of temporary differences; and other special circumstances in which recognition consideration is warranted, such as changes in tax laws, rates, or tax status.
- [Chapter 4, "Measurement"](#) — Expands on many of the topics that are introduced in Chapter 3, "Recognition and Derecognition." This chapter provides guidance on the amount at which an entity should measure a tax asset or liability in its financial statements when the recognition criteria for that asset or liability have been met (as discussed in Chapter 3). Specifically, this chapter focuses on (1) the appropriate tax rate to be used, (2) how uncertainty should be considered, and (3) how to evaluate DTAs for realizability and when a valuation allowance would be appropriate.
- [Chapter 5, "Presentation,"](#) and [Chapter 6, "Disclosure"](#) — Provide general guidance on presentation and disclosure matters related to the statement of financial position, income statement, and footnotes for income taxes. See also [Appendix D](#), which contains comprehensive disclosure examples (discussed below).
- [Chapter 7, "Intraperiod Tax Allocation"](#) — ASC 740 prescribes an accounting model, known as "intraperiod tax allocation," for allocating an entity's total annual income tax provision among continuing operations and the other components of an entity's financial statements (e.g., discontinued operations, OCI, and shareholders' equity). Although it may appear simple, this model is one of the more challenging aspects of income tax accounting. This chapter provides insights (including illustrations) into some of the complexities associated with intraperiod tax allocation. Updates to this chapter include the following added guidance:
  - 7.25 — Accounting for the Tax Effects of Contributions to Pass-Through Entities in Control-to-Control Transactions.

- **Chapter 8, "Other Considerations or Special Areas"** — Provides accounting and disclosure guidance on specific matters related to investments in subsidiaries and corporate joint ventures, including guidance on applying ASC 740 to the (1) tax consequences of undistributed earnings of subsidiaries, (2) change in ownership basis of subsidiaries, and (3) recognition of certain DTAs and DTLs. This chapter also covers presentation and disclosure issues not discussed in other chapters of this Roadmap.
- **Chapter 9, "Interim Reporting"** — The core principle of ASC 740-270 is that the interim period is integral to the entire financial reporting year. This chapter describes the general process for allocating an entity's annual tax provision to its interim financial statements. This chapter also discusses estimating an entity's annual effective tax rate (AETR), which is determined and updated in each interim reporting period.
- **Chapter 10, "Share-Based Compensation"** — This chapter provides recognition, measurement, and presentation guidance on the tax effects of share-based payment awards. It also includes guidance on interim reporting of tax effects of share-based payment awards and other related topics.
- **Chapter 11, "Business Combinations"** — Addresses the income tax considerations related to business combinations. In particular, the chapter focuses on some of the more challenging aspects of the business combination accounting guidance, such as contingent consideration, bargain purchases, acquisition costs, reacquired rights, preacquisition contingencies, and goodwill. Updates to this chapter include the following amended guidance:
  - 11.32 — Goodwill Impairment Test — Tax Considerations.
  - 11.33 — Determining the Deferred Tax Effects of a Goodwill Impairment.
  - 11.34 — Tax Effects of Goodwill Remaining in a Reporting Unit Upon Disposal of a Subsidiary That Was Previously Integrated Into the Reporting Unit.
- **Chapter 12, "Foreign Currency Matters"** — This chapter provides guidance on deferred income tax accounting for changes in tax or financial reporting bases that are the result of (1) changes in an entity's functional currency, (2) price-level-related changes, and (3) differences between a foreign entity's functional and local currency.
- **Chapter 13, "Qualified Affordable Housing Project Investments"** — Addresses ASU 2014-01, which provides guidance on accounting for investments in projects that qualify for affordable housing tax credits under U.S. federal tax law. This chapter provides guidance for circumstances in which an entity has adopted ASU 2014-01.
- **Appendix A** — Contains implementation guidance and illustrations from ASC 740.
- **Appendix B** — Contains responses to FAQs about how an entity should account for the tax effects of the Act in accordance with ASC 740.
- **Appendix C** — Contains excerpts from the ASC 740 glossary of terms that are important to the accounting for income taxes.
- **Appendix D** — Includes comprehensive disclosure examples.
- **Appendix E** — Comprises a sample of recent SEC comments on income tax matters, which may be particularly useful for SEC registrants.
- **Appendix F** — A comprehensive discussion of the key differences between U.S. GAAP and IFRS Standards in the accounting for income taxes.
- **Appendix G** — Glossary containing the full titles of topics, standards, and regulations used in the Roadmap.
- **Appendix H** — Glossary containing the full forms of abbreviations used throughout the Roadmap.

# Chapter 1 — Overview

The accounting for income taxes under ASC 740 is sometimes very specific and can be complex. An entity's primary objective in accounting for income taxes under ASC 740 is to reflect its after-tax financial position in its balance sheet. To accomplish this objective, an entity employs the balance sheet model for recording current and deferred taxes. This chapter summarizes the core concepts under ASC 740 and gives an overview of the objectives of accounting for income taxes.

## ASC 740-10

**05-1** The Income Taxes Topic addresses financial accounting and reporting for the effects of income taxes that result from an entity's activities during the current and preceding years. [FAS 109, paragraph 1] Specifically, this Topic establishes standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of all of the following:

- a. Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income
- b. Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting
- c. Operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years. [FAS 109, paragraph 3]

**05-2** This Topic includes the following Subtopics:

- a. Overall
- b. Intraperiod Tax Allocation
- c. Other Considerations or Special Areas
- d. Interim Reporting.

**05-3** The Overall Subtopic provides the majority of the accounting and reporting guidance related to income taxes. The other Subtopics in this Topic provide more detailed guidance on narrower elements of accounting and reporting for income taxes.

## **ASC 740-10 (continued)**

**05-4** Other Topics, including industry-specific Topics, may also have Income Taxes Subtopics that address the Topic-specific requirements for income taxes. Guidance in those Subtopics is intended to be incremental to the guidance otherwise established in the Income Taxes Topic. Topics with incremental Income Taxes Subtopics are:

- a. Investments—Equity Method and Joint Ventures, Subtopic 323-740
- b. Compensation—Stock Compensation, Subtopic 718-740
- c. Business Combinations, Subtopic 805-740
- d. Foreign Currency Matters, Subtopic 830-740
- e. Reorganizations, Subtopic 852-740
- f. Entertainment—Casinos, Subtopic 924-740
- g. Extractive Activities—Oil and Gas, Subtopic 932-740
- h. Financial Services—Depository and Lending, Subtopic 942-740
- i. Financial Services—Insurance, Subtopic 944-740
- j. Health Care Entities, Subtopic 954-740
- k. Real Estate—Common Interest Realty Associations, Subtopic 972-740
- l. Regulated Operations, Subtopic 980-740
- m. U.S. Steamship Entities, Subtopic 995-740.

## **Pending Content (Transition Guidance: ASC 740-10-65-6)**

**05-4** Other Topics, including industry-specific Topics, may also have Income Taxes Subtopics that address the Topic-specific requirements for income taxes. Guidance in those Subtopics is intended to be incremental to the guidance otherwise established in the Income Taxes Topic. Topics with incremental Income Taxes Subtopics are: [ASU 2017-15, paragraph 2]

- a. Investments—Equity Method and Joint Ventures, Subtopic 323-740
- b. Compensation—Stock Compensation, Subtopic 718-740
- c. Business Combinations, Subtopic 805-740
- d. Foreign Currency Matters, Subtopic 830-740
- e. Reorganizations, Subtopic 852-740
- f. Entertainment—Casinos, Subtopic 924-740
- g. Extractive Activities—Oil and Gas, Subtopic 932-740
- h. Financial Services—Depository and Lending, Subtopic 942-740
- i. Financial Services—Insurance, Subtopic 944-740
- j. Health Care Entities, Subtopic 954-740
- k. Real Estate—Common Interest Realty Associations, Subtopic 972-740
- l. Regulated Operations, Subtopic 980-740
- m. Subparagraph superseded by Accounting Standards Update No. 2017-15.

**05-5** There are two basic principles related to accounting for income taxes, each of which considers uncertainty through the application of recognition and measurement criteria:

- a. To recognize the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset
- b. To recognize a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards. [EITF 91-8, paragraph Status]

**ASC 740-10 (continued)**

**05-6** This Subtopic provides guidance for recognizing and measuring tax positions taken or expected to be taken in a tax return that directly or indirectly affect amounts reported in financial statements. This Subtopic also provides accounting guidance for the related income tax effects of individual tax positions that do not meet the recognition thresholds required in order for any part of the benefit of that tax position to be recognized in an entity's financial statements. Under this Subtopic, a tax position is first evaluated for recognition based on its technical merits. Tax positions that meet a recognition criterion are then measured to determine an amount to recognize in the financial statements. That measurement incorporates information about potential settlements with taxing authorities. [FIN 48, paragraphs B9, 2, and B27]

**05-7** A temporary difference refers to a difference between the tax basis of an asset or liability, determined based on recognition and measurement requirements for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Deferred tax assets and liabilities represent the future effects on income taxes that result from temporary differences and carryforwards that exist at the end of a period. Deferred tax assets and liabilities are measured using enacted tax rates and provisions of the enacted tax law and are not discounted to reflect the time-value of money.

**05-8** As indicated in paragraph 740-10-25-23, temporary differences that will result in taxable amounts in future years when the related asset or liability is recovered or settled are often referred to as taxable temporary differences. Likewise, temporary differences that will result in deductible amounts in future years are often referred to as deductible temporary differences. Business combinations may give rise to both taxable and deductible temporary differences. [FAS 109, paragraph 13]

**05-9** As indicated in paragraph 740-10-25-30, certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized. [FAS 109, paragraph 14]

**5-10** As indicated in paragraph 740-10-25-24, some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting. In such instances, there is no related, identifiable asset or liability for financial reporting, but there is a temporary difference that results from an event that has been recognized in the financial statements and, based on provisions in the tax law, the temporary difference will result in taxable or deductible amounts in future years. [FAS 109, paragraph 15]

**Objectives**

**10-1** There are two primary objectives related to accounting for income taxes:

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

As it relates to the second objective, some events do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. In some tax jurisdictions, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible. [FAS 109, paragraph 6]

**10-2** Ideally, the second objective might be stated more specifically to recognize the expected future tax consequences of events that have been recognized in the financial statements or tax returns. However, that objective is realistically constrained because:

- The tax payment or refund that results from a particular tax return is a joint result of all the items included in that return.
- Taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years.
- Information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations. [FAS 109, paragraph 7]

### ASC 740-10 (continued)

**10-3** Conceptually, a deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. That concept is an incremental concept. A literal application of that concept would result in measurement of the incremental tax effect as the difference between the following two measurements:

- a. The amount of taxes that will be payable or refundable in future years inclusive of reversing temporary differences and carryforwards
- b. The amount of taxes that would be payable or refundable in future years exclusive of reversing temporary differences and carryforwards. [FAS 109, paragraph 87]

However, in light of the constraints identified in the preceding paragraph, in computing the amount of deferred tax liabilities and assets, the objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. [FAS 109, paragraph 18]

## 1.01 Overview of ASC 740

As noted in ASC 740-10-10-1, an entity's overall objectives in accounting for income taxes under ASC 740 are to (1) "recognize the amount of taxes payable or refundable for the current year" and (2) "recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns."

Under the prior superseded guidance, the principal objective was matching. That is, total tax expense was determined without regard to timing differences, and the difference between that amount and the actual taxes payable was recorded as a deferred tax. The deferred tax accounts were residuals, reported as either deferred liabilities or assets. These amounts did not, except by coincidence, represent the amount of taxes that would be paid or refunded in a future reporting period.

Other previously superseded guidance was based on a balance sheet approach. This approach focused on the amount of taxes payable or receivable for the future tax return consequences of reporting-date temporary differences. In addition, under this other previously superseded guidance, recognition and measurement of DTAs and DTLs did not anticipate the tax consequences of earning income in future years. Two events were necessary to recognize a DTA: (1) the existence of a deductible temporary difference or tax credit or loss carryforward and (2) income (from taxable temporary differences or prior tax returns) that permitted the realization of the potential benefit. Because the tax consequences of earning income in future years could not be anticipated, this other previously superseded guidance effectively limited the recognition of net DTAs to the amount of the deductible temporary difference or loss that could be carried back to recover previously paid or accrued income taxes.

Under ASC 740, the balance sheet approach was modified to incorporate a "one event" approach to DTA recognition. In accordance with ASC 740, the critical event for recognition of an asset is the event that gives rise to the deductible temporary difference or tax credit or NOL carryforward. Once that event occurs, those tax benefits should be recognized subject to a realizability assessment. In effect, earning taxable income in future years is treated as a confirmation of realizability and not as a prerequisite to asset recognition. At the same time, management should consider future events to record those tax assets at amounts that are more likely than not to be realized in future tax returns. In the case of DTLs, ASC 740 requires an entity to include in its balance sheet an obligation for the tax consequences of taxable temporary differences even when losses are expected in future years.

The following is a brief summary of deferred tax accounting, in general, under ASC 740:

- DTLs are recognized for future taxable amounts.
- DTAs are recognized for future deductions and operating loss and tax credit carryforwards.
- The marginal tax rate is used to measure DTAs and DTLs.
- A valuation allowance is recognized to reduce DTAs to the amounts that are more likely than not to be realized.
- The amount of the valuation allowance is based on all available positive and negative evidence about the future.
- Deferred tax expense or benefit is computed as the difference between the beginning and ending balance of the net DTA or DTL for the period.
- Before the adoption of ASU 2015-17, DTAs and DTLs are classified as current or noncurrent in accordance with the classification of the related asset or liability for financial reporting purposes.
- The effects of changes in rates or laws are recognized on the date of enactment.

## 1.02 Objectives of ASC 740

The overall objective of accounting for income taxes is to reflect (1) the amount an entity currently owes to tax authorities and (2) an asset or liability for the tax effects of the transactions or events that have occurred but that have not yet been reflected in a tax return or vice versa. An asset will be recorded for items that will result in future tax deductions (sometimes referred to as a benefit), and liabilities are recorded for items that will result in the inclusion of future taxable income in an entity's tax return. This balance sheet approach is used to calculate temporary differences that, in effect, take into account the total tax that would be payable (or receivable) if all of an entity's assets and liabilities were realized at their carrying value at a specific time (the reporting date).

In certain situations, an entity may determine that its ability to actually use a deduction for a DTA on a future tax return is uncertain. For example, an entity may have recorded a DTA for accumulated operating losses that it can use to offset future income on future tax returns. However, on the basis of forecasts of future taxable income, the entity determines, using its best estimate, that it most likely will not be able to use all of the accumulated operating losses to offset future taxable income on future tax returns before the attribute expires under tax rules. In this situation, the entity would need to record a valuation allowance to reduce the DTA to the amount it ultimately expects to be able to deduct on its tax return. See [Chapter 4, "Measurement,"](#) for further discussion of valuation allowances.

The total tax provision for a period includes the amount of expense (or benefit) related to the total tax that is expected to be paid (or refunded) in connection with income, expenses, and other events captured in that period's financial statements. This provision consists of current tax expense (benefit) (i.e., the amount expected to be reflected on the current-period income tax return(s)) and deferred tax expense (or benefit) (i.e., change in DTAs and DTLs for the period). Generally, an increase in a DTA and a decrease in a DTL decrease deferred tax expense. Similarly, a decrease in a DTA and an increase in a DTL increase deferred tax expense.

Income tax expense (or benefit) is not just one line item in the income statement. A model known as "intraperiod tax allocation" (see [Chapter 7, "Intraperiod Tax Allocation"](#)) is used to allocate these amounts among other components of an entity's financial statements through discontinued operations, OCI, and shareholders' equity. This allocation also applies to the reporting of information in the interim financial statements. [Chapter 9, "Interim Reporting,"](#) discusses the method for allocating income tax expense (or benefit) among the interim periods on the basis of its core principle that the interim period is an integral component of the entire financial reporting year.

# Chapter 2 — Scope

The scope of ASC 740 can be described as including any tax that is based on income, regardless of how the tax is labeled by a jurisdiction. Although this principle may appear simple, entities must use significant judgment in determining whether a tax is within the scope of ASC 740 because the accounting model for income taxes is very different from the accounting model for other types of taxes that are not within ASC 740's scope. Those non-income taxes are accounted for following the general concepts in U.S. GAAP for the recognition of liabilities or other sections of the Codification, and therefore no deferred taxes are recognized. Uncertainties about whether a non-income tax is required to be paid under the law in particular circumstances generally are accounted for under the contingencies guidance in ASC 450. When a tax is determined to be an income tax, the income tax accounting guidance is required to be applied for each tax-paying component in each tax jurisdiction.

## ASC 740-10

**15-1** The Scope Section of the Overall Subtopic establishes the pervasive scope for all Subtopics of the Income Taxes Topic. Unless explicitly addressed within specific Subtopics, the following scope guidance applies to all Subtopics of the Income Taxes Topic.

### Entities

**15-2** The principles and requirements of the Income Taxes Topic are applicable to domestic and foreign entities in preparing financial statements in accordance with U.S. generally accepted accounting principles (GAAP), including not-for-profit entities (NFP) with activities that are subject to income taxes. [FAS 109, paragraph 4]

**15-2A** Paragraph not used.

**15-2AA** The Sections of this Subtopic relating to accounting for uncertain tax positions are applicable to all entities, including tax-exempt not-for-profit entities, pass-through entities, and entities that are taxed in a manner similar to pass-through entities such as real estate investment trusts and registered investment companies. [ASU 2009-06, paragraph 3]

### Transactions

**15-3** The guidance in the Income Taxes Topic applies to:

- a. Domestic federal (national) income taxes (U.S. federal income taxes for U.S. entities) and foreign, state, and local (including franchise) taxes based on income
- b. An entity's domestic and foreign operations that are consolidated, combined, or accounted for by the equity method. [FAS 109, paragraph 4]

**ASC 740-10 (continued)**

**15-4** The guidance in this Topic does not apply to the following transactions and activities:

- a. A franchise tax to the extent it is based on capital and there is no additional tax based on income. If there is an additional tax based on income, that excess is considered an income tax and is subject to the guidance in this Topic. See Example 17 (paragraph 740-10-55-139) for an example of the determination of whether a franchise tax is an income tax. [EITF 91-8, paragraph Discussion]
- b. A withholding tax for the benefit of the recipients of a dividend. A tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and is not an income tax if both of the following conditions are met:
  1. The tax is payable by the entity if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the entity would otherwise pay.
  2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders. [EITF 95-9, paragraph Discussion]

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

**Related Implementation Guidance and Illustrations**

- [Treatment of Certain Payments to Taxing Authorities](#) [ASC 740-10-55-67].
- [Example 17: Determining Whether a Tax Is an Income Tax](#) [ASC 740-10-55-139].

## 2.01 Taxes Within the Scope of ASC 740

ASC 740 clearly indicates that “income taxes” are the only taxes within its scope. ASC 740-10-20 defines income taxes as “[d]omestic and foreign federal (national), state, and local (including franchise) taxes based on income,” and it 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.”

Although ASC 740 provides no further guidance on this matter, the term “taxes based on income” implies a tax system in which the tax payable is calculated on the basis of the entity’s revenue minus the costs allowed by the jurisdiction being considered. For the tax to be an income tax, the tax computation would not need to include all income statement accounts but should include some determination that would be meaningful to most taxpayers or meaningful in relation to the specific income being taxed. A tax levied on a subset of the income statement, such as a tax on net investment income (i.e., a tax on investment income less investment-related expenses), would also qualify as a tax based on income since it would be computed on the basis of a portion of net income less expenses incurred to generate the income.

As explained above, the scope of ASC 740 is limited to “taxes based on income” when income is determined after revenues and gains are reduced by some amount of expenses and losses allowed by the jurisdiction. Therefore, a tax based solely on revenues (e.g., gross receipts or sales tax) would not be within the scope of ASC 740 because the taxable base amount is not reduced by any expenses. A tax based on gross receipts, revenue, or capital should be accounted for under other applicable literature (e.g., ASC 450). In contrast, a tax whose base takes into account both income and expenses is within the scope of ASC 740.

For example, not-for-profit foundations that make certain minimum distributions are generally exempt from federal income taxes but may be subject to an excise tax on their net investment income. Such an excise tax meets the definition of a tax based on income and therefore is within the scope of ASC 740. Alternatively, in some jurisdictions, qualifying entities may be subject to an excise tax (e.g., based on a percentage of assets or sales) in lieu of an income tax. Although this tax is levied in lieu of an income tax, it is not based on a measure of income and therefore is not within the scope of ASC 740.

## **2.02 Hybrid Taxes**

In a hybrid tax regime, an entity pays the greater of two tax computations, one of which is typically based on taxable profit and the other of which is not (e.g., it is based on gross revenue or capital). The tax rules and regulations of such a regime may state that an entity must always pay income tax but must also calculate taxes on the basis of the non-income-based measure(s). To the extent that the non-income-based measure or measures result in a larger amount, the entity would pay the difference between the income tax and the amount determined by using the non-income-based measure. This distinction may affect how the tax authority in the jurisdiction can use the tax revenue (e.g., income tax revenue may be used for general purposes, but the incremental tax may be earmarked for a specific purpose). The description of the amounts paid in the tax rules and regulations does not affect how a reporting entity determines the component of the hybrid taxes that is considered an income tax for accounting purposes.

When paying taxes in a hybrid tax regime, the basis for determining which taxes qualify as income taxes under ASC 740 may not always be clear, especially when certain taxes appear to have characteristics of both an income tax and a gross-revenue or capital-based tax. ASC 740-10-15-4 and the related implementation guidance beginning in ASC 740-10-55-139 establish a framework that should be applied to all hybrid tax regimes. More specifically, an entity should consider the various tax computations that can apply for the year. The non-income-tax component can be identified on the basis of the amount of tax that would be payable if the entity has no taxable income. In other words, the amount payable in the absence of income would be a non-income tax that is outside the scope of ASC 740. The tax payable for the year in excess of the portion that is considered a non-income tax would be an income tax and within the scope of ASC 740.

For example, an entity in a certain jurisdiction may be subject to tax that is determined on the basis of the greater of taxable income multiplied by an income tax rate or net equity multiplied by a capital tax rate. Alternatively, an entity may be subject to tax in a jurisdiction in which the regular corporate tax is based on the greater of a production-based computation or a profit-based computation (i.e., the production-based computation is a fixed minimum amount per ton of product sold, but the total tax due based on profits may exceed the production-based computation). In either of these jurisdictions, an entity should determine the amount of tax that would be payable in the absence of taxable profit. The amount payable in the absence of taxable income (i.e., the “floor” amount) is based on something other than taxable income and is therefore outside the scope of ASC 740 and should be included in pretax income. The floor amount should be included in pretax income, even if the total amount of taxes payable for the year is actually a tax on taxable profits (the latter being the greater of the two computations). Amounts payable in excess of the floor that result from an income tax computation are considered to be a tax based on income and are therefore within the scope of ASC 740.

**Example 2-1**

Assume that the regular corporate tax in Country A is based on the greater of 25 percent of taxable profit or 1 percent of net equity as of the last day of the prior year.

Assume that an entity's net equity as of the last day of the prior year is \$800,000 and that pretax income in the current year is \$80,000. The current tax computation is as follows:

Book pretax income	\$ 80,000	
Originating taxable temporary difference	<u>3,000</u>	
Taxable income	<u><u>\$ 77,000</u></u>	
Current tax payable (based on income)	\$ 19,250	(77,000 × 25%)
Capital tax ("floor" amount) that is considered to be outside the scope of ASC 740	<u>8,000</u>	(800,000 × 1%)
Current tax within the scope of ASC 740	<u><u>\$ 11,250</u></u>	

## 2.03 Accounting for Taxes Assessed on the Payor of a Dividend

Most taxes on dividends are assessed on the recipient of the dividend but are withheld by the payor. In these instances, the payment of the tax withheld (sometimes referred to as a "withholding tax") to the tax authority by the dividend payor is accounted for by the payor in its financial statements in equity as a part of the dividend. The "withholding tax" may still, however, be viewed as an income tax from the point of view of the recipient of the dividend since the tax is paid on behalf of the recipient.

However, in some jurisdictions, a tax based on dividends distributed is assessed directly on the dividend payor.

A tax assessed directly on an entity on the basis of dividends it has distributed may, under certain circumstances, be considered a withholding of tax for the benefit of the recipient and therefore accounted for in equity as part of the dividend (rather than as an expense of the payor).

ASC 740-10-15-4(b) states, in part:

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

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

If either of these criteria are not met, a tax assessed directly on the dividend payor should not be considered a withholding of tax for the benefit of the recipient. Instead, it should be accounted for by the payor as an income tax within the scope of ASC 740 or as a "non-income based" tax, depending on the substance of the tax.

If the tax is accounted for as an income tax within the scope of ASC 740, any tax benefit to the payor resulting from payment of the withholding tax should be recognized as income from continuing operations.

## 2.03A Accounting for Taxes Withheld on Certain Payments (e.g., Dividend, Interest, Royalty, or License)

ASC 740 does not provide guidance on determining whether recipients of certain payments (e.g., dividends or royalties) should account for associated statutory withholdings (commonly referred to as withholding taxes) as income taxes within the scope of ASC 740. Generally, the scope of ASC 740 is limited to "taxes based on income," and income is determined after revenues and gains are reduced by some amount of expenses and losses allowed by the jurisdiction. Therefore, a tax based solely on revenues would not be within the scope of ASC 740 because the taxable base amount is not reduced by any expenses. A tax based on gross receipts, revenue, or capital should be accounted for under other applicable literature (e.g., ASC 450).

ASC 740-10-55-24 states the following regarding taxes withheld from dividends:

Deferred tax liabilities and assets are measured using enacted tax rates applicable to capital gains, ordinary income, and so forth, based on the expected type of taxable or deductible amounts in future years. For example, evidence based on all facts and circumstances should determine whether an investor's liability for the tax consequences of temporary differences related to its equity in the earnings of an investee should be measured using enacted tax rates applicable to a capital gain or a dividend. **Computation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related dividends received deductions or foreign tax credits, and taxes that would be withheld from the dividend.**

[Emphasis added]

It can be inferred from this guidance that the FASB intended withholding taxes on dividends to be a component of income taxes. However, ASC 946-225-45-3 discusses the presentation of certain items in the statement of operations of an investment company and suggests that withholding taxes might, in fact, be considered as "other taxes." ASC 946-225-45-3 states, in part:

All of the following expenses are commonly reported separately: . . .

- g. Federal and state income taxes (these expenses shall be shown separately after the income category to which they apply, such as investment income and realized or unrealized gains)
- h. Other taxes (foreign withholding taxes shall be deducted from the relevant income item and disclosed parenthetically or shown as a separate contra item in the income section).

For a discussion on how to determine whether a withholding tax represents an income tax of the payor, see ASC 740-10-15-4 and [2.03](#) on accounting for taxes assessed on the payor of a dividend. In circumstances in which the withholding tax is determined not to be an income tax of the payor, questions often arise about whether it should be accounted for by the recipient as an income tax within the scope of ASC 740.

The recipient of a dividend or other payment that is subject to withholding tax should account for the withholding tax on the basis of its facts and circumstances. Relevant questions (not all inclusive or individually determinative) include the following:

- *If the recipient had qualifying expenditures in the local jurisdiction or had established a local presence, would the withholding tax be adjusted accordingly (i.e., would it not apply, or would it be reflected as an estimated tax payment on the income tax return)?*

The fact that the taxable income would be adjusted if there were qualifying expenditures would be a strong indicator that the withholding tax should be considered an income tax.

- *Is the payment effectively a distribution from the earnings of the paying entity? That is, is it a dividend and not a return of capital or other expense?*

If the amount was paid out of earnings of the paying entity, the withholding tax may represent an incremental layer of tax, imposed on the recipient, on the income of the payor. For example, although a dividend itself may seem to be revenue rather than income to the recipient (i.e., the recipient has not been able to directly reduce the dividend by expenses), the withholding tax is assessed on a net income figure (i.e., the paying entity has incurred expenses on its revenues) at the time of distribution. Therefore, the recipient has indirectly been allowed a deduction for the expenses associated with the revenue upon which the dividend is based given that the paying entity has taken these deductions before making the dividend.

- *Is the withholding tax creditable on an income tax return filed by the receiving entity or by the receiving entity's parent?*

While the ability to take a credit for the tax on an income tax return would not itself indicate that the tax is an income tax, many of the criteria used to evaluate whether the tax is creditable would most likely be relevant in the determination of whether the tax is an income tax for U.S. GAAP purposes

## 2.04 Refundable Tax Credits

Credits whose realization ultimately depends on taxable income (e.g., investment tax credits and R&D credits) are generally recognized as a reduction of income tax, regardless of whether they are accounted for under the flow-through method or the deferral method (as described in ASC 740-10-25-45 and 25-46).

Certain tax jurisdictions provide refundable credits (e.g., qualifying R&D credits in certain countries and state jurisdictions and alternative fuel tax credits for U.S. federal income tax) that do not depend on the entity's ongoing tax status or tax position (e.g., an entity may receive a refund despite being in a taxable loss position).

If realization of the tax credit does not depend on the entity's generation of future taxable income or the entity's ongoing tax status or tax position, the credit is not considered an element of income tax accounting under ASC 740. Thus, even if the credit claims are filed in connection with a tax return, the refunds are not considered part of income taxes and therefore are not within the scope of ASC 740. In such cases, an entity would not record the credit as a reduction of income tax expense; rather, the entity should determine the credit's classification on the basis of its nature.

When determining the classification of these credits, an entity may consider them to be a form of government grant or assistance. An entity may look to paragraphs 24 and 29 of IAS 20 for guidance on government grants. Under paragraph 24 of IAS 20, an entity presents government grants related to assets "either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset." Furthermore, paragraph 29 of IAS 20 states, "Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other Income'; alternatively, they are deducted in reporting the related expense."

In rare circumstances, a tax law may change the way a tax credit is realized. For example, a jurisdiction may have historically required that a credit be realized on the tax return as a reduction in taxes payable but subsequently changes the law so that the credit can be realized without an entity's first incurring a tax liability (i.e., the credit amount becomes refundable but was not when it arose). In this situation, an entity would generally continue to apply ASC 740 to the credits recognized at the time of the law change.

Any new refundable credits earned after the tax law change would be accounted for in accordance with the guidance in this section.

## **2.05 Income Tax Indemnifications Upon Sale of a Subsidiary That Previously Filed a Separate Tax Return**

In a business combination, it is common for one party to indemnify the other for a particular contingency. These indemnification agreements are sometimes related to income tax positions taken by the seller. For example, assume that Company A enters into an agreement to sell 100 percent of the outstanding stock in its wholly owned subsidiary, Company Z, to Company B. Before the sale, Z files a separate tax return in which a tax position is taken that requires the recognition of a liability for a UTB. As part of the purchase agreement, A indemnifies B for any future settlement with the tax authority in connection with the uncertain tax position taken by Z in its prior tax return. See [5.03](#) for accounting and presentation guidance on indemnification assets.

Because Z filed a separate tax return, A is not directly liable for any of Z's tax obligations after the sale. By indemnifying B for any loss related to Z's prior tax positions, however, A has entered into a guarantee contract, which would generally be within the scope of ASC 460 (see ASC 460-10-15-4(c) and ASC 460-10-55-13(c)).

Therefore, A would generally recognize a guarantee liability on the sale date and on each reporting date thereafter in accordance with the recognition and measurement provisions of ASC 460.

To the acquirer in such a business combination — B, in this scenario — A's indemnification with respect to Z may be an asset that must be recognized under ASC 805. [5.03](#) provides interpretive guidance, including examples, related to the acquirer's accounting in such circumstances.

### **Example 2-2**

Assume the following:

- The uncertain tax benefit is \$100.
- Settlement of the indemnification liability would result in a deduction for the seller.
- The guarantee is within the scope of ASC 460, and the initial guarantee liability determined under ASC 460 is \$90.
- Company A has an effective tax rate of 40 percent.
- For A, the disposition of Z does not qualify for presentation as a discontinued operation in accordance with ASC 205-20.

The following entries illustrate A's accounting for the UTB upon the sale of Z:

To record the indemnification liability (recognition would adjust the seller's gain and loss on sale):

Gain/loss on sale	90
Indemnification liability	90
To record the deductible temporary difference related to the difference between the reported amount and the tax basis of the indemnification liability (i.e., 40% of \$90):	
DTA	36
Deferred tax benefit	36

**Example 2-2 (continued)**

If the UTB liability were ultimately settled with the tax authority for \$75, Z would make a cash payment to the tax authority and A would make a cash payment to B in satisfaction of its indemnification liability. The following entries illustrate A's accounting upon settlement:

To record the settlement of its indemnification liability — by transferring cash to B — for less than the recorded amount of the guarantee liability:

Indemnification liability	90
Cash	75
Gain/loss on settlement	15

To record the reduction in taxes payable related to the deduction for the payment of the indemnification and reduction and reversal of the related DTA, resulting in a net tax expense of \$6 (\$15 gain on settlement × 40%):

Deferred tax expense	36
DTA	36
Current tax payable	30
Current tax expense	30

# Chapter 3 — Recognition and Derecognition

This chapter provides guidance on what types of assets and liabilities are recognized in accordance with ASC 740 and when those assets and liabilities should be recognized. The most typical types of assets and liabilities that are recognized in accordance with ASC 740 are DTAs and DTLs that arise as a result of temporary differences that exist as of the reporting date. A temporary difference is a difference between the financial reporting basis and the income tax basis, determined in accordance with the recognition and measurement criteria of ASC 740 (see [3.43](#) for additional guidance on this term as used herein), of an asset or liability that will result in a taxable or deductible item in future years when the financial reporting basis of the asset or liability is recovered or settled, respectively.

More specifically, this chapter provides guidance on when a tax position taken or expected to be taken on an originally filed or amended tax return or presented as an affirmative issue upon examination meets the ASC 740 recognition criteria; determining the unit of account to use in applying those criteria; when recognition or derecognition is warranted after the original assessment of the criteria; examples of temporary differences; and other special circumstances in which recognition consideration is warranted, such as changes in tax laws, rates, or tax status.

## General Recognition Approach

### ASC 740-10

**25-1** This Section establishes the recognition requirements necessary to implement the objectives of accounting for income taxes identified in Section 740-10-10. The following paragraph sets forth the basic recognition requirements while paragraph 740-10-25-3 identifies specific, limited exceptions to the basic requirements.

**25-2** Other than the exceptions identified in the following paragraph, the following basic requirements are applied in accounting for income taxes at the date of the financial statements:

- a. A tax liability or asset shall be recognized based on the provisions of this Subtopic applicable to tax positions, in paragraphs 740-10-25-5 through 25-17, for the estimated taxes payable or refundable on tax returns for the current and prior years.
- b. A deferred tax liability or asset shall be recognized for the estimated future tax effects attributable to temporary differences and carryforwards. [FAS 109, paragraph 8]

**ASC 740-10 (continued)**

**25-3** The only exceptions in applying those basic requirements are:

- a. Certain exceptions to the requirements for recognition of deferred taxes [FAS 109, paragraph 9] whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:
  1. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.
  2. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.
  3. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.
  4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. See paragraph 944-740-25-2 for the specific requirements related to this exception. [FAS 109, paragraph 31]
- b. Recognition of temporary differences related to deposits in statutory reserve funds by U.S. steamship entities (see paragraph 995-740-25-2). [FAS 109, paragraph 9]
- c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases [FAS 109, paragraph 256] as required by Subtopic 840-30.
- d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3).
- e. A prohibition on recognition of a deferred tax asset for the intra-entity difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements. Income taxes paid on intra-entity profits on assets remaining within the group are accounted for under the requirements of Subtopic 810-10.
- f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. [FAS 109, paragraph 9] See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

## **ASC 740-10 (continued)**

### **Pending Content (Transition Guidance: ASC 740-10-65-5)**

**25-3** The only exceptions in applying those basic requirements are:

- a. Certain exceptions to the requirements for recognition of deferred taxes [FAS 109, paragraph 9] whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future: [FAS 109, paragraph 31]
  1. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.
  2. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.
  3. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.
  4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. See paragraph 944-740-25-2 for the specific requirements related to this exception. [FAS 109, paragraph 31]
- b. Recognition of temporary differences related to deposits in statutory reserve funds by U.S. steamship entities (see paragraph 995-740-25-2)
- c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases [FAS 109, paragraph 256] as required by Subtopic 840-30
- d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3)
- e. A prohibition on recognition of a deferred tax asset for the difference between the tax basis of inventory in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements [FAS 109, paragraph 9] as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group. [ASU 2016-16, paragraph 4] Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.
- f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. [FAS 109, paragraph 9] See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

**ASC 740-10 (continued)****Pending Content (Transition Guidance: ASC 740-10-65-6)**

**25-3** The only exceptions in applying those basic requirements are:

- a. Certain exceptions to the requirements for recognition of deferred taxes [FAS 109, paragraph 9] whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future: [FAS 109, paragraph 31]
  1. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.
  2. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.
  3. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.
  4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. See paragraph 944-740-25-2 for the specific requirements related to this exception. [FAS 109, paragraph 31]
- b. Subparagraph superseded by Accounting Standards Update No. 2017-15
- c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Subtopic 840-30
- d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3)
- e. A prohibition on recognition of a deferred tax asset for the difference between the tax basis of inventory in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements [FAS 109, paragraph 9] as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group. [ASU 2016-16, paragraph 4] Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.
- f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. [FAS 109, paragraph 9] See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

## **ASC 740-10 (continued)**

### **Pending Content (Transition Guidance: ASC 842-10-65-1)**

**25-3** The only exceptions in applying those basic requirements are:

- a. Certain exceptions to the requirements for recognition of deferred taxes [FAS 109, paragraph 9] whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:
  1. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.
  2. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. See paragraphs 740-30-25-18 through 25-19 for the specific requirements related to this exception.
  3. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.
  4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. See paragraph 944-740-25-2 for the specific requirements related to this exception. [FAS 109, paragraph 31]
- b. Recognition of temporary differences related to deposits in statutory reserve funds by U.S. steamship entities (see paragraph 995-740-25-2) [FAS 109, paragraph 9]
- c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases [FAS 109, paragraph 256] as required by Subtopic 842-50
- d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3)
- e. A prohibition on recognition of a deferred tax asset for the difference between the tax basis of inventory in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements [FAS 109, paragraph 9] as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group. [ASU 2016-16, paragraph 4] Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.
- f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. [FAS 109, paragraph 9] See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

**25-4** References in this Subtopic to income taxes currently payable and (total) income tax expense are intended to also include income taxes currently refundable and (total) income tax benefit, respectively. [FAS 109, paragraph 10]

## 3.01 Exceptions to Recognition of Deferred Taxes

ASC 740 focuses on the exceptions to the recognition criteria before getting into the specifics of the criteria; accordingly, this section will address those exceptions first. Also see [Chapter 8, "Other Considerations or Special Areas,"](#) for further guidance on the exceptions to recognition of income taxes.

ASC 740-30-25-17 indicates that if specific "indefinite reversal criteria" are met, an entity is required to ignore the deferred tax consequences of certain temporary differences for financial reporting purposes. These exceptions are based on the belief that certain originating temporary differences between taxable income and pretax accounting income are related to transactions that either may not reverse until indefinite future periods or may never reverse.

The guidance below clarifies some of the common terms used in discussing the recognition exceptions in ASC 740.

## 3.02 Definition of Subsidiary and Corporate Joint Venture

When applying the requirements in ASC 740-10-25-3(a)(1), an entity should use the following guidance to determine whether an investment is in either a subsidiary or a corporate joint venture:

ASC 810-10-20 defines a subsidiary as follows:

An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)

However, ASC 740-10-20 does not specifically define the term "subsidiary" and does not refer to the definition in ASC 810-10. Rather, in practice, the original definition in Opinion 18 (codified in ASC 323) has been applied. That guidance stated that "subsidiary" referred to "a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock." Accordingly, while the definition in ASC 810 includes partnerships and trusts, those entities are not considered subsidiaries under ASC 740 because the earnings of such entities generally pass directly through to their owners. See [8.06](#) for further discussion of pass-through entities.

The term corporate joint venture is defined in ASC 740-10-20 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.

### 3.03 Definition of Foreign and Domestic Investments

ASC 740-10-25-3(a)(1) contains an exception to the requirement to provide a DTL for the “excess of the amount for financial reporting over the tax basis of an investment in a **foreign** subsidiary or a **foreign** corporate joint venture” (emphasis added), while ASC 740-30-25-7 contains an exception to the requirement to provide a DTL for the “excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned **domestic** subsidiary” (emphasis added). Accordingly, it is important to determine whether to treat an entity as a foreign or domestic entity.

An entity should determine whether an investment is foreign or domestic on the basis of the relationship of the investee to the tax jurisdiction of its immediate parent rather than the relationship of the investee to the ultimate parent of the consolidated group. This determination should be made from the “bottom up” through successive tiers of consolidation. At each level, it is necessary to determine whether the subsidiaries being consolidated are foreign or domestic with respect to the consolidating entity. A subsidiary that is treated as a domestic subsidiary under the applicable tax law of its immediate parent would be considered a domestic subsidiary under ASC 740. Examples 3-1 through 3-5 illustrate this concept.

#### Example 3-1

A U.S. parent entity, P, has a majority-owned domestic subsidiary, S1, which has two investments: (1) a majority ownership interest in a foreign entity, FS1, and (2) an ownership interest in a foreign corporate joint venture, FJV1. In preparing its consolidated financial statements, S1 consolidates FS1 and applies the equity method of accounting to its investment in FJV1. Under ASC 740, S1 would consider its investments in FS1 and FJV1 to be in a **foreign subsidiary** and **foreign corporate joint venture**, respectively. Parent P would treat S1 as a **domestic subsidiary** when consolidating S1.

#### Example 3-2

A U.S. parent entity, P, has a majority ownership interest in a subsidiary (chartered in a foreign country), FS, which has two investments: (1) a majority ownership interest in another entity, S1, and (2) an ownership interest in another corporate joint venture entity, S2. Both S1 and S2 are located in the same foreign country in which FS is chartered. When preparing its consolidated financial statements, FS would consider S1 and S2 a **domestic subsidiary** and **domestic corporate joint venture**, respectively, in determining whether to recognize deferred taxes in the foreign country on the outside basis difference of FS's investments in S1 and S2. Parent P would consider FS a **foreign subsidiary**.

#### Example 3-3

A foreign parent entity, FP, prepares U.S. GAAP financial statements and has two investments: (1) a majority-owned investment in a U.S. entity, US1, and (2) an investment in a corporate joint venture located in the United States, JVUS1. In preparing its consolidated financial statements, FP would consider US1 and JVUS1 a **foreign subsidiary** and a **foreign corporate joint venture**, respectively.

#### Example 3-4

A foreign entity, FP2, prepares U.S. GAAP financial statements and has two investments: (1) a majority-owned investment in another entity, S1, and (2) an investment in a corporate joint venture, JV1. Both S1 and JV1 are located in the same foreign country in which FP2 is chartered. In preparing its consolidated financial statements, FP2 would consider S1 and JV1 a **domestic subsidiary** and a **domestic corporate joint venture**, respectively.

**Example 3-5**

A U.S. parent entity, P, has a majority ownership interest in a subsidiary (chartered in a foreign country), FS, that has two investments: (1) a majority ownership interest in another entity, S1, located in the same foreign country in which FS is chartered, and (2) an investment in a corporate joint venture located in the United States, JVUS1. Before being consolidated by P, FS would consolidate S1 as a **domestic subsidiary** and would apply the equity method of accounting to JVUS1, as a **foreign corporate joint venture** to determine whether to recognize deferred taxes on the outside basis difference of its investments in S1 and JVUS1.

Some of the recognition exceptions in ASC 740 concern temporary differences associated with inside basis differences, while others relate to outside basis differences. While these terms are commonly used in relation to ASC 740, they are not defined in that guidance; see below for our definition.

### **3.04 Definition of “Inside” and “Outside” Basis Differences**

A basis difference arises when there is a difference between the financial reporting amount of an asset or liability and its tax basis, as determined by reference to the relevant tax laws in each tax jurisdiction. There are two categories of basis differences: “inside” basis differences and “outside” basis differences.

#### ***Inside Basis Difference***

An inside basis difference is a temporary difference between the carrying amount, for financial reporting purposes, of individual assets and liabilities and their tax bases that will give rise to a tax deduction or taxable income when the related asset is recovered or liability is settled.

An inside basis difference might, for example, result from an entity's election to use an accelerated depreciation method for determining deductions on a specific item of personal property for income tax purposes while using the straight-line method of depreciation for that item for financial reporting purposes.

Deferred taxes are always recorded on taxable and deductible temporary differences unless one of the exceptions in ASC 740-10-25-3 applies.

#### ***Outside Basis Difference***

An outside basis difference is the difference between the carrying amount of an entity's investment (e.g., an investment in a consolidated subsidiary) for financial reporting purposes and the underlying tax basis in that investment (e.g., the tax basis in the subsidiary's stock). From a consolidated financial reporting perspective, an entity's financial reporting carrying amount in a consolidated subsidiary is eliminated; however, book-to-tax differences in this amount may still result in the need to record deferred taxes.

Deferred taxes are always recorded on taxable and deductible temporary differences unless a specific exception applies. Whether an exception in ASC 740 applies to an outside basis difference depends on whether the difference results in a DTL or a DTA. DTLs are recorded on all outside basis differences that are taxable temporary differences unless one of the exceptions in ASC 740-10-25-3 is applicable. Under ASC 740-30-25-9, DTAs should not be recorded on outside basis differences (attributable to an investment in a subsidiary or corporate joint venture) unless it is apparent that the temporary difference will reverse in the foreseeable future (e.g., generally within the next 12 months). See [Chapter 8, “Other Considerations or Special Areas,”](#) for further discussion of the tax consequences of investments in pass-through entities.

Under ASC 740-30-25-7, outside basis differences in domestic entities (i.e., the holder of the investment is taxable in the same jurisdiction as the investee) would not be treated as taxable temporary differences if (1) the tax law provides a tax-free means to recover the reported amount of the investment and (2) the holder of the investment expects to recover the investment in that manner. The holder of the investment must meet both criteria to avoid recording the DTL.

Outside basis differences in foreign entities (i.e., the holder of the investment is taxable in a jurisdiction different from the investee's) are taxable temporary differences. DTLs should be recorded for these taxable temporary differences unless the exception in ASC 740-10-25-3(a)(1) applies.

For guidance on recording deferred taxes in a business combination on inside and outside basis differences, see [11.06](#).

### **3.05 Recognition of Deferred Taxes for Inside Basis Differences**

The indefinite reversal criterion in ASC 740-10-25-3(a)(1) relates specifically to differences between the tax basis and the financial reporting basis of an investment in a foreign subsidiary (referred to as "outside basis differences"). That is, a DTL is not recognized for such outside basis differences if they are not foreseeable of reversing. However, entities also have temporary differences within their foreign subsidiaries (referred to as "inside basis differences").

For example, inside basis differences within a U.S. parent's foreign subsidiary whose local currency is the functional currency may result from foreign laws that allow for the occasional restatement of fixed assets for tax purposes to compensate for the effects of inflation. The amount that offsets the increase in tax basis of fixed assets is sometimes described as a credit to revaluation surplus, which some view as a component of equity for tax purposes. That amount becomes taxable in certain situations, such as in the event of a liquidation of the foreign subsidiary or if the earnings associated with the revaluation surplus are distributed. In this situation, it is assumed that no mechanisms are available under the tax law to avoid eventual treatment of the revaluation surplus as taxable income.

ASC 740-30-25-17 clarifies that the indefinite reversal criterion should not be applied to inside basis differences of foreign subsidiaries. Because the inside basis difference related to the revaluation surplus results in taxable amounts in future years in accordance with the provisions of the foreign tax law, it qualifies as a temporary difference even though it may be characterized as a component of equity for tax purposes. Therefore, as described in ASC 830-740-25-7, a DTL must be provided on the amount of the revaluation surplus. This view is based on ASC 740-10-25-24, which indicates that some temporary differences are deferred taxable income and have balances only for income tax purposes. Therefore, these differences cannot be identified with a particular asset or liability for financial reporting purposes.

### **3.06 Deferred Tax Considerations Related to Withholding Taxes Imposed on Distributions From Disregarded Entities and Foreign Subsidiaries**

Multinational companies generally operate globally through entities organized under the laws of the respective foreign jurisdiction that govern the formation of legally recognized entities. These foreign entities might be considered partnerships or corporations under local law; however, sometimes no legal entity exists, and the assets and liabilities are simply viewed as an extension of the parent entity doing business in the jurisdiction (i.e., a "true branch" or "division").

In the case of a legal entity, under U.S. Treasury Regulation Sec. 301.7701-3 (the "check-the-box" regulations), certain eligible foreign entities may elect to be disregarded as entities separate from their parents (hereafter referred to as foreign disregarded entities). As a result of the check-the-box election,

the earnings of a foreign disregarded entity that is owned directly by a U.S. entity will, like those of a branch, be taxable in the United States as earned.

In many foreign jurisdictions, a resident corporation must pay a withholding tax upon a distribution of earnings to its nonresident shareholder(s). Since disregarded entities are often corporations under local law, the applicability of withholding tax on distributions will generally depend on whether the entity is regarded or disregarded for U.S. tax purposes. Although the distributing entity remits the withholding tax to the local tax authority (reducing the amount received by the parent), under the local tax statutes, the tax is generally assessed on the recipient of the distribution.

In the case of a foreign disregarded entity, no outside basis exists (from the perspective of U.S. tax law) because the foreign entity is viewed as a division of the parent as a result of the U.S. check-the-box election. In the case of a foreign regarded entity, its parent might still have no taxable temporary difference in its investment in the foreign entity because (1) all the unremitted earnings have already been taxed in the parent's tax jurisdiction (e.g., 100 percent of the unremitted earnings of a foreign subsidiary were taxable to its U.S. parent as Subpart F income in such a way that the financial reporting carrying amount and the tax basis are equal) or (2) cumulative translation adjustment (CTA) losses have reduced the financial reporting carrying value without a corresponding reduction in its tax basis.

Even when no taxable temporary difference exists (either in the assets of a disregarded entity or in the shares of a regarded entity), the foreign entity may have earnings that could be distributed to its parent, at which time withholding taxes would be imposed by the local tax authority.

We believe that there are two acceptable views on determining whether a parent should recognize a DTL for withholding taxes that are within the scope of ASC 740 and that would be imposed by the local tax authority on a distribution from a disregarded entity or foreign subsidiary: (1) the parent jurisdiction view and (2) the subsidiary jurisdiction view.

### ***View 1 — Parent Jurisdiction Perspective***

ASC 740-10-25-2 states, in part:

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

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

Further, ASC 740-10-55-24 states:

Deferred tax liabilities and assets are measured using enacted tax rates applicable to capital gains, ordinary income, and so forth, based on the expected type of taxable or deductible amounts in future years. For example, evidence based on all facts and circumstances should determine whether an investor's liability for the tax consequences of temporary differences related to its equity in the earnings of an investee should be measured using enacted tax rates applicable to a capital gain or a dividend. **Computation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related dividends received deductions or foreign tax credits, and taxes that would be withheld from the dividend.** [Emphasis added]

Under the parent jurisdiction view, a parent would apply ASC 740-10-55-24 by considering the withholding tax as a tax that the parent would incur upon the reversal of a U.S. jurisdiction taxable temporary difference that is attributable to unremitted earnings.

In the case of a disregarded entity, since (1) no outside basis difference exists (because the foreign entity is viewed as a division of the parent as a result of the U.S. check-the-box election) and (2) the earnings of the foreign disregarded entity are taxed in the parent's jurisdiction as they are generated,

there is generally no taxable temporary difference related to the net assets of the disregarded entity (i.e., the net assets that arose on account of unremitted earnings have a tax basis since the income of the disregarded entity was recognized for U.S. tax purposes as earned). In the absence of a U.S. taxable temporary difference for which a DTL can be recognized, a DTL cannot be recognized for the future withholding tax. Under this view, the withholding tax would be recognized in the period in which the actual withholding tax arises (as a current tax expense).

Similarly, a regarded foreign subsidiary would be unable to recognize a DTL when (1) all of its unremitted earnings have already been taxed by the United States (e.g., 100 percent of the unremitted earnings were taxable as Subpart F income in such a way that the financial reporting carrying amount and the tax basis are equal) or (2) CTA losses have reduced the financial reporting carrying value without a corresponding reduction in its tax basis. Without a U.S. taxable temporary difference, the requirement under ASC 740-10-55-24 for an entity to consider withholding taxes (when recording a DTL for a basis difference related to unremitted earnings expected to be reduced by remittances) would appear not to be applicable.

However, if an outside basis difference does exist in the parent's investment in the foreign subsidiary, the parent would apply ASC 740-10-55-24 when measuring the DTL to be recognized (i.e., it would include a DTL for the withholding tax).

### ***View 2 — Foreign Jurisdiction Perspective***

From the perspective of the local jurisdiction (i.e., the disregarded entity or subsidiary jurisdiction view), two separate and distinct taxpayers exist: (1) the distributing entity (which is generally viewed as a taxable legal entity in the local jurisdiction) and (2) the parent. Under the foreign jurisdiction view, the local jurisdiction taxes the distributing entity on its earnings as they occur, and it taxes the parent entity only when those "already net of tax" earnings are distributed. An entity that applies this view considers the perspective of the jurisdiction that is **actually** taxing the recipient (i.e., the local jurisdiction imposing the withholding tax) when determining whether the parent has a taxable temporary difference. From the perspective of the local jurisdiction, the parent has a financial reporting carrying amount in its investment in the distributing entity that is greater than its local tax basis — (i.e., from the perspective of the local jurisdiction, the entities have a "parent-corporate subsidiary" relationship since the election to disregard the entity is applicable only in the parent's jurisdiction and is not relevant in the local jurisdiction). Therefore, there is an "outside" taxable temporary difference and, in accordance with ASC 740-10-55-24, the measurement of the DTL should reflect withholding taxes to be incurred when the taxable temporary difference reverses.

Under this view, even in the case of a disregarded entity, the indefinite reversal criteria would be considered and, if the reversal of the taxable temporary difference is not foreseeable, no deferred taxes should be recognized.

## **3.07 Recognition of Deferred Taxes for Temporary Differences Related to the CTA**

Under foreign currency guidance in ASC 830, assets, liabilities, revenues, expenses, gains, and losses of a foreign subsidiary whose functional currency is the local currency are translated from that foreign currency into the reporting currency by using current exchange rates. Translation adjustments recognized as part of this process are not included in the determination of net income but are reported as a separate component of shareholders' equity (cumulative translation account). After a change in exchange rates, the translation process creates taxable and deductible temporary differences in amounts equal to the parent entity's translation adjustment because it changes the parent's financial

reporting amount of the investment in the foreign entity but the parent's tax basis in that entity generally does not change.

A DTA or DTL is required when an entity recognizes translation adjustments as a result of an exchange rate change if the parent entity is accruing income taxes on its outside basis difference in a particular investment (note that a CTA can be recorded on both the capital and undistributed earnings of the investment, as illustrated in Example 3-6 below). However, ASC 830-30-45-21 states that if "deferred taxes are not provided for unremitted earnings of a subsidiary, in those instances, deferred taxes shall not be provided on translation adjustments." In other words, if all or a portion of the earnings are not indefinitely reinvested and the related temporary differences will reverse within the foreseeable future (i.e., the earnings will be repatriated to the parent), translation adjustments associated with such unremitted earnings will impact the deferred taxes to be recorded. Conversely, if the earnings are indefinitely reinvested and the requirements in ASC 740-30 for not recording deferred taxes on unremitted earnings of a subsidiary have been met, deferred taxes on the translation adjustments are similarly not recorded.

### Example 3-6

Assume that Entity X, a calendar-year U.S. entity whose reporting currency is the U.S. dollar, has a majority-owned subsidiary, S, located in the United Kingdom, and that S's functional currency is the U.K. pound. In addition, assume that as of December 31, 20X1, S's net assets subject to translation under ASC 830 are 1,000 U.K. pounds, the exchange rate between the U.S. dollar and the U.K. pound is 1 to 1, X's tax basis in S's common stock is \$1,000, and S had \$100 in unremitted earnings for 20X1. Further assume that, in a manner consistent with ASC 830-10-55-10 and 55-11, the calculation of \$100 in unremitted earnings was based on "an appropriately weighted average exchange rate for the period."

Moreover, assume that on December 31, 20X2, S's common stock subject to translation is unchanged at 1,000 U.K. pounds, S's undistributed earnings for 20X2 are \$200 (on the basis of a weighted-average exchange rate for the period), and the exchange rate between the U.S. dollar and the U.K. pound is now 2 to 1. Thus, X's investment in S is translated at \$2,600, and the CTA account reflects a \$1,300 pretax gain. Entity X has the intent and ability to indefinitely reinvest undistributed earnings of S. Thus, in accordance with ASC 740-10-25-3(a)(1), no DTL is recognized on either the outside basis difference or the undistributed earnings of S. Further, in accordance with ASC 830-30-45-21, no deferred taxes are provided on the translation adjustments related to consolidating S's accounts, specifically the common stock or undistributed earnings.

However, if X does not have the intent and ability to indefinitely reinvest S's earnings (however, X believes its original investment in S is considered indefinite under ASC 740-30), a DTL should be recorded for the unremitted earnings as well as for the translation adjustment on the earnings of \$300 (on the basis of a weighted average of exchange rates for the period). However, X would not have to record a DTL for the CTA on the 1,000 U.K. pounds of common stock.

## 3.08 Hedge of a Net Investment in a Foreign Subsidiary

Entities sometimes enter into transactions to hedge their net investment in a foreign subsidiary (e.g., through the use of a forward contract). Under the derivatives and hedging guidance in ASC 815, such a transaction would be designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. Gains and losses on the effective portion of such hedging transactions are credited or charged directly to OCI through the CTA in accordance with ASC 815-35-35-1.

If such a hedging transaction creates a temporary difference but the parent does not provide for deferred taxes related to translation adjustments, the deferred taxes should nonetheless be recognized for the temporary difference created by the hedging transaction. The tax consequences of hedging gains or losses that are attributable to assets and liabilities of a foreign subsidiary or foreign corporate joint venture are not indefinitely postponed, as contemplated in ASC 740-10-25-3(a)(1). Therefore, a DTL or

DTA will result from hedging gains and losses, irrespective of whether a parent entity's investment in a foreign subsidiary or foreign corporate joint venture is considered indefinite. The tax consequences of establishing a DTA or DTL in hedging transactions are reported as a component of the CTA in accordance with ASC 740-20-45-11(b).

### **3.09 Deferred Taxes Recorded Through the Currency Translation Adjustment**

When a DTL or DTA related to a parent entity's cumulative foreign currency translation adjustments (see [3.07](#)) is recognized, the tax consequences of foreign currency exchange translations are reported as a component of the CTA account in accordance with ASC 740-20-45-11(b).

### **3.10 Whether a Change in Management's Plans for Reinvestment or Repatriation of Foreign Earnings Is a Recognized or Nonrecognized Subsequent Event**

An entity's documented plan for reinvestment of foreign earnings would enable it to overcome the presumption that all undistributed earnings of a foreign subsidiary will be transferred to the parent. An entity's operating plans (both domestically and internationally) and past experience are examples of the types of evidence that an entity needs to substantiate the parent entity's conclusion and representation that the earnings of the subsidiary are indefinitely reinvested. In some circumstances, an entity's reinvestment or repatriation plan may change because of various factors, such as the parent's liquidity requirements or changes in the tax ramifications of repatriation.

ASC 740-30-25-19 indicates that the impact of the change in plans would be accounted for in the period in which management's plans change (e.g., when management no longer can assert that all, or a portion, of its foreign earnings are indefinitely reinvested). However, an entity may need to use judgment to identify the period in which management's decision to change its plans occurred, especially if this decision occurs soon after the balance sheet date.

An entity should consider the nature and timing of the factors that influenced management's decision to change its plans when evaluating whether a change in management's plans for reinvestment or repatriation is a recognized or nonrecognized subsequent event under ASC 855. Specifically, if identifiable events occurred after the balance sheet date that caused the facts or conditions that existed as of the balance sheet date to change significantly, and management changed its intent regarding indefinite reinvestment because of the new facts, the change in intent may be a nonrecognized subsequent event.

In contrast, if the change in intent after the balance sheet date is due to factors other than responding to the occurrence of an identifiable event, the facts or conditions that existed at the end of the period are unlikely to have changed significantly. Therefore, if prior-period financial statements have not been issued or are not yet available to be issued (as these terms are defined in the subsequent-event guidance in ASC 855-10-20), the entity would generally be required to record the effect of the change in management's plan in these financial statements (i.e., a recognized subsequent event).

**Example 3-7**

Assume that an identifiable event (e.g., a change in tax rates associated with repatriation of foreign earnings) occurs in period 2 and that this event causes management to reconsider and change its plans in that period. The change in tax rates is an identifiable event that caused the facts or conditions that existed at the end of period 1 to change significantly. In this case, the effect of the change in plans, which is attributable specifically to the change in tax rate, should be recorded in period 2 (i.e., a nonrecognized subsequent event).

In contrast, an entity may change its repatriation plans because of operating factors or liquidity needs and, shortly after a reporting period, may not be able to assert that its foreign earnings are indefinitely reinvested. In this case, an entity must perform a careful analysis to determine whether the conditions causing the changes in management's plans existed at the end of the reporting period. The results of this analysis will affect whether the accounting effect of the change in plans should be recorded as a recognized or nonrecognized subsequent event under ASC 855.

See [Chapter 8, “Other Considerations or Special Areas,”](#) for further discussion of the indefinite reinvestment assertion.

### **3.11 Tax Consequences of a Change in Intent Regarding Remittance of Pre-1993 Undistributed Earnings**

It is possible for an entity to change its intent regarding remittance of (1) the portion of unremitted earnings that was generated for fiscal years beginning on or before December 15, 1992, for domestic subsidiaries and domestic corporate joint ventures or, (2) in the case of foreign corporations and foreign corporate joint ventures, unremitted earnings that were previously deemed indefinitely invested.

An entity should apply the guidance in ASC 740-30-25-17 and ASC 740-30-25-19 to tax consequences of a change in intent regarding unremitted earnings that arose in fiscal years beginning on or before December 15, 1992. This guidance states, in part:

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 . . . 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. . . .

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.

### Example 3-8

Assume that Entity X had \$2,000 of unremitted earnings from its investment in a domestic corporate joint venture that arose in fiscal years beginning on or before December 15, 1992, and that management has determined that all of the pre-1993 corporate joint venture earnings were indefinitely reinvested. Therefore, no DTL has been recorded. In addition, assume that during 20X1, unremitted earnings from the joint venture were \$1,000 and that X accrued the related deferred income taxes on these earnings. During 20X2, management of the joint venture changed its intent regarding remitting joint venture earnings, concluding that \$1,000 of retained earnings would be distributed (via a dividend) to X on December 31, 20X2, and \$1,000 on December 31, 20X3, respectively.

ASC 740-10-25-3(a) states that whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992, is determined on the basis of a LIFO pattern. Therefore, X would accrue, as of the date the change in intent occurred in 20X2, a DTL for an additional \$1,000 of taxable income representing the tax consequence of only \$1,000 of pre-1993 unremitted earnings; the deferred tax consequences of the other \$1,000 relate to income generated in post-1993 years, which was previously accrued in 20X1.

## 3.12 Tax Consequences of Bad-Debt Reserves of Thrift Institutions

Regulatory authorities require U.S. savings and loan associations and other qualified thrift lenders to appropriate a portion of earnings to general reserves and to retain the reserves as a protection for depositors. The term "general reserves" is used in the context of a special meaning within regulatory pronouncements. Provisions of the U.S. federal tax law permit a savings and loan association to deduct an annual addition to a reserve for bad debts in determining taxable income. This annual addition generally differs significantly from the bad-debt experience upon which determination of pretax accounting income is based. Therefore, taxable income and pretax accounting income of an association usually differ.

ASC 942-740-25-1 precludes recognition of a DTL for the tax consequences of bad-debt reserves "for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987" (i.e., the base-year amount), "unless it becomes apparent that those temporary differences will reverse in the foreseeable future." That is, the indefinite reversal notion of ASC 740-30-25-17 is applied to the entire amount of the base-year bad-debt reserve for tax purposes. ASC 942-740-25-2 states that a DTL should be recognized for the tax consequences of bad-debt reserves for "tax purposes . . . that arise in tax years beginning after December 31, 1987." That is, the excess of a tax bad-debt reserve over the base-year reserve is a temporary difference for which deferred taxes must be provided.

Application of the guidance in ASC 942-740-25-2 effectively results in a "two difference" approach to the measurement of deferred tax consequences of bad-debt reserves of thrift institutions:

- *Difference one* — A DTL is not recognized for the amount of tax bad-debt reserve that is less than the tax base-year amount (generally, amounts established at the beginning of the tax year in 1988). However, a DTL is recognized for any excess of the tax bad-debt reserve over the base-year amount.
- *Difference two* — A DTA is recognized for the entire allowance of bad debt established for financial reporting purposes (i.e., the "book" bad-debt reserve). As with any DTA, a valuation allowance is necessary to reduce the DTA to an amount that is more likely than not to be realized.

**Example 3-9**

This example illustrates the application of the two-difference approach for a thrift institution. Assume the following:

- The tax law froze the tax bad-debt reserve at the end of 1987. This limitation does not apply to utilization of future PTI deductions. However, experience method deductions for years after 1987 are limited to amounts that increase the tax bad-debt reserve to the base-year amount. (Under this method, a thrift is allowed a tax deduction to replenish its bad-debt reserve to the base-year amount.)
- The thrift elected to adopt ASC 740 retroactively to January 1, 1988.
- An annual election is permitted under the tax law. Bad-debt deductions may be computed on (1) the experience method or (2) the PTI method. The PTI percentage is 8 percent of taxable income.
- The association has no temporary differences other than those arising from loan losses.
- The enacted tax rate for all years is 40 percent.

	<b>20X1</b>	<b>20X2</b>	<b>20X3</b>	<b>20X4</b>
<b>Activity in Book — Bad-Debt Reserve</b>				
Beginning balance	\$ 500	\$ 500	\$ 300	\$ 600
Loan loss provision	100	100	400	300
Charge-offs	(100)	(300)	(100)	(320)
	<u>\$ 500</u>	<u>\$ 300</u>	<u>\$ 600</u>	<u>\$ 580</u>
<b>Activity in Tax — Bad-Debt Reserve</b>				
Base year (1987)	<u>\$ 850</u>			
Beginning balance (current)	\$ 850	\$ 910	\$ 850	\$ 910
PTI deductions	160		160	
Charge-offs	(100)	(300)	(100)	(320)
Experience method deductions		240		260
Ending balance	<u>\$ 910</u>	<u>\$ 850</u>	<u>\$ 910</u>	<u>\$ 850</u>
<b>Current Tax Liability</b>				
Pretax accounting income before loan loss provision	\$ 2,000	\$ 2,000	\$ 2,000	\$ 3,000
Tax bad-debt deduction	(160)	(240)	(160)	(260)
Taxable income	<u>\$ 1,840</u>	<u>\$ 1,760</u>	<u>\$ 1,840</u>	<u>\$ 2,740</u>
Current liability	<u>\$ 736</u>	<u>\$ 704</u>	<u>\$ 736</u>	<u>\$ 1,096</u>
<i>Deferred tax amounts are shown below.</i>				
	<b>20X0</b>	<b>20X1</b>	<b>20X2</b>	<b>20X3</b>
<b>Deferred Tax Balance</b>				
Deductible temporary difference*	\$ 500	\$ 500	\$ 300	\$ 600
Taxable temporary difference**		(60)		(60)
Net temporary difference	<u>\$ 500</u>	<u>\$ 440</u>	<u>\$ 300</u>	<u>\$ 540</u>
DTA — net	<u>\$ 200</u>	<u>\$ 176</u>	<u>\$ 120</u>	<u>\$ 216</u>

\* The book bad-debt reserve.

\*\* Excess, if any, of the tax bad-debt reserve over the base year (1987) tax bad-debt reserve.

**Example 3-9 (continued)**

Income statement amounts are shown below (select accounts).

	<b>20X1</b>	<b>20X2</b>	<b>20X3</b>	<b>20X4</b>
Income before taxes	\$ 1,900	\$ 1,900	\$ 1,600	\$ 2,700
Provision (benefit) for income taxes:				
Current	736	704	736	1,096
Deferred	24	56	(96)	(16)
	760	760	640	1,080
Net income	\$ 1,140	\$ 1,140	\$ 960	\$ 1,620
ETR	40%	40%	40%	40%

### **3.13 Tax Consequences of a Reduction of the Tax Base-Year Bad-Debt Reserve in an Annual Period**

As indicated in [3.12](#), ASC 942-740-25-1 concludes the indefinite reversal notion of ASC 740-30-25-17 is applied to the entire amount of the tax base-year bad debt reserve of savings and loan associations and other qualified thrift lenders. That is, a DTL is not recognized for the amount of tax bad-debt reserve that is less than the tax base-year reserve.

If the savings and loan association or thrift currently has the ability to refill the base-year reserve but has elected not to take the tax deductions to refill the base-year amount, the excess represents a potential tax deduction for which a DTA is recognized subject to a valuation allowance, if necessary. However, if the base-year reserve has been reduced because of a reduction in the amount of the qualifying loans, the exception provided in ASC 942-740-25-1 and 25-2 that applies to the base-year bad-debt reserve under ASC 740 should apply only to the current remaining base-year amount, as determined in accordance with IRC Section 585. Future increases in the base-year amount are a form of special deduction, as described in ASC 740-10-25-37, that should not be anticipated.

**Example 3-10**

Assume that Entity B, a bank holding company, acquired a 100 percent interest in a stock savings and loan association, Entity T, in a 20X0 business combination. In 20X1, B directed T to transfer a substantial portion of its existing loan portfolio to a sister corporation operating under a bank charter. The transfer was not contemplated as of the acquisition date. Further, assume that under IRC Section 585, this transfer reduces the tax base-year bad-debt reserve but the transfer of loans to a sister entity does not result in a current tax liability for the corresponding reduction in the base-year bad-debt reserve.

If management did not contemplate the transfer before 20X1, the effect of recording an additional DTL for the tax consequences of the reduction in the base-year bad-debt reserve for tax purposes should be recognized as a component of income tax expense from continuing operations in 20X1. The decision in 20X1 to transfer the loans is the event that causes the recognition of the deferred tax consequences of the reduction in the bad-debt reserve, and the additional expense should be recognized in that period.

### **3.14 Tax Consequences of a Reduction of the Tax Base-Year Bad-Debt Reserve in an Interim Period**

In determining its AETR for interim reporting purposes, a thrift institution may be able to assume that it will take the necessary actions before the end of its current fiscal year to restore its tax bad-debt reserve to the base-year amount.

Ordinarily, in measuring a DTL under ASC 740, an entity is precluded from assuming future transactions or events. For example, a DTL cannot be eliminated if an entity is expecting future tax losses. However, ASC 740-270-30 requires that an entity make its best estimate of the ETR expected to be applicable for the full fiscal year at the end of each interim period.

### Example 3-11

Assume that Institution T, a thrift institution operating a savings and loan association, has recorded a DTL for the portion of its tax bad-debt reserve in excess of its 1987 tax base-year reserve and a DTA related to the allowance for bad debts (i.e., the book bad-debt reserve) as of December 31, 20X0. During the six-month period ended June 30, 20X1, T experienced a significant reduction in its qualifying loan base as a result of mortgage loan refinancings. The reduction in qualifying loans has resulted in a reduction of the tax bad-debt reserve below the base-year amount. Under the tax law, a thrift institution incurs an income tax liability on any reductions below the tax base-year reserve. Institution T's management believes the entity will restore its tax bad-debt reserve to the base-year amount through a combination of new loan originations and investments in mortgage-backed securities. Also, assume that T's motivation for this action includes a desire to (1) minimize its income tax liability, (2) ensure compliance with requirements related to the 8 percent bad-debt deduction, and (3) ensure that it continues to qualify as a thrift under the tax law. Further assume that T is preparing its interim financial statements for the six-month period ended June 30, 20X1, which will be included in a public offering of securities.

In this example, ASC 740-270 allows T to anticipate actions to restore its tax bad-debt reserve to the base-year amount **provided that those actions are expected to occur before the close of its current fiscal year**. Inquiries should ordinarily be made to obtain assurance that the entity has the ability and intent to take such actions before the close of the fiscal year; such inquiries might include information about (1) directives from the entity's board of directors; (2) the entity's liquidity, which is necessary to permit new loans or acquisitions of qualifying securities; (3) the entity's compliance with any restrictions imposed by government regulations; and (4) loan originations or investments in mortgage-backed securities that have occurred after the interim reporting date but before the issuance of the interim financial statements. If a thrift applies this guidance and has not taken action to restore its tax bad-debt reserve to the base-year amount by the close of its current fiscal year, it cannot anticipate future actions to restore the reserve when measuring its DTL at the end of its fiscal year. For annual reporting purposes, there are no exceptions from ASC 740's prohibition against assuming future events to reduce or eliminate a DTL.

## 3.15 Realization of a DTA of a Savings and Loan Association: Reversal of a Thrift's Base-Year Tax Bad-Debt Reserve

An entity is not permitted to consider the tax consequences of a reversal of a thrift's base-year tax bad-debt reserve in assessing whether a valuation allowance is necessary for a DTA recognized for the tax consequences of a savings and loan association's bad-debt reserve unless a DTL has been recognized for that taxable temporary difference. As stated in ASC 942-740-25-1, a DTL for base-year bad-debt reserves is not recognized "unless it becomes apparent that those temporary differences will reverse in the foreseeable future."

## 3.15A Regulated Entities Subject to ASC 980

ASC 980-740 relies on the general standards of accounting for the effects of regulation in ASC 980, and consistent with those standards, requires recognition of (1) an asset when a DTL is recognized if it is probable that future revenue will be provided for the payment of those DTLs, and (2) a liability when a DTA is recognized if it is probable that a future reduction in revenue will result when that DTA is realized.

### **3.15B Construction in Progress and Plant in Service Recorded Net-of-Tax**

ASC 980-740-25-1 prohibits net-of-tax accounting on the basis that commingling assets and liabilities with their related tax effects confuses the relationship among the various classifications in financial statements.

In accordance with ASC 980-740-25-1, regulated entities adjust the reported net-of-tax amount of construction in progress and plant in service to the pretax amount.

### **3.16 Intra-Entity Transactions Between Different Tax-Paying Components**

On October 24, 2016, the FASB issued ASU 2016-16, which removes the prohibition in ASC 740 against the immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory (i.e., the current accounting for inventory transfers will remain unchanged). The ASU, which is part of the Board's simplification initiative, is intended to reduce the complexity of U.S. GAAP and diversity in practice related to the tax consequences of certain types of intra-entity asset transfers, particularly those involving intellectual property. The guidance below applies before adoption of ASU 2016-16.

After an intra-entity sale of inventory or other assets occurs at a profit between affiliated entities that are included in consolidated financial statements but not in a consolidated tax return, the acquiring entity's tax basis of that asset exceeds the reported amount in the consolidated financial statements. This occurs because, for financial reporting purposes, the effects of gains or losses on transactions between entities included in the consolidated financial statements are eliminated in consolidation.

ASC 740-10-25-3(e) requires that income taxes paid on intra-entity profits on assets remaining within the group be accounted for under the consolidation guidance in ASC 810-10 and prohibits recognition of a DTA for the difference between the tax basis of the assets in the buyers' tax jurisdiction and their cost as reported in the consolidated financial statements (i.e., after elimination of intra-entity profit). Specifically, ASC 810-10-45-8 states, "If income taxes have been paid on intra-entity profits on assets remaining within the consolidated group, those taxes shall be deferred or the intra-entity profits to be eliminated in consolidation shall be appropriately reduced."

The FASB concluded that in these circumstances, an entity's income statement should not reflect a tax consequence for intra-entity sales that are eliminated in consolidation. Under this approach, the tax paid or payable from the sale is deferred upon consolidation (as a prepaid income tax or as an increase in the carrying amount of the related asset) and is not included in tax expense until the inventory or other asset is sold to an unrelated third party. However, in situations involving the transfer of assets intended for internal use, the prepaid taxes should be amortized over the assets' expected life or, alternatively, by using another systematic and rational approach (e.g., on the basis of the ratio of actual sales as a percentage of total projected sales related to the asset). This prepaid tax is different from deferred taxes that are recorded in accordance with ASC 740 because it represents a past event whose tax effect has simply been deferred, rather than the future taxable or deductible differences addressed by ASC 740. Example 3-12 illustrates these conclusions for a situation involving the transfer of inventory.

**Example 3-12**

Assume the following:

- A parent entity, P, operates in a jurisdiction, A, where the tax rate is 40 percent. Parent P's wholly owned subsidiary, S, operates in a jurisdiction, B, where the tax rate is 50 percent.
- Parent P sells inventory to S at a \$100 profit, and the inventory is on hand at year-end. Assume that P purchased the inventory for \$200. Therefore, S's basis for income tax reporting purposes in jurisdiction B is \$300.
- Parent P prepares consolidated financial statements and, for financial reporting purposes, gains and losses on intra-entity transactions are eliminated in consolidation.

The following journal entry shows the income tax impact of this intra-entity transaction on P's consolidated financial statements.

**Journal Entry**

Prepaid income tax	40
Income taxes payable	40

In ASC 740, the FASB concluded that although the excess of the buyer's tax basis over the cost of transferred assets reported in the consolidated financial statements meets the technical definition of a temporary difference, in substance an entity accounts for this temporary difference by recognizing income taxes related to intra-entity gains that are not recognized in consolidated financial statements. The FASB decided to eliminate that conflict by prohibiting the recognition of deferred taxes in the buyer's jurisdiction for those differences and deferring the recognition of expense for the tax paid by the seller.

Assume that in a subsequent period, S sold the inventory that it acquired from P to an unrelated third party for the exact amount it previously paid P — \$300. The following journal entry shows the sales and related tax consequences that should be reflected in P's consolidated financial statements.

**Journal Entry**

Cash for sales	300
Cost of goods sold	200
Sales	300
Inventory	200
Income tax expense	40
Prepaid income tax	40

### 3.17 Subsequent Changes in Tax Rates Involving Intra-Entity Transactions

The guidance below applies before adoption of ASU 2016-16. See [3.16](#) for additional information on ASU 2016-16.

If a jurisdiction changes its tax rates after an intra-entity transaction but before the end product is sold to a third party, the prepaid tax that was recognized should not be revalued. This prepaid tax is different from deferred taxes that are recorded in accordance with ASC 740 (which would need to be revalued) because it represents a past event whose tax effect (i.e., tax payment) has simply been deferred, rather than the future taxable or deductible difference addressed by ASC 740. Thus, a subsequent change in the tax rates in either jurisdiction (buyer or seller) does not result in a change in the actual or future tax benefit to be received. In other words, a future reduction in rates in the seller's market does not change the value because the transaction that was taxed has passed and is complete. In the buyer's market, a change in rates does not make the previous tax paid in the other jurisdiction any more or less valuable either. The deferral is simply an income statement matching matter that arises in consolidation whose

aim is recognition of the ultimate tax effects (at the actual rates paid) in the period of the end sale to an external third party. Hence, prepaid taxes associated with intra-entity profits do not need to be revalued.

### 3.18 Indexing of the Tax Basis of Assets and Liabilities

The tax law for a particular foreign jurisdiction may permit or require taxpayers to adjust the tax basis of an asset or liability to take into account the effects of inflation. The inflation-adjusted tax basis of an asset or liability would be used to determine the future taxable or deductible amounts.

ASC 740-10-25-3(f) prohibits the recognition of a DTL or DTA for tax consequences of "differences related to assets and liabilities that, under [ASC 830], are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or **indexing for tax purposes**" (emphasis added).

Under ASC 830, assets and liabilities are remeasured when the local currency (which is generally the currency in which an entity files its tax returns) and the functional currency are not the same. The exception in ASC 740-10-25-3(f) applies only when the parent remeasures the foreign entity's financial statements from the local currency into the functional currency and therefore would not be applicable if the foreign entity prepared local-currency-denominated domestic financial statements in accordance with U.S. GAAP.

In addition, if the foreign entity's local currency is the functional currency (i.e., subject to translation rather than remeasurement), the guidance in ASC 740-10-25-3(f) does not apply. The foreign entity would recognize the deferred tax effects of any indexing, and the parent would then translate the resulting deferred taxes into the reporting currency. Example 3-13 illustrates this concept.

#### Example 3-13

Assume that X, an entity reporting under U.S. GAAP in U.S. dollars, has operations in a foreign country where the foreign currency is the functional currency. At the beginning of 20X2, the foreign jurisdiction enacted tax legislation that increased the tax basis of depreciable assets by 10 percent. That increase will permit X to deduct additional depreciation in current and future years. Further assume that X is subject to the guidance in ASC 740 and that, at the end of 20X1, the basis of depreciable assets is 1,000 foreign currency units (FC) for tax and financial reporting purposes; the foreign tax rate is 50 percent; and the current exchange rate between the foreign currency and the U.S. dollar is \$1.00 equals 2 FC.

Under ASC 740, X would establish a DTA on the enactment date. The DTA is measured in accordance with foreign tax law and is determined on the basis of the deductible temporary difference between the financial reporting basis of the asset (1,000 FC) and the indexed tax basis (1,100 FC). Thus, at the beginning of 20X2, X would record a DTA of 50 FC  $[(1,100 - 1,000) \times 50\%]$  in the foreign currency books of record. That DTA would be translated as \$25 ( $50 \text{ FC} \times 0.5$ ) on the basis of the current exchange rate.

## Tax Positions

### ASC 740-10

#### Basic Recognition Threshold

**25-5** This Subtopic requires the application of a more-likely-than-not recognition criterion to a tax position before and separate from the measurement of a tax position. [FIN 48, paragraph B28] See paragraph 740-10-55-3 for guidance related to this two-step process.

**ASC 740-10 (continued)**

**25-6** An entity shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. The term *more likely than not* means a likelihood of more than 50 percent; the terms *examined* and *upon examination* also include resolution of the related appeals or litigation processes, if any. [FIN 48, paragraph 6] For example, if an entity determines that it is certain that the entire cost of an acquired asset is fully deductible, the more-likely-than-not recognition threshold has been met. [FIN 48, paragraph A29] The more-likely-than-not recognition threshold is a positive assertion that an entity believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date. [FIN 48, paragraph 6] The level of evidence that is necessary and appropriate to support an entity's assessment of the technical merits of a tax position is a matter of judgment that depends on all available information. [FIN 48, paragraph B34]

**25-7** In making the required assessment of the more-likely-than-not criterion:

- a. It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.
- b. Technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities are widely understood, for example, by preparers, tax practitioners and auditors, those practices and precedents shall be taken into account.
- c. Each tax position shall be evaluated without consideration of the possibility of offset or aggregation with other positions. [FIN 48, paragraph 7]

**25-8** If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an entity shall recognize the benefit of the tax position in the first interim period that meets any one of the following conditions:

- a. The more-likely-than-not recognition threshold is met by the reporting date.
- b. The tax position is effectively settled through examination, negotiation or litigation.
- c. The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired. [FIN 48, paragraph 10]

Accordingly, a change in facts after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) shall be recognized in the period in which the change in facts occurs. [FIN 48, paragraph B38]

**25-9** A tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an entity shall make the assessment on a position-by-position basis, but an entity could conclude that all positions in a particular tax year are effectively settled. [FSP FIN 48-1, paragraph 3]

**25-10** As required by paragraph 740-10-25-8(b) an entity shall recognize the benefit of a tax position when it is effectively settled. An entity shall evaluate all of the following conditions when determining effective settlement:

- a. The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position.
- b. The entity does not intend to appeal or litigate any aspect of the tax position included in the completed examination.
- c. It is remote that the taxing authority would examine or reexamine any aspect of the tax position. In making this assessment management shall consider the taxing authority's policy on reopening closed examinations and the specific facts and circumstances of the tax position. Management shall presume the relevant taxing authority has full knowledge of all relevant information in making the assessment on whether the taxing authority would reopen a previously closed examination.

## ASC 740-10 (continued)

**25-11** In the tax years under examination, a tax position does not need to be specifically reviewed or examined by the taxing authority to be considered effectively settled through examination. Effective settlement of a position subject to an examination does not result in effective settlement of similar or identical tax positions in periods that have not been examined. [FIN 48, paragraph 10A]

**25-12** An entity may obtain information during the examination process that enables that entity to change its assessment of the technical merits of a tax position or of similar tax positions taken in other periods. However, the effectively settled conditions in paragraph 740-10-25-10 do not provide any basis for the entity to change its assessment of the technical merits of any tax position in other periods. [FIN 48, paragraph 10C]

**25-13** The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account to be used shall consider the manner in which the entity prepares and supports its income tax return and the approach the entity anticipates the taxing authority will take during an examination. [FIN 48, paragraph 5] Because the individual facts and circumstances of a tax position and of an entity taking that position will determine the appropriate unit of account, a single defined unit of account would not be applicable to all situations. [FIN 48, paragraph B13]

**25-14** Subsequent recognition shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. A tax position need not be legally extinguished and its resolution need not be certain to subsequently recognize the position. Subsequent changes in judgment that lead to changes in recognition shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period. [FIN 48, paragraph 12] See Sections 740-10-35 and 740-10-40 for guidance on changes in judgment leading to derecognition of and measurement changes for a tax position.

**25-15** A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs. [FIN 48, paragraph 13] Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.

**25-16** The amount of benefit recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability is created (or the amount of a net operating loss carryforward or amount refundable is reduced) for an unrecognized tax benefit because it represents an entity's potential future obligation to the taxing authority for a tax position that was not recognized under the requirements of this Subtopic. [FIN 48, paragraph 17]

**25-17** A tax position recognized in the financial statements may also affect the tax bases of assets or liabilities and thereby change or create temporary differences. A taxable and deductible temporary difference is a difference between the reported amount of an item in the financial statements and the tax basis of an item as determined by applying this Subtopic's recognition threshold and measurement provisions for tax positions. [FIN 48, paragraph 18] See paragraph 740-10-30-7 for measurement requirements.

### Tax Position No Longer Meets Recognition Criterion

**40-2** An entity shall derecognize a previously recognized tax position in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination. Use of a valuation allowance is not a permitted substitute for derecognizing the benefit of a tax position when the more-likely-than-not recognition threshold is no longer met. [FIN 48, paragraph 11] Derecognition shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Paragraph 740-10-30-7 explains that the reporting date is the date of the entity's most recent statement of financial position. Subsequent changes in judgment that lead to derecognition shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period. [FIN 48, paragraph 12]

**ASC 740-10 (continued)**

**40-3** If an entity that had previously considered a tax position effectively settled becomes aware that the taxing authority may examine or reexamine the tax position or intends to appeal or litigate any aspect of the tax position, the tax position is no longer considered effectively settled and the entity shall reevaluate the tax position in accordance with the requirements of this Subtopic for tax positions. [FIN 48, paragraph 10B]

**40-4** Paragraph 740-10-25-15 requires that a change in judgment that results in derecognition of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs. [FIN 48, paragraph 13] Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.

**Related Implementation Guidance and Illustrations**

- [Recognition and Measurement of Tax Positions — a Two-Step Process](#) [ASC 740-10-55-3].
- [Example 1: The Unit of Account for a Tax Position](#) [ASC 740-10-55-81].
- [Example 2: Administrative Practices — Asset Capitalization](#) [ASC 740-10-55-90].
- [Example 3: Administrative Practices — Nexus](#) [ASC 740-10-55-93].
- [Example 11: Information Becomes Available Before Issuance of Financial Statements](#) [ASC 740-10-55-117].
- [Example 32: Definition of a Tax Position](#) [ASC 740-10-55-223].
- [Example 33: Definition of a Tax Position](#) [ASC 740-10-55-224].
- [Example 34: Definition of a Tax Position](#) [ASC 740-10-55-225].
- [Example 35: Attribution of Income Taxes to the Entity or Its Owners](#) [ASC 740-10-55-226].
- [Example 36: Attribution of Income Taxes to the Entity or Its Owners](#) [ASC 740-10-55-227].
- [Example 37: Attribution of Income Taxes to the Entity or Its Owners](#) [ASC 740-10-55-228].
- [Example 38: Financial Statements of a Group of Related Entities](#) [ASC 740-10-55-229].

### 3.19 Consideration of Tax Positions Under ASC 740

ASC 740 applies to all tax positions in a previously filed tax return or tax positions expected to be taken in a future tax return. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of DTAs.

The definition of “tax position” in ASC 740-10-20 lists the following examples of tax positions that are within the scope of ASC 740:

1. “A decision not to file a tax return” (e.g., a decision not to file a specific state tax return because nexus was not established).
2. “An allocation or a shift of income between jurisdictions” (e.g., transfer pricing).
3. “The characterization of income or a decision to exclude reporting taxable income in a tax return” (e.g., interest income earned on municipal bonds).
4. “A decision to classify a transaction, entity, or other position in a tax return as tax exempt” (e.g., a decision not to include a foreign entity in the U.S. federal tax return).
5. “An entity’s status, including its status as a pass-through entity or a tax-exempt not-for-profit entity.”

Uncertainties related to tax positions not within the scope of ASC 740, such as taxes based on gross receipts, revenue, or capital, should be accounted for under other applicable literature (e.g., ASC 450).

## 3.20 Considerations of Tax Positions by Tax-Exempt or Pass-Through Entities

Many entities are exempt from paying taxes because they qualify as either a tax-exempt (e.g., not-for-profit organization) or a pass-through entity (e.g., Subchapter S corporation, partnership), or they function similarly to a pass-through entity (e.g., REIT, RIC). To qualify for tax-exempt or pass-through treatment, such entities must meet certain conditions under the relevant tax law.

According to the definition of a tax position in ASC 740-10-20, a decision to classify an entity as tax-exempt should be evaluated under ASC 740 for recognition and measurement. In some situations, it may be appropriate for the entity to consider how the administrative practices and precedents of the relevant tax authority could affect its qualification for tax-exempt or pass-through treatment.

For example, a Subchapter S corporation must meet certain conditions to qualify for special tax treatment. If the Subchapter S corporation violates one of these conditions, it might still qualify for the special tax treatment under one of the tax authority's widely understood administrative practices and precedents. Sometimes, however, these administrative practices and precedents are only available if an entity self-reports the violation. In assessing whether self-reporting affects an entity's ability to avail itself of administrative practices and precedents, the entity should consider whether relief would still be as readily available if, before self-reporting, the tax authority contacts the entity for an examination. If an entity has the ability to pursue relief, and the likelihood of relief is not compromised even if, before self-reporting, the tax authority makes contact for an examination, then the entity can rely on these administrative practices and precedents for recognition purposes because such administrative practices and precedents are not contingent upon self-reporting. However, if relief were no longer available, or the likelihood of relief were compromised had the tax authority contacted the entity for examination before self-reporting, then the administrative practice would be contingent upon self-reporting, and the entity would not be able to rely on these administrative practices and precedents for recognition purposes until the violation had actually been self-reported.

### 3.20A Unrecognized Tax Benefits and Spin-Off Transactions

In a spin-off transaction, a reporting entity (the "spinnor") may distribute one or more of its subsidiaries ("spinnees") to its shareholders in the form of a dividend. After the spin-off is finalized, complexities can arise in the accounting for uncertain tax positions in the separate financial statements of the spinnor and spinnee when, before a spin-off, they file a consolidated tax return as a "consolidated return group." Under U.S. federal tax law, members of a consolidated return group are severally liable for all tax positions taken in the consolidated return. The taxing authority typically seeks collection of the payment of the consolidated return group's tax liabilities from the parent of the consolidated return group; however, if the IRS cannot collect from the parent of the consolidated return group (e.g., the parent is insolvent), the IRS can seek payment from a subsidiary of the consolidated return group.

Consider an example in which Company A, in the current reporting period, spins off a portion of its business that was conducted by Company B. Before the spin-off, A and B were in the same federal consolidated return group and (1) A had recognized a liability for uncertain tax positions in its consolidated financial statements associated with B's operations and (2) B had recognized the liability in its stand-alone financial statements prepared under the separate-return approach (see 4.49). Under the terms of the separation agreement, A will be responsible for settlement of the uncertain tax positions in tax returns for periods before the spin-off. Company A is solvent as of the date of the spin-off and is expected to remain so afterward.

## **Company A**

Upon completion of the spin-off transaction, A should continue to recognize a liability associated with the uncertain tax position. Because the uncertain tax position was taken in a consolidated return group filed by A, the primary obligor under the consolidated return regulations was and will continue to be A. Accordingly, A should continue to recognize the liability for the UTB associated with the uncertain tax position under ASC 740.

## **Company B**

Each of the following views is acceptable:

- *View A* — Because A is the primary obligor, B cannot be the primary obligor and therefore should not continue to recognize the liability for the UTB. In accordance with the consolidated return regulations, the liability is retained by A, and B is typically only liable if A becomes insolvent. Accordingly, B no longer has an uncertain tax position under ASC 740 and would remove the liability with an offsetting credit to capital at the time of the spin-off. Company B would separately assess its contingent liability to the tax authority if A becomes insolvent under ASC 450.

This view is consistent with the guidance in ASC 405-40 on obligations resulting from joint and several liability obligations, which can be applied by analogy even though income taxes are not within its scope. ASC 405-40-30-1 states:

Obligations resulting from joint and several liability arrangements included in the scope of this Subtopic initially shall be measured as the sum of the following:

- a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors
- b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors. If some amount within a range of the additional amount the reporting entity expects to pay is a better estimate than any other amount within the range, that amount shall be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range shall be the additional amount included in the measurement of the obligation.
- *View B* — Because B is still an obligor under the consolidated return regulations, it should continue to record a liability for the UTB under ASC 740. The uncertain tax position was generated by B and presented in its separate company financial statements before the spin-off. In addition, although A insulates B from liability to a degree, B could be required to settle the uncertain tax position. Accordingly, B should apply ASC 740 in recording and subsequently measuring an uncertain tax benefit. Company B would also record an indemnification receivable, subject to (1) any contractual limitations on its amount and (2) management's assessment of the collectibility of the indemnification asset (by analogy to the guidance in ASC 805-20-35-4), reflecting the fact that A has agreed to be responsible for settlement of the uncertain tax positions.

While View A and View B are both acceptable, the selected method would represent an accounting policy that should be consistently applied and appropriately disclosed.

See [2.05](#) for additional guidance on indemnification agreements.

### **3.21 Accounting for the Tax Effects of Tax Positions Expected to Be Taken in an Amended Tax Return or Refund Claim or to Be Self-Reported Upon Examination**

In certain jurisdictions, an entity may elect to take a certain tax position on its original tax return but subsequently decide to take an alternative tax position (which is also acceptable) in an amended return. For example, an entity may amend a previously filed income tax return to retroactively elect a deduction for foreign taxes paid rather than to claim a credit or vice versa, or to file a refund claim to carry back a tax operating loss or tax credit to a prior year. Alternatively, an entity under examination may present to the examiner self-identified adjustments (i.e., affirmative adjustments) to change the amount of income, deductions, or credits reflected in the previously filed tax return that is under examination.<sup>1</sup>

The decision to file an amended tax return or refund claim or to self-report a tax position upon examination may be made before the end of the reporting period even though the process of actually preparing the amended tax return/refund claim, or self-reporting the tax position, might not occur until after the reporting period ends.

An entity should account for the tax effects of its intent to file amended tax returns or refund claims or to report self-identified audit adjustments (i.e., affirmative adjustments) in its financial statements by using the guidance in ASC 740-10. ASC 740-10-05-6 states, in part:

This Subtopic provides guidance for recognizing and measuring tax positions taken **or expected to be taken in a tax return** that directly or indirectly affect amounts reported in financial statements. [Emphasis added]

In addition, ASC 740-10-25-2 states:

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

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

While an amended return or refund claim may be filed after the reporting period has ended, an entity should account for the tax effects in the period in which it concludes that it expects to amend the return or file the refund claim. Such accounting should be consistent with the general recognition and measurement principles of ASC 740-10. An entity should determine its intent with respect to the filing of an amended return or refund claim as of each reporting date. Changes in intent with respect to the filing of an amended return or refund claim should be supported by a change in facts or circumstances.

In a manner consistent with the above discussion, refund claims that an entity intends to file in connection with the carryback of tax attributes (e.g., an NOL or a tax credit) should generally be reflected as an income tax receivable (after the entity considers the recognition and measurement principles of ASC 740-10) in the reporting period in which the entity concludes that it will file the refund claim.

Affirmative adjustments should be accounted for similarly to tax positions that will be taken on a tax return (i.e., similarly to an amended return or refund claim). That is, the entity should account for the tax positions associated with affirmative adjustments in the period in which the entity concludes that it intends to present the positions to an examiner in a future tax examination. Generally, we would expect

<sup>1</sup> Presenting affirmative adjustments upon examination, rather than claiming the position on an originally filed income tax return, might be part of the entity's strategy to avoid penalties on a particular tax position in a particular tax jurisdiction or to limit the jurisdiction's ability to make other changes to the year (i.e., changes that are unrelated to the adjustment being sought by the entity).

this to be the period in which the position was originally taken. Such accounting should be consistent with the general recognition and measurement principles of ASC 740-10.

Note that this section does not address the additional considerations that can arise when the filing of the amended tax return or refund claim, or the decision to self-report a tax position, represents the correction of an error. See [3.41](#) for additional guidance regarding those considerations.

### **3.22 Recognition and Measurement — Assumptions to Be Used**

Applying ASC 740 to determine how to recognize tax benefits in the financial statements is a two-step process of recognition (step 1) and measurement (step 2). Each step should be performed separately.

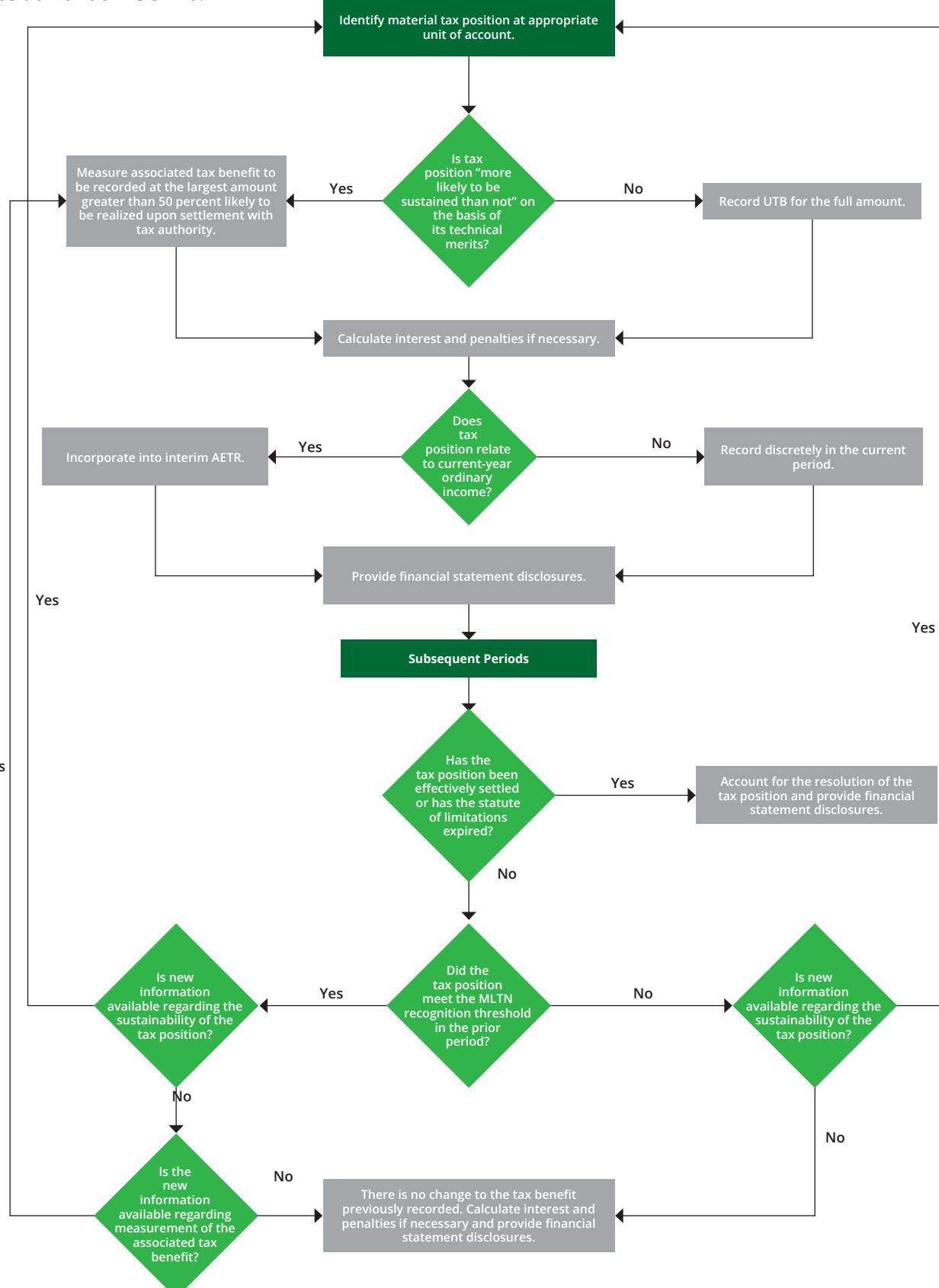
The following table summarizes the different assumptions an entity uses when applying steps 1 and 2:

<b>Step 1 — Recognition</b>	<b>Step 2 — Measurement</b>
The position will be examined.	Same.
The examiner will have full knowledge of all relevant information.	Same.
Offsetting or aggregating tax positions should not be considered.	Same.
The evaluation should be based solely on the position's technical merits.	The evaluation should be based on all relevant information available on the reporting date.
The conclusion should assume resolution in the court of last resort.	The conclusion should be based on the amount the taxpayer would ultimately accept in a negotiated settlement with the tax authority.

When recognizing a tax position, an entity often must assess the position's technical merits under the tax law for the relevant jurisdiction. That assessment often requires consultation with tax law experts.

### 3.23 Decision Tree for Recognizing Benefits of a Tax Position

The following decision tree provides an overview of the process for recognizing the benefits of a tax position under ASC 740:



### 3.24 Legal Tax Opinions Not Required to Support a Tax Position

An entity is not required to obtain a legal tax opinion to support its conclusion that a tax position meets the recognition criteria in ASC 740-10-25-6. However, an entity must have sufficient evidence to support its assertion that a tax benefit should be recognized on the basis of the technical merits of the relevant law. In addition, the entity should determine whether it has the appropriate expertise to evaluate all available evidence and the uncertainties associated with the relevant statutes or case law. The entity must use judgment in determining the amount and type of evidence it needs in addition to, or in lieu of, a tax opinion to demonstrate whether the more-likely-than-not recognition threshold is met.

### 3.25 Meaning of the Court of Last Resort and Its Impact on Recognition

As part of the technical merit assessment, an entity sometimes must assess what the outcome of a dispute would be if the matter was taken to the court of last resort. According to ASC 740-10-55-3, the “recognition threshold is met when the taxpayer (the reporting entity) concludes that . . . it is more likely than not that the taxpayer will sustain the benefit taken . . . in a dispute with taxing authorities if the taxpayer takes the dispute to the court of last resort.”

The court of last resort is the highest court that has discretion to hear a particular case. In determining whether a tax position meets the more-likely-than-not recognition threshold, an entity must consider how the court of last resort would rule. To form a conclusion, an entity must examine all law against which the court of last resort would evaluate the tax position.

In the United States, the U.S. Supreme Court, as the highest judicial body, is the highest court that has discretion to hear an income-tax-related case. It is thus the ultimate court for deciding the constitutionality of federal or state law. The “due process clause” and the “commerce clause” of the U.S. Constitution limit the states’ rights to tax.

The due process clause of the Fourteenth Amendment requires a definite link between a state and the person, property, or transaction it seeks to tax; the connection need not include physical presence in the state. This clause also requires that the income attributed to the state for tax purposes be rationally related to values connected with the taxing state. The commerce clause of the Constitution gives Congress the authority to regulate commerce among the states.

No state or federal law is allowed to violate the Constitution. In evaluating all tax positions for recognition under ASC 740, as well as for technical merits under the tax law as written and enacted, an entity must assess whether the U.S. Supreme Court would overturn that tax law. Generally, an entity will conclude that the U.S. Supreme Court would uphold the tax law. However, in certain situations, an entity may conclude that the applicable tax law violates the Constitution.

For example, with respect to economic nexus, an entity may determine that, under the tax law, it is more likely than not that it has incurred a tax obligation to the tax authority. However, the entity may also conclude that the same tax law more likely than not violates the Constitution. In other words, if the entity were to litigate this position to the U.S. Supreme Court, it is more likely than not that the U.S. Supreme Court, after evaluating such a law, would deem that law unconstitutional; in such a situation, the entity would therefore not have a tax obligation to the tax authority.

An entity must have sufficient evidence to support its conclusion about the constitutionality of the current tax law. This evidence will often be in the form of a legal opinion from competent outside counsel. The legal opinion would state whether the tax law violates the Constitution and whether it is more likely than not that the U.S. Supreme Court would overturn the enacted tax law.

The highest courts of jurisdictions outside the United States that hear income-tax-related cases may not be these jurisdictions' supreme courts. In addition, in foreign jurisdictions, supreme courts may also not evaluate a case against laws other than income tax laws. Tax positions should be evaluated against all laws that apply in each relevant jurisdiction.

### **3.26 Impact of the Likelihood of the U.S. Supreme Court's Hearing the Case**

Many more cases are filed with the U.S. Supreme Court than are heard; the justices exercise discretion in deciding which cases to hear. In rare circumstances, the U.S. Supreme Court issues certiorari for tax matters involving the constitutionality of state income taxes.

When evaluating the recognition criteria in ASC 740, an entity should not consider the likelihood that the U.S. Supreme Court will hear a case regarding the constitutionality of the applicable tax law. In assessing the tax position for recognition, an entity should assume that the case will be heard by the court of last resort.

If an entity concludes that its tax position does not meet the recognition threshold, it must determine the state income tax liability for UTBs to record on the basis of the measurement guidance in ASC 740.

### **3.27 Consideration of Widely Understood Administrative Practices and Precedents**

An assessment of whether a tax position meets the more-likely-than-not recognition threshold is based on the technical merits of the tax position.

ASC 740 permits consideration of past administrative practices and precedents only when the tax position taken by the entity could technically be a violation of tax law but is known to be widely accepted by the tax authority. An example of this concept is the tax authority's accepting the immediate deduction of the cost of acquired fixed assets that are below a reasonable dollar threshold even though this may be considered a technical violation of the tax law.

Because ASC 740 does not provide guidance on when an administrative practice and precedent is considered "widely understood," this assertion depends on the specific facts and circumstances of the tax position; therefore, an entity must use professional judgment to decide what constitutes "widely understood." An entity that asserts that an administrative practice and precedent is widely understood should document the basis of that assertion, including the evidence to support it. Such evidence may include reliable knowledge of the tax authority's past dealings with the entity on the same tax matter when the facts and circumstances have been similar. The use of administrative practices and precedents is expected to be infrequent.

In a letter dated December 22, 2006, SEC Chief Accountant Conrad Hewitt responded to a letter from the Investment Company Institute regarding the consideration of a tax authority's administrative practices and precedents. Mr. Hewitt noted that if the tax authority objects to an entity's tax position but has previously granted prospective transition by indicating that no additional taxes would be due for prior periods, the entity should **"consider the taxing authority's practice of addressing fund industry issues on a prospective basis as part of the administrative practices and precedents of the taxing authority"** (emphasis added) when analyzing the technical merits of the specific tax position. However, Mr. Hewitt did emphasize that in accordance with ASC 740-10-25-7(a), an entity must also presume that the tax position will be examined by a tax authority that has knowledge of all relevant information.

### 3.28 Applying ASC 740 to Questions About Economic Nexus

"Economic nexus" refers to a view, held by some states, that a company deriving income from the residents of a state should be taxable even when the connection with the state is not physical (i.e., its only contact with the state is economic). Many states have enacted tax laws that could subject an out-of-state entity to income taxes in that state in accordance with the economic nexus theory even when the entity has no physical presence in that state.

An entity should consult all relevant law and authorities to determine whether, for a state in which it does not file income tax returns, it is more likely than not that it does not have a filing obligation in that state. While the concept of economic nexus may sometimes be ambiguous and difficult to apply, an entity must, to comply with the requirements of ASC 740, assess the technical merits of its conclusion that it does not have economic nexus in a state. Specialists may be engaged to help form such a conclusion.

An entity that concludes it is more likely than not that it does not have economic nexus in a particular state has met the recognition threshold for this tax position.

Given the complexity of applying tax and financial accounting rules to these tax positions, management routinely makes judgments and estimates about the application of various technical rules (e.g., regarding the jurisdictions in which to report tax positions and how to allocate revenue and expenses among these jurisdictions). Certain operational activities may be taxable in multiple jurisdictions (e.g., federal and state authorities) or may need to be allocated between these jurisdictions on the basis of the application of tax rules (e.g., domestic versus international authorities, state versus state authorities). Therefore, it is not always certain how these rules should be applied. ASC 740 contains a framework for dealing with this uncertainty for an entity's tax positions. (See [Chapter 4, "Measurement,"](#) for guidance on this topic.)

### 3.29 Lookback Period for Accruing a State Income Tax Liability for UTBs

Assume an entity has a reasonable basis for not filing a state income tax return in a particular state. The entity has also concluded that it is more likely than not that it has economic nexus in that state, and therefore, the recognition threshold is not met.

Under ASC 740, if a tax position does not meet the recognition threshold, a liability is recognized for the total amount of the tax benefit of that tax position. That liability should not be subsequently derecognized unless there is a change in technical merits, the position is effectively settled, or the statute of limitations expires. Under U.S. tax law, the statute of limitations begins to run only when a tax return is filed. Therefore, when an entity does not file a state income tax return, no statute of limitations applies to the entity's conclusion that it does not have a filing obligation in that state.

Some state tax authorities may have a widely understood administrative practice and precedent indicating that, in the event of an examination and in the absence of a voluntary disclosure agreement, the tax authority would look back no more than a certain number of years to determine the amount of income tax deficiency due.

In the absence of such a widely understood administrative practice and precedent, ASC 740 would require accrual of the state income tax liability for every year in which it is more likely than not that the entity had economic nexus in that state. Each tax year's state tax liability for UTBs would be recorded in the amount of tax due, determined as if state income tax returns were prepared in accordance with ASC 740. Interest and penalties would be accrued under ASC 740 and on the basis of the relevant tax law. Such liabilities for UTBs would only be derecognized when (1) a change in available information indicates

that the technical merits of the position subsequently meet the more-likely-than-not recognition threshold or (2) the position is effectively settled.

If a state tax authority has a widely understood administrative practice and precedent of limiting the period over which it would look back to determine whether a tax return is due and a tax deficiency is owed, it is acceptable for an entity to consider such a widely understood administrative practice and precedent when calculating the liability for UTBs, as long as certain conditions are met.

For example, assume that an entity has not filed state income tax returns in a particular state and is aware of a widely understood administrative practice under which the state tax authority only requires entities that have not historically filed tax returns with that state to file six years of tax returns. Accordingly, at the end of each year, the entity is permitted to record a liability for UTBs for the amount of tax due to the state for the most recent six years as if tax returns, prepared in accordance with ASC 740, were filed for the most recent six years. Interest and penalties would be accrued on such deficiencies as required by ASC 740 and on the basis of the relevant tax law.

An entity should be able to demonstrate its consideration of all relevant facts and circumstances in reaching its conclusion about the maximum number of previous years that the state tax authority will require the entity to file under its widely understood administrative practices and precedents. The number of previous years that the entity believes the state tax authority will look to in assessing state tax deficiencies should not change unless new information becomes available. This guidance applies only to economic nexus when a statute of limitations does not expire because an income tax return has not been filed; it should not necessarily be applied to other situations.

Entities may also consider entering into a state's voluntary disclosure program, which may limit the number of prior years for which tax returns will be required. The terms and conditions of such programs vary between states; generally, however, voluntary disclosure programs limit lookback periods to three years. Therefore, when an entity has entered into a voluntary disclosure program, its liability for UTBs for that state's income taxes would be limited by the number of prior years for which tax returns will be required under the terms and conditions of the program, plus accrued interest and penalties, if applicable. Entities should consult their tax advisers regarding the effect of entering into a state's voluntary disclosure program.

### **3.30 Determining the Unit of Account**

ASC 740-10-25-13 states that the determination of the unit of account "is a matter of judgment based on the individual facts and circumstances." To determine the unit of account, an entity should consider, at a minimum, (1) the manner in which it supports and documents its income tax return and (2) the approach it expects the tax authorities will take during an examination. The entity may also consider:

- The composition of the position — whether the position is made up of multiple transactions that could be individually challenged by the tax authority.
- Statutory documentation requirements.
- The nature and content of tax opinions.
- The prior history of the entity (or reliable information about others' history) with the relevant tax authority on similar positions.

### **3.31 Whether Determination of the Unit of Account Is an Accounting Policy Choice**

The determination of the unit of account to which ASC 740 is applied is not an accounting policy choice; rather, it is a factual determination that is based on the facts and circumstances for the tax position being considered. Every tax position (e.g., transaction, portion of transaction, election, decision) for which a tax reporting consequence is reported in the financial statements is within the scope of ASC 740 and is, therefore, a possible unit of account to which ASC 740 applies. The unit of account is determined by evaluating the facts and circumstances of the tax position. See [3.30](#) for a list of factors for entities to consider in determining the unit of account and [3.32](#) for guidance on when it may be appropriate to change the unit of account.

### **3.32 Applying the Unit of Account**

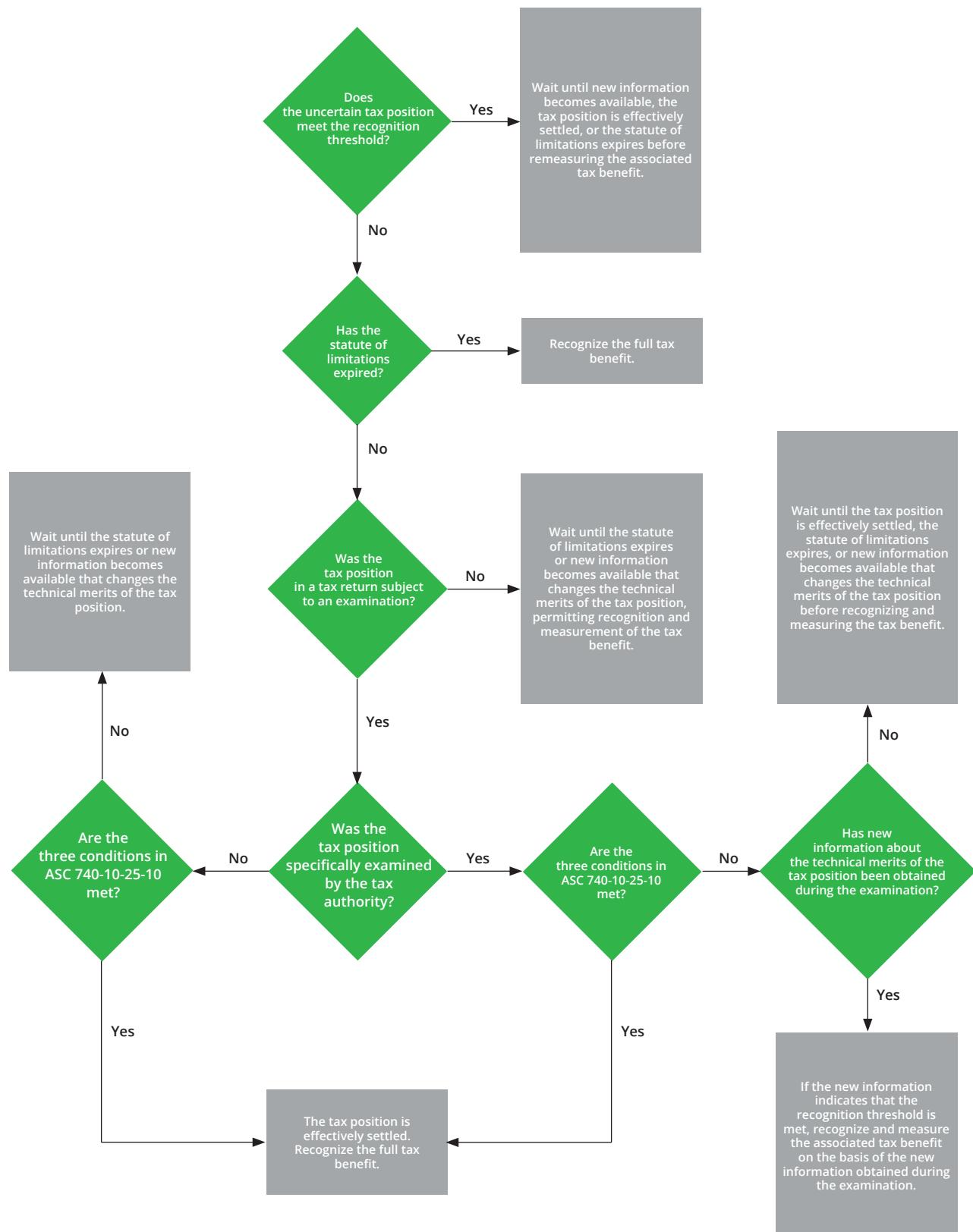
Once determined, the unit of account for a tax position should be the same for each position and similar positions from period to period unless changes in facts and circumstances indicate that a different unit of account is appropriate.

Changes in facts and circumstances that could cause management to reassess its determination of the unit of account include significant changes in organizational structure (i.e., sale of a subsidiary), recent experience with tax authorities, a change in tax law, and a change in the regulatory environment within a jurisdiction.

Although ASC 740-10-55-87 through 55-89 acknowledge that changes in a unit of account may occur, such changes are expected to be infrequent. Furthermore, if a change in unit of account is caused by something other than a change in facts and circumstances, it may be an indication that ASC 740 was applied incorrectly in prior periods.

A change in judgment regarding the appropriate unit of account that does not result from the correction of an error should be treated as a change in estimate and applied prospectively.

### 3.33 Decision Tree for the Subsequent Recognition, Derecognition, and Measurement of Benefits of a Tax Position



### 3.34 Evaluating the Recognition Threshold After Examination of a Tax Year

The examination of a tax year by the relevant authority in a jurisdiction (e.g., IRS in the United States) does not mean that all tax positions not disputed by the tax authority meet the more-likely-than-not recognition threshold. An entity cannot assert that a tax position can be sustained on the basis of its technical merits simply because the tax authority did not dispute or disallow the position. This lack of dispute or disallowance may be because the tax authority is overlooking a position that is specifically prohibited from being considered by ASC 740-10-25-7.

ASC 740-10-25-12 acknowledges that an entity may obtain information in an examination that leads it to change its evaluation of the tax position's technical merits. However, an entity's conclusion that a position is "effectively settled," as described in ASC 740-10-25-8, is not a basis for changing its assessment of the technical merits of that or a similar tax position. See [3.35](#) for further discussion regarding effective settlement.

### 3.35 Effectively Settled Tax Positions

A tax position that was included in an examination by the tax authority can be considered effectively settled without being legally extinguished. An entity must use significant judgment in determining whether a tax position is effectively settled.

A tax position is considered effectively settled when both the entity and the tax authority believe that the examination is complete and that the likelihood of the tax authority's reexamining the tax position is remote (as defined in ASC 450). Although a tax position can only be considered effectively settled if it was part of a completed examination, a tax position that is part of an examination does not need to be specifically reviewed by the tax authority to be considered effectively settled; however, the fact that an issue was not examined will affect the assessment of whether examination or reexamination is remote.

For a tax position to be considered effectively settled, it must meet all of the following conditions in ASC 740-10-25-10:

- a. The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position.
- b. The entity does not intend to appeal or litigate any aspect of the tax position included in the completed examination.
- c. It is remote that the taxing authority would examine or reexamine any aspect of the tax position. In making this assessment management shall consider the taxing authority's policy on reopening closed examinations and the specific facts and circumstances of the tax position. Management shall presume the relevant taxing authority has full knowledge of all relevant information in making the assessment on whether the taxing authority would reopen a previously closed examination.

If the tax authority has specifically examined a tax position during the examination process, an entity should consider this information in assessing the likelihood that the tax authority would reexamine the tax position included in the completed examination. Effective settlement of a position subject to an examination does not result in effective settlement of similar or identical tax positions in periods that have not been examined.

Accordingly, an entity must first determine whether the tax authority has completed its examination procedures, including all appeals and administrative reviews that are required and are expected to be performed for the tax position. For U.S. federal income tax positions, we believe the condition that all administrative reviews be complete includes reviews by the Joint Committee on Taxation for cases that are subject to the committee's approval. A completed tax examination may be related only to specific tax positions or to an entire tax year. While it is common for all tax positions for a particular tax year to

be effectively settled at the same time, there may be circumstances in which individual tax positions are effectively settled at different times.

The entity must then determine whether it intends to appeal or litigate any aspect of the tax position associated with the completed examination. If the entity does not intend to appeal or litigate, it must determine whether the tax authority's subsequent examination or reexamination of any aspect of the tax position is remote.

In determining whether to reopen a closed examination, tax authorities follow policies that vary depending on the type of examination and the agreement entered into between the taxpayer and the tax authority. For example, a tax authority may be permitted to reexamine a previously examined tax position (or all tax positions that were part of a closed examination) only if specific conditions exist, such as fraud or misrepresentation of material fact. An entity must base the likelihood that the tax authority would examine or reexamine a tax position on individual facts and circumstances, assuming that the tax authority has available to it all relevant information. The entity may need to use significant judgment to evaluate whether individual tax positions included in the completed examination meet the conditions of a tax authority's policy not to examine or reexamine a tax position. If the likelihood is considered remote and the other conditions are met, the tax position is effectively settled and the entity recognizes the full benefit associated with that tax position.

Given the complexities in the determination of whether a tax position has been effectively settled, consultation with income tax accounting advisers is encouraged.

A tax position that is determined to be effectively settled must be reevaluated if (1) an entity becomes aware that the tax authority may examine or reexamine that position or (2) the entity changes its intent to litigate or appeal the tax position. In addition, an entity may obtain information in an examination that leads it to change its evaluation of the technical merits; however, effective settlement is not a basis for changing an assessment of the technical merits of a position.

### **3.36 Finality or Certainty of Outcome in Subsequent Recognition, Derecognition, or Measurement of a Tax Position**

Management's assessment of UTBs is an ongoing process. ASC 740-10-25-14, ASC 740-10-35-2, and ASC 740-10-40-2 stipulate that management, when considering the subsequent recognition and measurement of the tax benefit associated with a tax position that did not initially meet the recognition threshold and the subsequent derecognition of one that did, should base such assessments on its "best judgment given the facts, circumstances, and information available at the reporting date."

The finality or certainty of a tax position's outcome through settlement or expiration of the statute of limitations is not required for the subsequent recognition, derecognition, or measurement of the benefit associated with a tax position. However, such changes in judgment should be based on management's assessment of new information only, not on a new evaluation or interpretation of previously available information.

ASC 740-10-25-8 states, "If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an entity shall recognize the benefit of the tax position in the first interim period that meets any one of the following conditions:

- The more-likely-than-not recognition threshold is met by the reporting date.
- The tax position is effectively settled through examination, negotiation or litigation.
- The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired."

An entity that has taken a tax position that previously did not meet the more-likely-than-not recognition threshold can subsequently recognize the benefit associated with that tax position only if new information changes the technical merits of the position or the tax position is effectively settled through examination (see 3.35). New information may include, but is not limited to, developments in case law, changes in tax law and regulations, and rulings by the tax authority.

An entity that has taken a tax position that previously did meet the more-likely-than-not recognition threshold can subsequently remeasure the benefit associated with the tax position without the limitation that the new information must change the technical merits of the position. For example, new information may result from a recently completed examination by the tax authority of a tax year that includes a similar type of tax position.

### **3.37 New Information Obtained After the Balance Sheet Date Concerning Uncertain Tax Positions**

Under ASC 740, an entity should not consider new information that is received after the balance sheet date, but that is not available as of the balance sheet date, when evaluating an uncertain tax position as of the balance sheet date. Specifically, paragraph B38 in the Basis for Conclusions of Interpretation 48 (not codified in ASC 740), states:

In deliberating changes in judgment in this Interpretation, the Board decided that recognition and measurement should be based on all information available at the reporting date and that a subsequent change in facts and circumstances should be recognized in the period in which the change occurs. Accordingly, a change in facts subsequent to the reporting date but prior to the issuance of the financial statements should be recognized in the period in which the change in facts occurs.

Note that subsequent events are currently accounted for under ASC 855. The guidance in ASC 740 applies only to situations covered by ASC 740 and is not analogous to other situations covered by ASC 855. ASC 855 prescribes the accounting requirements for two types of subsequent events: (1) recognized subsequent events, which constitute additional evidence of conditions that existed as of the balance sheet date and for which adjustment of previously unissued financial statements is required, and (2) nonrecognized subsequent events, which constitute evidence of conditions that did not exist as of the balance sheet date but arose after that date and for which only disclosure is required.

Examples 3-14 and 3-15 illustrate the consideration of new information concerning an uncertain tax position that is received after the balance sheet date.

#### **Example 3-14**

As of the balance sheet date, an entity believes that it is more likely than not that an uncertain tax position will be sustained. Before the financial statements are issued or are available to be issued, management becomes aware of a recent court ruling that occurred after the balance sheet date and that disallowed a similar tax position taken by another taxpayer. Because the court ruling occurred after the balance sheet date, the entity should reflect any change in its assessment of recognition and measurement that resulted from the new information in the first interim period after the balance sheet date.

#### **Example 3-15**

Assume that (1) an entity finalizes a tax litigation settlement with the tax authority after the balance sheet date but before its financial statements are issued or are available to be issued and (2) the events that gave rise to the litigation had taken place before the balance sheet date. According to ASC 740, the entity should not adjust its financial statements to reflect the subsequent settlement; however, the entity should disclose, in the notes to the financial statements, the settlement and its effect on the financial statements.

### 3.38 Interim Accounting for a Change in Judgment

An entity may change its judgment regarding (1) the validity of a tax position based on the more-likely-than-not recognition threshold or (2) the amount of benefit that is expected to be realized in a negotiated settlement with the taxing authority.

For interim financial reporting purposes, the accounting for a change in judgment about a tax position taken or to be taken in the current year is different from the accounting for a change in judgment about a tax position taken in a prior fiscal year. To maintain consistency with the existing requirements of ASC 740-270 for interim reporting, ASC 270, ASC 740-10-25-15, and ASC 740-270-35-6 require the following accounting:

- The effect of a change in judgment regarding a tax position taken in a prior fiscal year is recorded entirely in the interim period in which the judgment changes (similarly to taxes on a significant, unusual, or infrequently occurring item).
- The effect of a change in judgment regarding a tax position taken in a prior interim period in the same fiscal year is allocated to the current and subsequent interim periods by inclusion in the revised AETR.

### 3.39 Changes in Judgment Regarding a Tax Position Taken in the Current Year

Example 3-16 demonstrates changes in judgment regarding a tax position taken in the current year.

#### Example 3-16

In the first quarter of 20X7, an entity:

- Estimates that its ordinary income for fiscal year 20X7 will be \$4,000 (\$1,000 per quarter). Assume a tax rate of 40 percent.
- Enters into a transaction that is expected to permanently reduce its 20X7 taxable income by \$1,000; thus, its total tax expense for the year is expected to be \$1,200. Assume that the transaction meets the recognition threshold and that the full \$400 will be recognized under ASC 740.

Estimated pretax book income for 20X7	\$ 4,000
Estimated income tax expense for 20X7 (includes the \$400 tax benefit)	\$ 1,200
Estimated AETR	30%

Accordingly, for each quarter in 20X7 (provided that earnings are ratable), ordinary income and income tax expense are expected to be \$1,000 and \$300, respectively.

During the second quarter of 20X7, the entity receives new information indicating that the tax position related to the \$1,000 deduction no longer meets the more-likely-than-not recognition threshold. Therefore, in preparing its second-quarter financial statements, the entity updates its estimate of the AETR as follows:

Estimated pretax net income for 20X7 (\$1,000 per quarter)	\$ 4,000
Estimated income tax expense for 20X7 (excludes the \$400 benefit)	\$ 1,600
Estimated AETR	40%

On the basis of the new information received in the second quarter, the entity should report the following ordinary income and income tax expense for each quarter during 20X7:

**Example 3-16 (continued)**

	Ordinary Income		Tax			
	For the Quarter	Year-to-Date	Estimated AETR	Year-to-Date	Less Previously Provided	For the Quarter
First quarter of 20X7	\$ 1,000	\$ 1,000	30%	\$ 300	\$ —	\$ 300
Second quarter of 20X7	1,000	2,000	40%	800	300	500
Third quarter of 20X7	1,000	3,000	40%	1,200	800	400
Fourth quarter of 20X7	<u>1,000</u>	4,000	40%	1,600	1,200	<u>400</u>
		<u>\$ 4,000</u>				<u>\$ 1,600</u>

The effect of the change in judgment over a tax position taken in the current fiscal year is recognized by changing the estimated AETR to 40 percent, which does not reflect any benefit for the tax position. Of the \$400 total change representing the loss of the tax benefit previously thought to be more likely than not, a \$200 UTB is recognized in the second quarter and the remaining UTB of \$200 is recognized evenly in the third and fourth quarters.

### 3.40 Changes in Judgment Regarding a Tax Position Taken in the Prior Year

Example 3-17 demonstrates changes in judgment regarding a tax position taken in the prior year.

**Example 3-17**

In the first quarter of 20X7, an entity estimates that its AETR for the year will be 30 percent.

In the second quarter of 20X7, the entity receives new information indicating that a tax position taken in 20X6 no longer meets the more-likely-than-not recognition threshold. The benefit recognized for that tax position in the 20X6 financial statements was \$400. No similar tax positions were taken or are expected to be taken in 20X7.

Assuming that ordinary income for each of the quarters is \$1,000 per quarter, the entity determines income tax expense in each of the quarters in 20X7 as follows:

	Ordinary Income	Tax			Total
		Applicable to Ordinary Income	Applicable to Change in Judgment Regarding a Prior Year's Tax Position	Total	
First quarter of 20X7	\$ 1,000	\$ 300	\$ —	\$ 300	
Second quarter of 20X7	1,000	300	400	700	
Third quarter of 20X7	1,000	300	—	300	
Fourth quarter of 20X7	<u>1,000</u>	<u>300</u>	<u>—</u>	<u>300</u>	
	<u>\$ 4,000</u>	<u>\$ 1,200</u>	<u>\$ 400</u>	<u>\$ 1,600</u>	

The effect of the change in judgment regarding the tax position taken in 20X6 is recorded as a discrete item in the second quarter of 20X7, the period in which the judgment changed, and does not affect the AETR to be applied to 20X7 income.

### 3.41 Distinguishing a Change in Estimate From a Correction of an Error

A change in a prior-year tax provision can arise from either a change in accounting estimate or the correction of an error.

The primary source of guidance on accounting changes and error corrections is ASC 250. ASC 250-10-20 defines a change in accounting estimate as a “change that has the effect of adjusting the carrying amount of an existing asset or liability . . . Changes in accounting estimates result from new information.” A change in a prior-year tax provision is a change in accounting estimate if it results from new information, a change in facts and circumstances, or later identification of information that was not reasonably knowable or readily accessible as of the prior reporting period. In addition, ASC 740-10-25-14 and ASC 740-10-35-2 state that the subsequent recognition and measurement of a tax position should “be based on management’s best judgment given the facts, circumstances, and information available at the reporting date” and that subsequent changes in management’s judgment should “result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.”

In contrast, ASC 250-10-20 defines an error in previously issued financial statements (an “error”) as an “error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.” In determining whether the change is a correction of an error, an entity should consider whether the information was or should have been “reasonably knowable” or “readily accessible” from the entity’s books and records in a prior reporting period and whether the application of information at that time would have resulted in different reporting. The determination of when information was or should have been reasonably knowable or readily accessible will depend on the entity’s particular facts and circumstances.

Distinguishing between a change in accounting estimate and a correction of an error is important because they are accounted for and reported differently. In accordance with ASC 250-10-45-23, an error correction is typically accounted for by **restating** prior-period financial statements. However, ASC 250-10-45-17 specifies that a change in accounting estimate is accounted for prospectively “in the period of change if the change affects that period only or in the period of change and future periods if the change affects both.” Under ASC 250-10-50-4, if the change in estimate affects several future periods, an entity must disclose the “effect on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period.”

If the change to the prior-period tax provision is determined to be an error, the entity should look to ASC 250 for guidance on how to report the correction of the error. Additional guidance is also provided by SAB Topics 1.M (SAB 99) and 1.N (SAB 108).

An entity must often use judgment in discerning whether a change in a prior-year tax provision results from a correction of an error or a change in estimate. The sections below list examples of changes in accounting estimate and error corrections.

The following are examples of changes that should be accounted for as changes in accounting estimate:

- A change in judgment (as a result of a change in facts or circumstances or the occurrence of an event) regarding the sustainability of a tax position or the need for a valuation allowance.
- The issuance of a new administrative ruling.
- Obtaining additional information on the basis of the experience of other taxpayers with similar circumstances.
- Adjusting an amount for new information that would not have been readily accessible from the entity's books and records as of the prior reporting date. For example, to close its books on a timely basis, an entity may estimate certain amounts that are not readily accessible. In this case, as long as the entity had a reasonable basis for its original estimate, the subsequent adjustment is most likely a change in estimate.
- Developing, with the assistance of tax experts, additional technical insight into the application of the tax law with respect to prior tax return positions involving very complex or technical tax issues. Because both tax professionals and the tax authorities are continually changing and improving their understanding of complex tax laws, such circumstances typically constitute a change in estimate rather than an error.
- Making a retroactive tax election that affects positions taken on prior tax returns if the primary factors motivating such a change can be tied to events that occurred after the balance sheet date.
- Deciding to pursue a tax credit or deduction retroactively that was previously considered not to be economical but that becomes prudent because of a change in facts and circumstances. Such a decision is a change in estimate if the entity evaluated the acceptability of the tax position as of the balance sheet date and analyzed whether the tax position was economical but concluded that it was not prudent to pursue this benefit. The decision would not be considered a change in estimate if the entity did not consider or otherwise evaluate the acceptability of the tax position as of the balance sheet date.

The following are examples of changes that should be accounted for as error corrections:

- Intentionally misstating a tax accrual.
- Discovering a mathematical error in a prior-year income tax provision.
- Oversight or misuse of facts or failure to use information that was reasonably knowable and readily accessible as of the balance sheet date.
- Misapplying a rule or requirement or the provisions of U.S. GAAP. One example is a situation in which an entity fails to record a DTA, a DTL, a tax benefit, or a liability for UTBs that should have been recognized in accordance with ASC 740 on the basis of the facts and circumstances that existed as of the reporting date that were reasonably knowable when the financial statements were issued.
- Adjusting an amount for new information that would have been readily accessible from the entity's books and records as of the prior reporting period. In assessing whether information was or should have been "readily accessible," an entity should consider the nature, complexity, relevance, and frequency of occurrence of the item.

### 3.42 Deferred Tax Consequences of UTBs

Recording a liability for a UTB may result in a corresponding temporary difference and DTA. Examples 3-18 and 3-19 illustrate how a DTA can arise from the accounting for a UTB.

#### Example 3-18

Company A has taken an uncertain tax position in State B that reduces its taxes payable by \$10,000 in that state. In assessing the uncertain tax position under ASC 740, A determines that it is not more likely than not that the position, on the basis of its technical merits, will be sustained upon examination. Therefore, A records a \$10,000 liability for the UTB.

Company A will receive an additional federal tax deduction if it is ultimately required to make an additional tax payment to the state. Therefore, A should record a DTA for the indirect benefit from the potential disallowance of the uncertain tax position taken on its tax return in State B.

If the tax rate is 40 percent, A would record the following journal entries to account for the uncertain tax position and the indirect tax benefit:

Current income tax expense	10,000
Liability for UTBs	10,000
DTA for indirect tax benefit	4,000
Deferred income tax expense	4,000

Like other DTAs, the DTA created as a result of recording the liability for the UTB should be evaluated for realizability.

#### Example 3-19

Company A has operations in State B but has never filed a tax return in that state. ASC 740-10-20 indicates that the "decision not to file a tax return" is a tax position. In assessing the tax position under ASC 740, A determines that it may have nexus in State B and that it is not more likely than not that the position, on the basis of its technical merits, will be sustained upon examination. Therefore, A records a \$10,000 liability for the taxes payable to State B for the current and prior years.

However, if A were to file a return in State B, it would also have a large deductible temporary difference that would result in an \$8,000 DTA in that state. Therefore, A should record a DTA as a result of potential nexus in State B and evaluate it for realizability.

Company A would record the following journal entries to account for the uncertain tax position and the related temporary difference:

Current income tax expense	10,000
Liability for unrecognized state tax benefits	10,000
DTA for indirect temporary differences	8,000
Deferred income tax expense	8,000

Note that in this scenario, A may have other tax consequences to consider as a result of recording a liability for taxes payable in State B (e.g., an additional federal deduction, as referred to in Example 3-18).

See [6.21](#) for further discussion of the presentation of deferred taxes resulting from UTBs.

## Temporary Differences

### ASC 740-10

**25-18** Income taxes currently payable for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year.

**25-19** However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

- a. The amount of taxable income and pretax financial income for a year
- b. The tax bases of assets or liabilities and their reported amounts in financial statements.

Guidance for computing the tax bases of assets and liabilities for financial reporting purposes is provided in this Subtopic. [FAS 109, paragraph 10]

**25-20** An assumption inherent in an entity's statement of financial position prepared in accordance with generally accepted accounting principles (GAAP) is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples include the following:

- a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.
- b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.
- c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.
- d. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.
- e. A reduction in the tax basis of depreciable assets because of tax credits. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered. For example, a tax law may provide taxpayers with the choice of either taking the full amount of depreciation deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or taking the full tax credit and a reduced amount of depreciation deductions.
- f. Investment tax credits accounted for by the deferral method. Under the deferral method as established in paragraph 740-10-25-46, investment tax credits are viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred investment tax credits may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.
- g. An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency. The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

### ASC 740-10 (continued)

- h. Business combinations and combinations accounted for by not-for-profit entities (NFPs). There may be differences between the tax bases and the recognized values of assets acquired and liabilities assumed in a business combination. [FAS 109, paragraph 11] There also may be differences between the tax bases and the recognized values of assets acquired and liabilities assumed in an acquisition by a not-for-profit entity or between the tax bases and the recognized values of the assets and liabilities carried over to the records of a new entity formed by a merger of not-for-profit entities. [FAS 164, paragraph E9(a)] Those differences will result in taxable or deductible amounts when the reported amounts of the assets or liabilities are recovered or settled, respectively. [FAS 109, paragraph 11]

### Pending Content (Transition Guidance: ASC 740-10-65-5)

**25-20** An assumption inherent in an entity's statement of financial position prepared in accordance with generally accepted accounting principles (GAAP) is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples include the following:

- a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.
- b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.
- c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.
- d. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.
- e. A reduction in the tax basis of depreciable assets because of tax credits. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered. For example, a tax law may provide taxpayers with the choice of either taking the full amount of depreciation deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or taking the full tax credit and a reduced amount of depreciation deductions.
- f. Investment tax credits accounted for by the deferral method. Under the deferral method as established in paragraph 740-10-25-46, investment tax credits are viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred investment tax credits may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.
- g. An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency. The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

**ASC 740-10 (continued)****Pending Content (Transition Guidance: ASC 740-10-65-5) (continued)**

- h. Business combinations and combinations accounted for by not-for-profit entities (NFPs). There may be differences between the tax bases and the recognized values of assets acquired and liabilities assumed in a business combination. [FAS 109, paragraph 11] There also may be differences between the tax bases and the recognized values of assets acquired and liabilities assumed in an acquisition by a not-for-profit entity or between the tax bases and the recognized values of the assets and liabilities carried over to the records of a new entity formed by a merger of not-for-profit entities. [FAS 164, paragraph E9(a)] Those differences will result in taxable or deductible amounts when the reported amounts of the assets or liabilities are recovered or settled, respectively. [FAS 109, paragraph 11]
- i. Intra-entity transfers of an asset other than inventory. There may be a difference between the tax basis of an asset in the buyer's tax jurisdiction and the carrying value of the asset reported in the consolidated financial statements as the result of an intra-entity transfer of an asset other than inventory from one tax-paying component to another tax-paying component of the same consolidated group. That difference will result in taxable or deductible amounts when the asset is recovered. [ASU 2016-16, paragraph 4]

**25-21** The examples in (a) through (d) in the preceding paragraph illustrate revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in pretax financial income. Those differences between taxable income and pretax financial income also create differences (sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in the financial statements. The examples in (e) through (h) in the preceding paragraph illustrate other events that create differences between the tax basis of an asset or liability and its reported amount in the financial statements. For all eight examples, the differences result in taxable or deductible amounts when the reported amount of an asset or liability in the financial statements is recovered or settled, respectively. [FAS 109, paragraph 12]

**Pending Content (Transition Guidance: ASC 740-10-65-5)**

**25-21** The examples in (a) through (d) in paragraph 740-10-25-20 illustrate revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in pretax financial income. Those differences between taxable income and pretax financial income also create differences (sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in the financial statements. The examples in (e) through (i) in paragraph 740-10-25-20 illustrate other events that create differences between the tax basis of an asset or liability and its reported amount in the financial statements. For all of the examples, the differences result in taxable or deductible amounts when the reported amount of an asset or liability in the financial statements is recovered or settled, respectively. [FAS 109, paragraph 12]

**25-22** This Topic refers collectively to the types of differences illustrated by those eight examples and to the ones described in paragraph 740-10-25-24 as temporary differences.

**Pending Content (Transition Guidance: ASC 740-10-65-5)**

**25-22** This Topic refers collectively to the types of differences illustrated by the examples in paragraph 740-10-25-20 and to the ones described in paragraph 740-10-25-24 as temporary differences. [FAS 109, paragraph 13]

### ASC 740-10 (continued)

**25-23** Temporary differences that will result in taxable amounts in future years when the related asset or liability is recovered or settled are often referred to as taxable temporary differences (the examples in paragraph 740-10-25-20(a); (d); and (e) are taxable temporary differences). Likewise, temporary differences that will result in deductible amounts in future years are often referred to as deductible temporary differences (the examples in paragraph 740-10-25-20(b); (c); (f); and (g) are deductible temporary differences). Business combinations (the example in paragraph 740-10-25-20(h)) may give rise to both taxable and deductible temporary differences. [FAS 109, paragraph 13]

#### Pending Content (Transition Guidance: ASC 740-10-65-5)

**25-23** Temporary differences that will result in taxable amounts in future years when the related asset or liability is recovered or settled are often referred to as taxable temporary differences (the examples in paragraph 740-10-25-20(a), (d), and (e) are taxable temporary differences). Likewise, temporary differences that will result in deductible amounts in future years are often referred to as deductible temporary differences (the examples in paragraph 740-10-25-20(b), (c), (f), and (g) are deductible temporary differences). Business combinations [FAS 109, paragraph 13] and intra-entity transfers of assets other than inventory [ASU 2016-16, paragraph 4] (the examples in paragraph 740-10-25-20(h) through (i)) may give rise to both taxable and deductible temporary differences. [FAS 109, paragraph 13]

**25-24** Some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting.

**25-25** That occurs, for example, when a long-term contract is accounted for by the percentage-of-completion method for financial reporting and by the completed-contract method for tax purposes. The temporary difference (income on the contract) is deferred income for tax purposes that becomes taxable when the contract is completed. Another example is organizational costs that are recognized as expenses when incurred for financial reporting and are deferred and deducted in a later year for tax purposes. [FAS 109, paragraph 15]

#### Pending Content (Transition Guidance: ASC 606-10-65-1)

**25-25** That occurs, for example, when revenue on a long-term contract [FAS 109, paragraph 15] with a customer is recognized over time using a measure of progress to depict performance over time in accordance with the guidance in Subtopic 606-10, for financial reporting that is different from the recognition pattern used for tax purposes (for example, when the contract is completed). [ASU 2014-09, paragraph 179] The temporary difference (income on the contract) is deferred income for tax purposes that becomes taxable when the contract is completed. Another example is organizational costs that are recognized as expenses when incurred for financial reporting and are deferred and deducted in a later year for tax purposes. [FAS 109, paragraph 15]

**25-26** In both instances, there is no related, identifiable asset or liability for financial reporting, but there is a temporary difference that results from an event that has been recognized in the financial statements and, based on provisions in the tax law, the temporary difference will result in taxable or deductible amounts in future years. [FAS 109, paragraph 15]

**25-27** An entity might be able to delay the future reversal of taxable temporary differences by delaying the events that give rise to those reversals, for example, by delaying the recovery of related assets or the settlement of related liabilities.

**25-28** A contention that those temporary differences will never result in taxable amounts, however, would contradict the accounting assumption inherent in the statement of financial position that the reported amounts of assets and liabilities will be recovered and settled, respectively; thereby making that statement internally inconsistent. Because of that inherent accounting assumption, the only question is when, not whether, temporary differences will result in taxable amounts in future years. [FAS 109, paragraph 78]

**ASC 740-10 (continued)**

**25-29** Except for the temporary differences addressed in paragraph 740-10-25-3, which shall be accounted for as provided in that paragraph, an entity shall recognize a deferred tax liability or asset for all temporary differences and operating loss and tax credit carryforwards in accordance with the measurement provisions of paragraph 740-10-30-5. [FAS 109, paragraph 16]

**Related Implementation Guidance and Illustrations**

- [Examples of Temporary Differences](#) [ASC 740-10-55-49].
- [Example 23: Effects of Subsidy on Temporary Difference](#) [ASC 740-10-55-165].
- [Example 24: Built-In Gains of S Corporation](#) [ASC 740-10-55-168].
- [Example 26: Direct Transaction With Governmental Taxing Authority](#) [ASC 740-10-55-202].

### 3.43 Tax Bases Used in the Computation of Temporary Differences

The tax bases of assets and liabilities used to compute temporary differences do not always correspond to the amounts contained in the filed tax return. ASC 740-10-20 defines the term “temporary difference,” in part, as follows:

A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.

Accordingly, under ASC 740, the tax bases of assets and liabilities used to compute temporary differences as well as loss and tax credit carryforwards may not necessarily be consistent with information contained in as-filed tax returns or the schedules used to prepare such returns. Instead, such tax bases and carryforwards are computed on the basis of amounts that meet the recognition threshold of ASC 740 and are measured in accordance with ASC 740. That is, for financial reporting purposes, income tax assets and liabilities, including DTAs and DTLs, are computed on the basis of what might be characterized as a “hypothetical ASC 740 tax return,” which may reflect tax bases of (1) assets and liabilities and (2) tax loss and credit carryforwards that may not be consistent with the as-filed tax return.

In addition, ASC 740-10-45-12 states that a “liability recognized for an unrecognized tax benefit shall not be classified as a deferred tax liability unless it arises from a taxable temporary difference.”

### 3.44 Temporary Differences

While many of an entity’s transactions receive identical tax and financial reporting treatment, there are some situations in which they will be treated differently. The authoritative literature preceding ASC 740 used the term “timing difference” to describe differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax financial accounting income. Timing differences were described as differences that originate in one period and reverse or “turn around” in one or more subsequent periods.

The term “temporary difference,” as used in ASC 740, encompasses more than the timing differences defined in the authoritative literature preceding ASC 740. The method that an entity uses to calculate temporary differences under ASC 740 stresses the economic impact of recovering and settling assets and liabilities at their reported amounts. Consequently, a DTA or DTL will be recognized for almost all

basis differences that exist on the balance sheet date. ASC 740-10-20 defines a temporary difference as follows:

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

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

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

ASC 740-10-25-20 gives examples of situations in which a difference between the tax basis of an asset or liability and its reported amount in the financial statements will result in taxable or deductible amounts in future year(s) when the reported amount of the asset or liability is recovered or settled. See [4.26](#) and [4.27](#) for additional examples.

### **3.45 Income Tax Consequences of Issuing Debt With a Conversion Feature Accounted for Separately as a Derivative**

Entities that issue convertible debt must assess whether the instrument's conversion feature should be accounted for separately (bifurcated) in accordance with relevant U.S. GAAP (e.g., ASC 470-20). Under U.S. GAAP, the entity must also determine whether a conversion feature that is bifurcated should be classified as equity or as a derivative.

ASC 740-10-55-51 provides guidance on accounting for tax consequences of convertible debt instruments that contain a beneficial conversion feature that is bifurcated and accounted for as equity. In addition, the income tax accounting guidance in ASC 470-20-25-27 addresses situations in which (1) a convertible debt instrument may be settled in cash upon conversion and (2) the conversion feature is bifurcated and accounted for as equity.

However, the income tax accounting guidance is not as explicit on situations in which the conversion feature is bifurcated and accounted for as a separate derivative liability. In such cases, there is typically a difference between the book and tax basis of both the debt instrument and the conversion feature accounted for as a derivative liability. These basis differences result because, although the convertible debt instrument is separated into two units of accounting for financial reporting purposes (the debt instrument and the conversion feature), typically the debt is not bifurcated for tax purposes. In such circumstances, deferred taxes should be recorded for the basis differences of both the debt and the derivative liability.

The tax basis difference associated with a debt conversion feature that is a derivative liability is considered a deductible temporary difference. ASC 740-10-20 defines a temporary difference as a difference "that will result in taxable or deductible amounts in future years when the reported amount of the . . . liability is recovered or settled." Further, ASC 740-10-20 states that "[e]vents that do not have tax consequences do not give rise to temporary differences." This conclusion is also based by analogy on the income tax accounting guidance on beneficial conversion features and conversion features bifurcated from convertible debt instruments that may be settled in cash upon conversion.

ASC 740-10-55-51 addresses the income tax accounting for beneficial conversion features and states, in part:

The issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying [ASC 740]. The recognition of a beneficial conversion feature effectively creates two separate instruments — a debt instrument and an equity instrument — for financial statement purposes while it is accounted for as a debt instrument, for example, under the U.S. Federal Income Tax Code. Consequently, the reported amount in the financial statements (book basis) of the debt instrument is different from the tax basis of the debt instrument. The basis difference that results from the issuance of convertible debt with a beneficial conversion feature is a temporary difference for purposes of applying [ASC 740] because that difference will result in a taxable amount when the reported amount of the liability is recovered or settled. That is, the liability is presumed to be settled at its current carrying amount (reported amount).

The convertible debt guidance in ASC 470-20-25-27 addresses the income tax accounting for conversion features bifurcated from convertible debt instruments that may be settled in cash upon conversion. This paragraph states, in part:

Recognizing convertible debt instruments within the scope of the Cash Conversion Subsections as two separate components — a debt component and an equity component — may result in a basis difference associated with the liability component that represents a temporary difference for purposes of applying Subtopic 740-10.

Accordingly, any difference between the financial reporting basis and tax basis of both the convertible debt instrument and the derivative liability should be accounted for as a temporary difference in accordance with ASC 740. However, as demonstrated in Example 3-20, if the settlement of the convertible debt and derivative liability at an amount greater than their combined tax basis would not result in a tax-deductible transaction, a net DTA should not be recorded.

### Example 3-20

On January 1, 20X1, Entity A issues 100,000 convertible notes at their par value of \$1,000 per note, raising total proceeds of \$100 million. The embedded conversion feature must be accounted for separately from the convertible notes (i.e., as a derivative instrument under ASC 815). On January 1, 20X1, and December 31, 20X1, the derivative liability has a fair value of \$40 million and \$35 million, respectively. The notes bear interest at a fixed rate of 2 percent per annum, payable annually in arrears on December 31, and mature in 10 years. The notes do not contain embedded prepayment features other than the conversion option.

The tax basis of the notes is \$100 million, and A's tax rate is 40 percent. Entity A is entitled to tax deductions based on cash interest payments but will receive no tax deduction if the payment of consideration upon conversion is in excess of the tax basis of the convertible notes (\$100 million), regardless of the form of that consideration (cash or shares).

Transaction costs are not considered in this example.

#### Journal Entries: January 1, 20X1

Cash	100,000,000
Debt discount	40,000,000
Debt	100,000,000
Derivative liability	40,000,000
To record the issuance of the convertible debt.	
Income tax provision	16,000,000
DTL	16,000,000
To record the DTL for the temporary difference between the financial reporting basis of the debt (\$60 million) and the tax basis of the debt (\$100 million).	

**Example 3-20 (continued)**

DTA	16,000,000
Income tax provision	16,000,000

To record the DTA for the temporary difference between the financial reporting basis of the derivative liability (\$40 million) and the tax basis of the derivative liability (\$0).

As shown above, the deferred tax balances will typically offset each other at issuance. However, the temporary differences will not remain equivalent because the derivative liability will typically be marked to fair value on an ongoing basis while the discount on the debt will accrete toward the principal balance, as shown below.

**Journal Entries: December 31, 20X1**

Interest expense	5,144,587
Debt discount	3,144,587
Cash	2,000,000

To record the amortization of the debt discount and the payment of the cash interest for the first year.

Derivative liability	5,000,000
Gain on change in derivative liability fair value	5,000,000

To record the change in the fair value of the derivative liability in the first year.

DTL	1,257,835
Income taxes payable	800,000
Income tax provision	2,057,835

To record the tax effects of the interest expense, consisting of \$800,000 of current tax benefits and \$1,257,835 of deferred tax benefits.

Income tax provision	2,000,000
DTA	2,000,000

To record the decrease in the DTA for the change in the financial reporting carrying value of the derivative liability from \$40 million to \$35 million.

Because A presumes that the liabilities will be settled at their current carrying value (reported amount) in the future **and** the combined carrying value is less than the combined tax basis, the settlement will result in a taxable transaction. Accordingly, the basis differences meet the definition of a temporary difference under ASC 740 and a net DTL is recorded. However, if the fair value of the derivative liability would have increased and the combined carrying value (reported amount) of the convertible debt and derivative liability would have exceeded the combined tax basis, the basis differences would not meet the definition of a temporary difference under ASC 740 because the settlement of convertible debt and derivative liability at an amount greater than their combined basis would **not** result in a tax-deductible transaction.

Therefore, it is acceptable for A to record deferred taxes for the basis differences but only to the extent that the combined carrying value of the convertible debt and derivative liability is equal to or less than the combined tax basis. In other words, at any point, A could have a net DTL related to the combined carrying value, but not a net DTA.

### 3.46 Income Tax Effects on Medicare Part D Subsidy Receipts

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the “2003 Act”) established a prescription drug benefit under Medicare Part D and a federal subsidy to employers offering retiree prescription drug coverage that provides a benefit that is at least as valuable as Medicare Part D coverage. An employer’s promise to provide postretirement prescription drug coverage (“coverage”) is recorded as a component of the other postretirement benefit obligation. When that

coverage benefit meets certain criteria, the employer becomes eligible to receive the federal retiree drug subsidy (the “subsidy”), which is then recorded as an offset against the obligation (the obligation is recorded net of the subsidy, and the net amount is actuarially determined).

On March 23, 2010, and March 30, 2010, President Obama signed into law the Patient Protection and Affordable Care Act and the Health Care and Education Affordability Reconciliation Act of 2010 (the “2010 Health Care Act”), respectively. This health care legislation eliminated certain tax deductions related to the subsidy.

Under the 2003 Act, the subsidy received is not considered taxable income to the employer for federal income tax purposes. ASC 740-10-55-57 states that “[i]n the periods in which the subsidy affects the employer’s accounting for the plan,” the subsidy should not affect any plan-related temporary differences that are accounted for under ASC 740 because the subsidy is exempt from federal taxation. Therefore, an employer should not record any deferred taxes when recognizing in AOCI the portion of unrecognized actuarial gain that is related to the subsidy.

However, the 2010 Health Care Act repealed the provision in the 2003 Act that permitted deduction of the entire portion of the prescription drug coverage expense that was offset by the subsidy. Therefore, prescription drug expenditures equal to the subsidy amount are no longer tax-deductible under the 2010 Health Care Act. As a result, the expected future tax deduction is reduced by an amount equal to the subsidy, and the corresponding DTA must be adjusted.

In accordance with ASC 740, the expense associated with adjusting this DTA would have been recognized as tax expense in continuing operations in the period in which the change in tax law was enacted. However, if a full valuation allowance was recorded against the DTA, the remeasurement of the DTA would not have resulted in tax expense because the DTA has been previously reserved. In addition, the DTA is not adjusted downward (i.e., no tax expense is recognized) for amounts that are expected to be settled before the effective date of this provision of the 2010 Health Care Act.

### **3.47 Recognizing Deferred Taxes for Indefinite-Lived Assets**

ASC 740-10-25-20 states, in part:

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

An entity would recognize deferred taxes for a temporary difference related to an indefinite-lived asset (e.g., land, indefinite-lived intangible assets, and DTAs for tax-deductible goodwill in excess of financial reporting goodwill). Although the tax effect may be delayed indefinitely, the ability to do so is not a factor in the determination of whether a temporary difference exists. ASC 740-10-55-63 addresses this issue, stating that “deferred tax liabilities may not be eliminated or reduced because an entity may be able to delay the settlement of those liabilities by delaying the events that would cause taxable temporary differences to reverse. Accordingly, the deferred tax liability is recognized.”

See [4.04](#) for guidance on measuring deferred taxes for indefinite-lived assets when different tax rates may apply. In addition, see [4.27](#) for guidance on whether an entity can use the reversal of a DTL related to an indefinite-lived asset as a source of taxable income to support the realization of DTAs.

### 3.48 Deferred Tax Considerations When Goodwill Becomes a Finite-Lived Asset

Under ASC 350-20-15-4, a private company can elect a simplified, alternative approach to subsequently account for goodwill (the “goodwill accounting alternative”). Under this approach, the company can amortize goodwill related to each business combination on a straight-line basis, generally over a period of 10 years.

A private company that elects the goodwill accounting alternative should consider several things when preparing its provision for income taxes. Those considerations vary, in part, depending on whether the goodwill is deductible for tax purposes:

- *Non-tax-deductible goodwill* — The accounting alternative does not change the prohibition on the recognition of a DTL for goodwill that is not deductible for tax purposes. The amortization of goodwill for financial reporting purposes will typically create a reconciling item related to the effective tax rate (i.e., an unfavorable permanent difference).
- *Tax-deductible goodwill* — The amortization of financial reporting goodwill will result in either an increase or a decrease to deferred taxes depending on how it compares with the related tax amortization in the period.

When both tax-deductible and non-tax-deductible goodwill are present, an entity must determine the amount of financial reporting goodwill amortization attributable to the components of goodwill that were originally determined in acquisition accounting. (See [11.20](#) for more information about the recognition of deferred taxes on the basis of the components of goodwill.) Entities should consider whether they have already established a policy for such an allocation in connection with a past goodwill impairment and, if so, should apply such a policy consistently. One method that is commonly used in such circumstances is a pro rata allocation. (See [11.33](#) for an example illustrating a pro rata allocation.) Under a pro rata allocation approach for goodwill amortization, an entity would proportionally allocate the amortization to tax-deductible and nondeductible goodwill on the basis of the proportion of each. Other approaches may also be acceptable. Further complexities arise when the goodwill in a reporting unit is associated with multiple acquisitions or spans multiple taxing jurisdictions.

In addition, an entity’s postacquisition tax amortization of component 1 goodwill (see [11.20](#)) may have created DTLs. Because these DTLs were previously associated with an indefinite-lived intangible asset, they generally would not have been considered a source of income for the realization of DTAs. However, because of the recharacterization of goodwill as a finite-lived asset, the DTL could potentially be a source of taxable income supporting the recoverability of a DTA.

### 3.49 Deferred Tax Consequences of Synthetic Leases

Entities (lessees) often enter into complex leasing arrangements involving special-purpose entities to achieve off-balance-sheet financing of real property. One such arrangement is a “synthetic lease.” The objective of a synthetic lease is for the lessee to achieve operating lease treatment for financial reporting purposes under the lease guidance in ASC 840. For income tax purposes, the entity is treated as the owner of the property. Therefore, the entity only recognizes rent expense in its financial statements but capitalizes the property and the related debt obligation in its income tax return. (Note that the consolidations guidance in ASC 810 may require entities to consolidate certain synthetic lease transactions.)

In a synthetic lease structure, because the tax bases of the property and related debt differ from their reported amounts in the financial statements, deferred tax consequences are created and a temporary difference arises. A temporary difference exists because the recognition and measurement requirements under the tax law are different from those under the financial accounting standards. Even if an entity has not recorded an asset and liability for financial reporting purposes, it is entitled to the future tax benefits (deductions) from the depreciation of the property and the interest from the debt. Accordingly, the entity should record a DTA and DTL for the future tax consequences related to the depreciation of the property and the amortization of the debt, respectively. The initial recording of the DTA and DTL generally offset each other. Subsequently, a net DTA or DTL generally will result because the methods of depreciating the property are different from those for amortizing the debt. If the property is held for the full term of the lease, the DTA and DTL will reverse over time.

### **3.50 Considering the Impact of Tax Method Changes**

For U.S. federal income tax purposes, the periods in which income is taxable and expenditures are deductible may depend on the taxpayer's federal income tax accounting method. While entities are required to apply their established federal income tax accounting method unless they affirmatively change the method to be used, an entity might determine that it is using an impermissible federal income tax accounting method and decide to change to a permissible method. Alternatively, a taxpayer that is using a permissible federal income tax accounting method may decide to change to a different permissible method.

Method changes generally result in a negative or positive adjustment to taxable income during the year in which the method change becomes effective. A negative ("favorable") adjustment results in a deduction recognized in the year of change. A positive ("unfavorable") adjustment results in an increase in taxable income that is generally recognized over four tax years.

To change its federal income tax accounting method, an entity must file a Form 3115. A method change that requires advance written consent from the IRS before becoming effective is referred to as a "manual" or "nonautomatic" method change. Conversely, a method change that is deemed to be approved by the IRS when the Form 3115 is filed with the IRS is referred to as an "automatic" method change.

In determining the financial statement impact of a change in a federal income tax accounting method, an entity should consider whether the change is (1) from an impermissible method to a permissible method or (2) from a permissible method to another permissible method.

#### ***Impermissible to Permissible***

An entity that is using an impermissible federal income tax accounting method should assess its tax position by applying the recognition and measurement principles of ASC 740-10 to determine whether the improper accounting method results in an uncertain tax position for which an UTB, interest, and penalties should be recorded in the financial statements.

Changes from an impermissible to a permissible federal income tax accounting method generally result in an unfavorable adjustment that is recognized as an increase in taxable income over four tax years. Further, when an entity files a Form 3115 for a change from an impermissible to a permissible federal income tax accounting method and obtains consent from the IRS (either automatic deemed consent or express written consent), it receives "audit protection" for prior tax years, which provides relief from interest and penalties.

A change in a U.S. federal income tax accounting method that results in an unfavorable adjustment and does not conform to the financial accounting treatment for the related item (i.e., the new permissible accounting method for U.S. federal income tax purposes differs from the financial reporting accounting method) will usually result in two temporary differences:

- The difference between the new income tax basis of the underlying asset or liability and the financial reporting carrying amount.
- A future taxable income adjustment under Section 481(a) of the IRC, which represents the cumulative taxable income difference between historical taxable income determined under the previous federal income tax accounting method and historical taxable income determined under the new federal income tax accounting method.

### **Permissible to Permissible**

An entity that is currently using a permissible federal income tax accounting method generally does not have a UTB. A change from a permissible federal income tax accounting method to another permissible federal income tax accounting method may result in a favorable or unfavorable adjustment to cumulative taxable income. In a manner similar to how an entity would recognize an unfavorable adjustment for a change from an impermissible method to a permissible method, an unfavorable adjustment for a change from a permissible method to another permissible method is generally recognized over four tax years, resulting in two temporary differences when the new federal income tax accounting method does not conform to the financial accounting treatment for the related item. A change in a federal income tax accounting method that results in a favorable adjustment and does not conform to the financial accounting treatment for the related item will generally result in one temporary difference — specifically, the difference between the income tax basis of the underlying asset or liability and the financial reporting carrying amount. The entire favorable IRC Section 481(a) adjustment is recognized in the tax return in the year of change.

#### **Example 3-21**

##### **Change From an Impermissible Federal Income Tax Accounting Method to a Permissible Method With a Positive (Unfavorable) Adjustment**

In prior years, Company A, a profitable company, accrued a liability for employee bonuses based on amounts earned under its corporate bonus plan. As of December 31, 20X3, the liability for accrued bonuses was \$250. For federal income tax purposes, A had deducted the bonuses in the year accrued. In analyzing its tax position in accordance with ASC 740-10, A determined that for federal income tax purposes, the bonuses did not qualify as a federal income tax deduction when accrued for financial reporting purposes. Consequently, A recorded a \$100 liability ( $\$250 \times 40\%$  tax rate) for the UTB and accrued a \$5 liability for accrued interest as of the year ended December 31, 20X3. Company A's policy is to classify interest related to UTBs as income taxes payable. Further, A recognized a DTA of \$100 for the accrued bonuses that is actually deductible in future years.

**Example 3-21 (continued)**

In the first quarter of 20X4, A filed a Form 3115 to change from the impermissible federal income tax accounting method for employee bonuses to the permissible method of deducting the bonus amounts when paid. The accounting method change results in the following changes to the income tax accounts:

<b>Debit (Credit)</b>	<b>Before</b>	<b>Impact of Form 3115/ Current-Year Change</b>	<b>After</b>
DTA — accrued bonus	\$ 100		\$ 100
UTB liability	(105)	\$ 105 <sup>(a)</sup>	—
Current tax payable	—	(25) <sup>(b)</sup>	(25)
Current DTL — IRC Section 481(a) adjustment <sup>(e)</sup>	—	(25) <sup>(c)</sup>	(25)
Noncurrent DTL — IRC Section 481(a) adjustment <sup>(e)</sup>	—	(50) <sup>(d)</sup>	(50)
Income tax (benefit)	—	(5) <sup>(a)</sup>	—

(a) Reversal of UTB and interest liability upon IRS consent (either automatic deemed consent or express written consent).  
(b) Current liability for the IRC Section 481(a) adjustment that is taxable in the current year.  
(c) DTL for the IRC Section 481(a) taxable temporary difference that is not taxable in the current year but reverses within one year.  
(d) DTL for the IRC Section 481(a) taxable temporary difference that is taxable in periods beyond one year.  
(e) This presentation is appropriate before adoption of ASU 2015-07. After adoption of ASU 2015-07, these amounts would be presented as a single, noncurrent DTL.

**Example 3-22****Change From a Permissible Federal Income Tax Accounting Method to Another Permissible Method With a Negative (Favorable) Adjustment**

For federal income tax purposes, Company B, a profitable company, uses the full inclusion method for advance payments received for the sale of goods (i.e., for federal income tax purposes, the full amount of advance payments is included in taxable income in the period in which they are received). For financial reporting purposes, B defers the recognition of revenue upon receipt of the \$500 of advance payments; the deferral results in a deductible temporary difference and the recognition of a DTA of \$200.

After completing a review of its federal income tax accounting methods, B files a Form 3115 to change to a one-year deferral method for federal income tax purposes in accordance with Revenue Procedure 2004-34. This results in a favorable IRC Section 481(a) adjustment of \$500 that will be recognized on the current-year federal income tax return. Since this item is a change from a permissible method to another permissible method, there is no UTB. Assume that B has a current tax payable of \$1,000 before the 481(a) adjustment. The accounting method change results in the following adjustments to the income tax accounts:

<b>Debit (Credit)</b>	<b>Before</b>	<b>Impact of Form 3115</b>	<b>After</b>
DTA — advance payments	\$ 200	\$ (200) <sup>(a)</sup>	\$ —
Current tax payable	(1,000)	200 <sup>(b)</sup>	(800)

(a) Reversal of original DTA recorded.

(b) Decrease to current tax payable because of favorable IRC Section 481(a) adjustment.

### **3.51 When to Recognize the Impact of Tax Method Changes**

In determining when to recognize the impact of a change in a federal income tax accounting method, an entity should consider the following:

- Whether the change is (1) from an impermissible method to a permissible method or (2) from a permissible method to another permissible method.
- Whether the change is nonautomatic ("manual") or automatic.

A manual method change requires the affirmative written consent of the IRS after receipt of Form 3115 from the entity requesting the change. An entity will be granted an automatic method change if (1) the requested change qualifies for automatic approval by the IRS under published guidance and (2) the entity complies with all provisions of the automatic change request procedures.

#### ***Impermissible to Permissible***

##### **Manual Method Change**

Generally, the reversal of UTBs, interest, and penalties as a result of a manual change in a federal income tax accounting method from an impermissible method to a permissible method should be recognized when audit protection is received (i.e., when the entity has filed a Form 3115 and has received the affirmative written consent of the IRS). However, if the entity has met all of the requirements of such method change, there may be circumstances in which the ultimate consent of the IRS is considered perfunctory (i.e., IRS approvals for similar method change requests have always been granted). In these circumstances, if it would be unreasonable for the IRS to withhold consent, we believe that an entity may reflect the change in the period in which the Form 3115 is filed. Consultation with tax and accounting advisers is encouraged in these situations.

##### **Automatic Method Change**

If an entity meets all of the requirements for an automatic method change and complies with all provisions of the automatic change request procedures, consent from the IRS is not required. Accordingly, the financial statement impact should be reflected when the entity has filed a Form 3115.

#### ***Permissible to Permissible***

##### **Manual Method Change**

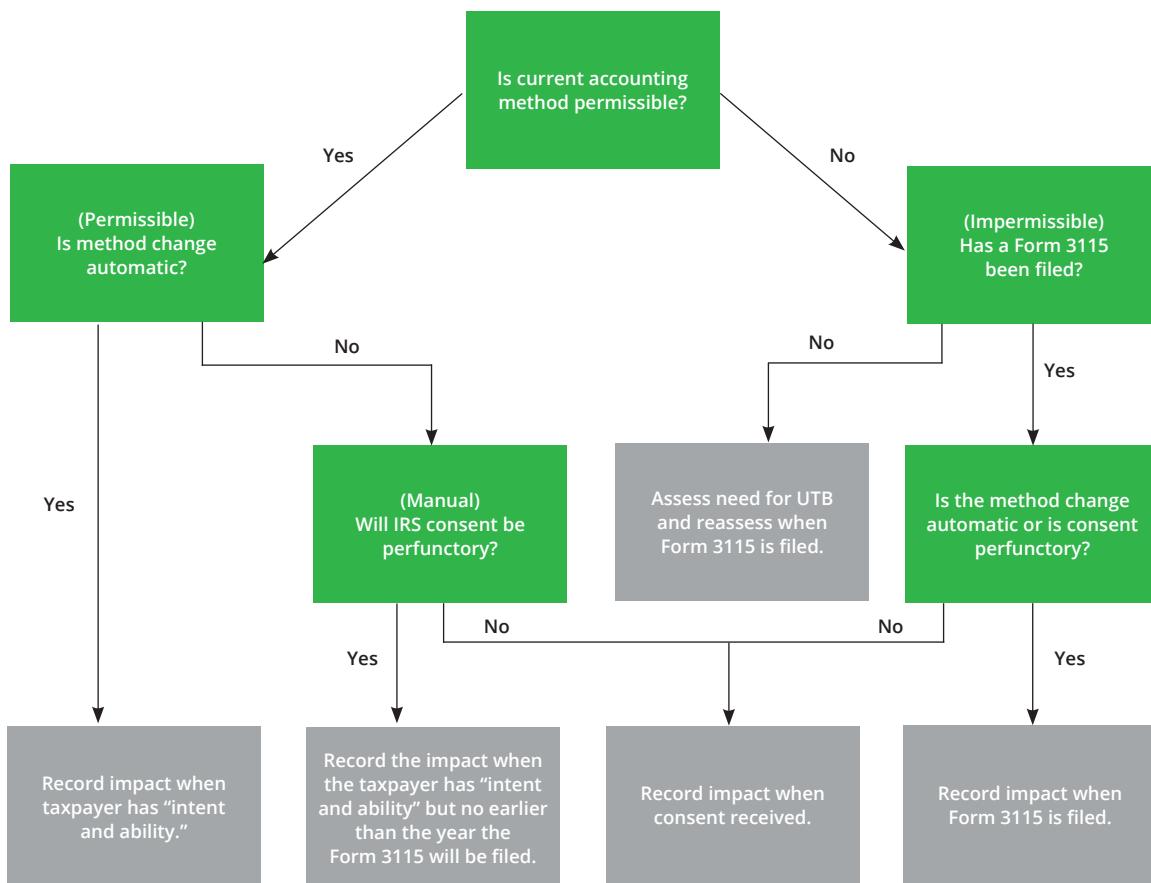
Generally, the impact of a manual change in a federal income tax accounting method from one permissible method to another permissible method should be recognized when the entity has filed a Form 3115 and has received the affirmative written consent of the IRS. However, if consent of the IRS is considered perfunctory, the financial statement impact of such method change may be reflected when the entity has concluded that it is qualified and has the intent and ability to file a Form 3115 with the IRS, but no earlier than the first interim period of the year in which the Form 3115 will be filed.

##### **Automatic Method Change**

If an entity meets all requirements for an automatic method change from one permissible method to another permissible method, consent from the IRS is not required. Accordingly, the financial statement impact should be reflected when the entity has concluded that it qualifies for the method change and that it has the intent and ability to file a Form 3115.

## Summary

The following flowchart summarizes the timing for recognition of changes in U.S. federal income tax accounting method:



## 3.51A Accounting for Foreign Branch Operations

A U.S. corporation generally conducts business in a foreign country by establishing either a branch or a separate legal entity in that country. A true branch generally refers to a fixed site (e.g., an office or plant) in which a U.S. corporation conducts its operations. However, a branch can also refer to a separate foreign legal entity that the U.S. corporation has elected to treat as a disregarded entity under the U.S. Treasury entity-classification income tax regulations (commonly referred to as the "check-the-box" regulations, under which an eligible entity may elect its tax classification, or tax status, for U.S. income tax reporting purposes).

For U.S. income tax reporting purposes, a foreign branch is not considered a separate taxable entity; rather, it is an extension of its U.S. parent. Accordingly, any income or loss generated by a foreign branch is included in the U.S. parent company's income tax return (i.e., subject to U.S. income taxes) in the period in which it is earned. In addition to being included in the U.S. parent company's income tax return, the income or loss generated by a foreign branch is generally subject to tax in the local country. That is, foreign branches are generally subject to double taxation (in the United States and in the local country). To mitigate the effects of this double taxation, U.S. income tax law allows a U.S. corporation to

either deduct the income taxes incurred in the local country or claim those income taxes as a foreign tax credit (FTC) in its U.S. income tax return (i.e., the local-country taxes affect the determination of U.S. tax). The foreign branch is required to account for income tax in its local country in accordance with ASC 740.

Because a branch is subject to taxation in two different countries, it will generally have two sets of temporary differences related to its activities. One set of temporary differences will reflect the differences between the book and tax basis of the assets and liabilities of the branch as determined under the local-country tax law (i.e., the in-country temporary differences). The other set of temporary differences will reflect the differences between the book and tax basis of the assets and liabilities of the branch as determined under U.S. tax law (the "U.S. temporary differences"). Further, because local-country income taxes can be deducted when the parent computes U.S. taxable income, or be credited when it computes U.S. income taxes payable, the in-country DTAs and DTLs give rise to U.S. temporary differences, and U.S. DTLs and DTAs should be established to account for the U.S. income tax effects of the future reversal of in-country DTAs and DTLs.

The accounting for U.S. temporary differences related to a foreign branch is similar to the accounting for federal temporary differences related to state taxes, as illustrated in the following table:

	<b>Foreign Branch</b>	<b>U.S. State</b>
Files local tax return	Yes	Yes
Maintains local DTAs and DTLs	Yes	Yes
Computes U.S. federal tax consequences of local DTAs and DTLs reversing	Yes	Yes

In accordance with U.S. income tax law, an entity incurring foreign income taxes may, year to year, elect to either claim a FTC or deduct foreign taxes. Theoretically, FTCs are more beneficial to entities, but there are restrictions on the credits' use. As a result, it may be more beneficial to deduct the foreign taxes. If an entity elects to claim a credit for foreign taxes but is not able to use all of its FTCs, such excess is carried forward (i.e., the excess cannot be deducted because of the election to claim credits for foreign taxes incurred that year).

In assessing the U.S. tax impact of the reversal of in-country DTAs and DTLs, an entity should estimate whether it will claim foreign tax credits or deductions in the year in which such in-country DTAs and DTLs reverse. If an entity determines it will be claiming FTCs in the year in which a net in-country DTL reverses, the entity would record an "anticipatory" FTC DTA, subject to realizability considerations. This "anticipatory" FTC DTA is unlike most tax credits, which are typically not recognized until generated on a tax return, because it represents the direct U.S. tax consequences of an inside "in-country" temporary difference (i.e., it is not related to the parent's outside basis difference in the foreign entity). See 4.35 for more information about determining the need for a valuation allowance related to FTCs.

Similarly, the U.S. corporation would recognize a DTL associated with an in-country DTA (i.e., the gross in-country DTA reduced by valuation allowance) because, when the branch generates income in future years that is offset by an in-country loss carryforward, deductible temporary difference, or both, that income will be taxable in the United States without corresponding FTCs related to the income.

The examples below illustrate the deferred tax accounting related to branch temporary differences discussed above. For simplicity, the effects of foreign currency have been disregarded.

**Example 3-22A****FTC Election Anticipated in the United States**

Assume that a U.S. parent company (Parent Co) establishes a branch (Branch Co) in Country X. Parent Co is subject to tax in the United States at 35 percent, and Branch Co is subject to tax in X at 25 percent. In addition, the taxes paid by Branch Co in X are fully creditable in the United States without limitation, and Parent Co intends to elect to claim FTCs in the year in which the foreign temporary difference reverses.

There are two temporary differences related to Branch Co's operations in the current year, which are the same under the tax laws in both Country X and the United States, as shown below:

Description	Book Basis	Tax Basis	Deductible (Taxable) Temporary Difference
Property, plant, and equipment (PP&E)	\$ 2,500,000	\$ 1,500,000	\$ (1,000,000)

Since Branch Co is subject to tax in both the United States and X, Branch Co computes its deferred taxes separately for each jurisdiction. In X, Branch Co determines that it has a DTL of \$250,000, which is equal to the temporary difference shown above multiplied by the local tax rate in X.

In the United States, Parent Co determines that it has a DTL of \$350,000 related to the PP&E, which is equal to the temporary difference shown above, multiplied by the U.S. tax rate of 35 percent. However, because the taxes paid in X are fully creditable in the United States when actually incurred, Parent Co also determines that it has a DTA equal to Branch Co's DTL in X [\$250,000]. That is, when the temporary difference reverses, Branch Co will pay additional taxes of \$250,000 in X, but because such foreign taxes paid will be claimed as a credit by Parent Co, Parent Co will effectively receive a benefit equal to 100 percent of Branch Co's DTL or, in other words, a dollar-for-dollar reduction of its income taxes payable. Therefore, Parent Co records an "anticipatory" FTC DTA of \$250,000. A summary of the impact on the consolidated balance sheet of the above is as follows:

Description	Parent Co	Branch Co	Consolidated
Deferred taxes related to PP&E	\$ (350,000)	\$ (250,000)	\$ (600,000)
Anticipatory FTC	250,000	—	250,000
Total deferred taxes	\$ (100,000)	\$ (250,000)	\$ (350,000)

**Example 3-22B****Foreign Tax Deduction Anticipated in the United States**

Assume that the facts are the same as those in Example 1, except that Parent Co anticipates deducting the foreign taxes in its income tax return when the temporary difference reverses (instead of claiming them as a FTC).

In this scenario, there would be no changes to Branch Co's or Parent Co's accounting for their respective DTL related to the PP&E. However, instead of recording an "anticipatory" FTC DTA for 100 percent of Branch Co's DTL, Parent Co would recognize a foreign tax deduction DTA equal to 35 percent of Branch Co's DTL. That is, because Parent Co will deduct the foreign taxes on its income tax return, it will only receive a benefit equal to 35 percent (i.e., the statutory rate) of the deduction. The following table summarizes the impact on the consolidated balance sheet of the above:

Description	Parent Co	Branch Co	Consolidated
Deferred taxes related to PP&E	\$ (350,000)	\$ (250,000)	\$ (600,000)
Future foreign tax deduction	87,500	—	87,500
Total deferred taxes	\$ (262,500)	\$ (250,000)	\$ (512,500)

**Example 3-22C****Foreign Branch Losses**

Assume that a U.S. parent company (Parent Co) establishes a branch (Branch Co) in Country X. Parent Co is subject to tax in the United States at 35 percent, and Branch Co is subject to tax in X at 25 percent.

In 20X6, Branch Co generated an operating loss of \$1 million that is allowed to be carried forward indefinitely under the tax law in X. Branch Co concludes that it will be able to realize the loss carryforward against taxable income it will generate in future years and, therefore, no valuation allowance is necessary. Parent Co generated taxable income of \$3 million (excluding the loss generated by Branch Co) in 20X6.

In this scenario, Branch Co recognizes a deferred tax benefit of \$250,000 by establishing a DTA for the in-country loss carryforward (\$1 million loss × the local tax rate). Further, Parent Co would recognize a current benefit of \$350,000 (\$1 million × the U.S. tax rate) because it would reduce the amount of taxes it would otherwise owe in the United States as a result of Branch Co's loss. In the absence of any other accounting entries recorded by Parent Co, both Parent Co and Branch Co would recognize a benefit for the loss (i.e., a double benefit); however, Parent Co must also record a DTL equal to the DTA recognized by Branch Co. As a result, the total benefit recognized in the consolidated financial statements related to the Branch Co loss in the year in which the loss occurs is equal to the current benefit recognized by Parent Co (\$350,000), as shown below:

Description	Parent Co	Branch Co	Consolidated
DTA (deferred benefit) related to Branch Co loss	\$ —	\$ 250,000	\$ 250,000
Current benefit related to Branch Co loss	350,000	—	350,000
DTL (deferred expense) related to Branch Co loss	(250,000)	—	(250,000)
Total tax benefit (expense)	\$ 100,000	\$ 250,000	\$ 350,000

**Example 3-22C (continued)**

Further assume that in 20X7, Branch Co generates \$1 million of taxable income and uses its entire loss carryforward (i.e., Branch Co pays no income taxes in 20X7 in Country X). Branch Co would reverse its DTA related to the loss carryforward and recognize a deferred tax expense of \$250,000. The income generated by Branch Co would also be included on Parent Co's income tax return in 20X7 and would result in a current tax expense in the United States of \$350,000 because it increases the amount of taxes Parent Co would otherwise owe. Parent Co also reverses the DTL that it had recognized related to Branch Co's DTA and recognizes a deferred tax benefit of \$250,000. As a result, the total expense recognized in the consolidated financial statements related to the Branch Co income in the year in which the income is generated is equal to the current expense recognized by Parent Co (\$350,000), as shown below:

Description	Parent Co	Branch Co	Consolidated
Reduction of DTA (deferred tax expense) related to Branch Co loss	\$ —	\$ (250,000)	\$ (250,000)
Current expense related to Branch Co income	(350,000)	—	(350,000)
Reduction of DTL (deferred tax benefit) related to Branch Co loss	250,000	—	250,000
Total tax benefit (expense)	\$ (100,000)	\$ (250,000)	\$ (350,000)

### 3.51B Deferred Income Taxes Related to a Foreign Branch: Accounting for Changes in a Parent's Deferred Taxes Due to Changes in Exchange Rates

See [3.51A](#) for guidance on accounting for these temporary differences related to foreign branch operations.

Because a foreign branch of a U.S. parent operates in a foreign country, its functional currency as determined under ASC 830 may be, and often is, different from the U.S. parent's functional currency. For example, the branch's functional currency may be the local currency, while the U.S. parent's functional currency is the U.S. dollar (USD). Generally, U.S. income tax rules require the branch's taxable income or loss to be calculated in the branch's functional currency and then translated into USD by using the average exchange rate for the taxable year. Because the U.S. tax bases of the branch's assets and liabilities are maintained in the branch's functional currency, the U.S. temporary differences and DTAs and DTLs related to such assets and liabilities must be calculated in the functional currency; then, the appropriate exchange rate must be used to translate the DTAs and DTLs into USD. Therefore, exchange rate changes will cause the financial reporting carrying value of the U.S. parent's DTAs or DTLs related to the U.S. temporary differences to fluctuate.

When exchange rate fluctuations cause fluctuations in the carrying value of DTAs or DTLs related to U.S. temporary differences, each of the following views is acceptable for recording the offsetting entry:

- *View A* — The offsetting adjustment should be recognized in the CTA account. The exchange rate fluctuation's effect on the carrying value of the assets, including the change in the DTA or DTL, would be captured in CTA as part of the translation of the investment in the branch. Therefore, the foreign currency exchange rate effect on the DTA or DTL would be part of the tax effect of such translation adjustment, which should be recorded in CTA in accordance with ASC 740-20-45-11(b) and ASC 830-20-45-5.

- *View B* — The offsetting adjustment should be recognized in the U.S. parent's income statement. Although the branch is considered a foreign entity under ASC 830, the DTAs or DTLs related to the U.S. temporary differences represent assets and liabilities of the parent entity rather than those of the branch being translated. Accordingly, the DTAs or DTLs represent the U.S. parent's assets or liabilities that are denominated in a currency other than its functional currency. Exchange rate fluctuations will increase or decrease the amount of the parent's functional currency cash flows upon recovery or settlement of the DTA or DTL; therefore, in accordance with ASC 830-20-35-1, such fluctuations would be reported as foreign currency transaction gains or losses in the determination of net income. Alternatively, under ASC 830-740-45-1, the U.S. parent may classify the transaction gain or loss in deferred tax benefit or expense rather than in pretax income if that presentation is considered more useful.

The selected method should be applied consistently to all DTAs and DTLs related to U.S. temporary differences denominated in a foreign currency.

#### **Example 3-22D**

Assume that a U.S. parent company (Parent Co) establishes a branch (Branch Co) in the United Kingdom. In accordance with ASC 830, management determines that the functional currency of Parent Co is the U.S. dollar, and that of Branch Co is the British pound. Parent Co is subject to tax in the United States at 35 percent, and Branch Co is subject to tax in the United Kingdom at 20 percent. In addition, the taxes paid by Branch Co in the United Kingdom are fully creditable in the United States without limitation, and Parent Co intends to elect to claim FTCs in the year in which the foreign temporary difference reverses.

Assume the following:

- In 20X6, Branch Co had pretax book income of £200,000.
- For U.S. income tax purposes, Branch Co has a taxable temporary difference of £100,000 due to accelerated depreciation.
- Branch Co had no other U.K. or U.S. temporary differences.
- The exchange rates in effect during 20X6 were as follows:
  - January 1 £1 = \$1.5
  - December 31 £1 = \$1.2
  - Weighted average £1 = \$1.3

### Example 3-22D (continued)

Parent Co calculates the currency adjustment for the DTAs and DTLs associated with the U.S. temporary differences as follows:

<b>U.S. Temporary Difference</b>	<b>Beginning of Year</b>	<b>Calendar Year</b>	<b>End of Year</b>
Fixed assets	0	(£100,000)	(£100,000)
Tax rate	35%	35%	35%
DTL	0	(£35,000)	(£35,000)
Branch taxes — anticipatory FTCs (DTA)	0	£20,000	£20,000
Net DTL	0	(£15,000)	(£15,000)
Year-end spot exchange rate			1.2
U.S. DTA (DTL) required on December 31, 20X6			(\$18,000)
U.S. beginning of year DTA (DTL) plus change in U.S. DTA/DTL recognized at weighted average during 20X6			(\$19,500)
Adjustment required			\$1,500

To record the currency adjustment of \$1,500, Parent Co would make the following journal entries:

#### Journal Entry: View A

DTL	1,500
CTA	1,500

#### Journal Entry: View B

DTL	1,500
Transaction gain <b>or</b> deferred tax benefit	1,500

## Basis Differences That Are Not Temporary Differences

### ASC 740-10

**25-30** Certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized. One example, depending on the provisions of the tax law, could be the excess of cash surrender value of life insurance over premiums paid. That excess is a temporary difference if the cash surrender value is expected to be recovered by surrendering the policy, but is not a temporary difference if the asset is expected to be recovered without tax consequence upon the death of the insured (if under provisions of the tax law there will be no taxable amount if the insurance policy is held until the death of the insured). [FAS 109, paragraph 14]

**ASC 740-10 (continued)**

**25-31** Tax-to-tax differences are not temporary differences. Recognition of a deferred tax asset for tax-to-tax differences is prohibited as tax-to-tax differences are not one of the exceptions identified in paragraph 740-10-25-3. An example of a tax-to-tax difference is an excess of the parent entity's tax basis of the stock of an acquired entity over the tax basis of the net assets of the acquired entity. [EITF D-31]

### 3.52 Permanent Differences

The authoritative literature preceding ASC 740 defined permanent differences as differences that arise from statutory provisions under which (1) specified revenues are exempt from taxation and (2) specified expenses are not allowable as deductions in the determination of taxable income.

Although ASC 740 does not define the term "permanent difference," entities consider the effects of permanent differences on the measurement of DTAs and DTLs under ASC 740. For example, entities consider these effects when (1) estimating future taxable income, which notionally begins with pretax accounting income adjusted for permanent differences, or (2) when determining the estimated AETR to apply to interim periods in a fiscal year. The following table illustrates many of the more common permanent differences that result from the application of U.S. federal tax law.

Accounting Description	Treatment	Tax Treatment
Tax-exempt securities:		
1. Interest income	Income	Tax-exempt (IRC Section 103).
2. Interest paid on debt incurred to buy or carry tax-exempt securities	Expense	Not deductible (IRC Section 265).
3. Amortization of bond premium	Expensed by using interest method (ASC 835-30-35-2)	Not deductible (IRC Section 171(a)); however, basis of bond must be reduced by amount of amortization (IRC Section 1016(a)(5)).
4. Gains or losses upon disposition	Income (loss)	a. No gain or loss if HTM by original buyer. b. If sold or redeemed before maturity, capital gain (loss).
Illegal bribes and kickbacks	Expense	Not deductible.
Treble damages; payments involving criminal proceedings	Expense	Not deductible (IRC Section 162(g)).

(Table continued)

<b>Accounting Description</b>	<b>Treatment</b>	<b>Tax Treatment</b>
Expenses paid or incurred to influence the general public with respect to legislative matters, elections, or referendums	Expense	Not deductible (IRC Section 162(c)(2)).
Expenses paid or incurred with respect to legislative matters that are not indirect interest to the taxpayer's trade of business	Expense	Not deductible (IRC Treas. Reg. 1.162-20(c)).
Fines and penalties paid to the government of the United States, a territory or possession of the United States, the District of Columbia, a foreign country, or a political subdivision of any of the above for the violation of any law	Expense	Not deductible (IRC Section 162(f)).
Worthless debts from political parties	Expense	Generally, not deductible. May be deducted by banks and other taxpayers if more than 30 percent of all receivables acquired during normal course of business are due from political parties (IRC Section 271).
Income and expenses from source within possessions of the United States	Income and expense	Income may be exempt and deductions not allowed if certain conditions are met (IRC Section 931).
Certain expenses that a taxpayer chooses to claim a credit in lieu of (i.e., FTC, jobs credit)	Expense	Not deductible.
Meals and entertainment expense	Expense	50 percent reduction in expense for tax purposes (IRC Section 274(n)).
Political contributions	Expense	Not deductible (IRC Treas. Reg. 1.162-20(c)(1)).
Certain losses on the disposition of consolidated-group subsidiary stock	Expense	Not deductible (IRC Treas. Reg. 1.1502-36).

### **3.53 Examples of Basis Differences That Are Not Temporary Differences**

ASC 740-10-25-30 states that “[c]ertain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized.”

Basis differences that do not result in taxable or deductible amounts in future years include the following:

#### ***Entity-Owned Life Insurance***

Under U.S. federal tax law, deductions for certain insurance premiums on officers and directors are not deductible for tax purposes. However, for financial reporting purposes, the cash surrender value of life insurance policies for which the entity is the beneficiary is reported in its balance sheet as an asset. Because the proceeds of such a policy are not taxable under the tax law if they are held until the death of the insured, no DTL would be recognized for the basis difference (excess of cash surrender value over total premiums paid) under ASC 740 provided that management intended not to realize the benefits available under the policy before the death of the executives. A history of reversions, before the death of an insured that results in realization of a portion or all of the excess cash surrender value, would generally be inconsistent with an assertion that proceeds will not be taxable. However, loans that are collateralized against the surrender value of such policies might not be considered inconsistent with that assertion (e.g., if the action is taken primarily to reduce the cost of borrowed funds).

#### ***Domestic Subsidiaries***

The excess of a parent entity's investment in the stock of a domestic subsidiary for financial reporting purposes over the tax basis in that stock is not a taxable temporary difference for which recognition of a DTL is required if the tax law provides a means by which the reported amount of the investment could be recovered tax-free and the entity expects to use that means. Under U.S. federal tax law, such means include a tax-free liquidation or a statutory merger. See further discussion in [8.15](#).

#### ***Built-in Gains Related to Tax Status Conversions***

Under U.S. federal tax law, “C corporations” are taxed on their income and gains directly. However, “S corporations” are not directly taxed but their income and gains are passed through to the individual tax returns of their shareholders. Under tax law, an entity that converts from C status to S status may be subject to a corporate-level tax if certain built-in gains that exist on the conversion date are realized within the 10-year period after the conversion election. If the assets subject to built-in gains tax are not expected to be sold or disposed of within the 10-year period after the conversion, the related basis differences are not temporary differences under ASC 740 for which a DTL is recognized because recovery of the assets will not result in taxable amounts at the corporate level. If a portion of, or the entire, related asset is expected to be sold or disposed of within the 10-year period prescribed under tax law, the related basis differences are temporary differences for which a DTL is recognized at the corporate level.

An expectation that recovery or settlement of an asset or liability will be without tax consequences does not eliminate the requirement under ASC 740 to recognize a DTL or DTA. Thus, an entity must recognize DTAs and DTLs in the absence of (1) a tax law provision that would allow the recovery or settlement, without tax consequences, of an asset or liability that gives rise to a taxable or deductible basis difference and the entity has the intent and ability to recover or settle the item in a tax-free manner or (2) a specific exception identified in ASC 740.

An often-cited example illustrating this point is an excess of the reported amount of an acquired identified intangible asset for financial reporting purposes (e.g., a customer list that has no tax basis). Although, under tax law, an entity in this situation will not receive a tax deduction in the future for the recovery of the intangible asset, recognition of a DTL is nevertheless required because it is assumed, for financial reporting purposes, that the entity will generate future revenues at least equal to the recorded amount of the investment and that recovery will result in future taxable amounts.

## Change in Tax Status

### ASC 740-10

**25-32** An entity's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset shall be recognized for temporary differences in accordance with the requirements of this Subtopic at the date that a nontaxable entity becomes a taxable entity. A decision to classify an entity as tax exempt is a tax position.

**25-33** The effect of an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and a change in tax status that results from a change in tax law is recognized on the enactment date. [FAS 109, paragraph 28]

**25-34** For example, if an election to change an entity's tax status is approved by the taxing authority (or filed, if approval is not necessary) early in Year 2 and before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) for Year 1, the effect of that change in tax status shall not be recognized in the financial statements for Year 1. [QA 109, paragraph 11]

### Cessation of an Entity's Taxable Status

**40-6** A deferred tax liability or asset shall be eliminated at the date an entity ceases to be a taxable entity. [FAS 109, paragraph 28] As indicated in paragraph 740-10-25-33, the effect of an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and a change in tax status that results from a change in tax law is recognized on the enactment date. [FAS 109, paragraph 28]

## 3.54 Change in Tax Status of an Entity

ASC 740-10-25-32 states that a DTL or DTA is recognized for temporary differences in existence on the date a nontaxable entity becomes a taxable entity. Conversely, under ASC 740-10-40-6, DTAs and DTLs should be eliminated when a taxable entity becomes a nontaxable entity. ASC 740-10-45-19 notes that the effect of a change in tax status should be recorded in income from continuing operations as follows:

### Recognition Date

ASC 740-10-25-33 indicates that the effect of an entity's election to voluntarily change its tax status is recognized when the change is approved or, if approval is unnecessary (e.g., approval is perfunctory), on the filing date. Therefore, the recognition date is either the filing date, if regulatory approval is deemed perfunctory, or the date regulatory approval is obtained. The recognition date for a change in tax status that results from a change in tax law, such as the change that occurred in the U.S. federal tax jurisdiction for Blue Cross/Blue Shield entities as a result of the enactment of the Tax Reform Act of 1986, is the enactment date.

If an entity voluntarily elects to change its tax status after the entity's year-end but before the issuance of its financial statements, that subsequent event should be disclosed but not recognized (a nonrecognized subsequent event). For example, if an entity filed an election on January 1, 20X9, before the financial statements for the fiscal year ended December 31, 20X8, are issued, the entity should disclose the change in tax status and the effects of the change (i.e., pro forma financial information), if material, in the 20X8 financial statements. See [6.04](#) for a discussion of the potential disclosure impact when an entity changes its tax status from nontaxable to taxable.

## **Effective Date**

The effective date of an entity's election to voluntarily change to nontaxable status can differ depending on the laws of the applicable tax jurisdiction. For example, in the United States, the effective date of a change in status election from a C corporation to an S corporation can be either of the following:

1. Retroactive to the beginning of the year in which the election is filed if the filing or necessary approval occurs within the first two and a half months of the fiscal year (i.e., by March 15 for a calendar-year-end entity).
2. At the beginning of the next fiscal year.

In scenario (1), the effective date would be January 1 of the current year and would be accounted for no earlier than when the election is filed; in scenario (2), however, the effective date would be January 1 of the following year for calendar-year-end entities. Note that for a change to nontaxable status in scenario (2), the effect of the change in status would be **recognized** on the approval date or filing date, provided that approval is perfunctory, as illustrated in Example 3-23.

## **Measurement — Change From Nontaxable to Taxable**

When an entity changes its status from nontaxable to taxable, DTAs and DTLs should be recognized for any temporary differences in existence on the recognition date (unless the entity is subject to one of the recognition exceptions in ASC 740-10-25-3). The entity should measure those recognizable temporary differences in accordance with ASC 740-10-30.

## **Measurement — Change From Taxable to Nontaxable**

In a change to a nontaxable status, the difference between the net DTA and DTL immediately before the recognition date and the net DTA and DTL on the recognition date represents the financial statement effect of a change in tax status. If the recognition date of the change in nontaxable status is before the effective date, entities will generally need to schedule the reversal of existing temporary differences to estimate the portion of these differences that is expected to reverse after the recognition date. Temporary differences that are expected to reverse after the effective date should be derecognized, while those that are expected to reverse before the effective date should be maintained in the financial statements. However, some temporary differences may continue even after a change to nontaxable status, depending on the applicable tax laws (e.g., U.S. built-in gain tax). For further discussion of built-in gain taxes, see [3.62](#).

### **Example 3-23**

Entity X, a C corporation, is a calendar-year-end entity and files an election on June 30, 20X8, to become a nontaxable S corporation effective January 1, 20X9. In this example, IRS approval is perfunctory for the voluntary change because the entity meets all the requirements to become a S corporation; therefore, the effect of the change in tax status should be recognized as of June 30, 20X8 (the recognition date).

Entity X's change to nontaxable status will result in the elimination of the portion of all DTAs and DTLs related to temporary differences that are scheduled to reverse after December 31, 20X8, and will not be taxable under the provisions of the tax law for S corporations. The only remaining DTAs or DTLs in the financial statements as of June 30, 20X8, will be those associated with temporary differences that existed on the recognition date that will reverse during the period from July 1, 20X8, to December 31, 20X8, plus the tax effects of any temporary differences that will reverse after December 31, 20X8, that are taxable under the provisions of the tax law for S corporations (e.g., built-in gain tax). Entity X should record any effects of eliminating the existing DTAs and DTLs that will reverse after the effective date of January 1, 20X9, in income from continuing operations.

Entity X will not recognize net deferred tax expense or benefit during the period between the recognition date and the effective date of January 1, 20X9, in connection with temporary differences that arise during this time unless they are scheduled to reverse before December 31, 20X8, or will be subject to tax under the tax law for S corporations.

### 3.54A Tax Effects of a “Check-the-Box” Election

U.S. multinational companies typically conduct business in foreign jurisdictions through entities that are organized under the laws of the jurisdictions in which they operate. These entities might take the legal form of a corporation or partnership in their respective jurisdictions. Notwithstanding an entity's classification in the foreign jurisdiction, the U.S. Treasury has promulgated entity-classification income tax regulations, commonly referred to as the “check-the-box” regulations, under which an eligible foreign entity<sup>2</sup> may separately elect its tax classification, or tax status, for U.S. income tax reporting purposes. Under the check-the-box regulations, an eligible entity may elect, for U.S. income tax reporting purposes, to be treated as a corporation, treated as a partnership (if it has more than one owner), or disregarded (i.e., treated as an entity not separate from its owner if it has only one owner). An eligible entity electing to be treated as a disregarded entity is considered a branch of its parent for U.S. income tax purposes.

As a result of an eligible entity's check-the-box election to change its status from a regarded foreign corporation to a disregarded branch of a U.S. parent, the post-check-the-box operations of the foreign entity will become taxable when earned for U.S. tax purposes, requiring the parent entity to recognize U.S. deferred taxes on existing temporary differences and eliminate any outside basis difference (as opposed to the nonrecognition of an outside basis difference due to the application of an exception). Similarly, a foreign subsidiary directly owned by a U.S. parent may have previously elected, for U.S. income tax reporting purposes, to be treated as a disregarded entity. If the entity elects, for U.S. income tax reporting purposes, to “uncheck the box” and change its status from a disregarded entity to a regarded foreign corporation, the taxable income or loss of the foreign entity will no longer be immediately included in taxable income of the U.S. parent, requiring the derecognition of U.S. deferred taxes on the assets held inside the foreign corporation. Although the guidance in ASC 740-10-25-32 predates the introduction of the check-the-box regulations, the need to recognize or derecognize DTAs and DTLs as a result of the election makes the check-the-box election analogous to a change in tax status. Accordingly, we generally believe that the tax effects of recognizing or derecognizing DTAs and DTLs should be recorded in continuing operations on the approval date or on the filing date if approval is not necessary.

#### Example 3-23A

Assume that a U.S. parent owns 100 percent of FS, which operates in jurisdiction X and is not otherwise taxable in the United States. The U.S. parent had previously directed FS to check the box and be treated as a branch for U.S. tax purposes. At year-end 20X1, the U.S. parent states that it plans for FS to uncheck the box in 20X2, resulting in the derecognition (if nontaxable) or reversal (if taxable) of U.S. deferred taxes on inside basis differences. If an outside basis difference exists when the box is unchecked, the U.S. parent will need to assess it for recognition under the exceptions in ASC 740-30-25-18(a) and ASC 740-30-25-9.

The plan to have FS uncheck the box should be accounted for as a change in status, and the tax effects (including the initial recognition of any outside basis difference DTA or DTL) should be reflected in 20X2.

However, if the check-the-box election only affects an entity's recognition or measurement of the tax effects of its outside basis difference of its investment in the subsidiary, an alternative view is that the check-the-box election is not considered a change in tax status. Under the alternative view, the election could be perceived simply as a choice that would be accounted for at the time the parent intends to make it. In support of this alternative view, we note that (1) the guidance on change in status in ASC 740-10-25-32 predates the introduction of the check-the-box regulations and (2) the guidance in ASC 740-30-25-18(a) and ASC 740-30-25-9 is intent-focused and forward-looking (i.e., it permits the entity to determine whether the amounts will reverse in the foreseeable future). Accordingly, if a check-the-box election for a foreign corporation is only expected to result in the avoidance of a reversal of either a

<sup>2</sup> While check-the-box elections are most commonly considered in a foreign context, the same elections can be made for domestic entities.

taxable or deductible temporary difference with respect to the outside basis difference in a subsidiary, it would be appropriate to recognize (and measure) the related deferred tax effects when the entity is internally committed to making the election, and the election is within the entity's control.

### **Example 3-23B**

Assume that a U.S. parent owns 100 percent of FS1, which operates in jurisdiction X and is not taxable in the United States. FS1 owns 100 percent of FS2, which operates in jurisdiction Y and is also not taxable in the United States. FS2 is eligible to make a check-the-box election for U.S. income tax reporting purposes. FS1 had a transaction with FS2 on December 15, 20X1, which gives rise to a type of income that the U.S. parent must recognize under the Subpart F rules (i.e., a deemed dividend that would result in a current tax payable). For U.S. income tax-planning purposes, however, the U.S. parent plans to cause FS2 to make a check-the-box election that will result in FS2's treatment as a foreign disregarded entity effective on December 1, 20X1, allowing the U.S. parent to avoid recognizing the deemed dividend in 20X1 (i.e., the transaction will no longer be between FS1 and FS2 since under U.S. tax law they will be considered a single legal entity).<sup>3</sup>

As of December 31, 20X1, the check-the-box election had not yet been filed, but the U.S. parent has the intent and ability to cause FS2 to file the election and will do so by February 13, 20X2, the last day the election can be made and still be effective as of December 1, 20X1 (generally such elections can be made with retroactive effect of up to 75 days).

As in Example 3-28, the U.S. parent could record a current tax liability for the deemed dividend between FS1 and FS2 that occurred in 20X1 and recognize the effects of the check-the-box election (i.e., the reversal of the current tax liability) in 20X2. Alternatively, because the check-the-box election will not change the tax status of FS2 in its local jurisdiction or from the perspective of FS1 (i.e., there are no other tax effects of the election), the U.S. parent could assert that (1) the election should be considered relevant only under the guidance on taxable temporary differences in foreign subsidiaries (generally, no deferred tax liability is recognized unless it is foreseeable that the temporary difference will reverse) and, as a result of the planned election, (2) the outside basis difference related to its investment in FS1 will not reverse. Under this alternative view, the U.S. parent's intent and ability to direct FS2 to make the election would be considered in the measurement of the U.S. parent's deferred and current tax liability related to its investment in FS1 as of December 31, 20X1 (i.e., no current or deferred tax liability would be recognized).

## **3.55 Recognition Date for Conversion to a REIT**

A corporate entity may elect to be a REIT if it meets certain criteria under the U.S. IRC. As a REIT, an entity is allowed a tax deduction for dividends paid to shareholders. By paying dividends equal to its annual taxable income, a REIT can avoid paying income taxes on otherwise taxable income. This in-substance tax exemption would continue as long as (1) the entity intends to continue to pass all the qualification tests, (2) there are no indicators of failure to meet the qualifications, and (3) the entity expects to distribute substantially all of its income to its shareholders.

The IRS is not required to approve an entity's election of taxable status as a REIT, nor does the entity need to file a formal election. Rather, to be eligible for taxable status as a REIT, an entity must meet the IRC requirements of a REIT. For example, the entity must:

- Establish a legal structure appropriate for a REIT (i.e., corporation, trust, or association that is not a financial institution or subchapter L insurance company).
- Distribute the accumulated earnings and profits (E&P) of the corporation to the shareholders before election of REIT status.
- Adopt a calendar tax year.
- File its tax return as a REIT (Form 1120-REIT) by the normal due date.

<sup>3</sup> The check-the-box election is not part of a larger restructuring transaction.

Because ASC 740 does not specifically address when the tax effects of a conversion to REIT status should be recognized, diversity has developed in practice. One view is that the effect of a conversion to REIT status would be recognized when the entity has committed to a plan to convert its tax status and has met all the legal requirements to be a REIT under the IRC, including the distribution of accumulated E&P of the corporation to the shareholders. An entity must use judgment to determine what constitutes its commitment to conversion (e.g., approval by the board of directors, securing financing to distribute accumulated E&P, public announcement). The recognition date of conversion to REIT status generally would not be contingent on the filing of the first tax return as a REIT because this is normally a perfunctory step.

Alternatively, some entities have analogized an election of REIT status to a change in tax status (i.e., taxable to nontaxable) in accordance with ASC 740-10-25-32 (see [3.54](#)). According to this view, the recognition of REIT status would most likely not be until the election is made with the IRS upon the entity's filing of its initial-year tax return (the filing date).

### **3.56 Loss of Nontaxable Status as a Result of Acquisition**

An entity's taxable status may change as a result of a business combination. For example, an S corporation could lose its nontaxable status when acquired by a C corporation. When an entity's status changes from nontaxable to taxable, DTAs and DTLs should be recognized for any temporary differences in existence on the recognition date (unless one of the recognition exceptions in ASC 740-10-25-3 is applicable). Entities should initially measure such recognizable temporary differences in accordance with ASC 740-10-30. See [3.54](#) for further discussion of recognizing and measuring changes in tax status.

If the loss of the acquiree's nontaxable status directly results from an acquisition, temporary differences in existence on the acquisition date should be recognized as part of the business combination acquisition accounting (i.e., through goodwill during the measurement period) under ASC 805-740-25-3 and 25-4. If, because of the acquisition, the acquired entity no longer meets the requirements to be considered a nontaxable entity, all the basis differences in the entity that would be considered taxable or deductible temporary differences would be recognized on the acquisition date. From the acquirer's perspective, the tax status of the consolidated entity has not changed (i.e., it acquired a taxable entity and the status change immediately before the acquisition). If a valuation allowance is established, all subsequent changes (i.e., after the measurement period) are recorded in accordance with ASC 740, typically in income from continuing operations. See [11.36](#) for more information.

However, if the business combination is deemed a transaction "among or with shareholders," the initial tax effects of changes in the tax bases of assets or liabilities should be charged or credited directly to shareholders' equity, as discussed in ASC 740-20-45-11(g). Any subsequent changes in valuation allowances should be recorded in accordance with ASC 740, typically in income from continuing operations. See [7.24](#) for further discussion and examples of transactions "among or with shareholders."

If the acquiree issues separate financial statements and the effects of the business combination are not "pushed down" to the acquiree, the recognition of DTAs and DTLs on the acquisition date should be treated as a change in tax status (i.e., through income from continuing operations), as discussed in ASC 740-10-25-32. This is because, from a stand-alone perspective, the results of the business combination have not been reflected in the financial statements of the acquiree and the loss of the acquiree's nontaxable status therefore is not viewed as a direct result of its acquisition. As a result, the change in tax status of the acquiree is recognized through income from continuing operations. See a discussion of separate financial statements starting at [4.49](#) in [Chapter 4, "Measurement."](#)

### **3.57 Successor Entity's Accounting for the Recognition of Income Taxes When the Predecessor Entity Is Nontaxable**

In connection with a transaction such as an IPO, the historical partners in a partnership (the "founders") may establish a C corporation that will invest in the partnership at the time of the transaction. In the case of an IPO, the C corporation is typically established to serve as the IPO vehicle (i.e., it is the entity that will ultimately issue its shares to the public) and, therefore, ultimately becomes an SEC registrant. These transactions have informally been referred to in the marketplace as "Up-C" transactions.

The founders typically control the C corporation even after the IPO (i.e., the founders sell an economic interest to the public while retaining shares with voting control but no economic interest). The C corporation uses the IPO proceeds to purchase an economic interest in the partnership along with a controlling voting interest. Accordingly, the C corporation consolidates the partnership for book purposes. Because the C corporation is taxable, it will need to recognize deferred taxes related to its investment in the partnership. This outside basis difference is created because the C corporation (1) receives a tax basis in the partnership units that is equal to the amount paid for the units (i.e., fair value) but (2) has carryover basis in the assets of the partnership for U.S. GAAP reporting (because the transaction is a transaction among entities under common control).

Typically, the original partnership is the C corporation's predecessor entity and the C corporation is the successor entity (and the registrant). After the transaction becomes effective, the registrant's initial financial statements reflect the predecessor entity's operations through the effective date and the successor entity's post-effective operations in a single set of financial statements (i.e., the predecessor and successor financial statements are presented on a contiguous basis). Since no step-up in basis occurs for financial statement purposes because of the common-control nature of the transaction, the income statement and balance sheet are presented without use of a "black line." The equity statement, however, reflects the recognition of a noncontrolling interest as of the effective date and prospectively in the registrant's post-effective financial statements. In addition, the C corporation must recognize deferred taxes upon investing in the partnership, which occurs on the effective date.

In such situations, questions often arise about whether (1) the predecessor entity's tax status has changed in such a way that the deferred tax benefit or expense related to the recognition of the deferred tax accounts would be accounted for in the income statement or (2) there has been a contribution of assets among entities under common control, in which case the recognition of the corresponding deferred tax accounts would be accounted for in equity.

While the formation of the new C corporation has resulted in a change in the reporting entity, we do not believe that the predecessor entity's tax status has changed. In fact, in the situation described above, the predecessor entity was formerly structured as a partnership and continues to exist as a partnership after the effective date (i.e., the founders continue to own an interest in the same entity, which remains a "flow-through" entity to them both before and after the effective date) even though the successor entity's financial statements are presented on a contiguous basis with the predecessor entity's financial statements, albeit with the introduction of a noncontrolling interest.

Accordingly, we believe that the recognition of taxes on the C corporation's investment in the partnership should be recorded as a direct adjustment to equity, as if the former partners in that partnership contributed their investments (along with the corresponding tax basis) to the C corporation. The additional step-up in tax basis received by the C corporation upon its investment in the partnership

(and in the flow-through tax basis of the underlying assets and liabilities of the partnership) after the effective date would similarly be reflected in equity in accordance with ASC 740-20-45-11(g), which states:

All changes in the tax bases of assets and liabilities caused by **transactions among or with shareholders** shall be included in equity including the effect of valuation allowances initially required upon recognition of any related deferred tax assets. Changes in valuation allowances occurring in subsequent periods shall be included in the income statement. [Emphasis added]

#### Example 3-24

F1 and F2 own LP, a partnership with net assets whose book basis is \$2,000 and fair value is \$20,000. F1 and F2 have a collective tax basis of \$1,000 in their units of the partnership and a collective DTL of \$400. (Assume that the tax rate is 40 percent and that the outside basis temporary difference will reverse through LP's normal operating activities.)

F1 and F2 form Newco, a C corporation, which sells nonvoting shares to the public in exchange for IPO proceeds of \$12,000. Newco records the following entry:

Cash	12,000
Equity	12,000

Newco then uses the IPO proceeds to purchase 60 percent of the units of LP from F1 and F2. Because Newco and LP are entities under common control, Newco records a \$2,000 investment in LP's assets (at F1's and F2's historical book basis as if the net assets were contributed) along with a noncontrolling interest of \$800 (representing the units of LP still held by F1 and F2) and a corresponding reduction in equity of \$10,800 for the deemed distribution to F1 and F2. This leaves \$1,200 that is attributable to the controlling interest (which also reflects the book basis of Newco's investment in the assets of LP). Newco records the following entry:

Investment in the assets of LP	2,000
Equity	10,800
Noncontrolling interest in LP	800
Cash	12,000

If it is assumed that Newco is subject to a 40 percent tax rate and that Newco's tax basis in the units has remained consistent with F1's and F2's historical tax basis in LP, Newco will also record a DTL of \$240 ( $[\$1,200 \text{ book basis} - \$600 \text{ tax basis}] \times 40\%$ ), with an offset to equity, as follows:

Equity	240
DTL	240

In other words, F1 and F2 have effectively contributed their 60 percent investment in LP (along with 60 percent of their corresponding DTL related to LP) to Newco.

Because the sale of units of LP to Newco is a taxable transaction, F1 and F2 would have taxable income of \$11,400 (\$12,000 proceeds less tax basis of the interest sold (60% of \$1,000)), resulting in taxes payable of \$2,280 ( $\$11,400 \times 20\%$  capital gains rate). F1 and F2 would also eliminate the portion of their collective DTL that was effectively contributed to Newco ( $[\$2,000 \text{ book basis} - \$1,000 \text{ tax basis}] \times 60\% \times 20\%$ ). Newco would receive a tax basis in the units of LP that is equal to its purchase price of \$12,000 and would record a DTA of \$4,320 ( $[\$12,000 \text{ tax basis} - \$1,200 \text{ book basis}] \times 40\%$ ), ignoring realizability considerations.

In accordance with ASC 740-20-45-11(g), Newco's change in deferred taxes as a result of a change in its tax basis in its investment in LP would be recorded directly in equity as follows:

DTA	4,320
DTL	240
Equity	4,560

### **3.58 Accounting for the Elimination of Income Taxes Allocated to a Predecessor Entity When the Successor Entity Is Nontaxable**

In connection with a transaction such as an IPO, a parent may plan to contribute the “unincorporated” assets, liabilities, and operations of a division or disregarded entity to a new company (i.e., a “newco”) at or around the time of the transaction. In the case of an IPO, the newco is typically established to serve as the IPO vehicle (i.e., it is the entity that will ultimately issue its shares to the public) and, therefore, ultimately becomes an SEC registrant.

Typically, the division or disregarded entity is determined to be the newco’s predecessor entity and the newco is determined to be the successor entity. After the transaction is effective, the successor’s initial financial statements reflect the predecessor entity’s operations through the effective date and the successor entity’s operations after the effective date in a single set of financial statements (i.e., the predecessor and successor financial statements are presented on a contiguous basis). Since no step-up in basis occurs for financial statement purposes because of the common-control nature of the transaction, the income statement and balance sheet are typically presented without the use of a “black line.”

If the predecessor entity’s financial statements have been filed publicly, those financial statements would generally include an income tax provision because SAB Topic 1.B.1 requires that both members (i.e., corporate subsidiaries) and nonmembers (i.e., divisions or disregarded entities) of a group that are part of a consolidated tax return include an allocation of taxes when those members or nonmembers issue separate financial statements.<sup>4</sup> When the successor entity is nontaxable (e.g., a master limited partnership), however, the successor entity will need to eliminate (upon effectiveness) any deferred taxes that were previously allocated to the predecessor entity.<sup>5</sup>

In situations in which deferred income taxes that were allocated to the predecessor entity are eliminated in the successor entity’s financial statements when the successor entity is nontaxable, questions often arise about whether (1) the predecessor entity’s tax status has changed in the manner discussed in ASC 740-10-25-32 such that the deferred tax benefit/expense from the elimination of the deferred tax accounts would be accounted for in the income statement, as prescribed by ASC 740-10-45-19, or (2) the deferred taxes were effectively retained by the contributing entity, suggesting that the deferred taxes should be eliminated through equity.

As noted above, while the predecessor entity has received an allocation of the parent’s consolidated income tax expense, the predecessor entity typically comprises unincorporated or disregarded entities that are not individually considered to be taxpayers under U.S. tax law (i.e., the historical owner was, and continues to be, the taxpayer). Accordingly, we do not believe that the predecessor entity’s tax status has changed in the manner discussed in ASC 740-10-25-32. Rather, we believe that the parent has retained the previously allocated deferred taxes (which is consistent with removing the deferred taxes through equity). Alternatively, the removal of the net deferred tax accounts, particularly in the case of a net DTL, might be analogous to the extinguishment (by forgiveness) of intra-entity debt. ASC 470-50-40-2 provides guidance on such situations, noting that “extinguishment transactions between related entities may be in essence capital transactions.” Accordingly, we believe that it is appropriate to reflect the elimination of deferred income taxes that were allocated to the predecessor entity as a direct adjustment to the successor entity’s equity on the effective date of the transaction.

<sup>4</sup> See [4.47](#) for guidance on acceptable methods of allocating income taxes to members of a group and [4.56](#) for a discussion of the allocation of income taxes to single member LLCs.

<sup>5</sup> If the parent actually contributes a member (corporate subsidiary) to a nontaxable successor entity and the successor entity will continue to own that C Corporation, previously allocated deferred taxes would not be eliminated and this guidance would not be applicable. However, such situations are rare.

The elimination of deferred taxes via an adjustment to equity is also consistent with an SEC staff speech by Leslie A. Overton, associate chief accountant in the SEC's Division of Corporation Finance, at the 2001 AICPA Conference on Current SEC Developments. Ms. Overton discussed a fact pattern in which the staff believed that certain operations that would be left behind upon a spinoff (i.e., retained by the parent) still needed to be included in the historical carve-out financial statements of the predecessor entity to best illustrate management's track record with respect to the business operations being spun. However, Ms. Overton concluded her speech by noting that "[a]ssets and operations that are included in the carve-out financial statements, but not transferred to Newco should be reflected as a distribution to the Parent at the date Newco is formed."

### **3.59 Voluntary Change in Tax Status of an Acquired Entity**

Voluntary changes in tax status are usually recorded through income from continuing operations, as discussed in ASC 740-10-25-32 and ASC 740-10-40-6 (recognition of income taxes and derecognition of income taxes, respectively). However, in rare circumstances, a voluntary change in tax status may be such an integral feature of a business combination that the change in tax status may warrant accounting as part of the acquisition accounting (i.e., through goodwill). In such circumstances, consultation with accounting advisers is encouraged to assess the appropriate accounting.

### **3.60 Change in Tax Status as a Result of a Common-Control Merger**

An entity's taxable status may change through a common-control merger. For example, an S corporation could lose its nontaxable status when acquired by a C corporation in a transaction accounted for as a merger of entities under common control. When an entity's status changes from nontaxable to taxable, the entity should recognize DTAs and DTLs for any temporary differences that exist as of the recognition date (unless these temporary differences are subject to one of the recognition exceptions in ASC 740-10-25-3). The entity should initially measure those recognizable temporary differences in accordance with ASC 740-10-30.

The combined financial statements should not be adjusted to include income taxes of the S corporation before the date of the common-control merger. ASC 740-10-25-32 states that DTAs and DTLs should be recognized "at the date that a nontaxable entity becomes a taxable entity." Therefore, any periods presented in the combined financial statements before the common-control merger should not be adjusted for income taxes of the S corporation.

However, it may be appropriate for an entity to present pro forma financial information, including the income tax effects of the S corporation (as if it had been a C corporation), in the historical combined financial statements for all periods presented. For more information on financial reporting considerations, see [6.04](#).

### **3.61 Change in Tax Status to Taxable: Accounting for an Increase in Tax Basis**

Upon an entity's change in tax status, the entity may also recognize a step-up in tax basis in certain circumstances. For example, in the U.S. federal jurisdiction, upon a change in tax status from a nontaxable partnership to a taxable C corporation, the entity may recognize a step-up in tax basis for its assets in an amount equivalent to the taxable gain recognized by the former partners. The former partners must recognize a taxable gain when the liabilities being assumed by the corporation exceed the tax basis in the assets being transferred to the corporation.

Generally, the expense or benefit from recognizing the DTLs and DTAs as a result of the change in tax status should be included in income from continuing operations. ASC 740-10-45-19 states:

When deferred tax accounts are recognized or derecognized as required by paragraphs 740-10-25-32 and 740-10-40-6 due to a change in tax status, the effect of recognizing or derecognizing the deferred tax liability or asset shall be included in income from continuing operations.

Conversely, any tax benefit attributable to an increase in the tax basis of an entity's assets resulting from a transaction with or among shareholders should be allocated to equity. ASC 740-20-45-11(g) states:

All changes in the tax bases of assets and liabilities caused by transactions among or with shareholders shall be included in equity including the effect of valuation allowances initially required upon recognition of any related deferred tax assets. Changes in valuation allowances occurring in subsequent periods shall be included in the income statement.

A change in tax status, in and of itself, will generally not cause an increase in the tax basis of assets. However, when the liabilities exceed the tax basis in the assets, under U.S. tax law, the partner is treated as having entered into a taxable exchange with the newly formed corporation, receiving taxable consideration (in the form of the corporation's assumption of the partner's liabilities) in exchange for the assets being transferred to the corporation. When the liabilities assumed exceed the tax basis of the assets being transferred, the partner both realizes and recognizes a gain for U.S. income tax purposes.

The corporation determines its initial tax basis in the assets by using the partnership's historical tax basis **plus** an amount equal to the gain recognized by the former partners (now shareholders) on account of the taxable exchange with the corporation. In the absence of the taxable exchange with the shareholder, the tax basis would have been strictly the historical basis of the assets in the hands of the partnership. Therefore, an entity should use that historical tax basis when determining the amount of deferred taxes required that are directly related to the change in status. The adjustment of that initial amount of deferred taxes on account of the increase in tax basis corresponding to the gain recognized by the partners (now shareholders) should be recognized in equity since it is directly on account of a transaction with or among the shareholders. See [7.24](#) for further discussion and examples of tax consequences involving transactions with or among shareholders.

We are aware of an alternative approach in practice under which all of the tax effects arising in connection with a change in tax status (including the deferred tax effect of any incremental step-up in tax basis related to the shareholder gain) would be allocated to income from continuing operations in accordance with ASC 740-10-45-19. This approach is based on the previous discussion in EITF Issue 94-10, which noted that the guidance contained therein did not address shareholder transactions that involve a change in the tax status of a company (such as a change from nontaxable S-corporation status to taxable C-corporation status). While it is not clear whether this statement was intended to address any incremental step-up afforded the partnership as a result of income being recognized by its partners, we would also accept this approach.

### **3.62 Built-in Gain: Recognition and Measurement**

Upon an entity's change in tax status from a taxable C corporation to a nontaxable S corporation or REIT, it may have net unrealized "built-in gains." A built-in gain arises when the fair market value of an asset is greater than its adjusted tax basis on the date of the entity's change in tax status. Under U.S. tax law, if a built-in gain associated with an asset is realized before the required holding period from the change in tax status expires (i.e., the recognition period), the entity would be subject to corporate-level tax on the gain. However, if this gain is realized after the recognition period, the built-in gain would not be subject to tax.

Whether an entity continues to record a DTL associated with the built-in gain tax on the date of conversion to nontaxable status depends on whether any of the net unrealized built-in gain is expected to be recognized and taxable during the recognition period. Any subsequent change in that determination would result in either recognition or derecognition of a DTL.

An entity should consider the following items in determining when tax associated with an unrealized built-in gain should be recognized, and how the related DTL should be measured, either upon conversion to nontaxable status or anytime during the recognition period.

## ***Recognition***

An entity must first determine whether it expects that a tax will be due on a net unrealized built-in gain within the recognition period. ASC 740-10-55-65 provides the following guidance on this topic:

A C corporation that has temporary differences as of the date of change to S corporation status shall determine its deferred tax liability in accordance with the tax law. Since the timing of realization of a built-in gain can determine whether it is taxable, and therefore significantly affect the deferred tax liability to be recognized, shall be considered. [Emphasis added]

The following are examples of items that an entity should consider when evaluating “actions and elections that are expected to be implemented” under ASC 740-10-55-65:

- *Management's intentions regarding each item with a built-in gain* — Whether a DTL is recorded for a temporary difference depends on management's intentions for each item with a built-in gain. That is, an entity should evaluate management's intent and ability to do what is necessary to prevent a taxable event (e.g., holding marketable securities for the minimum amount of time) before determining whether a DTL should be recorded.
- *Overall business plans* — The conclusion about whether realization of a built-in gain is expected to trigger a tax liability for the entity should be consistent with management's current actions and future plans. That is, the plans for assets should be consistent with, for example, the entity's liquidity requirements and plans for expansion. Management's budgets, forecasts, and analyst presentations are examples of information that could serve as evidence of management's intended plans.
- *Past actions* — The entity should also consider past actions to determine whether they support management's ability to represent that, for example, an asset will be held for the minimum amount of time necessary to preclude a taxable event.
- *Nature of the item* — The nature of the item could also affect whether a built-in gain is expected to result in a taxable event.

## ***Measurement***

Under ASC 740-10-55-65, if, after considering the “actions and elections that are expected to be implemented,” an entity expects to be subject to a built-in gain tax through the disposition of an asset within the recognition period, the entity must recognize the related DTL at the lower of:

- The net unrecognized built-in gain (based on the applicable tax law).
- The existing temporary difference as of the date of the change in tax status.

The DTL recognized should lead to the recognition of DTAs for attribute carryforwards (i.e., net operating or capital losses) that are expected to be used in the same year in which the built-in gain tax is triggered.

If the potential gain (first bullet above) exceeds the temporary difference (second bullet above), the related tax should not be recognized earlier than the period in which the pretax financial reporting income (or gain) is recognized (or is expected to be recognized in the case of amounts that would be considered "ordinary income," as that term is used in connection with the AETR).

Furthermore, ASC 740-10-55-169 requires an entity to "remeasure the deferred tax liability for net built-in gains based on the provisions of the tax law" as of each subsequent financial statement date until the end of the recognition period. This remeasurement should include a reevaluation of the recognition considerations noted above and should describe management's intent and ability to do what is necessary to prevent a taxable event. Remeasurement of the DTL is generally recorded through continuing operations under the intraperiod tax guidance.

See ASC 740-10-55-168 for an example illustrating the measurement of a DTL associated with an unrecognized built-in gain resulting from an entity's change from a taxable C corporation to nontaxable S corporation.

## Tax Holidays

### ASC 740-10

**25-35** There are tax jurisdictions that may grant an entity a holiday from income taxes for a specified period. These are commonly referred to as tax holidays. An entity may have an expected future reduction in taxes payable during a tax holiday. [FAS 109, paragraph 183]

**25-36** Recognition of a deferred tax asset for any tax holiday is prohibited because of the practical problems in distinguishing unique tax holidays (if any exist) for which recognition of a deferred tax asset might be appropriate from generally available tax holidays and measuring the deferred tax asset. [FAS 109, paragraph 184]

## 3.63 Tax Consequences of Tax Holidays

When a tax jurisdiction grants an exemption from tax on income that would otherwise give rise to an income tax obligation, the event is sometimes referred to as a tax holiday. In most jurisdictions that offer tax holidays, the benefit is available to any entity that qualifies for the holiday (similarly to the election of S corporation status under U.S. federal tax law). For other jurisdictions, tax holidays may involve a requirement that is controlled by the entity. For example, the jurisdiction may, for economic reasons, waive income taxes for a given period if an entity constructs a manufacturing facility located within the jurisdiction.

In accordance with ASC 740-10-25-35 and 25-36, an entity is not permitted to recognize the tax benefit of a tax holiday, regardless of the scenario giving rise to the benefit. In other words, it would be inappropriate for the entity to record a DTA to reflect the fact that it will not be paying taxes for the period of the tax holiday. However, the tax rate applied to temporary differences should reflect the effects of the tax holiday (see [4.06](#)).

## 3.63A Accounting for Temporary Differences Related to Investment Tax Credits

The ITC guidance in ASC 740-10-25-46 specifies that an entity can use one of two methods to account for the receipt of an ITC as an item of income in the financial statements: (1) the deferral method or (2) the flow-through method.

Under the deferral method, the ITC would result in a reduction to income taxes payable (or an increase in a DTA if the credit is carried forward to future years, subject to assessment for realization) that is recognized as either a reduction to the carrying value of the related asset or as a deferred credit. The benefit of the ITC is typically reflected in net income as a reduction to depreciation expense over the productive life of the related property (rather than as a reduction to income tax expense).<sup>6</sup> Under this method, temporary differences are created when either the financial statement carrying amount of the acquired property is reduced or when a deferred credit is recorded. In some cases, receipt of the credit results in a statutory reduction in the tax basis of the related asset, which also affects the temporary basis difference.

Under the flow-through method, the ITC would result in (1) a reduction to income taxes payable for the year in which the credit arises (or an increase in a DTA if the credit is carried forward to future years, subject to assessment for realization) and (2) an immediate reduction to income tax expense. Under this method, temporary differences are generally created only if a statutory reduction in tax basis occurs.

The following two approaches are acceptable for recording the tax effect of temporary differences created by ITCs:

- *Gross-up approach* — Under this approach, there is no immediate income statement recognition because the DTA or DTL is recorded as an adjustment to the carrying value of the acquired property (or deferred credit). The simultaneous equations method is used to calculate the final book basis of the acquired property and the DTA or DTL. (For a discussion and illustration of the simultaneous equations method, see ASC 740-10-25-51 and ASC 740-10-55-171 through 55-182.)
- *Income statement approach* — Under this approach, the DTA or DTL is recorded with an offset to income tax expense.

Both approaches are discussed below in greater detail. Note that the approach an entity selects is an accounting policy election that should be applied consistently. Note also that this Q&A applies only to the accounting for ITCs. An entity should not analogize to other situations. In circumstances other than those related to ITCs, consultation with accounting advisers is recommended.

<sup>6</sup> We are also aware of an alternative view under which the deferred credit would be reversed through the income tax provision in accordance with paragraph 3 of Opinion 4.

**Example 3-24A****ITC With No Statutory Reduction to Tax Basis**

Assume the following:

- Entity A invests in a qualifying asset for \$1,000 that entitles A to an ITC for 25 percent of the purchase price, and it records the following initial entry:

**Entry 1A**

Property, plant, and equipment	1,000
Cash	1,000

To record the initial purchase.

- In accordance with the tax law, there is no associated reduction in the tax basis of the related asset.
- Entity A's applicable tax rate is 40 percent.

**Deferral Method**

Under the deferral method, A recognizes the reduction in taxes payable and records the offsetting credit as a reduction in the carrying value of the asset, as shown in the following journal entry:

**Entry 1B**

Income taxes payable	250
Property, plant, and equipment	250

To record the reduction of income taxes payable and the related reduction in the carrying value of the qualifying asset under the deferral method.<sup>7</sup>

If there is no corresponding adjustment to the tax basis of the qualifying asset (per the tax law), a deductible temporary difference of \$250 arises. The accounting treatment for the DTA depends on whether A has elected the gross-up approach or the income statement approach.

**Gross-Up Approach**

Under the gross-up approach, A's application of a simultaneous equation yields a DTA of \$167 (rounded) and a reduction to the recorded amount of the qualifying asset of \$167 (rounded). Thus, the qualifying asset should be recorded at \$583 (\$1,000 purchase price less the \$250 ITC less the \$167 DTA). Entity A will record all of the entries above as well as the following entry to account for the qualifying asset, the ITC, and the initial basis difference in the qualifying asset:

**Entry 1C**

DTA	167
Property, plant, and equipment	167

To record the DTA determined using the gross-up approach [initial deductible temporary difference of  $\$250 \times 40\% \text{ tax rate} \div (1 - 40\% \text{ tax rate}) = \$167 \text{ DTA}$ ].

<sup>7</sup> Instead of reducing the carrying value of the qualifying asset, A could record a "deferred credit," which would result in the same deferred tax accounting treatment (i.e., there would be a book-to-tax difference related to the deferred credit that is recorded for book purposes but not for tax purposes).

**Example 3-24A (continued)*****Income Statement Approach***

Under the income statement approach, A records a DTA of \$100 as a component of income tax expense. Entity A will record Entry 1B above and the following entry to account for the initial basis difference in the qualifying asset:

**Entry 1D**

DTA	100
Deferred tax expense	100

To record the DTA under the income statement approach (\$250 deductible temporary difference  $\times$  40% tax rate = \$100 DTA).

***Flow-Through Method***

Under the flow-through method, A recognizes the reduction in taxes payable and records the offsetting credit as a current income tax benefit, as shown in the following journal entry:

**Entry 1E**

Income taxes payable	250
Current income tax expense	250

To record the reduction of income taxes payable and the related income tax benefit under the flow-through method.

Because there is no adjustment to the book basis of the qualifying asset and it is assumed that there is no adjustment to the tax basis of the qualifying asset (per the tax law), no deductible temporary difference arises. Therefore, the gross-up and income statement approaches are not applicable.

**Example 3-24B*****ITC With Statutory Reduction to Tax Basis***

Assume the same facts as in Example 1 except that in accordance with the tax law, there is an associated reduction in the tax basis of the related property equal to 50 percent of the ITC (i.e., \$125). Entity A records the same initial entry as follows:

**Entry 2A**

Property, plant, and equipment	1,000
Cash	1,000

To record the initial purchase.

***Deferral Method***

Under the deferral method, A recognizes the reduction in taxes payable and records the offsetting credit as a reduction in the carrying value of the asset, as shown in the following journal entry:

**Entry 2B**

Income taxes payable	250
Property, plant, and equipment	250

To record the reduction of income taxes payable and the related reduction in the carrying value of the qualifying asset under the deferral method.<sup>8</sup>

<sup>8</sup> See [footnote 7](#).

**Example 3-24B (continued)**

Because the corresponding adjustment to the tax basis of the qualifying asset (per the tax law) differs from that of the adjustment made to the carrying value of the qualifying asset, a deductible temporary difference of \$125 arises (\$750 book basis vs. \$875 tax basis). The accounting treatment for the related DTA depends on whether A has elected the gross-up approach or the income statement approach.

**Gross-Up Approach**

Under the gross-up approach, A's application of a simultaneous equation yields a DTA of \$83 (rounded) and a reduction to the recorded amount of the qualifying asset of \$83 (rounded). Thus, the qualifying asset should be recorded at \$667 (\$1,000 purchase price less the \$250 ITC less the \$83 DTA determined herein). Entity A will record the entries above and the following entry to account for the initial basis difference in the qualifying asset:

**Entry 2C**

DTA	83
Property, plant, and equipment	83

To record the DTA determined under the simultaneous equations method [initial deductible temporary difference of  $\$125 \times 40\% \text{ tax rate} \div (1-40\% \text{ tax rate}) = \$83 \text{ DTA}$ ].

**Income Statement Approach**

Under the income statement approach, A records a \$50 DTA as a component of tax expense. Entity A will record Entry 2B and the following entry to account for the qualifying asset, the ITC, and the initial basis difference in the qualifying asset:

**Entry 2D**

DTA	50
Deferred tax expense	50

To record the DTA under the income statement approach ( $\$125 \text{ deductible temporary difference} \times 40\% \text{ tax rate} = \$50 \text{ DTA}$ ).

**Flow-Through Method**

Under the flow-through method, A recognizes the reduction in taxes payable and records the offsetting credit as a current income tax benefit, as shown in the following journal entry:

**Entry 2E**

Income taxes payable	250
Current income tax expense	250

To record the reduction of income taxes payable and the related income tax benefit under the flow-through method.

Although there is no adjustment to the book basis of the qualifying asset under this approach, the tax basis of the qualifying asset (per the tax law) differs from the book basis of the qualifying asset, and a taxable temporary difference of \$125 arises (\$1,000 book basis vs. \$875 tax basis). The accounting treatment for the related DTL depends on whether A has elected the gross-up approach or the income statement approach.

**Example 3-24B (continued)****Gross-Up Approach**

Under the gross-up approach, A's application of a simultaneous equation yields a DTL of \$83 (rounded) and an increase to the recorded amount of the qualifying asset of \$83 (rounded). Thus, the qualifying asset should be recorded at \$1,083 (\$1,000 purchase price plus the \$83 DTL determined herein). Entity A will record Entry 2E and the following entry to account for the initial basis difference in the qualifying asset:

**Entry 2F**

Property, plant, and equipment	83
DTL	83

To record the DTA under the income statement approach ( $\$125 \text{ deductible temporary difference} \times 40\% \text{ tax rate} = \$50 \text{ DTA}$ ).

**Income Statement Approach**

Under the income statement approach, A would not use the simultaneous equations method. Rather, A would apply its tax rate of 40 percent to the taxable temporary difference of \$125, resulting in the recognition of a \$50 DTL with the offset to deferred tax expense. Entity A will record Entry 2E and the following entry to account for the qualifying asset, the ITC, and the initial basis difference in the qualifying asset:

**Entry 2G**

Deferred tax expense	50
DTL	50

To record the DTL under the income statement approach ( $\$125 \text{ taxable temporary difference} \times 40\% \text{ tax rate} = \$50 \text{ DTL}$ ).

**Effect of Anticipated Future Special Deductions, Losses, and Tax Credits****ASC 740-10****Anticipated Future Special Deductions**

**25-37** The tax benefit of statutory depletion and other types of special deductions such as those that may be available for certain health benefit entities and small life insurance entities in future years shall not be anticipated for purposes of offsetting a deferred tax liability for taxable temporary differences at the end of the current year. [FAS 109, paragraph 231] The tax benefit of special deductions ordinarily is recognized no earlier than the year in which those special deductions are deductible on the tax return. However, some portion of the future tax effects of special deductions are implicitly recognized in determining the average graduated tax rate to be used for measuring deferred taxes when graduated tax rates are a significant factor and the need for a valuation allowance for deferred tax assets. In those circumstances, implicit recognition is unavoidable because those special deductions are one of the determinants of future taxable income and future taxable income determines the average graduated tax rate and sometimes determines the need for a valuation allowance. [FAS 109, paragraph 232] See Section 740-10-30 for measurement requirements related to determining tax rates and a valuation allowance for deferred tax assets.

**Anticipation of Future Losses Not Permitted**

**25-38** Conceptually, under an incremental approach as discussed in paragraph 740-10-10-3, the tax consequences of tax losses expected in future years would be anticipated for purposes of:

- Nonrecognition of a deferred tax liability for taxable temporary differences if there will be no future sacrifice because of future tax losses that otherwise would expire unused
- Recognition of a deferred tax asset for the carryback refund of taxes paid for the current or a prior year because of future tax losses that otherwise would expire unused.

However, the anticipation of the tax consequences of future tax losses is prohibited. [FAS 109, paragraph 185]

## ASC 740-10 (continued)

### ***Anticipated Future Tax Credits***

**25-39** Certain foreign jurisdictions tax corporate income at different rates depending on whether that income is distributed to shareholders. For example, while undistributed profits in a foreign jurisdiction may be subject to a corporate tax rate of 45 percent, distributed income may be taxed at 30 percent. Entities that pay dividends from previously undistributed income may receive a tax credit (or tax refund) equal to the difference between the tax computed at the undistributed rate in effect the year the income is earned (for tax purposes) and the tax computed at the distributed rate in effect the year the dividend is distributed. [EITF 95-10, paragraph Issue]

**25-40** In the separate financial statements of an entity that pays dividends subject to the tax credit to its shareholders, a deferred tax asset shall not be recognized for the tax benefits of future tax credits that will be realized when the previously taxed income is distributed; rather, those tax benefits shall be recognized as a reduction of income tax expense in the period that the tax credits are included in the entity's tax return. [EITF 95-10, paragraph Discussion]

**25-41** The accounting required in the preceding paragraph may differ in the consolidated financial statements of a parent that includes a foreign subsidiary that receives a tax credit for dividends paid, if the parent expects to remit the subsidiary's earnings. Assume that the parent has not availed itself of the exception for foreign unremitted earnings that may be available under paragraph 740-30-25-17. [EITF 95-20, paragraph Issue] In that case, in the consolidated financial statements of a parent, the future tax credit that will be received when dividends are paid and the deferred tax effects related to the operations of the foreign subsidiary shall be recognized based on the distributed rate because, as assumed in that case, the parent is not applying the indefinite reversal criteria exception that may be available under that paragraph. However, the undistributed rate shall be used in the consolidated financial statements to the extent that the parent has not provided for deferred taxes on the unremitted earnings of the foreign subsidiary as a result of applying the indefinite reversal criteria recognition exception. [EITF 95-20, paragraph Discussion]

For more information, see [4.11](#) and [4.18](#).

## Alternative Minimum Tax

### ASC 740-10

**25-42** The following guidance refers to provisions of the Tax Reform Act of 1986; however, it shall not be considered a definitive interpretation of the Act for any purpose.

**25-43** The Tax Reform Act of 1986 established an alternative minimum tax system in the United States. Under the Act, an entity's federal income tax liability is the greater of the tax computed using the regular tax system (regular tax) or the tax under the alternative minimum tax system. A credit (alternative minimum tax credit) may be earned for tax paid on an alternative minimum tax basis that is in excess of the amount of regular tax that would have otherwise been paid. With certain exceptions, the alternative minimum tax credit can be carried forward indefinitely and used to reduce regular tax, but not below the alternative minimum tax for that future year. The alternative minimum tax system shall be viewed as a separate but parallel tax system that may generate a credit carryforward. Alternative minimum tax in excess of regular tax shall not be viewed as a prepayment of future regular tax to the extent that it results in alternative minimum tax credits. [EITF 87-8, paragraph Issue]

**25-44** A deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraphs 740-10-30-5(d) through (e). [FAS 109, paragraph 19]

For more information, see [4.15](#), [4.16](#), and [4.17](#).

## Investment Tax Credits

### ASC 740-10

**25-45** An investment credit shall be reflected in the financial statements to the extent it has been used as an offset against income taxes otherwise currently payable or to the extent its benefit is recognizable under the provisions of this Topic. [APB 2, paragraph 16]

**25-46** While it shall be considered preferable for the allowable investment credit to be reflected in net income over the productive life of acquired property (the deferral method), treating the credit as a reduction of federal income taxes of the year in which the credit arises (the flow-through method) is also acceptable. [APB 2, paragraph 13]

## Changes in Laws or Rates

### ASC 740-10

**25-47** The effect of a change in tax laws or rates shall be recognized at the date of enactment. [EITF D-30]

**25-48** The tax effect of a retroactive change in enacted tax rates on current and deferred tax assets and liabilities shall be determined at the date of enactment using temporary differences and currently taxable income existing as of the date of enactment. [EITF 93-13, paragraph Discussion]

### 3.64 Retroactive Changes in Tax Laws or Rates and Expiring Provisions That May Be Reenacted

If retroactive tax legislation is enacted, the effects are recognized as a component of income tax expense or benefit from continuing operations in the financial statements for the interim or annual period that includes the enactment date. The FASB reached this conclusion because it believes that the event to be recognized is the enactment of new legislation. Therefore, the appropriate period in which to recognize the retroactive provisions of a new law is the period of enactment.

Further, entities should not anticipate the reenactment of a tax law or rate that is set to expire or has expired. Rather, under ASC 740-10-30-2, an entity should consider the currently enacted tax law, including the effects of any expiration, in calculating DTAs and DTLs.

If the provision is subsequently reenacted, the entity would look to ASC 740-10-25-47 and measure the effect of the change as of the date of reenactment.

### 3.65 Enacted Changes in Tax Laws or Rates That Affect Items Recognized in OCI

Changes in tax law may also affect DTAs and DTLs attributable to items recognized in OCI but not in net income. These items include foreign currency translation adjustments under ASC 830, actuarial gains and losses and prior service cost or credit recognized under ASC 715, and market value adjustments attributable for certain equity securities under the investment guidance in ASC 320. In addition, other items are recorded directly in shareholders' equity and affect the measurement of tax assets and liabilities when an enacted change in tax law occurs. These include the tax benefits for certain share-based payment awards under ASC 718, deductible expenditures reported as a reduction of the proceeds from issuing capital stock, tax benefits recognized in a taxable business combination accounted for as a common-control merger, and certain tax benefits recognized after a quasi-reorganization.

The effect of changes in tax law related to items recorded directly in shareholders' equity is always recorded in continuing operations in the period of enactment. The FASB concluded that the entire tax effect of a change in enacted tax rates should be allocated to continuing operations to avoid sometimes complex problems. The effect of the change in tax law on income tax expense attributable to continuing operations should be disclosed in the reconciliation required by ASC 740-10-50-12. This requirement could produce unusual relationships between pretax income from continuing operations and income tax expense or benefit, as illustrated in Example 3-25.

### Example 3-25

Assume the following:

- An entity's only temporary difference at the end of years 20X2 and 20X3 is the foreign currency translation adjustment of \$500, which arose in year 20X1 and resulted in the recording of a \$170 DTL.
- The applicable tax rate at the end of 20X1 and 20X2 is 34 percent. A tax law change is enacted at the beginning of year 20X3 that changes the applicable tax rate to 40 percent.
- The following tables show the income statements for 20X2 and 20X3 and the balance sheets at the end of 20X2 and 20X3:

Income Statement (Select Accounts)	20X2	20X3
Pretax income from continuing operations	<u>\$ 1,000</u>	<u>\$ 1,000</u>
Income tax expense		
Current	340	400
Deferred	<u>—</u>	<u>30</u>
Total	<u>340</u>	<u>430</u>
Net income	<u>\$ 660</u>	<u>\$ 570</u>
ETR	34%	43%

Balance Sheet (Select Accounts)	December 31	
	20X2	20X3
DTL	<u>\$ 170</u>	<u>\$ 200</u>
Equity CTA	500	500
Deferred tax thereon	<u>(170)</u>	<u>(170)</u>
Net balance	<u>\$ 330</u>	<u>\$ 330</u>

**Example 3-25 (continued)**

The following is an analysis of the facts in this example:

- Changes in tax laws affect the DTAs and DTLs of items originally recorded directly in shareholders' equity. The effect of the change is recognized as an increase or decrease to a DTL or DTA and a corresponding increase or decrease in income tax expense or benefit from continuing operations in the period of enactment.
- Tax law changes can significantly affect an entity's ETR because the effect of the change is computed on the basis of all cumulative temporary differences and carryforwards on the measurement date. In this case, the 6 percent tax rate increase related to the CTA amounts to \$30 and is reflected as deferred tax expense in 20X3.
- After a tax rate change, the tax consequence previously recorded in shareholders' equity no longer "trues up" given the current tax rate (i.e., because the tax effects are reversed at 40 percent after being initially recorded in equity at 34 percent, a 6 percent differential is created in equity). This "differential" may continue to be recorded as a component of OCI until an entire category (e.g., AFS securities, pension liabilities) that originally gave rise to the difference has been eliminated completely (e.g., if the entire marketable security portfolio were sold). An exception to this accounting might exist if the entity specifically tracks its investments for income tax purposes (as discussed in [7.17](#)), identifying which investments have tax effects reflected in equity at the old rate and which have tax effects reflected in equity at the new rates. However, because this level of tracking is usually impractical, the applicability of this alternative would be rare.

### **3.66 Reporting Tax Effects of a Change in Tax Law in Discontinued Operations**

Entity W, a diversified financial service entity, disposed of its wholly owned subsidiary, Entity T, in a prior year. The disposition resulted in a loss from discontinued operations in that prior year.

Although historically W has been a profitable entity, it incurred operating loss carryforwards related to T's operations in a state tax jurisdiction, since tax law precluded W from filing a consolidated tax return with T. Entity W is currently applying ASC 740.

In the current year, the same state tax jurisdiction enacted a change in tax law that permits entities to elect to file consolidated tax returns. The change is retroactive to the period covered by the losses incurred by T. Thus, W plans to file for recovery of state income taxes paid in that jurisdiction. Recovery will be determined on the basis of the difference between (1) the amount of income taxes paid by W in those prior years less (2) the amount of taxes that would have been paid if W had been allowed to consolidate its tax return with T for the relevant years.

In this scenario, W cannot report the tax consequences of the recovery of prior-year income taxes as a component of discontinued operations in the current year. ASC 740-10-30-26 and ASC 740-10-25-48, respectively, conclude that:

The reported tax effect of items not included in income from continuing operations (for example, discontinued operations . . .) that arose during the current fiscal year and before the date of enactment of tax legislation shall be measured based on the enacted rate at the time the transaction was recognized for financial reporting purposes.

The tax effect of a retroactive change in enacted tax rates on current and deferred tax assets and liabilities shall be determined at the date of enactment using temporary differences and currently taxable income existing as of the date of enactment.

In applying this guidance, an entity should consider the change in tax rates to be analogous to a change in tax law. Thus, for example, the effect of a tax law change allowing refund of prior-year income taxes would be accounted for in the same manner as a change in tax rates. This conclusion is based on the guidance in ASC 740-10-35-4 and ASC 740-10-45-15, which states that DTAs or DTLs should be adjusted

for the effect of a change in tax law or rates and that “the effect shall be included in income from continuing operations for the period that includes the enactment date.”

In this example, W should not report the effects of recovery of prior-year income taxes until it has satisfied all requirements imposed by the tax law. ASC 450-30-25-1 and ASC 450-30-50-1 provide guidance on accounting for, and disclosures about, gain contingencies.

## Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations

### ASC 740-10

**25-49** The following guidance addresses the accounting when an asset is acquired outside of a business combination and the tax basis of the asset differs from the amount paid.

**25-50** The tax basis of an asset is the amount used for tax purposes and is a question of fact under the tax law. An asset’s tax basis is not determined simply by the amount that is depreciable for tax purposes. For example, in certain circumstances, an asset’s tax basis may not be fully depreciable for tax purposes but would nevertheless be deductible upon sale or liquidation of the asset. In other cases, an asset may be depreciated at amounts in excess of tax basis; however, such excess deductions are subject to recapture in the event of sale. [EITF 98-11, paragraph Issue]

**25-51** The tax effect of asset purchases that are not business combinations in which the amount paid differs from the tax basis of the asset shall not result in immediate income statement recognition. The simultaneous equations method shall be used to record the assigned value of the asset and the related deferred tax asset or liability. (See Example 25, Cases A and B [paragraphs 740-10-55-171 through 55-182] for illustrations of the simultaneous equations method.) For purposes of applying this requirement, the following applies:

- a. An acquired financial asset shall be recorded at fair value, an acquired asset held for disposal shall be recorded at fair value less cost to sell, and deferred tax assets shall be recorded at the amount required by this Topic.
- b. An excess of the amounts assigned to the acquired assets over the consideration paid shall be allocated pro rata to reduce the values assigned to noncurrent assets acquired (except financial assets, assets held for disposal, and deferred tax assets). If the allocation reduces the noncurrent assets to zero, the remainder shall be classified as a deferred credit. (See Example 25, Cases C and D [paragraphs 740-10-55-183 through 55-191] for illustrations of transactions that result in a deferred credit.) The deferred credit is not a temporary difference under this Subtopic.
- c. A reduction in the valuation allowance of the acquiring entity that is directly attributable to the asset acquisition shall be accounted for in accordance with paragraph 805-740-30-3. Subsequent accounting for an acquired valuation allowance (for example, the subsequent recognition of an acquired deferred tax asset by elimination of a valuation allowance established at the date of acquisition of the asset) would be in accordance with paragraphs 805-740-25-3 and 805-740-45-2.

**25-52** The net tax benefit (that is, the difference between the amount paid and the deferred tax asset recognized) resulting from the purchase of future tax benefits from a third party which is not a government acting in its capacity as a taxing authority shall be recorded using the same model described in the preceding paragraph. (See Example 25, Case F [paragraph 740-10-55-199] for an illustration of a purchase of future tax benefits.)

**25-53** Transactions directly between a taxpayer and a government (in its capacity as a taxing authority) shall be recorded directly in income (in a manner similar to the way in which an entity accounts for changes in tax laws, rates, or other tax elections under this Subtopic). (See Example 26 [paragraph 740-10-55-202] for an illustration of a transaction directly with a governmental taxing authority.)

**25-54** In situations in which the tax basis step up relates to goodwill that was previously not deductible, no deferred tax asset would be recorded for the increase in basis except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill.

**ASC 740-10 (continued)**

**25-55** In the event that an entity purchases tax benefits that result from intra-entity transactions between members of a consolidated entity, paragraph 740-10-25-3(e), which prohibits recognition of a deferred tax asset for the difference between the tax basis of assets in the buyer's tax jurisdiction and the cost of those assets as reported in the consolidated financial statements, shall be applied. [EITF 98-11, paragraph Discussion]

**Pending Content (Transition Guidance: ASC 740-10-65-5)**

**25-55** In the event that an entity purchases tax benefits that result from intra-entity transfers of inventory between members of a consolidated entity, paragraph 740-10-25-3(e), which prohibits recognition of a deferred tax asset for the difference between the tax basis of inventory in the buyer's tax jurisdiction and the cost of that inventory as reported in the consolidated financial statements, shall be applied. [EITF 98-11, paragraph Discussion]

**Related Implementation Guidance and Illustrations**

- [Example 25: Purchase Transactions That Are Not Accounted for as Business Combinations](#) [ASC 740-10-55-170].
- [Example 26: Direct Transaction With Governmental Taxing Authority](#) [ASC 740-10-55-202].

**ASC 740-10 — SEC Materials**

**S25-1** See paragraph 740-10-S99-3, SEC Observer Comment: Accounting for Acquired Temporary Difference in Certain Purchase Transactions that Are Not Accounted for as Business Combinations, for SEC Staff views on accounting for such transactions.

**S99-3** The following is the text of SEC Observer Comment: Accounting for Acquired Temporary Differences in Certain Purchase Transactions that Are Not Accounted for as Business Combinations.

Paragraph 740-10-25-50 provides guidance on the accounting for acquired temporary differences in purchase transactions that are not business combinations. The SEC staff would object to broadly extending this guidance to adjust the basis in an asset acquisition to situations different from those illustrated in Examples 25 through 26 (see paragraphs 740-10-55-170 through 55-204) without first having a clear and complete understanding of those specific fact patterns. [EITF 98-11, paragraph Discussion]

**Interest and Penalties****ASC 740-10**

**25-56** When the tax law requires interest to be paid on an underpayment of income taxes, an entity shall begin recognizing interest expense in the first period the interest would begin accruing according to the provisions of the relevant tax law. [FIN 48, paragraph 15]

**25-57** If a tax position does not meet the minimum statutory threshold to avoid payment of penalties (considering the factors in paragraph 740-10-25-7), an entity shall recognize an expense for the amount of the statutory penalty in the period in which the entity claims or expects to claim the position in the tax return. If penalties were not recognized when the position was initially taken, the expense shall be recognized in the period in which the entity's judgment about meeting the minimum statutory threshold changes. [FIN 48, paragraph 16]

**Accrued Interest and Penalties Related to Tax Positions Subsequently Meeting the Recognition Criteria**

**40-5** A tax position that did not meet the recognition requirements of paragraph 740-10-25-6 may have resulted in the accrual of interest and penalties under the requirements of paragraphs 740-10-25-56 through 25-57. Previously recognized interest and penalties associated with tax positions that subsequently meet one of the conditions in paragraph 740-10-25-8 shall be derecognized in the period that condition is met. [FIN 48, paragraph 16]

### 3.67 Recognition and Measurement of Interest and Penalties

An entity should accrue and compute interest and penalties by applying the statutory rates to the difference between (1) tax benefits recognized under ASC 740 and (2) tax benefits reflected by the as-filed tax position. ASC 740-10-30-29 requires that an entity recognize and compute interest expense by applying the applicable statutory rate of interest to the difference between the tax position recognized in the financial statements, in accordance with ASC 740, and in the as-filed tax position. Penalties should be accrued if the position does not meet the minimum statutory threshold necessary to avoid payment of penalties unless a widely understood administrative practices and precedents exception (discussed below) is applicable. Therefore, the accrual of interest and penalties is a direct result of the amount of UTBs recorded in the financial statements under ASC 740 and should be computed according to the provisions of the tax law.

Paragraphs B52 and B53 of Interpretation 48, which were not codified, explain that the FASB, during its redeliberations of the provisions of Interpretation 48, considered whether to require accrual of interest on (1) management's best estimate of the amount that would ultimately be paid to the tax authority upon settlement or (2) the difference between the tax benefit of the as-filed tax position and the amount recognized in the financial statements. The FASB concluded that accruing interest on the basis of management's best estimate would be inconsistent with the approach required in Interpretation 48 for recognizing tax positions and that the amount of interest and penalties recognized should be consistent with the amount of tax benefits reported in the financial statements. Therefore, ASC 740 requires accrual of interest and penalties on the basis of the difference between the tax benefit of the as-filed tax position and the amount recognized in the financial statements under ASC 740, computed in accordance with the provisions of the relevant tax law.

An entity should consider a tax authority's widely understood administrative practices and precedents in determining whether the minimum statutory threshold to avoid the assessment of penalties has been met. If the tax authority has a widely understood administrative practice or precedent that modifies the circumstances under which a penalty is assessed (relative to the statutory criteria), the entity should consider this administrative practice or precedent in determining whether a penalty should be assessed. Anecdotal evidence, such as an entity's historical experience with the tax authority in achieving penalty abatement, would not be considered an administrative practice.

To take such a widely understood policy into consideration, an entity must conclude that the tax authority would not assess penalties provided that the tax authority has full knowledge of all the relevant facts. The use of such a policy is limited to whether the tax authority would assess penalties. It does not apply to the determination of the amount of penalties that the entity will actually pay once they are assessed. That is, a tax authority's historical practice of abating penalties during negotiations with the entity when the threshold to avoid the assessment of penalties has not been met is not relevant to the accrual and measurement of penalties. If an entity concludes that penalties are applicable under ASC 740-10-25-56 because there is no widely understood policy, the entity must calculate the penalties to accrue on the basis of the applicable tax code.

#### Example 3-26

A U.S. corporate entity applies the provisions of ASC 740 to its tax positions and recognizes a liability for its UTBs. The entity accrues interest by applying the applicable statutory rate of interest to the difference between the tax position recognized in the financial statements, in accordance with ASC 740, and in the as-filed tax position. The entity identifies a written policy in the tax authority's manual that allows its field agents to ignore the statute and not assess penalties when an entity has a reasonable basis for its return position and the tax authority would apply the exception in the entity's specific situation. The entity may take that policy into consideration in determining whether it must accrue penalties related to its UTBs.

**Example 3-27**

An entity applies the provisions of ASC 740 to its tax positions and recognizes a liability for its UTBs. The entity accrues interest by applying the applicable statutory rate of interest to the difference between the tax position recognized in the financial statements, in accordance with ASC 740, and in the as-filed tax position. The entity's past experience indicates it is probable that the tax authority will abate all penalties assessed during the examination process. The entity may not take its past experience into consideration because it does not constitute a widely understood administrative practice or precedent relative to whether a penalty would be assessed under the circumstances. Since the entity did not meet the minimum statutory threshold to avoid the assessment of penalties, the entity must accrue penalties on the basis of the applicable statutory rate.

### **3.68 Interest Income on UTBs**

ASC 740 does not discuss the recognition and measurement of interest income on UTBs; however, an entity should recognize and measure interest income to be received on an overpayment of income taxes in the first period in which the interest would begin accruing according to the provisions of the relevant tax law.

It is preferable for a public entity to present interest income attributable to an overpayment of income taxes as an element of nonoperating income, separately stated in the income statement or in a note to the financial statements as **interest on refund claims due from tax authorities**. This presentation is consistent with SEC Regulation S-X, Rule 5-03(b)(7).

On the basis of informal discussions with the SEC staff, we understand that the staff currently does not have a view on this matter and may not object to an entity's including interest income attributable to overpayment of income taxes as an element of its provision for income taxes. Accordingly, the SEC staff has advised us that if an entity's accounting policy is to include interest income attributable to overpayment of income taxes within the provision for income taxes, this policy must be prominently disclosed and transparent to financial statement users.

The SEC staff has indicated that it believes a public entity that has an accounting policy to include interest income or expense on overpayments and underpayments of income taxes should consistently display such amounts as income tax in the balance sheets, statements of operations, statements of cash flows, and other supplemental disclosures. Specifically, public entities should consider presenting the following disclosure of the components of the income tax provision, either on the face of the statements of operations or in a note to the financial statements:

Current tax expense (benefit)	\$ XXX
Tax expense (benefit) recognized for UTBs in the income statement	XXX
Interest expense, gross of related tax effects	XXX
Interest income, gross of related tax effects	XXX
Penalties, gross of related tax effects	XXX
Deferred tax expense (benefit)	XXX
Tax benefits charged or credited to APIC	<u>XXX</u>
<b>Total tax provision</b>	<b>\$ XXX</b>

ASC 740 does not provide guidance on the classification (i.e., current or deferred provision) of accrued interest expense, interest income, and penalties when these amounts are recorded in the income tax provision. Accordingly, entities may make an accounting policy election to record these amounts in either the current or deferred income tax provision and should disclose the election in the financial statements, if material.

This disclosure is also recommended for nonpublic entities, since it may help financial statement users understand the effect of interest expense and income.

### **3.69 Capitalization of Interest Expense**

Interest expense recognized on the underpayment of income tax is not eligible for capitalization under ASC 835-20. ASC 835-20-30-2 indicates that the amount of interest cost to be capitalized is the amount that theoretically could have been avoided if expenditures for the asset had not been made. Entities have two alternatives: (1) repay existing borrowings or (2) invest in an asset. The entity could avoid interest cost by choosing to repay a borrowing instead of investing in an asset. Once the decision to invest in the asset is made, the relationship between the investment in the asset and the incurrence of interest cost makes the interest cost analogous to a direct cost in the asset (i.e., the two alternatives are linked).

The liability for UTBs recognized under ASC 740 is not a result of the investment alternatives above; rather, it is a result of a difference in the amount of benefit recognized in the financial statements compared with the amount taken, or expected to be taken, in a tax return. The liability for UTBs is not a borrowing, as contemplated in ASC 835-20, and should not be considered a financing activity. Therefore, the related interest expense should not be capitalized but should be expensed as incurred.

### **3.70 Recognition of the Accrual for Penalties**

In many jurisdictions, penalties may be imposed when a specified threshold of support for a tax position taken is not met. In the United States, some penalties are transaction-specific (i.e., not based on taxable income) and others, such as penalties for substantial underpayment of taxes, are based on the amount of additional taxes due upon settlement with the tax authority.

ASC 740-10-25-57 indicates that an entity must recognize, on the basis of the relevant tax law, an expense for the amount of a statutory penalty in the period in which the tax position that would give rise to a penalty has been taken or is expected to be taken in the tax return. Penalties required under the relevant tax law should thus be recorded in the same period in which the liability for UTBs is recognized. If the penalty was not recorded when the tax position was initially taken because the position met the minimum statutory threshold, the entity should recognize the expense in the period in which its judgment about meeting the minimum statutory threshold changes.

#### **Example 3-28**

On December 31, 20X7, a calendar-year-end entity expects to take a tax position that will reduce its tax liability in its 20X7 tax return, which will be filed in 20X8. The entity concludes that the tax position lacks the specified confidence level (e.g., substantial authority) required to avoid the payment of a penalty under the relevant tax law. In its December 31, 20X7, financial statements, the entity should record a liability for the penalty amount the tax authority is expected to assess on the basis of the relevant tax law.

# Chapter 4 — Measurement

This chapter provides guidance on the amount at which an entity should measure a tax asset or liability in its financial statements when the recognition criteria for that asset or liability have been met (as discussed in [Chapter 3, “Recognition and Derecognition”](#)). Specifically, this chapter focuses on (1) the appropriate tax rate to be used, (2) how uncertainty should be considered, and (3) how to evaluate DTAs for realizability and when a valuation allowance would be appropriate. As the complexity of an entity’s legal structure and jurisdictional footprint increases, so do the challenges with measuring tax assets and liabilities. The guidance in this chapter applies equally to highly complex organizations as well as to simple entities that operate in a single jurisdiction.

## General Measurement Approach

### ASC 740-10

**30-1** This Section provides guidance on the measurement of total income tax expense. While most of this guidance focuses on the initial measurement of deferred tax assets and liabilities, including determining the appropriate tax rate to be used, the requirements for measuring current taxes payable or refundable are also established. This guidance also addresses the consideration and establishment of a valuation allowance for deferred tax assets. Requirements for entities that issue separate financial statements and are part of a group that files a consolidated tax return are also established in this Section.

### Basic Requirements

**30-2** The following basic requirements are applied to the measurement of current and deferred income taxes at the date of the financial statements:

- a. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- b. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized. [FAS 109, paragraph 8]

**30-3** Total income tax expense (or benefit) for the year is the sum of deferred tax expense (or benefit) and income taxes currently payable or refundable.

### Deferred Tax Expense (or Benefit)

**30-4** Deferred tax expense (or benefit) is the change during the year in an entity’s deferred tax liabilities and assets. For deferred tax liabilities and assets recognized in a business combination or in an acquisition by a not-for-profit entity during the year, it is the change since the acquisition date. Paragraph 830-740-45-1 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred foreign tax liability or asset when the reporting currency is the functional currency. [FAS 109, paragraph 16]

### ASC 740-10 (continued)

**30-5** Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

- a. Identify the types and amounts of existing temporary differences and the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period.
- b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (see paragraph 740-10-30-8).
- c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate.
- d. Measure deferred tax assets for each type of tax credit carryforward.
- e. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance shall be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. [FAS 109, paragraph 17]

### **Income Taxes Payable or Refundable (Current Tax Expense [or Benefit])**

**30-6** Income taxes payable or refundable (current tax expense [or benefit]) are determined under the recognition and measurement requirements for tax positions established in paragraph 740-10-25-2 for recognition and in this Section for measurement.

**30-7** A tax position that meets the more-likely-than-not recognition threshold shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon settlement using the facts, circumstances, and information available at the reporting date. As used in this Subtopic, the term *reporting date* refers to the date of the entity's most recent statement of financial position. For further explanation and illustration, see Examples 5 through 10 (paragraphs 740-10-55-99 through 55-116). [FIN 48, paragraph 8]

### **Related Implementation Guidance and Illustrations**

- [Measurement of Deferred Tax Liabilities and Assets](#) [ASC 740-10-55-23].
- [Operating Loss and Tax Credit Carryforwards and Carrybacks](#) [ASC 740-10-55-34].
- [Example 5: Highly Certain Tax Positions](#) [ASC 740-10-55-99].
- [Example 6: Measurement With Information About the Approach to Settlement](#) [ASC 740-10-55-102].
- [Example 7: Measurement With More Limited Information About the Approach to Settlement](#) [ASC 740-10-55-105].
- [Example 8: Measurement of a Tax Position After Settlement of a Similar Position](#) [ASC 740-10-55-108].
- [Example 9: Differences Relating to Timing of Deductibility](#) [ASC 740-10-55-110].
- [Example 10: Change in Timing of Deductibility](#) [ASC 740-10-55-113].

## 4.01 Measuring Deferred Taxes in Consolidated Financial Statements When a Foreign Subsidiary Uses a Local Statutory Basis of Accounting to Prepare Its Financial Statements

Multinational companies often have multiple layers of financial reporting, and each layer may be prepared by using a different basis of accounting. For example, a foreign subsidiary of a U.S.-based multinational company may have to prepare the following sets of accounts:

1. Financial statements prepared in accordance with U.S. GAAP for inclusion in the consolidated financial statements of the U.S. parent (U.S. GAAP financial statements).
2. Financial statements prepared in accordance with the comprehensive basis of accounting required by the jurisdiction in which the subsidiary resides (local GAAP or statutory financial statements).
3. Books and records prepared in accordance with the requirements of the tax authority of the jurisdiction in which the subsidiary resides for local income tax reporting purposes (local jurisdiction tax basis).

While it is not necessary for a foreign subsidiary to prepare statutory financial statements in order to prepare U.S. GAAP financial statements, a foreign subsidiary that is subject to statutory reporting requirements will often use a reconciliation approach to prepare its U.S. GAAP financial statements. That is, the foreign subsidiary will often prepare statutory financial statements first and identify differences between those amounts and the local jurisdiction tax basis (commonly referred to as "stat-to-tax differences") when determining deferred taxes to be recognized in the statutory financial statements. The foreign subsidiary will then adjust those financial statements to reconcile or convert them to U.S. GAAP (commonly referred to as "stat-to-GAAP differences").

Questions often arise concerning how deferred taxes should be computed for purposes of a company's consolidated financial statements prepared in accordance with U.S. GAAP when both stat-to-GAAP and stat-to-tax differences are present. ASC 740-10-20 defines a temporary difference as "a difference between the tax basis of an asset or liability . . . and its reported amount in the financial statements." Accordingly, temporary differences related to assets and liabilities of a foreign subsidiary are computed on the basis of the difference between the reported amount in the U.S. GAAP financial statements and the tax basis of the subsidiary's assets and liabilities (which inherently includes both stat-to-GAAP and stat-to-tax differences).

Companies that use the reconciliation approach, however, will generally develop temporary differences for each asset and liability in two steps. Accordingly, when using the reconciliation approach, companies must ensure that any deferred taxes on the statutory books (related to stat-to-tax differences) are not double-counted in the U.S. GAAP financial statements.

### Example 4-1

Assume the following:

- A U.S. parent consolidates FS, a foreign corporation operating in Jurisdiction Y, which has a 20 percent income tax rate.
- FS is required to file statutory financial statements with Y and prepares these financial statements in accordance with its local GAAP.
- FS has one asset with a basis of \$4 million, \$6 million, and \$7 million for local income tax, statutory, and U.S. GAAP reporting purposes, respectively.<sup>1</sup>

Corporation FS's deferred taxes related to the single asset may be determined by comparing its U.S. GAAP basis of \$7 million with its local income tax basis of \$4 million to arrive at its total DTL of \$0.6 million ( $[\$7 \text{ million} - \$4 \text{ million}] \times 20\%$ ) for U.S. GAAP financial statement purposes.

Alternatively, if FS uses a reconciliation approach, FS's stat-to-tax basis difference is \$2 million ( $\$6 \text{ million} - \$4 \text{ million}$ ), resulting in the recording of a \$0.4 million ( $\$2 \text{ million} \times 20\%$ ) DTL in FS's statutory financial statements. FS's stat-to-GAAP adjustment (difference) is \$1 million ( $\$7 \text{ million} - \$6 \text{ million}$ ), resulting in an additional DTL of \$0.2 million ( $\$1 \text{ million} \times 20\%$ ) for purposes of the U.S. GAAP financial statements. The total DTL reported in the U.S. GAAP financial statements in connection with FS's asset is \$0.6 million, representing the \$0.4 million recorded in the statutory financial statements and the \$0.2 million recorded as part of the stat-to-GAAP reconciling adjustments. For presentation purposes, the \$0.4 million DTL related to the stat-to-tax difference and the \$0.2 million DTL related to the stat-to-GAAP difference should be combined and presented as a single DTL in the balance sheet and disclosures.

If the U.S. parent does not take into consideration the \$0.4 million DTL already recorded in the statutory financial statements and records an incremental \$0.6 million DTL as a U.S. GAAP adjustment, it would effectively double-count the temporary difference associated with the \$2 million basis difference between the statutory and tax bases of the asset.

## Applicable Tax Rate Used to Measure Deferred Taxes

### ASC 740-10

**30-8** Paragraph 740-10-10-3 establishes that the objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. [FAS 109, paragraph 18] Deferred taxes shall not be accounted for on a discounted basis. [APB 10, paragraph 6]

**30-9** Under tax law with a graduated tax rate structure, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate shall be used for measurement of a deferred tax liability or asset by entities for which graduated tax rates are not a significant factor. Entities for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized. See Example 16 (paragraph 740-10-55-136) for an illustration of the determination of the average graduated tax rate. Other provisions of enacted tax laws shall be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized. [FAS 109, paragraph 18]

**30-10** In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 740-10-30-5(d) through (e). [FAS 109, paragraph 19]

<sup>1</sup> For ease of illustration, currency differences are ignored.

**ASC 740-10 (continued)**

**30-11** The objective established in paragraph 740-10-10-3 relating to enacted tax rate(s) expected to apply is not achieved through measurement of deferred taxes using the lower alternative minimum tax rate if an entity currently is an alternative minimum tax taxpayer and expects to always be an alternative minimum tax taxpayer. No one can predict whether an entity will always be an alternative minimum tax taxpayer. Furthermore, it would be counterintuitive if the addition of alternative minimum tax provisions to the tax law were to have the effect of reducing the amount of an entity's income tax expense for financial reporting, given that the provisions of alternative minimum tax may be either neutral or adverse but never beneficial to an entity. It also would be counterintuitive to assume that an entity would permit its alternative minimum tax credit carryforward to expire unused at the end of the life of the entity, which would have to occur if that entity was always an alternative minimum tax taxpayer. [FAS 109, paragraph 90] Use of the lower alternative minimum tax rate to measure an entity's deferred tax liability could result in understatement for either of the following reasons:

- a. It could be understated if the entity currently is an alternative minimum tax taxpayer because of temporary differences. Temporary differences reverse and, over the entire life of the entity, cumulative income will be taxed at regular tax rates.
- b. It could be understated if the entity currently is an alternative minimum tax taxpayer because of preference items but does not have enough alternative minimum tax credit carryforward to reduce its deferred tax liability from the amount of regular tax on regular tax temporary differences to the amount of tentative minimum tax on alternative minimum tax temporary differences. In those circumstances, measurement of the deferred tax liability using alternative minimum tax rates would anticipate the tax benefit of future special deductions, such as statutory depletion, which have not yet been earned. [FAS 109, paragraph 91]

**30-12** If alternative tax systems exist in jurisdictions other than the U.S. federal jurisdiction, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction (that is, a mechanism similar to the U.S. alternative minimum tax credit) between the two systems. [FAS 109, paragraph 19]

***Effect of Anticipated Future Special Deductions and Tax Credits on Deferred Tax Rates*****Anticipated Future Special Deductions**

**30-13** As required by paragraph 740-10-25-37, the tax benefit of special deductions ordinarily is recognized no earlier than the year in which those special deductions are deductible on the tax return. However, some portion of the future tax effects of special deductions are implicitly recognized in determining the average graduated tax rate to be used for measuring deferred taxes when graduated tax rates are a significant factor and the need for a valuation allowance for deferred tax assets. In those circumstances, implicit recognition is unavoidable because those special deductions are one of the determinants of future taxable income and future taxable income determines the average graduated tax rate and sometimes determines the need for a valuation allowance. [FAS 109, paragraph 232]

**Anticipated Future Tax Credits**

**30-14** Paragraph 740-10-25-39 notes that certain foreign jurisdictions may tax corporate income at different rates depending on whether that income is distributed to shareholders. Paragraph 740-10-25-40 addresses recognition of future tax credits that will be realized when the previously taxed income is distributed. Under these circumstances, the entity shall measure the tax effects of temporary differences using the undistributed rate. [EITF 95-10, paragraph Discussion]

**30-15** As noted in paragraph 740-10-25-41, the accounting required in the consolidated financial statements of a parent that includes a foreign subsidiary that receives a tax credit for dividends paid may differ from the accounting required for the subsidiary. See that paragraph for the rates required to be used to measure deferred income taxes in such consolidated financial statements.

**Related Implementation Guidance and Illustrations**

- [Alternative Minimum Tax](#) [ASC 740-10-55-31].
- [Example 14: Phased-In Change in Tax Rates](#) [ASC 740-10-55-129].
- [Example 15: Change in Tax Rates](#) [ASC 740-10-55-131].
- [Example 16: Graduated Tax Rates](#) [ASC 740-10-55-136].
- [Example 18: Special Deductions](#) [ASC 740-10-55-145].

## 4.02 Tax Rate Used in Measuring Operating Losses and Tax Credits

Operating losses and some tax credits that arise but are not used in the current year may be carried back to recover taxes paid in prior years or carried forward to reduce taxes payable in future years. An entity usually first considers whether an operating loss or tax credit may be carried back to recover taxes paid in previous years. If the benefit from an operating loss or tax credit is carried back, the entity recognizes a receivable (current tax benefit) for the amount of taxes paid in prior years that is refundable by carryback of a current-year operating loss or tax credit. The entity measures the current income tax receivable by using the rate applicable to the prior year(s) for which the refund is being claimed.

The entity then carries forward any remaining NOL or tax credit to reduce future taxes payable. NOL and tax credit carryforwards are recognized as DTAs in the period in which they arise. In accordance with ASC 740-10-10-3, the entity measures such DTAs by “using the enacted tax rate(s) expected to apply to taxable income in the periods in which” the DTAs are expected to be realized. (See [4.09](#) and [4.10](#) for guidance on determining the applicable tax rate when an entity operates in a jurisdiction with graduated tax rates.)

As with other DTAs, the entity must determine whether a valuation allowance is needed for its operating loss and tax credit carryforwards. The entity must assess whether it is more likely than not that part or all of the DTA will not be realized during the carryforward period. If so, the entity must establish a valuation allowance that is sufficient to reduce the DTA to the amount that is more likely than not to be realized. (Example 19 in ASC 740-10-55-149 illustrates “recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years when a valuation allowance is necessary in the loss year.”)

## 4.03 Determining the Applicable Tax Rate on a Loss Carryback

ASC 740-10-30-8 states that a DTL or DTA should be measured by “using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.” Measurements are based on elections (e.g., an election to carryback or carryforward a tax loss) that an entity is expected to make in the future. An entity must consider enacted changes in tax laws or rates that become effective for a particular future year or years when determining the tax rate to use in measuring the tax consequences of temporary differences that are expected to reverse in those years. The tax rate to be applied to a loss carryback is the rate expected to apply to taxable income for the year the loss is carried back to.

### Example 4-2

In the current year, Entity A has pretax book income of \$2,000 and \$2,500 of current-year deductions that give rise to future taxable temporary differences; a tax loss of \$500 is therefore created. Also in the current year, the statutory rate was scheduled to increase from 35 percent to 40 percent. Assume that A plans to elect to carry back the tax loss.

In this example, the applicable tax rate would be the enacted rate for the year the loss is carried back to. In the current year, A would reflect \$2,000 of the deductions at 40 percent, since A would use \$2,000 of the deductible temporary differences to offset the current-year pretax income, and \$500 of deductions at 35 percent, since A would carry back the \$500 loss to offset prior-year tax income.

## 4.04 Measuring Deferred Taxes for Indefinite-Lived Intangible Assets When Different Tax Rates May Apply

Under ASC 350, an intangible asset whose life extends beyond the foreseeable horizon is classified as having an indefinite life ("indefinite-lived intangible asset"). An indefinite-lived intangible asset is not amortized for financial reporting purposes until its useful life is determined to be no longer indefinite. However, the applicable tax law may allow or require such assets to be amortized. Since the amortization is deductible in the determination of taxable income, a temporary difference arises between the financial reporting carrying value and the tax basis of indefinite-lived intangible assets.

ASC 740-10-30-8 states that an entity should measure deferred taxes by "using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized." However, certain jurisdictions may impose a tax rate for ordinary income that is different from the tax rate for income that is capital in nature (i.e., capital gains). In those instances, ASC 740 does not provide specific guidance on how to determine which tax rate (i.e., ordinary or capital) is "expected" to apply in the future.

Unlike depreciable or amortizable assets, which are presumed to be recovered through future revenues, indefinite-lived intangible assets are not presumed to decline in value (i.e., they are not expected to be consumed over time). However, as noted in ASC 350-30-35-4, the "term indefinite does not mean the same as infinite or indeterminate." Further, entities are required to evaluate the remaining useful life of indefinite-lived intangible assets during each reporting period; when an intangible asset's useful life is no longer considered indefinite, the carrying value of the asset must be amortized. When an indefinite-lived intangible asset becomes finite-lived, it is generally presumed that the asset will be recovered through future revenues.

Therefore, in jurisdictions in which the ordinary tax rate and capital gains tax (CGT) rate differ, entities should determine, on the basis of their specific facts and circumstances, the expected manner of recovery of the carrying value of indefinite-lived intangible assets (e.g., through sale or eventual consumption when the asset becomes finite-lived). The tax rate used to measure deferred taxes for indefinite-lived intangible assets should be consistent with the expected manner of recovery. For example, if an entity determines that the expected manner of recovery is through sale of the indefinite-lived intangible asset, the entity should use the CGT rate in measuring deferred taxes related to that asset.

See [3.47](#) for guidance on recognizing deferred taxes for indefinite-lived assets. In addition, see [4.27](#) for guidance on whether an entity can use the reversal of a DTL related to an indefinite-lived asset as a source of taxable income to support the realization of DTAs.

## 4.05 Use of a Blended Rate to Measure Deferred Taxes

Deferred taxes ordinarily must be determined separately for each tax-paying component in each tax jurisdiction. However, in practice, some entities employ a "blended-rate" approach in measuring deferred taxes at the legal-entity level. Such an approach may simplify the ASC 740 calculation for entities operating in multiple jurisdictions (e.g., operating in multiple U.S. states).

ASC 740-10-55-25 states:

If deferred tax assets or liabilities for a state or local tax jurisdiction are significant, [ASC 740-10] requires a separate deferred tax computation when there are significant differences between the tax laws of that and other tax jurisdictions that apply to the entity. In the United States, however, many state or local income taxes are based on U.S. federal taxable income, and aggregate computations of deferred tax assets and liabilities for at least some of those state or local tax jurisdictions might be acceptable. In assessing whether an aggregate calculation is appropriate, matters such as differences in tax rates or the loss carryback and carryforward periods in those state or local tax jurisdictions should be considered. Also, the provisions of paragraph 740-10-

45-6 about offset of deferred tax liabilities and assets of different tax jurisdictions should be considered. In assessing the significance of deferred tax expense for a state or local tax jurisdiction, it is appropriate to consider the deferred tax consequences that those deferred state or local tax assets or liabilities have on other tax jurisdictions, for example, on deferred federal income taxes.

An entity should use significant judgment and continually assess whether it is acceptable to use a blended-rate approach in light of (1) the considerations in ASC 740-10-55-25, among others, and (2) the specific facts and circumstances. For example, a change in circumstances in one of the jurisdictions from one year to the next (e.g., a nonrecurring event or a change in tax rate) may result in a conclusion that the use of a blended rate is unacceptable.

In all cases, the results of using a blended-rate approach should not be materially different from the results of separately determining deferred taxes for each tax-paying component in each tax jurisdiction.

## **4.06 Effect of Tax Holidays on the Applicable Tax Rate**

Recognition of a DTA for a tax holiday is prohibited by ASC 740-10-25-35 and 25-36; however, the effects of a tax holiday should be reflected in the tax rate applied to taxable and deductible temporary differences that are expected to reverse in a period in which the tax holiday is in effect.

Using a rate that reflects the tax holiday to record a DTA or DTL for temporary differences scheduled to reverse during the period of a tax holiday does not violate the “recognition of a deferred tax asset for any tax holiday is prohibited” language of ASC 740-10-25-36. Rather, in such circumstances, a DTL or DTA is merely reduced from one computed at the statutory tax rate as if a tax holiday did not apply to one computed at the statutory tax rate that is in effect during a tax holiday. Example 4-3 illustrates the accounting for the tax benefits of a tax holiday.

### **Example 4-3**

Assume that at the end of 20X1, an entity operates in a tax jurisdiction with a 50 percent tax rate and that \$1,000 of a total of \$2,000 of taxable temporary differences will reverse during years in which that jurisdiction grants the entity an unconditional tax holiday at a zero tax rate. Therefore, a DTL of \$500 ( $\$1,000 \times 50\%$ ) would be recognized in the entity's balance sheet at the end of 20X1. Further assume that in 20X2, a year covered by the tax holiday, the entity generates \$3,000 of taxable income in that jurisdiction and that \$1,000 of taxable temporary differences reversed, as expected. During 20X2, the entity would make no adjustment to its DTL (because the taxable temporary difference reversed as expected) and no current tax payable or current tax expense would be recognized for the taxable income generated during 20X2. Note that SAB Topic 11.C would require disclosures about the effects of the tax holiday.

## **4.07 Consideration of Certain State Matters, Including Optional Future Tax Elections, in the Measurement of DTAs and DTLs**

ASC 740 requires that when measuring its DTAs and DTLs, an entity use the enacted tax rate that is expected to apply in periods in which the DTAs or DTLs are expected to be recovered or settled. An entity should consider the following factors when measuring DTAs and DTLs in U.S. state income tax jurisdictions:

### **State Apportionment**

In the measurement of DTAs and DTLs for U.S. state income tax jurisdictions, state apportionment factors are part of the computation. State apportionment factors are used to allocate DTAs and DTLs to various states and are determined in accordance with the income tax laws of each state. The factors are typically based on the percentage of sales, payroll costs, or assets attributable to a particular state. Apportionment factors are not tax rates, but because entities must consider them in determining the amount of income to apportion to an individual state, they play a large role in the measurement of an

entity's state DTAs and DTLs. The deferred tax rate is the product of the temporary difference multiplied by the product of the applicable apportionment factor and the enacted state tax rate (temporary difference  $\times$  expected apportionment factor  $\times$  state tax rate = DTA or DTL).

The apportionment factors generally should be those that are expected to apply when the asset or liability underlying the temporary difference is recovered or settled on the basis of existing facts and circumstances. An entity could use actual apportionment factors for recent years, adjusted for any expected changes either in the business activities in that state or to reflect already enacted tax laws for that jurisdiction, as a reasonable estimate when measuring deferred taxes. However, expected changes, such as a business combination or the disposition of a long-lived asset, should not be reflected in the apportionment factors until they are recognized in the financial statements. A number of states have revised their apportionment rules. For example, California enacted significant apportionment changes in late February 2009. California will allow companies to elect, beginning with the 2011 tax year, to use a single factor (sales) for apportioning income to California. Thus, in this case, expected future apportionment factors, rather than recent actual apportionment factors, would be used to allocate deferred taxes.

An entity should assume that temporary differences will reverse in tax jurisdictions in which the related assets or liabilities are subject to tax and therefore should apply the enacted tax rate for that particular state when measuring deferred state taxes. When measuring the related DTA or DTL, it is not appropriate for an entity to assume that taxable or deductible amounts related to temporary differences will be shifted to a different tax jurisdiction through future intra-entity transactions.

### ***Optional Future Tax Elections***

If the state has enacted changes to the tax rate or apportionment factor that can be implemented through a tax election but the election is only available for tax purposes in periods after the reporting date, the entity must measure its DTAs and DTLs by using the enacted tax rate that is expected to apply in periods in which the DTAs or DTLs are expected to be recovered or settled. In the California example above, an entity cannot make the apportionment election until 2011. As noted previously, the state tax rate is, in effect, the product of the apportionment factor and the enacted state tax rate. Therefore, if the entity expects that it will make the election, it should consider the election when measuring its DTAs and DTLs. ASC 740-10-55-23 states, in part:

Measurements [of DTAs and DTLs] are based on elections (for example, an election for loss carryforward instead of carryback) that are expected to be made for tax purposes in future years. **Presently enacted changes in tax laws and rates that become effective for a particular future year or years must be considered when determining the tax rate to apply to temporary differences reversing in that year or years.** Tax laws and rates for the current year are used if no changes have been enacted for future years.  
[Emphasis added]

ASC 740-10-45-15 requires that a change in tax law that gives rise to a change in the measurement of DTAs and DTLs (such as a change in the apportionment rules) be reflected **in the period that includes the enactment date.** For example, if an entity expects to make the California single-factor election, it must recognize, in the interim or annual period that includes the enactment date (February 2009), the effect that the election will have on the amount of the DTA or DTL relative to the temporary differences expected to reverse in years after 2010.

## 4.08 Situations in Which Determining the Applicable Tax Rate May Be Complex

Determining the tax rate to apply to certain types of temporary differences and carryforwards may not always be straightforward. For example, certain tax jurisdictions might allow for different tax rates on ordinary income and capital gains, while others may allow for different tax rates depending on whether earnings are distributed. The following are two examples of situations in which determining the applicable tax rate may be complex:

### ***Distributed and Undistributed Earnings of a German Subsidiary***

Germany, under its prior laws, serves as an example of a jurisdiction in which corporate income is taxed at different rates depending on whether it is distributed to shareholders. ASC 740-10-25-39 states:

Certain foreign jurisdictions tax corporate income at different rates depending on whether that income is distributed to shareholders. For example, while undistributed profits in a foreign jurisdiction may be subject to a corporate tax rate of 45 percent, distributed income may be taxed at 30 percent. Entities that pay dividends from previously undistributed income may receive a tax credit (or tax refund) equal to the difference between the tax computed at the undistributed rate in effect the year the income is earned (for tax purposes) and the tax computed at the distributed rate in effect the year the dividend is distributed.

This example thus involves consideration of whether the distributed rate or the undistributed rate should be used to measure the tax effects of temporary differences.

ASC 740-10-30-14 (which applies only to stand-alone entities in the applicable jurisdiction and not to subsidiaries of U.S. entities) states that an entity should use the undistributed rate to measure the tax effects of temporary differences, since it is appropriate to recognize the tax benefit from the future tax credit only when the entity had actually distributed assets to its shareholders and included the tax credit in its tax return. Recognizing the tax benefit before that point would constitute an overstatement of the entity's assets and equity. This is similar to the accounting for a "special deduction" discussed in ASC 740-10-25-37.

However, the rate to be used in the applicable jurisdiction by a parent in its consolidated financial statements is different from that for stand-alone foreign entities. Specifically, ASC 740-10-25-41 states that "in the consolidated financial statements of a parent, the future tax credit that will be received when dividends are paid and the deferred tax effects related to the operations of the foreign subsidiary shall be recognized based on the distributed rate," as long as the parent is not applying the indefinite reversal criteria of ASC 740-30-25-17. The basis for ASC 740-10-25-41 is that the parent has the unilateral ability to require the foreign subsidiary to pay dividends and that the consolidated financial statements reflect all other tax effects of distributing earnings. In addition, the consolidated financial statements are intended to provide users with information regarding the total amount of net assets and liabilities available to creditors. Requiring an entity to provide additional taxes at the parent level on the basis of repatriation of earnings, but not to record the tax benefit associated with that repatriation, would result in an understatement of the assets available to creditors.

Conversely, ASC 740-10-25-41 states, in part, that the "undistributed rate shall be used in the consolidated financial statements to the extent that the parent has not provided for deferred taxes on the unremitted earnings of the foreign subsidiary as a result of applying the indefinite reversal criteria recognition exception." This is consistent with ASC 740-30-25-14, which states, in part:

A tax benefit shall not be recognized . . . for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized under the requirements of paragraph 740-30-25-18.

In other words, it would be inappropriate to record a tax benefit attributable to a distribution when all other tax effects of distributing these earnings have not been recorded.

### ***Distributed Earnings of a Mexican Subsidiary***

Unlike Germany, whose tax law offers credits on distributed profits, Mexico enacted a change in its tax law on December 31, 1998, that enables taxpayers to defer tax payments. Under this law, income taxes are assessed on current earnings at a rate of 35 percent. However, the law only requires current payment of income taxes computed at a rate of 32 percent for 1999, changing to 30 percent for 2000 and thereafter, of taxable income at the time the tax return is filed. The remaining payment of 3 percent of taxable income in 1999, and 5 percent thereafter, is due to the government as dividend payments are made to the entity's shareholders.

In its separate financial statements, a Mexican entity should use the ultimate tax rate of 35 percent to record taxes because the deferred tax amount represents an unavoidable liability for the Mexican company and the amount of that tax is not available for distribution to shareholders. ASC 740-10-25-3 addresses a similar situation — “policyholders’ surplus” of stock life insurance companies — that illustrates the need to accrue taxes at the higher rate.

If a liability exists at the Mexican-subsidiary level and no other exemptions in ASC 740-10-25-3 are applicable (i.e., the indefinite reversal criteria of ASC 740-30-25-17 cannot be applied to analogous types of differences), derecognition of the tax liability (even in consolidation) would only be possible in accordance with the liability guidance in ASC 405-20-40-1, which states, in part:

A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
  1. Delivery of cash
  2. Delivery of other financial assets
  3. Delivery of goods or services
  4. Reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Because neither of these criteria has been met, all companies, regardless of whether they state that earnings are indefinitely reinvested, should accrue taxes and provide for the deferred tax effects of Mexican operations at the stated statutory rate of 35 percent.

Some might argue that, at the consolidated level, the Mexican tax law appears similar to the guidance in ASC 740-10-25-41 in that a non-Mexican parent of a Mexican subsidiary is able to effectively defer the additional 3 percent or 5 percent tax indefinitely by electing not to distribute earnings. However, in substance, the two tax laws and resulting tax consequences are very different.

Under ASC 740-10-25-41, the undistributed rate should be used when a shareholder will not repatriate earnings, because it would be inconsistent to record in the consolidated financial statements a tax benefit associated with an earnings distribution but not to recognize a liability for all other tax effects of distributing these earnings.

Conversely, under the Mexican tax law, an entity incurs a liability at the time it earns taxable income. While the entity is permitted to defer the liability until a distribution is made, the “net” unpaid tax will never represent earnings attributable to shareholders. Rather, the entity will always be liable to the government for the full amount of the tax. Thus, unlike use of the undistributed rate under ASC 740-10-25-41, use of the undistributed rate in this situation under the Mexican tax law would artificially inflate equity by reflecting amounts that shareholders can never realize.

Still others might argue that, in substance, this incremental tax has characteristics of a withholding tax (especially with respect to a non-Mexican parent). However, in form, the obligating events that give rise to a tax liability vary substantially. In a withholding tax situation, the incremental tax is assessed (or the obligating event occurs) on the distribution date. Under the Mexican tax law, however (irrespective of the ultimate payment terms), tax is assessed only at the time income is generated. In addition, withholding taxes are generally intended as a tax on shareholders, whereas the Mexican tax is assessed as a tax on the corporation and its income.

Accordingly, for income subject to Mexican income tax, the 35 percent rate should be used to accrue taxes and should be applied to all temporary differences. In addition, the incremental tax amount associated with current earnings should be recorded as a deferred tax item even though it technically may not meet the definition of a DTA or DTL in ASC 740. (Another example of an item that is treated as “deferred” despite not meeting this definition is the classification of taxes on intra-entity transfers of inventory or on post-1992 policyholders’ surplus.)

### ***Other Situations in Which Determining the Applicable Tax Rate Can Be Difficult***

The following are a few additional situations in which determining the applicable tax rate can be complicated:

- Graduated tax rates are expected to be a significant factor (see [4.09](#)).
- Losses are expected in future years (see [4.11](#)).
- A phased-in change in tax rates is enacted (see [4.12](#) and [4.13](#)).
- The tax law permits special deductions (see [4.17](#)).
- An unusually large temporary difference is expected to reverse in a single future year.
- The tax law restricts use of operating loss or tax credit carryforwards.
- An entity has a limited history of operations.
- A hybrid tax system (see [4.19](#)).

## **4.09 Graduated Tax Rates**

ASC 740-10-30-8 states that an entity measures a DTL or DTA by “using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.” Under U.S. federal tax law, entities are subject to graduated tax rates on their taxable income. However, all taxable income that exceeds a specified amount is taxed at a single flat tax rate (currently 35 percent).

Further, ASC 740-10-30-9 states that the single flat tax rate “shall be used for measurement of a deferred tax liability or asset by entities for which graduated tax rates are not a significant factor.”

## 4.10 Measurement When Graduated Tax Rates Are a Significant Factor

Entities that typically pay tax at the highest graduated tax rates will not find such rates a significant factor in determining the rate used for measuring DTAs and DTLs. However, for some entities, graduated tax rate structures, such as those found in the IRC and the tax laws of many states and other tax jurisdictions, may affect the determination of the applicable tax rate used to measure deferred tax consequences under ASC 740.

ASC 740-10-30-9 states that “[e]ntities for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized.” When determining whether graduated tax rates are significant and, consequently, the applicable tax rate for measuring DTAs and DTLs, an entity must, at least notionally, estimate future taxable income for the year(s) in which existing temporary differences or carryforwards will enter into the determination of income tax. That estimate of future income includes (1) income or loss exclusive of reversing temporary differences and (2) reversal of existing taxable and deductible temporary differences. Further, projections of future income should be consistent with projections made elsewhere by the entity. Example 4-4 illustrates the measurement of DTAs and DTLs when graduated tax rates are a significant factor.

### Example 4-4

Assume the following:

- At the end of 20X1, Entity X, which operates in a single tax jurisdiction, has \$30,000 of deductible temporary differences, which are expected to result in tax deductions of approximately \$10,000 for each of the next three years: 20X2–20X4.
- Historically, the tax jurisdiction's graduated tax rate structure has affected the determination of X's income tax liability.
- The graduated tax rates in the tax jurisdiction are as follows:

Taxable Income Over	Not Over	Tax Rate
\$ 0	\$ 50,000	15%
50,000	75,000	25%
75,000	100,000	34%
100,000	335,000	39%
335,000	10,000,000	34%
10,000,000	15,000,000	35%
15,000,000	18,333,333	38%
18,333,333		35%

**Example 4-4 (continued)**

- Entity X's estimate of pretax income for each of years 20X2–20X4 is \$410,000, \$110,000, and \$60,000, respectively, excluding reversals of temporary differences.

Estimated taxable income and estimated income taxes payable for those years are computed as follows:

	<b>Future Years</b>		
	<b>20X2</b>	<b>20X3</b>	<b>20X4</b>
Estimated pretax income — exclusive of temporary differences	\$ 410,000	\$ 110,000	\$ 60,000
Reversing deductible temporary differences	<u>(10,000)</u>	<u>(10,000)</u>	<u>(10,000)</u>
(a) Estimated taxable income	<u><u>\$ 400,000</u></u>	<u><u>\$ 100,000</u></u>	<u><u>\$ 50,000</u></u>
Tax based on graduated tax rates:			
$(\$50,000 \times 15\%)$	7,500	7,500	7,500
$(\$25,000 \times 25\%)$	6,250	6,250	
$(\$25,000 \times 34\%)$	8,500	8,500	
$(\$235,000 \times 39\%)$	91,650		
(over $\$335,000 \times 34\%$ )	<u>22,100</u>		
(b) Estimated tax	<u><u>\$ 136,000</u></u>	<u><u>\$ 22,250</u></u>	<u><u>\$ 7,500</u></u>
(c) Applicable tax rate (b ÷ a)	34%	22.3%	15%
Deferred income tax ( $\$10,000 \times c$ )	<u><u>\$ 3,400</u></u>	<u><u>\$ 2,230</u></u>	<u><u>\$ 1,500</u></u>

Entity X's average applicable tax rate is 23.8 percent  $[(\$3,400 + \$2,230 + \$1,500) \div \$30,000]$ . Therefore, X recognizes a DTA of  $\$7,130 (\$30,000 \times 23.8\%)$  at the end of 20X1. A valuation allowance would be recognized if realization of all or a portion of the DTA does not meet the more-likely-than-not recognition threshold in ASC 740.

If, after initially recording the DTA or DTL, X changes its estimate of the applicable tax rate because of changes in its estimate of taxable income in some future year, the effect of such a change in the estimated applicable tax rate should be included in income from continuing operations in the period of the change in estimate.

If X's estimate of taxable income for 20X2–20X4 was between \$335,000 and \$10 million per year, the amount of income tax liability would not be affected by the graduated rate structure and, therefore, X may not be required to estimate amounts and periods over which existing temporary differences will reverse. In this situation, X would measure the DTA at the 34 percent rate.

## 4.11 Measurement When Future Tax Losses Are Expected in a Graduated Tax Rate Structure

ASC 740-10-25-38 states, in part:

Conceptually . . . the tax consequences of tax losses expected in future years would be anticipated for purposes of:

- Nonrecognition of a deferred tax liability for taxable temporary differences if there will be no future sacrifice because of future tax losses that otherwise would expire unused
- Recognition of a deferred tax asset for the carryback refund of taxes paid for the current or a prior year because of future tax losses that otherwise would expire unused.

Under ASC 740-10-25-38, an entity is not permitted to anticipate the tax consequences of future tax losses when measuring the deferred tax consequences of existing taxable temporary differences. Accordingly, the entity uses the lowest tax rate in a graduated tax structure, rather than zero, to measure a DTL for tax consequences of taxable temporary differences if tax losses that would otherwise

expire unused are expected in future years. Under such circumstances, a DTL established in the initial period in which future losses are expected would be eliminated in subsequent years when the tax losses are actually incurred. Therefore, under ASC 740, an entity that expects not to pay income taxes in the future because of expected tax losses is prohibited from avoiding recognition of a DTL for the tax consequences of taxable temporary differences that exist as of the balance sheet date. Example 4-5 illustrates the measurement of the deferred tax consequences of taxable temporary differences when tax losses are expected in future years.

#### Example 4-5

Assume that Entity X has \$200,000 of taxable temporary differences at the end of 20X1 that will reverse in 20X2 and that the enacted statutory tax rate is as follows:

Taxable Income	Tax Rate
\$1 – \$100,000	10%
\$100,001 and above	20%

In addition, assume that (1) X expects to incur a tax loss of \$500,000 next year that includes the reversal of taxable temporary differences and (2) the loss will expire unused because loss carrybacks and carryforwards are prohibited under tax law. At the end of 20X1, X would record a DTL of \$20,000 ( $\$200,000 \times 10\%$ ) because the lowest tax rate of 10 percent, rather than a zero tax rate, is used to measure the deferred tax consequences of the existing taxable temporary differences if losses are expected in future years and those losses are expected to expire unused.

Assume that X's expectations about the future are correct and that, during 20X2, it incurs a substantial loss carryforward that expires unused. At the end of 20X2, X would eliminate the \$20,000 DTL established at the end of 20X1 and would record a corresponding credit as a component of income tax expense (benefit) from continuing operations for 20X2 (i.e., the DTL eliminated in the loss year is the tax benefit recognized as a result of the loss in continuing operations that will not be carried back).

## 4.12 Measurement When Phased-In Changes in Tax Rates Are Enacted

A phased-in change in tax rates occurs when an enacted law specifies that the tax rate applied to taxable income will change in future periods. One of the more significant phased-in changes occurred under the U.S. federal tax law enacted in 1986, which stipulated that the corporate tax rate would be 46 percent in 1986, 40 percent in 1987, and 34 percent in 1988 and thereafter.

The following guidance from ASC 740-10-55-23 applies to measurement when phased-in changes in tax rates are enacted:

The tax rate or rates . . . used to measure deferred tax liabilities and deferred tax assets are the enacted tax rates expected to apply to taxable income in the years that the liability is expected to be settled or the asset recovered. Measurements are based on elections (for example, an election for loss carryforward instead of carryback) that are expected to be made for tax purposes in future years. Presently enacted changes in tax laws and rates that become effective for a particular future year or years must be considered when determining the tax rate to apply to temporary differences reversing in that year or years. Tax laws and rates for the current year are used if no changes have been enacted for future years. An asset for deductible temporary differences that are expected to be realized in future years through carryback of a future loss to the current or a prior year (or a liability for taxable temporary differences that are expected to reduce the refund claimed for the carryback of a future loss to the current or a prior year) is measured using tax laws and rates for the current or a prior year, that is, the year for which a refund is expected to be realized based on loss carryback provisions of the tax law.

ASC 740-10-55-129 and 55-130 illustrate the measurement of a DTL for the tax consequences of taxable temporary differences when there is a phased-in change in tax rates under three different scenarios: (1) when future income is expected, (2) when future losses are expected, and (3) when taxable income

in years after expected loss years are expected to be offset by tax loss carryforwards. Also see the discussion in [4.25](#).

## **4.13 Measurement When Contingent Phased-In Changes in Tax Rates Are Enacted**

A phased-in change in tax rates occurs when an enacted law specifies that the tax rate applied to taxable income will change in future periods. In certain jurisdictions, the change in tax rates may be contingent on an event outside an entity's control.

In accordance with ASC 740, the "tax rate . . . used to measure deferred tax liabilities and deferred tax assets are the enacted tax [rate] expected to apply to taxable income in the years that the liability is expected to be settled or the asset recovered." ASC 740 does not provide guidance on determining what rate to use when there is more than one possible rate and this determination is contingent on events that are outside an entity's control. Therefore, entities in jurisdictions in which a phased-in change in tax rates is enacted will need to establish a policy (see alternative approaches below) for determining the rate to be used in measuring DTAs and DTLs. This policy should be consistently applied and contain proper documentation of the scheduling of DTAs and DTLs, the basis for judgments applied, and the conclusions reached.

Example 4-6 illustrates a jurisdiction in which there is more than one possible rate and the change in tax rates is contingent on an event outside the entity's control.

### **Example 4-6**

In March 2008, the State of West Virginia legislature passed a bill (S.B. 680) to provide business tax relief over future years in the form of phased-in reductions in the CNIT rate. The rate reduction schedule is as follows:

#### **Schedule — CNIT Rate**

Tax years beginning on or after January 1, 2009	8.50%
Tax years beginning on or after January 1, 2012	7.75%
Tax years beginning on or after January 1, 2013	7.00%
Tax years beginning on or after January 1, 2014	6.50%

With the exception of the rate reduction in 2009, the rate reductions can be suspended or reversed if the state's rainy day funds fall below 10 percent of the state's general revenue budget as of the preceding June 30 (the "10 percent test"). For example, if the 10 percent test is not passed on June 30, 2011, the 7.75 percent rate reduction is suspended until the test is passed in a subsequent year. The suspension (and any subsequent suspension) continues until the 10 percent test is passed, and then the rate reduction will occur on the following January 1. The 10 percent test continues on an annual basis after January 1, 2014, and if the test is not passed, the rate will revert to 7.75 percent until the test is again passed.

**Example 4-6 (continued)**

The following are two alternative approaches, based on this example, that an entity might use to determine the applicable tax rate in any given year:

**Alternative 1**

An entity might view the phased-in rate reduction as being similar to a graduated tax rate or, alternatively, as an exemption from a graduated tax rate. (For examples illustrating graduated tax rates, see ASC 740-10-55-136 through 55-138.) Under ASC 740, when a tax jurisdiction has a two-rate schedule, an entity should determine whether the graduated rates have a material effect and, if so, should forecast its future income to determine which rate to apply to its taxable temporary differences. In the above example, the entity would need to assess whether the 10 percent test will be passed to determine its future rate by period.

An entity should have sufficient documentation regarding its assessment of whether the 10 percent test will be met in future periods (e.g., consideration of the state's budget forecasts, spending levels, anticipated needs for rainy day funds), since this is the basis under law for applying the lower of two applicable tax rates in any given year.

**Alternative 2**

An entity might establish a policy to use the highest enacted rate potentially applicable for a future period as the applicable rate until the contingency is resolved (i.e., the 10 percent test is passed). The lower rate would only be applied to DTAs and DTLs for which the associated liability is expected to be settled or asset recovered in that one period, because an assumption that subsequent 10 percent tests will be passed for those future periods would be inappropriate.

## **4.14 Consideration of U.S. AMT Credit Carryforwards**

Entities that pay tax under the U.S. AMT system receive a tax credit (AMT credit carryforward) for the tax paid in excess of the amount computed on the basis of the regular tax system. This AMT credit carryforward has no expiration date. The credit is available to reduce future **regular** taxes but only to the extent that the credit used in a particular year reduces regular tax in that year to no more than the tax computed under the AMT system. ASC 740-10-55-31 through 55-33 provide guidance on measuring DTAs and DTLs and the AMT credit carryforward under the AMT system.

## **4.15 AMT Rate Not Applicable for Measuring DTLs**

It is **not** appropriate for an entity subject to the U.S. federal tax jurisdiction, including Blue Cross/Blue Shield organizations or other entities subject to special deductions under the tax law, to use the 20 percent AMT rate to measure their DTLs. ASC 740-10-30-10 states that "[i]n the U.S. federal jurisdiction, the applicable tax rate is the **regular** tax rate" (emphasis added) and that an entity recognizes a DTA for AMT credit carryforwards if realization is **more likely than not**.

In addition, ASC 740-10-25-37 states, in part:

The tax benefit of . . . special deductions such as those that may be available for certain health benefit entities and small life insurance entities in future years shall not be anticipated.

As stated in ASC 740-10-30-11, the failure to use the regular tax rate would result in an understatement of deferred taxes if the AMT results from preferences but the entity has insufficient AMT credit carryovers to reduce its effective rate on taxable temporary differences to the AMT rate. In this situation, use of the AMT rate to measure DTAs and DTLs would anticipate the tax benefit of special deductions.

## 4.16 Example Illustrating the Application of ASC 740 to the AMT System in the U.S. Federal Jurisdiction

Example 4-7 illustrates the application of ASC 740 to the AMT system in the U.S. federal jurisdiction.

### Example 4-7

Assume the following:

- An entity is determining its DTAs and DTLs in the U.S. federal jurisdiction at the end of 20X1.
- The applicable rate under the regular tax system is 34 percent.
- DTAs and DTLs are computed as follows:

	<b>DTA (DTL)</b>
Taxable temporary difference ( $\$1,000 \times 34\%$ )	\$ (340)
Deductible temporary difference ( $\$250 \times 34\%$ )	85
AMT credit carryforward	<u>100</u>
Net DTL before management's assessment of the need for a valuation allowance	<u>\$ (155)</u>

#### Case 1

The entity, a manufacturer, is an AMT taxpayer as a result of its use of accelerated depreciation, which is deducted earlier for regular taxable income than for AMTI. AMT will be paid for approximately two more years, after which the entity expects to revert back to the regular tax system.

#### Case 2

The entity, a leasing company, is an AMT taxpayer as a result of the AMT adjustment for depreciation on leased equipment purchases. The entity believes it will pay taxes under the AMT system for the foreseeable future because the level of future leasing transactions is expected to equal or exceed current levels.

#### Analysis — Cases 1 and 2

The entities are not required to record a valuation allowance to reduce the DTA recognized for the AMT credit carryforward because the AMT credit can offset a portion of the existing net DTL from \$255 to \$155. Because AMT net temporary differences of  $\$750 (\$1,000 - \$250) \times 14\% (34\% - 20\%)$  equal \$105, realization of the AMT credit is **more likely than not**.

#### Case 3

Assume the same facts as in Cases 1 and 2, except:

- The entity's DTAs and DTLs are computed as follows:

	<b>DTA (DTL)</b>
Taxable temporary difference ( $\$324 \times 34\%$ )	\$ (110)
Deductible temporary difference ( $\$250 \times 34\%$ )	85
AMT credit carryforward	<u>100</u>
Net DTA before management's assessment of the need for a valuation allowance	<u>\$ 75</u>

- The entity is a leasing company that consistently generates AMT as a result of the AMT adjustment for depreciation. In addition, the entity believes it will pay taxes under the AMT system for the foreseeable future because the level of future leasing transactions is expected to equal or exceed current levels. The entity does not believe it will be an AMT taxpayer indefinitely.

**Example 4-7 (continued)****Analysis — Case 3**

Realization of AMT credits sufficient to offset \$10  $[(\$324 - \$250) \times 14\%]$  of the net DTL is more likely than not. Realization of the remaining \$90 of AMT credits depends on whether the entity will generate regular taxable income in excess of AMTI in future years. Realization of the \$90 of excess AMT credit is more likely than not (provided that sufficient regular taxable income will be generated to permit use of the AMT credits) unless the entity expects to be in the AMT mode over its life. Evidence that the entity will be in the AMT mode for the foreseeable future should not necessarily lead to a conclusion that it will be in the AMT mode over its life. For example, if the leasing company stopped executing new leases and allowed the old leases to "run off," the entity would again become subject to regular taxes.

See [4.28](#) for considerations related to whether a DTA recognized for the tax benefit on existing AMT credit carryforwards should be reduced by a valuation allowance.

**Case 4**

Assume the same facts as in Case 3, except:

- The entity is a health care provider that consistently generates AMT as a result of the AMT preference for special deductions for Blue Cross/Blue Shield entities under Section 833 of the IRC. The entity's management believes it will pay taxes under the AMT system for the foreseeable future and over the entity's life.

**Analysis — Case 4**

Realization of AMT credits sufficient to offset \$10  $[(\$324 - \$250) \times 14\%]$  of the net DTL is more likely than not. Realization of the remaining \$90 of AMT credits depends on whether the entity will generate regular taxable income in excess of AMTI in future years. Because it is assumed that the entity will be in the AMT mode over its life, a \$90 valuation allowance is necessary.

## **4.17 Consideration of Special Deductions That Are Permitted Under the Tax Law**

The tax law permits entities in particular industries to recognize certain tax benefits for special deductions. The term "special deduction" is not defined, but ASC 740-10-25-37 offers three examples: (1) tax benefits for statutory depletion, (2) special deductions for certain health benefit entities (e.g., Blue Cross/Blue Shield providers), and (3) special deductions for small life insurance companies. In addition, ASC 740-10-55-27 through 55-30 state that the deduction for qualified domestic production activities under Section 199 of the IRC also qualifies as a special deduction.

An entity is not permitted to anticipate tax benefits for special deductions when measuring the DTL for taxable temporary differences at the end of the current year. ASC 740-10-25-37 requires that the "tax benefit of special deductions ordinarily [be] recognized no earlier than the year in which those special deductions are deductible on the tax return." Although an entity is not permitted to anticipate future special deductions when measuring DTLs, the future tax effects of special deductions may nevertheless affect (1) "the average graduated tax rate to be used for measuring deferred taxes when graduated tax rates are a significant factor" and (2) "the need for a valuation allowance for deferred tax assets." ASC 740-10-25-37 states, "In those circumstances, implicit recognition is unavoidable because those special deductions are one of the determinants of future taxable income and future taxable income determines the average graduated tax rate and sometimes determines the need for a valuation allowance." For more information, see [4.14](#), [4.15](#), and [4.16](#) on AMT credit carryforwards.

The following sections summarize the special deductions discussed above:

### ***Statutory Depletion***

Sections 611–613 of the IRC allow entities in certain extractive industries, such as oil and gas and mining, to take a deduction for “depletion” when determining taxable income for U.S. federal tax purposes. The depletion deduction for a particular taxable year is calculated as the greater of cost depletion or percentage depletion. Cost depletion is based on the cost of the reserves, and percentage depletion is based on multiplying gross income from the property by a specified statutory percentage, subject to certain limitations. As with other special deductions, entities cannot anticipate the tax benefit from statutory depletion when measuring the DTL related to a taxable temporary difference at year-end. The statutory depletion tax benefit would be recognized no earlier than the year in which the depletion is deductible on the entity’s income tax return.

### ***Blue Cross/Blue Shield***

Section 833 of the IRC entitles Blue Cross and Blue Shield plans to special tax deductions that are not available to other insurers. The deduction allowed for any taxable year is the excess (if any) of (1) 25 percent of the sum of (a) claims incurred during the taxable year and (b) expenses incurred in connection with the administration, adjustment, or settlement of claims over (2) the “adjusted surplus” as of the beginning of the taxable year.

### ***Small Life Insurance Companies***

Section 806 of the IRC allows small life insurance companies to take a deduction equal to 60 percent of the entity’s tentative life insurance company taxable income (LICTI) up to \$3 million. The deduction is phased out for tentative LICTI between \$3 million and \$15 million. In addition, the small life insurance company deduction is disallowed if a company has assets of \$500 million or more.

### ***Domestic Production Activities Deduction***

On October 22, 2004, the American Jobs Creation Act of 2004 (the “Jobs Creation Act”) was enacted into law in the United States. This act repealed certain extra-territorial income tax provisions and provided additional U.S. tax deductions for qualifying domestic production activities. In addition, the Jobs Creation Act allowed for a tax deduction of up to 9 percent of the lesser of (1) qualified production activities income or (2) taxable income (after the deduction for the use of any NOL carryforwards). This tax deduction is limited to 50 percent of W-2 wages paid by the taxpayer. ASC 740-10-55-27 through 55-30 provide implementation guidance clarifying that the production activities deduction should be accounted for as a special deduction in accordance with ASC 740-10-25-37.

**Example 4-8**

This example illustrates the determination of the consequences of existing temporary differences and carryforwards when special deductions exist under the tax law.

Assume the following:

- Entity X is measuring the deferred tax consequences of an existing \$300,000 taxable temporary difference at the end of 20X1 that is expected to reverse and enter into the determination of taxable income in 20X2.
- Under tax law, taxable income is taxed at the following rates:

Taxable Income	Tax Rate
\$0 – \$50,000	15%
\$50,001 – \$75,000	25%
\$75,001 – \$100,000	34%
\$100,001 – \$335,000	39%
\$335,001 – \$10,000,000	34%
\$10,000,001 – \$15,000,000	35%
\$15,000,001 – \$18,333,333	38%
\$18,333,334 and over	35%

- Entity X is considered a small life insurance company under the tax law and is entitled to a special deduction that is equal to 60 percent of taxable income before the special deduction.

The following table illustrates the determination of the DTL at the end of 20X1 in each of three independent scenarios of taxable income (loss) expected in 20X2:

	Scenarios		
	A	B	C
1. Expected future taxable income (loss) for 20X2, excluding temporary differences	\$ 1,000,000	\$ 100,000	\$ (400,000)
2. Taxable temporary difference	300,000	300,000	300,000
3. Special deduction $[(1+2) \times 60\%]$	(780,000)	(240,000)	—
4. Expected future taxable income (loss)	\$ 520,000	\$ 160,000	\$ (100,000)
5. Expected future tax liability*	\$ 176,800	\$ 45,650	\$ —
6. Applicable tax rate $(5 \div 4)**$	34%	28.5%	15%
7. DTL $(2 \times 6)$	\$ 102,000	\$ 85,500	\$ 45,000

\* Calculated by using the statutory tax rates.

\*\* If there are no other sources of taxable income that would support a conclusion that realization of the loss is more likely than not, ASC 740 requires that the lowest graduated tax rate, rather than zero, be used to measure the deferred tax consequences of the taxable temporary difference (as discussed in 4.11).

Measurement of the deferred tax consequences of a taxable temporary difference does not reflect any tax benefit for future special deductions unless graduated tax rates are a factor that is significant to measurement of an entity's tax liability. If graduated tax rates are significant, a portion of the benefit of a special deduction will be recognized through a reduction of the average graduated tax rate used to measure the tax consequences of taxable temporary differences.

## 4.18 Measurement of Basis Differences in an Adjusted Gross Receipts Tax Regime

It is increasingly common for tax jurisdictions to assess tax on businesses on the basis of an amount computed as gross receipts less certain current-period deductions that are specifically identified by statute ("adjusted gross receipts"). The tax assessed on adjusted gross receipts may be in addition to, or in lieu of, a tax based on a comprehensive income measure. Individual tax jurisdictions that assess taxes on the basis of adjusted gross receipts typically define which entities are taxable, what constitutes gross receipts, and which deductions are permitted. In addition, an entity may have certain assets that do not appear to directly interact, or that only partially interact, with the adjusted gross receipts tax (GRT) base. In applying the principles of ASC 740 to the differences in these individual tax jurisdictions, an entity may encounter various complexities.

There are acceptable methods under ASC 740 to assess whether book and tax basis differences in the statement of financial position represent taxable or deductible temporary differences under an adjusted GRT regime. Because the starting point for a jurisdictional assessment of business taxes on adjusted gross receipts is typically total revenues and not net income, recovery and settlement of book assets and liabilities, respectively, with a tax basis different from their respective book carrying values, will result in a subsequent-period tax consequence. Accordingly, an entity must apply the principles in ASC 740 carefully when assessing whether to recognize a DTL or DTA for the estimated future tax effects attributable to temporary differences. An entity must determine:

1. Whether there is a basis difference under ASC 740 for all or a portion of the book carrying value of assets and liabilities in the statement of financial position.
2. If there is a basis difference, whether it is temporary and thus must be recognized under ASC 740.
3. If there is a temporary difference, whether it is a taxable or deductible temporary difference for which a DTA or DTL must be recognized.

Consider the following scenarios:

- *Scenario 1* — A tax jurisdiction permits raw material purchases to be deducted from gross receipts in the period in which the materials are acquired but prohibits any deduction for internal labor costs incurred in any period. At the end of the reporting period, the book carrying value of an entity's inventory of \$100 includes \$80 of raw materials purchased from third parties and \$20 of capitalized labor costs. Accordingly, the tax basis of the inventory is \$0 at the end of the reporting period.
- *Scenario 2* — A tax jurisdiction prohibits deductions for acquired capital assets. The entity is permitted to compute the period taxable gross receipts on the basis of total revenues less either a cost of goods sold deduction, a compensation deduction, or 30 percent of total revenues. Accordingly, the tax basis of the entity's property, plant, and equipment is \$0 at the end of the reporting period.

In practice, there are two views (see below) on how an entity should recognize the DTL related to its inventory and property, plant, and equipment book-versus-tax basis difference that exists at period-end.

Information from Scenario 1 above is used to illustrate the two views.

### ***View 1 — Record Deferred Taxes on the Entire Book/Tax Basis Difference***

At the end of the reporting period, the temporary difference related to the inventory is \$100, for which a DTL would be recorded. This view is consistent with the presumption in ASC 740-10-25-20 that the reported amounts of assets and liabilities will be recovered and settled, respectively, and that basis differences will generally result in a taxable or deductible amount in some future period. Adjusted gross receipts will increase by \$100 in the future when the inventory is recovered (i.e., sold) at its book carrying value. There will be no deduction for cost of sales because the \$80 of material costs is deducted in the period in which the materials are acquired and no tax deduction is permitted in any period for labor-related costs.

As noted above, a premise underlying the application of ASC 740 is that all assets are expected to be recovered at their reported amounts in the statement of financial position. If that recovery will result in taxable income in a future period (or periods), the items represent a taxable temporary difference and DTLs should be recognized regardless of whether the nature of the asset recovery is by sale or use or represents an observable direct deduction from jurisdictional gross receipts.

### ***View 2 — Record Deferred Taxes Only on Items That Will Enter Into the Measurement of Both Book and Taxable Income in a Current or Future Period***

At the end of the reporting period, the temporary difference related to the inventory is \$80, for which a DTL would be recorded because only \$80 of the capitalized inventory costs is (or was) deductible for tax reporting purposes. The capitalized labor element of \$20 represents a nondeductible basis difference between the financial statements and tax return (i.e., a “permanent” difference) because the tax jurisdiction does not permit entities to make any deductions for labor costs in computing the tax assessed.

## **4.19 Deferred Tax Treatment of Hybrid Taxes**

In a hybrid tax regime, an entity pays the greater of two tax computations, one of which is typically based on taxable profit and the other of which is not (e.g., it is based on gross revenue or capital). The tax rules and regulations of such a regime may state that an entity must always pay income tax but must also calculate taxes on the basis of the non-income-based measure(s). To the extent that the non-income-based measure or measures result in a larger amount, the entity would pay the difference between the income tax and the amount determined by using the non-income-based measure. This distinction may affect how the tax authority in the jurisdiction can use the tax revenue (e.g., income tax revenue may be used for general purposes, but the incremental tax may be earmarked for a specific purpose). The description of the amounts paid in the tax rules and regulations does not affect how a reporting entity determines the component of the hybrid taxes that is considered an income tax for accounting purposes.

[2.02](#) discusses hybrid tax regimes and addresses how to determine whether any part of the tax due under a hybrid tax regime is within the scope of ASC 740. After making that determination, if an entity does not expect to have an income tax component or expects to have an income tax component infrequently, no deferred taxes should be recognized. If, however, an entity determines that some portion of the future taxes payable will be within the scope of ASC 740, it must then determine how to measure its deferred taxes.

As discussed in ASC 740-10-10-3, the objective of measuring deferred taxes is to use “the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.” However, in a hybrid tax regime, because some component of an entity’s overall tax liability (even when the amount payable is determined as a percentage of taxable profits) may be accounted for as a component of pretax income, questions have often arisen about the appropriate tax rate to use for measuring DTAs and DTLs.

The tax rate used to measure deferred taxes should take into account the total amount of taxes expected to be paid that will be treated as a component of pretax income. The appropriate tax rate is determined by dividing the amount expected to be classified as an *income tax* by total taxable income.

In determining the tax rate that is expected to apply when temporary differences reverse, entities that treat a portion of the tax paid as a component of pretax income are effectively subject to a graduated-tax system, since the implicit tax rate (amount treated as income tax divided by taxable income) will be lower than the enacted rate and may vary from period to period as pretax income fluctuates (although most entities should be able to base their tax rate on an expected average level of income). Accordingly, if the amount to be treated as a component of pretax income significantly affects an entity’s implicit tax rate, an entity should generally apply the guidance in ASC 740-10-55-136 through 55-138 on graduated-tax rates when computing the applicable enacted tax rate. The estimated future annual income used to determine the appropriate tax rate should be estimated taxable income including permanent items and special deductions. As noted in ASC 740-10-25-37, the effects of future special deductions (or other permanent differences) should also be considered, since “those special deductions are one of the determinants of future taxable income and future taxable income determines the average graduated tax rate.” The tax used to determine the appropriate tax rate should, however, be computed before the reduction for credits.

#### **Example 4-9**

Assume the same facts as in [Example 2-1](#), in which an entity is taxed on the basis of the greater of 25 percent of taxable profit or 1 percent of net equity as of the last day of the prior year. Deferred taxes would be calculated as follows (provided that the entity expects to owe taxes in future years in excess of the “floor,” so those taxes are therefore within the scope of ASC 740 and the entity must record deferred taxes):

##### **Deferred Tax Computation**

Expected book pretax income in year 2	\$ 72,000	
Expected reversal of taxable temporary difference in year 2	<u>3,000</u>	
Expected taxable income in year 2	75,000	
Enacted statutory income tax rate expected to apply in year 2	<u>25%</u>	
Expected year 2 current tax computed on income	18,750	
Expected year 2 capital tax (same as year 1 due to distributions)	<u>8,000</u>	(800,000 × 1%)
Expected year 2 current tax within the scope of ASC 740	<u>\$ 10,750</u>	

##### **Deferred Taxes Calculated by Using Graduated-Tax Method**

Rate to be applied to temporary difference	14.3%	(10,750 ÷ 75,000)
Deferred tax to be provided in year 1	\$ 430	(3,000 × 14.3%)

In limited circumstances, it may be acceptable to use the enacted statutory tax rate to measure deferred taxes in a hybrid tax regime. For example, in a hybrid tax regime, an entity will not pay income taxes unless its level of taxable income is high enough (i.e., exceeds a minimum threshold) to result in a tax liability greater than the liability determined by using the non-income-based measure. If an entity expects to have taxable income in future years that is greater than that minimum (and that is therefore subject to an income-based tax), each incremental dollar of taxable income in those years (including reversals of taxable temporary differences) would be taxed at the enacted statutory rate. Similarly, each incremental dollar of loss or deduction (including reversals of deductible temporary differences) would result in a benefit at the enacted statutory rate. In such circumstances, using the enacted statutory rate to measure deferred taxes fully allows for the incremental effect that the reversal of the temporary difference will have on future taxes payable. This alternative approach is premised on the facts that (1) while variability of the effective tax rate in a hybrid tax regime makes it analogous to a graduated-rate system, the graduated-rate guidance is not directly applicable, and (2) ASC 740-10-10-3 states, in part:

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

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

While the FASB ultimately decided to require that entities measure DTAs and DTLs by using enacted rates in light of constraints associated with implementing the incremental approach, we believe that, given the unique nature of hybrid tax regimes, application of the principle described in ASC 740-10-10-3 would be acceptable in the limited circumstances discussed above.

Use of this method would not be acceptable, however, if the deferred tax items, in and of themselves (e.g., existing NOL carryforwards or other similar large deductible temporary differences), would reduce the amount of income tax payable to an amount that is less than the non-income-based tax payable (i.e., the “floor”), since no benefit is realized for those deductions. This scenario is illustrated in the example below.

**Example 4-10**

Assume that the regular corporate tax in Country A is the greater of (1) 10 percent of taxable profit or (2) 1 percent of net equity as of the last day of the current year. Further assume that losses can be used to offset future income but cannot be carried back.

	Year 1		Year 2		Year 3	
			Graduated Tax Method	Statutory Tax Method	Graduated Tax Method	Statutory Tax Method
Capital	\$ 800	\$ 800	\$ 800	\$ 800	\$ 800	\$ 800
Pretax income (loss)	100	(100)	(100)	(100)	100	100
Taxable income before NOL carryforward	100	(100)	(100)	(100)	100	100
NOL carryforward*	N/A	N/A	N/A	N/A	(100)	(100)
Taxable income	100	(100)	(100)	(100)	—	—
Statutory tax rate	10%	10%	10%	10%	10%	10%
Total current tax computed on income (greater of capital or income)	10	8	8	8	8	8
Capital tax	8	8	8	8	8	8
Current tax within scope of ASC 740	2	—	—	—	—	—
Deferred tax expense (benefit)	—	(2)	(10)	2	—	10
Total taxes — capital and income	<u>\$ 10</u>	<u>\$ 6</u>	<u>\$ (2)</u>	<u>\$ 10</u>	<u>\$ 18</u>	

\* NOLs can only be carried forward.

As depicted above, when there is \$100 of pretax income, excluding the effects of special deductions or permanent differences, one would expect a total of \$10 of tax expense (\$8 pretax expense and \$2 tax expense). However, when the statutory tax rate is used to measure the NOL DTA, there is a net tax benefit of \$2 (\$8 pretax expense and \$10 income tax benefit) in the year in which the NOL DTA is recognized and a total tax expense of \$18 (\$8 pretax expense and \$10 income tax expense) in the year in which the NOL DTA is used (higher than the total expected tax expense of \$10). When the NOL DTA is measured at the implicit graduated rate of 2 percent, there is a \$10 net expense in the year in which the NOL is used (\$8 pretax expense and \$2 income tax expense), which is identical to what would be recognized in the absence of an NOL carryforward.

## 4.20 Applicability of Pushdown Accounting to Income Taxes and Foreign Currency Translation Adjustments

ASC 740-10-30-5 indicates that deferred taxes must be “determined separately for each tax-paying component . . . in each tax jurisdiction.” ASC 805-50 does not require an entity to apply pushdown accounting for separate financial statement reporting purposes. However, to properly determine the temporary differences and to apply ASC 740 accurately, an entity must push down, to each tax-paying component, the amounts assigned to the individual assets and liabilities for financial reporting purposes. That is, because the cash inflows from assets acquired or cash outflows from liabilities assumed will be reflected on the tax return of the respective tax-paying component, the acquirer has a taxable or deductible temporary difference related to the entire amount recorded under the acquisition method (compared with its tax basis), regardless of whether such fair value adjustments are actually pushed down and reflected in the acquiree’s statutory or separate financial statements.

An entity can either record the amounts in its subsidiary’s books (i.e., actual pushdown accounting) or maintain the records necessary to adjust the consolidated amounts to what they would have been had the amounts been recorded on the subsidiary’s books (i.e., notional pushdown accounting). The latter method can often make recordkeeping more complex.

Further, an entity must convert the entire amount recorded under the acquisition method for a particular asset or liability to the currency in which the tax-paying component files its tax return (the “tax currency”) to properly determine the (1) temporary difference associated with the particular asset or liability and (2) the corresponding DTA or DTL (i.e., deferred taxes are calculated in the tax currency and then translated or remeasured in accordance with ASC 830).

### Example 4-11

Assume the following:

- A U.S. parent acquires the stock of U.S. Target (UST), which owns Entity A, a foreign corporation operating in Jurisdiction X, in which the income tax rate is 25 percent.
- Entity A must file statutory financial statements with X that are prepared in accordance with A’s local GAAP; the acquisition does not affect these financial statements or A’s tax basis in its assets and liabilities in X.
- As a result of the acquisition, A will record a fair value adjustment of \$10 million related to its intangible assets, which will be amortized for U.S. GAAP purposes over 10 years, the estimated useful life of the intangible assets, which was not recognized for statutory purposes.
- Entity A’s functional currency and local currency is the euro. As of the date of acquisition, the conversion rate from the U.S. dollar (USD) to the euro was 1 USD = 1 euro. At the end of year 1, the conversion rate was 1.20 USD = 1 euro.

Entity A will record its intangible assets as part of its statutory-to-U.S.-GAAP adjustments (“stat-to-GAAP adjustments”) and will not be entitled to any amortization deduction for local income tax reporting purposes. However, the cash flows related to such intangible assets will be reported on A’s local income tax return prospectively, and such cash flows will be taxable in X. Thus, A must recognize a \$2.5 million DTL as part of its stat-to-GAAP adjustments related to the excess of the intangible assets’ U.S. GAAP reporting basis over its income tax basis. This DTL will reverse as the intangible assets are amortized for U.S. GAAP financial statement reporting purposes. The year-end stat-to-GAAP adjustments and related currency conversions (in thousands) are as follows:

**Example 4-11 (continued)**

Description	Conversion Rate as of Date of Acquisition: 1 euro = 1 USD				Conversion Rate at End of Year 1: 1 euro = 1.20 USD	
	Statutory Financial Statements — Local GAAP	Stat-to- GAAP Adjustment	GAAP — Local Currency	GAAP — Reporting Currency	GAAP — Local Currency	GAAP — Reporting Currency
Intangibles	—	€ 10,000	€ 10,000	\$ 10,000	€ 9,000*	\$ 10,800
Goodwill	—	€ 2,500	€ 2,500	\$ 2,500	€ 2,500	\$ 3,000
DTL	—	€ (2,500)	€ (2,500)**	\$ (2,500)	€ (2,250)	(2,700)

\* The carrying value after amortization of €1,000.

\*\* ASC 805-740-25-9 prohibits the recognition of a DTL for the financial reporting goodwill in excess of the amount that is amortizable for tax.

**Example 4-11A**

Assume the same facts as in Example 4-11, except that A has net operating loss carryforwards and, on the reporting date, has significant objectively verifiable negative evidence. Entity A has determined that the only available source of future taxable income is the reversal of existing DTLs.

Entity A's statutory books at the end of year 1 (in thousands) are as follows:

Description	GAAP — Local Currency	Tax — Local Currency	Difference	DTA/(DTL)
NOL carryforward	—	€ 10,000	€ 10,000	€ 2,500 [a]

Parent's books, for A's original business combination entries, at the end of year 1 (in thousands) are as follows:

Description	GAAP — Local Currency	Tax — Local Currency	Difference	DTA/(DTL) — Local Currency
Intangibles	€ 9,000*	—	€ 9,000	€ (2,250) [b]
Goodwill	€ 2,500	—	€ 2,500	—

\* The carrying value after amortization of €1,000.

Entity A's DTL that is recorded on the parent's books represents an available future source of income in the assessment of the realization of A's DTAs. Accordingly, A's net DTA (before valuation allowance) at the end of year 2 is €250 ([a] + [b] in the tables above) or \$300 (€250 × 1.2); therefore, on the basis of the evidence, a full valuation allowance will be needed. Regardless of whether the entries are actually or notionally pushed down, A's net DTA to be assessed for realizability should be the same.

## Establishment of a Valuation Allowance for Deferred Tax Assets

### ASC 740-10

**30-16** As established in paragraph 740-10-30-2(b), there is a basic requirement to reduce the measurement of deferred tax assets not expected to be realized.

#### Pending Content (Transition Guidance: ASC 825-10-65-2)

**30-16** As established in paragraph 740-10-30-2(b), there is a basic requirement to reduce the measurement of deferred tax assets not expected to be realized. An entity shall evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with the entity's other deferred tax assets. [ASU 2016-01, paragraph 35]

**30-17** All available evidence, both positive and negative, shall be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed. Information about an entity's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required. [FAS 109, paragraph 20]

**30-18** Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

- a. Future reversals of existing taxable temporary differences
- b. Future taxable income exclusive of reversing temporary differences and carryforwards
- c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law
- d. Tax-planning strategies (see paragraph 740-10-30-19) that would, if necessary, be implemented to, for example:
  1. Accelerate taxable amounts to utilize expiring carryforwards
  2. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
  3. Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets. [FAS 109, paragraph 21]

**30-19** In some circumstances, there are actions (including elections for tax purposes) that:

- a. Are prudent and feasible
- b. An entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused
- c. Would result in realization of deferred tax assets.

This Subtopic refers to those actions as tax-planning strategies. An entity shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. See paragraphs 740-10-55-39 through 55-48 for additional guidance. [FAS 109, paragraph 22] Implementation of the tax-planning strategy shall be primarily within the control of management but need not be within the unilateral control of management. [FAS 109, paragraph 107]

## ASC 740-10 (continued)

**30-20** When a tax-planning strategy is contemplated as a source of future taxable income to support the realizability of a deferred tax asset, the recognition and measurement requirements for tax positions in paragraphs 740-10-25-6 through 25-7; 740-10-25-13; and 740-10-30-7 shall be applied in determining the amount of available future taxable income. [FIN 48, paragraph 9]

**30-21** Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include, but are not limited to, the following:

- a. A history of operating loss or tax credit carryforwards expiring unused
- b. Losses expected in early future years (by a presently profitable entity)
- c. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years
- d. A carryback, carryforward period that is so brief it would limit realization of tax benefits if a significant deductible temporary difference is expected to reverse in a single year or the entity operates in a traditionally cyclical business. [FAS 109, paragraph 23]

**30-22** Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include, but are not limited to, the following:

- a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
- b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
- c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual or infrequent item) is an aberration rather than a continuing condition. [FAS 109, paragraph 24]

**30-23** An entity shall use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. [FAS 109, paragraph 25] A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome. [FAS 109, paragraph 103]

**30-24** Future realization of a tax benefit sometimes will be expected for a portion but not all of a deferred tax asset, and the dividing line between the two portions may be unclear. In those circumstances, application of judgment based on a careful assessment of all available evidence is required to determine the portion of a deferred tax asset for which it is more likely than not a tax benefit will not be realized. [FAS 109, paragraph 98]

**30-25** See paragraphs 740-10-55-34 through 55-38 for additional guidance related to carrybacks and carryforwards.

**ASC 740-10 (continued)****Related Implementation Guidance and Illustrations**

- [Recognition of Deferred Tax Assets and Deferred Tax Liabilities](#) [ASC 740-10-55-7].
- [Offset of Taxable and Deductible Amounts](#) [ASC 740-10-55-12].
- [Pattern of Taxable or Deductible Amounts](#) [ASC 740-10-55-13].
- [The Need to Schedule Temporary Difference Reversals](#) [ASC 740-10-55-15].
- [Operating Loss and Tax Credit Carryforwards and Carrybacks](#) [ASC 740-10-55-34].
- [Tax-Planning Strategies](#) [ASC 740-10-55-39].
- [Example 4: Valuation Allowance and Tax-Planning Strategies](#) [ASC 740-10-55-96].
- [Example 12: Basic Deferred Tax Recognition](#) [ASC 740-10-55-120].
- [Example 13: Valuation Allowance for Deferred Tax Assets](#) [ASC 740-10-55-124].
- [Example 19: Recognizing Tax Benefits of Operating Loss](#) [ASC 740-10-55-149].
- [Example 20: Interaction of Loss Carryforwards and Temporary Differences](#) [ASC 740-10-55-156].
- [Example 21: Tax-Planning Strategy With Significant Implementation Cost](#) [ASC 740-10-55-159].
- [Example 22: Multiple Tax-Planning Strategies Available](#) [ASC 740-10-55-163].

**4.21 Consideration of Future Events**

In general, entities should consider all currently available information about future events when determining whether a valuation allowance is needed for DTAs. ASC 740-10-30-17 states, in part:

Information about an entity's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years.

Entities must exercise professional judgment when assessing information that is obtained after the balance sheet date but before the financial statements are issued or are available to be issued. See [4.41](#) for further discussion of the effect of nonrecurring items on estimates of future income.

The following are future events that entities should not consider or anticipate when assessing the realizability of DTAs.

- Changes in tax laws or rates (see ASC 740-10-35-4).
- Changes in tax status (see ASC 740-10-25-32 and 25-33).
- Expected business combinations.
- Expected initial public offerings.
- Events that are inconsistent with financial reporting assertions as of the balance sheet date. For example, anticipating sales of held-to-maturity securities would be inconsistent with management's intent and with the classification of such securities. Similarly, entities should not anticipate the sale of indefinite-lived intangible assets that are not classified as held for sale as of the reporting date, because doing so would be inconsistent with management's assessment of the useful life of these assets.
- Events that depend on future market conditions or that are otherwise not within the entity's control. For example, an entity should not anticipate income associated with forgiveness of indebtedness to reduce an otherwise required valuation allowance.

See [4.31](#) for a discussion of how financial statement assertions affect the consideration of tax-planning strategies.

## 4.22 Sources of Taxable Income

ASC 740-10-30-18 lists four sources that may enable realization of a DTA, stating, in part:

The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

- a. Future reversals of existing taxable temporary differences
- b. Future taxable income exclusive of reversing temporary differences and carryforwards
- c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law
- d. Tax-planning strategies (see paragraph 740-10-30-19) that would, if necessary, be implemented to, for example:
  1. Accelerate taxable amounts to utilize expiring carryforwards
  2. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
  3. Switch from tax-exempt to taxable investments.

Sources (a) and (c) above can often be objectively verified. Because sources (b) and (d) are based on future events, their determination is more subjective. An entity should first consider the objectively verifiable sources. If, within the appropriate time frame, those sources will generate sufficient taxable income of the right character (e.g., capital or ordinary), an entity may not need to assess the likelihood of other future taxable income.

The implementation guidance from ASC 740-10-55-16 and 55-17 illustrates that the timing of the deductions and other benefits associated with a DTA must coincide with the timing of the taxable income. An entity may sometimes need to devise a qualifying tax-planning strategy (see source (d) above) to change the timing or character of the future taxable income. Such a strategy should be given more weight (see ASC 740-10-30-23) than a forecast of future taxable income from future events (see source (b) above), since it constitutes more objectively verifiable evidence of realizability.

## 4.23 Examples Illustrating Sources of Taxable Income

Examples 4-12 through 4-14 illustrate three of the four sources of taxable income listed in ASC 740-10-30-18 (see [4.30](#) for examples illustrating tax-planning strategies).

### Example 4-12

#### Existing Taxable Temporary Differences That Will Reverse in the Future

Generally, the existence of sufficient taxable temporary differences will enable use of the tax benefit of operating loss carryforwards, tax credit carryforwards, and deductible temporary differences, irrespective of future expected income or losses from other sources identified in ASC 740-10-30-18. For example, if an entity has \$300,000 of taxable temporary differences that are expected to reverse over the next 10 years and deductible temporary differences of \$25,000 that are expected to reverse within the next several years, realization of the DTA is more likely than not within the 20-year carryforward period in the U.S. federal tax jurisdiction (15-year carryforward period for deductible temporary differences in tax years before August 6, 1997). Thus, in this situation, a DTA would be recorded and no valuation allowance would be necessary even if future losses are expected or a cumulative loss exists as of the measurement date.

**Example 4-13****Future Taxable Income Exclusive of Reversing Temporary Differences and Carryforwards**

Detailed forecasts, projections, or other analyses are not required if an entity is expected to have sufficient future taxable income to support recognition of its DTAs. Further, an entity is not required to follow any specific guidelines in preparing forecasts or projections. Thus, although ASC 740 requires estimates of future income, an entity must use judgment in determining the extent of data to be accumulated and the process to be followed.

Assume that an entity has incurred a \$1,000 operating loss for tax purposes in 20X2, which it cannot carryback to offset against prior-year profits. The tax law permits the entity to use loss carryforwards to reduce taxable income in future years. During 20X2, the entity enters into a binding contract with a new customer to provide its services for three years for \$1,500 per year. This new contract will provide the entity with taxable income in the coming year. The entity will be able to use the carryforward because sufficient taxable amounts will be present. Thus, a valuation allowance might not be necessary in this situation even if negative evidence such as the following is present: (1) a history of operating losses that have expired unused; (2) a carryback/carryforward period that is so brief that it would limit realization of tax benefits if a significant deductible temporary difference is expected to reverse in a single year or the entity operates in a traditionally cyclical business; and (3) unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis.

**Example 4-14****Refunds Available by Carryback of Losses to Offset Taxable Income in Prior Years**

Some tax laws (e.g., those in the U.S. federal tax jurisdiction) permit taxpayers to carry back operating loss or tax credits to obtain refunds of taxes paid in prior years. The extent to which the carryback benefit is possible depends on the length of the carryback period and the amounts and character of taxable income generated during that period.

The ability to recover taxes paid in the carryback period is a form of positive evidence that will overcome negative evidence such as the following: (1) cumulative losses; (2) a history of operating losses expiring unused; (3) losses expected in early future years; (4) unsettled circumstances that, if unfavorably resolved, would adversely affect future operations; and (5) a brief carryforward period. For example, assume that an entity has a deductible temporary difference of \$1,000 at the end of 20X1 and that pretax income and taxable income are zero. If at least \$1,000 of taxable income is available for carryback refund of taxes paid during the year in which the temporary difference becomes deductible, realization of the DTAs for the net deductible amount is more likely than not even though tax losses are expected in early future years.

## **4.24 Evaluating a DTA (for Realization) of a Debt Security Attributed to an Unrealized Loss Recognized in OCI**

A debt security classified as AFS or HTM may result in the recognition of unrealized holding gains or losses in OCI as the fair value of the security changes over the contractual term of the investment. A holding loss would be tax-deductible if the debt security was recovered at its carrying value on the balance sheet date; therefore, the difference between the carrying amount of a debt security and its tax basis is a deductible temporary difference. In addition, if an entity has the intent and ability to hold the debt security until recovery of its amortized cost, increases in the security's fair value up to its amortized cost basis will reverse out of AOCI over the contractual life of the investment, resulting in no cumulative change in the entity's comprehensive income or future taxable income. In this respect, the temporary differences associated with unrealized gains and losses on debt securities are unlike other types of temporary differences because they do not affect the income statement or the tax return if held until recovery of the debt securities' amortized cost.

ASC 320-10-35-1(b) requires an entity to exclude unrealized holding gains and losses for AFS debt securities from earnings and report them as a net amount in OCI. ASC 320-10-35-18 requires that an entity assess debt securities classified as either AFS or HTM to determine whether a decline in fair value below the amortized cost is considered other than temporary. Under ASC 320-10-35-33A through 35-33C, before the adoption of ASU 2016-13,<sup>2</sup> an OTTI is triggered if (1) an entity has the intent to sell the security, (2) it is more likely than not that it will be required to sell the security before recovery, or (3) it does not expect to recover the entire amortized cost basis of the security (referred to as a credit loss).

Under step 3 of the impairment test, if an entity concludes that the present value of the cash flows expected to be collected is less than the amortized cost basis of the security, the impairment is considered an OTTI. In that situation, the entity records only the credit-related portion of the impairment loss in earnings (i.e., the difference between the security's present value of expected cash flows and amortized cost basis). Accordingly, for AFS and HTM debt securities, the amount recognized in OCI is the difference between the fair value of the debt security and the amortized cost less the credit loss component of the OTTI.

ASC 740-20-45-11(b) requires that the tax effects of gains and losses that occur during the year that are included in comprehensive income but excluded from net income (e.g., unrealized gains and losses on AFS securities) be charged or credited directly to related components of shareholders' equity.

The financial statement assertions of ASC 320 regarding the expected recovery of the amortized cost basis of a debt security differ from the assertions of ASC 740 regarding the evaluation of the realizability of DTAs generated from unrealized losses of those securities. ASC 320 requires management to determine whether a decline in the fair value of a debt security below amortized cost is other than temporary and to recognize any credit loss in earnings. ASC 740 requires an entity to measure the tax effects of a deductible temporary difference for the same debt security (the DTA) on the basis of an expected recovery of the carrying value as of the reporting date. In the ASC 740 assessment of whether a valuation allowance is required, an entity may not be permitted to assume recovery of the debt security to its amortized cost, whereas ASC 320 allows for such an assumption under step 3 of the impairment test. Under ASC 320, the presumption for any noncredit losses is that the debt security will recover to its amortized cost basis (as of the reporting date); accordingly, an entity does not need any further source of taxable income to demonstrate realization of this specific deductible temporary difference. Any unrealized loss recorded in OCI will reverse over the contractual term of the security without affecting the entity's cumulative comprehensive income or taxable income.

In January 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new guidance clarifies that, upon the effective date of the ASU, "an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets." For public business entities, the amendments in ASU 2016-01 are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

<sup>2</sup> ASU 2016-13 was issued June 2016 and significantly amends the guidance in U.S. GAAP on the measurement of financial instruments. For PBEs that meet the U.S. GAAP definition of an SEC filer, ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For PBEs that do not meet the U.S. GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

## **Before Adoption of ASU 2016-01**

There are two acceptable approaches (described below) for evaluating a DTA that is recognized as a result of an unrealized loss on a debt security that is recognized in OCI. Approach 1 is based on the view that the entity would exclude the DTA attributed to unrealized holding losses of a debt security recognized in OCI from its other DTAs when evaluating the need for a valuation allowance because this deductible temporary difference will not require future taxable income for realization on the basis of the assumption that the debt security will be held until recovery. Approach 2 is based on the view that the entity must evaluate the reporting entity's collective DTAs for realization on the basis of all expected future sources of taxable income. The SEC staff has indicated that it would accept either of the two approaches. Selection of either alternative is an accounting policy decision that, once made, must be consistently applied.

### **Approach 1**

Under this approach, periodic unrealized holding gains and losses do not reflect the economic return on an investment that will be held until recovery of its amortized cost, which may be maturity. Unrealized gains and losses recognized in OCI any time before the security's maturity have no effect on an entity's comprehensive income (or taxable income) over the life of the investment. Accordingly, tax effects of these temporary differences should be excluded from other of the entity's DTAs being evaluated for realization, because the DTA recognized for unrealized losses of a debt security included in OCI does not require a source of future taxable income for realization. The recovery is predictable and effectively guaranteed through the collection of contractual cash flows (provided that collectibility is not a concern). Likewise, an entity needs to carefully analyze a DTL for unrealized gains on an AFS debt security to determine whether it can provide a source of taxable income for realizing the benefit of other deductible temporary differences. The unrealized gains (that give rise to DTLs) may not ultimately provide a source of taxable income if, for example, the debt instrument is held until maturity. (See [4.30](#) for additional discussion on examples of qualifying tax-planning strategies.)

Proponents of Approach 1 believe it is inappropriate to recognize, within reported results of operations, tax effects of fair value changes in debt securities when those changes will not be included in earnings. Accordingly, when evaluating whether it is more likely than not that DTAs will be realizable, an entity should exclude debt security DTAs established in OCI from other DTAs (i.e., those requiring a source of future taxable income for realization). Given the unique nature of this temporary difference, it is inappropriate for an entity to apply this approach (by analogy) when evaluating other DTAs, including DTAs recognized as a result of a credit loss or an OTTI recognized in earnings.

The difference between a debt security's new amortized cost and its reporting-date fair value does not require a future source of taxable income to demonstrate realization because the expected manner of recovery of the investment is based on a decision not to dispose of the investment before recovery.

Accordingly, to apply Approach 1 to assessing the realization of a DTA, an entity must still demonstrate its intent and ability to hold the debt security until recovery.

### **Approach 2**

Under this approach, even if the entity has the intent and ability to hold the debt security until maturity, the DTAs related to the tax effect of unrealized losses on the debt securities cannot, under ASC 740, be excluded from the realization assessment of the entity's other DTAs. Under ASC 740, an entity determines the total tax provision by (1) identifying temporary differences, (2) recognizing and measuring DTAs and DTLs, and (3) assessing the overall need for a valuation allowance against DTAs and

reflecting all sources of income. Only then is that total provision allocated in the financial statements as either net income or AOCI.

Proponents of this approach believe that a debt security DTA should not be excluded from the entity's evaluations of overall DTAs for realization. Proponents of Approach 2 observe that, while the ability and intent to hold a debt security until recovery implies a source of future taxable income, this fact should not be considered in isolation. Rather, this source of future income must be considered in the context of all other entity sources of future taxable income and expected losses. If verifiable sources of future comprehensive income and expected losses do not produce aggregate future taxable income sufficient for realization of the collective DTAs, a valuation allowance is required.

In addition, proponents of Approach 2 believe that the objectives of ASC 220, which require an entity to report OCI, are consistent with the objectives of ASC 740, which reflect an asset/liability approach. Under Approach 2, an entity's ability to recover a debt security's amortized cost as of the balance sheet date would be evaluated. Therefore, management's assertion about its intent or ability to hold a security with an unrealized loss until recovery or maturity should not be a factor. Rather, proponents of Approach 2 believe that DTAs related to debt securities should be evaluated with other DTAs.

### ***After Adoption of ASU 2016-01***

Upon adoption of ASU 2016-01, Approach 1 will no longer be acceptable.

## **4.25 Determining the Pattern of Reversals of Temporary Differences**

To apply the provisions of ASC 740, an entity must have a general understanding of the reversal patterns of temporary differences because, in certain instances, such an understanding is relevant to the measurement of DTAs and DTLs (e.g., when assessing the need for a valuation allowance under ASC 740-10-30-18 or in determining the applicable tax rate in accordance with ASC 740-10-30-8 and 30-9).

Although ASC 740-10-55-22 states that the "methods used for determining reversal patterns should be systematic and logical," ASC 740 does not specify in detail how the reversal patterns for each class of temporary differences should be treated and indicates that in many situations there might be more than one logical approach. The amount of scheduling of reversal patterns that might be necessary, if any, will therefore depend on the specific facts and circumstances. The implementation guidance in ASC 740-10-55-12 and 55-13 suggests that two concepts are important to determining the reversal patterns for existing temporary differences:

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

Further, ASC 740-10-55-22 states, in part, that "[m]inimizing complexity is an appropriate consideration in selecting a method for determining reversal patterns" and that an entity should use the same method of reversal when measuring the deferred tax consequences for a "particular category of temporary differences for a particular tax jurisdiction." For example, if the loan amortization method and the present value method are both systematic and logical reversal patterns for temporary differences that originate as a result of assets and liabilities that are measured at present value, an entity engaged in leasing activities should consistently use either of those methods for all its temporary differences related to leases that are recorded as lessor receivables, because those temporary differences relate

to a particular category of items. If that same entity also has temporary differences resulting from loans receivable, a different method of reversal might be used because those differences relate to another category of temporary difference.

ASC 740-10-55-22 also states:

If the same temporary difference exists in two tax jurisdictions (for example, U.S. federal and a state tax jurisdiction), the same method should be used for that temporary difference in both tax jurisdictions. The same method for a particular category in a particular tax jurisdiction should be used consistently from year to year.

An entity should report any change in the method of reversal as a change in accounting principle in accordance with ASC 250.

## **4.26 Examples Illustrating the Determination of the Pattern of Reversals of Temporary Differences**

The following examples describe several types of temporary differences and provide some common methods (i.e., for illustrative purposes only) for determining the pattern of their reversal. Other methods may also be acceptable if they are consistent with the guidance in ASC 740-10-55 on determining reversal patterns, as further discussed in [4.25](#).

### ***State and Local Tax Jurisdictions***

In the computation of an entity's U.S. federal income tax liability, income taxes that are paid to a state or municipal jurisdiction are deductible. Thus, ASC 740-10-55-20 states:

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

### ***Accrued Liability for Disallowed Expenses***

Under the tax law, an entity may have a basis for deductions (e.g., repair expenses) and may have accrued a liability for the probable disallowance of those deductions. If such deductions are disallowed, they would be capitalized for tax purposes and would then be deductible in later years. ASC 740-10-55-21 states that the accrual of the liability in this situation "has the effect of [implicitly] capitalizing those expenses for tax purposes" and that those "expenses are considered to result in deductible amounts in the later years" in which, for tax purposes, the deductions are expected to be allowed. Moreover, this paragraph states that "[i]f the liability for unrecognized tax benefits is based on an overall evaluation of the technical merits of the tax position, scheduling should reflect the evaluations made in determining the liability for unrecognized tax benefits that was recognized."

The change in the timing of taxable income or loss caused upon the disallowance of expenses may affect an entity's realization assessment of DTA recognized for the tax consequences of deductible temporary differences, operating loss, and tax credit carryforwards. For example, upon disallowance of those expenses, taxable income for that year will be higher. Similarly, taxable income for years after the disallowance will be lower because the deductions are being amortized against taxable income in those years. An entity should consider the impact of disallowance in determining whether realization of a DTA meets the more-likely-than-not recognition threshold in ASC 740.

## **Accrued Interest and Penalties**

An entity that takes an aggressive position in a tax return filing often will accrue a liability in its financial statements for interest and penalties that it would incur if the tax authority successfully challenged that position. Such an entity should schedule a deductible amount for the accrued interest for the future year in which that interest is expected to become deductible as a result of settling the underlying issue with the tax authority.

Because most tax jurisdictions do not permit deductions for penalties, a temporary difference does not generally result from the accrual of such amounts for financial reporting purposes.

## **Tax Accounting Method Changes**

ASC 740-10-55-59 states that a "change in tax law may require a change in accounting method for tax purposes, for example, the uniform cost capitalization rules required by the Tax Reform Act of 1986" (the Tax Reform Act). Under the uniform capitalization rules, calendar-year entities revalued "inventories on hand at the beginning of 1987 . . . as though the new rules had been in effect in prior years." The resulting adjustment was included in the determination of taxable income or loss over not more than four years. ASC 740-10-55-58 through 55-62 indicate that the uniform capitalization rules initially gave rise to two temporary differences.

ASC 740-10-55-60 and 55-61 describe these two temporary differences as follows:

One temporary difference is related to the additional amounts initially capitalized into inventory for tax purposes. As a result of those additional amounts, the tax basis of the inventory exceeds the amount of the inventory for financial reporting. That temporary difference is considered to result in a deductible amount when the inventory is expected to be sold. Therefore, the excess of the tax basis of the inventory over the amount of the inventory for financial reporting as of December 31, 1986, is considered to result in a deductible amount in 1987 when the inventory turns over. As of subsequent year-ends, the deductible temporary difference to be considered would be the amount capitalized for tax purposes and not for financial reporting as of those year-ends. The expected timing of the deduction for the additional amounts capitalized in this example assumes that the inventory is not measured on a LIFO basis; temporary differences related to LIFO inventories reverse when the inventory is sold and not replaced as provided in [ASC 740-10-55-13].

The other temporary difference is related to the deferred income for tax purposes that results from the initial catch-up adjustment. As stated above, that deferred income likely will be included in taxable income over four years. Ordinarily, the reversal pattern for this temporary difference should be considered to follow the tax pattern and would also be four years. This assumes that it is expected that inventory sold will be replaced. However, under the tax law, if there is a one-third reduction in the amount of inventory for two years running, any remaining balance of that deferred income is included in taxable income for the second year. If such inventory reductions are expected, then the reversal pattern will be less than four years.

## **LIFO Inventory**

ASC 740-10-55-13 states:

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

For most entities, an assumption that inventory will be replaced through purchases or production does not ordinarily present difficulty. However, if there is doubt about the ability of an entity to continue to operate as a going concern, the entity should evaluate available evidence to determine whether it can make this assumption when measuring DTAs and DTLs under ASC 740. The ability to assume that

inventory can be replaced might affect the recognition of a DTA when realization depends primarily on the reversal of a taxable temporary difference. For example, if an entity is unable to replace inventory because of financial or operating difficulties, a taxable temporary difference resulting from LIFO inventory accounting would not be available to offset the tax consequences of future deductions for retirement benefits that have been accrued for financial reporting purposes but that will become deductible many years in the future when the benefits are paid.

### ***Obsolete Inventory***

For financial reporting purposes, inventory may be written down to net realizable value (e.g., when obsolescence occurs). Generally, for tax purposes, the benefit of such a write-down cannot be realized through deductions until disposition of the inventory. Thus, in such circumstances, there is a deductible temporary difference between the reported amount of inventory and its underlying tax basis. This temporary difference should be assumed to be deductible in the period in which the inventory deductions are expected to be claimed.

### ***Cash Surrender Value of Life Insurance***

Under ASC 325-30, an asset is recognized for financial reporting purposes in the amount of the cash surrender value of life insurance purchased by an entity. ASC 740-10-25-30 cites the “excess of cash surrender value of life insurance over premiums paid” as an example of a basis difference that “is not a temporary difference if the [cash surrender value] is expected to be recovered without tax consequence upon the death of the insured.” If, however, the policy is expected to be surrendered for its cash value, the entity would include in taxable income any excess cash surrender value over the cumulative premiums paid (note that the tax basis in the policy is generally equal to cumulative premiums paid). The resulting taxable temporary difference should be scheduled to reverse in the year in which the entity expects to surrender the policy.

### ***Land***

The financial reporting basis of the value assigned to land may differ from the tax basis. Such a difference may result from (1) property acquired in a nontaxable business combination, (2) differences between capitalized costs allowable under accounting standards and those allowable under tax law, or (3) property recorded at predecessor cost for financial reporting purposes because it was acquired through a transaction among entities under common control. Regardless of the reason for the difference, the entity should assume that the temporary difference will reverse in the year in which the land is expected to be sold to an unrelated third party; otherwise, the timing of the reversal would be indefinite. If, however, the sale is assumed to be on an indefinite future date, the entity cannot use the indefinite reversal criterion in ASC 740-30-25-17 to avoid recognizing the deferred tax consequences of a temporary difference related to land.

### ***Nondepreciable Assets***

In some jurisdictions, certain office buildings and other real estate cannot be depreciated under local tax law. The tax authority may permit the tax basis of such property to be routinely increased for the approximate loss in purchasing power caused by inflation. The tax basis, as adjusted for indexing, is used to measure the capital gain or loss. For financial reporting purposes, depreciation is recognized on such assets. The effects of indexing for tax purposes and depreciation for financial reporting purposes create deductible temporary differences that reverse upon disposition of the associated assets. A DTA is recognized in accordance with ASC 740, subject to the prohibition in ASC 740-10-25-3(f) for foreign economies that are highly inflationary (the functional currency is the reporting currency in accordance with ASC 830).

See [Chapter 12, "Foreign Currency Matters,"](#) for further guidance on the income tax impact of foreign currency matters, including indexation.

## **Assets Under Construction**

For financial reporting purposes, the carrying amount and tax basis of an asset under construction for an entity's own use may differ as a result of differences in capitalized costs (e.g., interest capitalized under ASC 835-20 may differ from the amount to be capitalized for tax purposes). The difference between the amount reported for construction in progress for financial reporting purposes and its related tax basis should be scheduled to reverse over the expected depreciable life of the asset, which should not commence before the date on which the property is expected to be placed into service.

## **Disposal of Long-Lived Assets by Sale**

A deductible temporary difference results when, under ASC 360-10-35-37, a loss is recognized for a write-down to fair value less costs to sell for assets to be disposed of by sale. Because the deductions for losses cannot generally be applied to reduce taxable income until they occur, the temporary difference should be assumed to reverse during the period(s) in which such losses are expected to be deductible for tax purposes.

## **Costs Associated With Exit or Disposal Activities**

Under ASC 420, the fair value of certain exit or disposal costs (e.g., contract termination) is recorded on the date the activity is initiated (e.g., contract termination date) and is accreted to its settlement amount on the basis of the discount rate initially used to measure the liability. Generally, an entity cannot apply the deductions for exit or disposal activities to reduce taxable income until they occur; therefore, the resulting deductible temporary differences should be scheduled to reverse during the period(s) in which such losses are expected to be deductible for tax purposes.

## **Loss Contingencies**

Under ASC 450, the estimated losses on contingencies that are accrued for financial reporting purposes when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated are not deductible for tax purposes until paid. The resulting deductible temporary differences should be scheduled to reverse during the periods in which the losses are expected to be deductible for tax purposes.

## **Warranty Reserves**

In most tax jurisdictions, tax deductions for accrued warranty costs are not permitted until the obligation is settled. The temporary differences attributable to warranty accruals for financial reporting purposes should be scheduled to reverse during the years in which the tax deductions are expected to be claimed.

## **Organizational Costs**

In the U.S. federal tax jurisdiction, an entity generally uses the straight-line method to defer organizational costs and amortize them to income over five years. Such costs are recognized as an expense for financial reporting purposes in the period in which they are incurred unless an entity can clearly demonstrate that the costs are associated with a future economic benefit. If the costs are reported as an expense in the period in which they are incurred, any deductible temporary differences should be scheduled to reverse on the basis of the future amortization of the tax basis of the organizational asset recorded for tax purposes.

## **Long-Term Contracts**

Before the Tax Reform Act, use of the completed-contract method for tax purposes resulted in significant temporary differences for many entities that used the percentage-of-completion method for financial reporting purposes. The Tax Reform Act eliminated this use of the completed-contact method (except for small contractors that are defined under the law), requiring that an entity determine taxable income by using the percentage-of-completion method or a hybrid of the completed-contract and percentage-of- completion methods for contracts entered into after February 1986.

For entities that are permitted to continue using the completed-contract method for tax purposes, a temporary difference will result in future taxable income in the amount of gross profit recognized for financial reporting purposes. The reversal of these differences would be assumed to occur on the basis of the period in which the contract is expected to be completed.

If the percentage-of-completion method is used for both tax and financial reporting purposes, temporary differences may nevertheless result because the gross profit for tax purposes may be computed differently from how gross profit is computed for book purposes. To schedule the reversals of these temporary differences, an entity would generally need to estimate the amount and timing of gross profit for tax and financial reporting purposes.

If a hybrid method is used for tax purposes and the percentage-of-completion method is used for financial reporting purposes, the temporary differences might be allocated between the portions of the contract that are accounted for under the completed-contract method and those accounted for under the percentage-of- completion method for tax purposes. Under this approach, the amount attributable to the use of the completed- contract method for tax purposes might be scheduled to reverse, thereby increasing taxable income, during the year in which the contract is expected to be completed. The amount of temporary differences attributable to differences in the percentage-of-completion methods for financial reporting and tax purposes might be allocated and scheduled on the basis of the estimates of future gross profit for financial reporting and tax purposes.

## **Pension and Other Postretirement Benefit Obligations**

Under ASC 715, an employer generally recognizes the estimated cost of providing defined benefit pension and other postretirement benefits to its employees over the estimated service period of those employees. It records an asset or liability representing the amount by which the present value of the estimated future cost of providing the benefits either exceeds or is less than the fair value of plan assets at the end of the reporting period.

Under U.S. tax law, however, an employer generally does not receive a deduction until it makes a contribution to its pension plan or pays its other postretirement benefit obligations (e.g., retiree medical costs). Because tax law generally precludes an entity from taking deductions for these costs until the pension contribution is made or the other postretirement benefit obligations are paid, the accounting required under ASC 715 usually results in significant taxable or deductible temporary differences for employers that provide such benefits.

ASC 715-30-55-4 and 55-5 explain that a taxable temporary difference related to an overfunded pension obligation will reverse if (1) the plan is terminated to recapture excess assets or (2) periodic pension cost exceeds future amounts funded. For an overfunded obligation, we believe that the pattern of taxable amounts in future years should generally be determined to be consistent with the pattern in scenario (2). That is, we believe that the pattern of taxable amounts in future years that will result from the temporary difference should generally be considered the same as the pattern of estimated net periodic pension cost (as that term is defined in ASC 715-30-20) for financial reporting for the following year and succeeding

years, if necessary, until future net periodic pension cost, on a cumulative basis, equals the amount of the temporary difference. Under this approach, additional employer contributions to the plan, if any, are ignored. It may be estimated, however, that in early years, there will be net periodic pension income (because the plan is significantly overfunded). If so, the existing overfunded amount will not be recovered until the later years for which it is estimated that there will be net periodic pension cost.

For an underfunded plan, the pattern of deductible amounts in future years that will result from the temporary difference could be considered the same as the pattern by which estimated future tax-deductible contributions are expected to exceed future interest cost on the benefit obligation existing at the end of the reporting period. This approach is similar to determining the pattern of reversals for other discounted liabilities (e.g., amortizing a loan). Under this approach, each estimated tax-deductible contribution to the plan in future years would be allocated initially to (1) estimated future interest expense on the projected benefit obligation existing at the end of the reporting period and then to (2) the projected benefit obligation existing at the end of the reporting period.

### ***Deferred Income and Gains***

For tax purposes, certain revenue or income is taxed upon receipt of cash (e.g., rental income, loan, or maintenance fees received in advance). However, for financial reporting purposes, such income is deferred and recognized in the period in which the fee or income is earned. The amounts deferred in an entity's balance sheet will result in a deductible temporary difference because, for tax purposes, no tax basis in the item exists.

Temporary differences from revenues or gains deferred for financial reporting purposes, but not for tax purposes, should be assumed to result in deductible amounts when the revenues or gains are expected to be earned or generated (i.e., when the deferred credit is expected to be settled).

### ***Allowances for Doubtful Accounts***

The Tax Reform Act requires most taxpayers to use the specific charge-off method to compute bad-debt deductions for tax purposes. For financial reporting purposes, entities recognize loan losses in the period in which the loss is estimated to occur. Such recognition creates a deductible temporary difference in the amount of the allowance for doubtful accounts established for financial reporting purposes. It is expected that an allowance for doubtful accounts as of the current balance sheet date will result in deductible amounts in the year(s) in which such accounts (1) are expected to be determined to be worthless for tax purposes or (2) are planned to be sold (if held for sale).

### ***Unremitted Earnings of Foreign Subsidiaries***

ASC 740-10-25-3 permits entities to forgo recognition of a DTL on unremitted foreign earnings that are indefinitely invested. However, if an entity routinely receives remittances of earnings from foreign affiliates and either will continue to do so or intends to receive such remittances in the foreseeable future, it must recognize a DTL. In the assessment of the amounts and timing of future income from these sources, the expected remittances should be based on the expected timing of the cash flows or distribution of dividends in kind (i.e., assets other than cash). When measuring the tax consequences of remittances, an entity should consider whether the amounts will be distributions of capital or ordinary income, as well as any foreign withholding taxes and resulting foreign tax credits that may result.

## Property, Plant, and Equipment

An entity might find it necessary to schedule the reversals of temporary differences related to depreciable assets for two primary reasons: (1) to assess whether it has sufficient taxable income of the appropriate character, within the carryback/carryforward period available under the tax law, to conclude that realization of a DTA is more likely than not and (2) to calculate the tax rate used to measure DTAs and DTLs by determining the enacted tax rates expected to apply to taxable income in the periods in which the DTLs or DTAs are expected to be settled or realized. In each case, the entity must estimate the amounts and timing of taxable income or loss expected in future years. Further, ASC 740-10-55-14 states, "For some assets or liabilities, temporary differences may accumulate over several years and then reverse over several years. That pattern is common for depreciable assets."

### Example 4-15

The following example illustrates the scheduling of temporary differences for depreciable assets. Assume the following:

- An entity acquired depreciable assets for \$1,000 at the beginning of 20X1.
- For financial reporting purposes, the property is depreciated on a straight-line basis over five years; for tax purposes, the modified accelerated cost recovery method is used.
- The following table illustrates the depreciation schedules:

Year	Tax Cumulative	Financial Reporting	Tax Over (Under) Financial Reporting	
20X1	\$ 350	\$ 200	\$ 150	\$ 150
20X2	260	200	60	210
20X3	156	200	(44)	166
20X4	110	200	(90)	76
20X5	110	200	(90)	(14)
20X6	<u>14</u>	<u>=</u>	14	—
	<u>\$ 1,000</u>	<u>\$ 1,000</u>		

In December 20X1, the temporary difference of \$150 (financial statement carrying amount of \$800 less tax basis of \$650) will result in a future net taxable amount. If the originating differences are considered, the temporary difference of \$150 should be scheduled to reverse in the following manner as of the end of 20X1:

Future Years	(Originating) Reversing Amount
20X2	\$ (60)
20X3	44
20X4	90
20X5	90
20X6	<u>(14)</u>
	<u>\$ 150</u>

**Example 4-15 (continued)**

If the entity does not consider future originating differences to minimize the complexity of scheduling reversal patterns, a FIFO pattern would be used and the \$150 taxable temporary difference would be scheduled as follows on December 31, 20X1:

<b>Future Years</b>	<b>(Originating) Reversing Amount</b>
20X2	\$ —
20X3	44
20X4	90
20X5	16
20X6	<u>—</u>
	<u>\$ 150</u>

## **4.27 Using the Reversal of a DTL for an Indefinite-Lived Asset as a Source of Taxable Income**

Generally, the reversal of a DTL related to an indefinite-lived asset cannot be used as a source of taxable income to support the realization of DTAs. A taxable temporary difference related to an indefinite-lived asset (e.g., land, indefinite-lived intangible assets, and tax-deductible “component 1” goodwill) will reverse only when the indefinite-lived asset is sold. If a sale of an indefinite-lived asset is not expected in the foreseeable future, the reversal of the related DTL generally cannot be scheduled, so an entity generally cannot consider the reversal a source of future taxable income when assessing the realizability of DTAs. There are, however, circumstances such as the following in which it may be appropriate to consider a DTL related to an indefinite-lived asset as a source of taxable income:

- If the sale of an indefinite-lived asset is expected in the foreseeable future (e.g., the asset is classified as held for sale) and the related DTL **can** therefore be scheduled to reverse.
- If it is anticipated that the indefinite-lived asset will be reclassified as finite-lived. For example, an R&D asset acquired in a business combination that is initially classified as indefinite-lived will be reclassified as finite-lived once the project is completed or abandoned.
- If the DTA being assessed for realizability is related to an attribute with an unlimited carryforward period, such attribute will either be realized before the sale of the indefinite-lived asset (so no valuation allowance is required) or will still be available in the indefinite future when the indefinite-lived asset is ultimately recovered by sale.

For example, if an entity had NOL in a jurisdiction with an unlimited carryforward period, it may be appropriate to consider a DTL related to an indefinite-lived asset as a source of taxable income to support realization of the NOL. That is, when the DTL is ultimately realized through sale of the indefinite-lived asset, the entity could immediately realize the NOL as long as there are no restrictions on the ability to use the NOL to offset the reversal of the taxable temporary difference (e.g., if the NOL were limited in use to 70 percent of taxable income, then only 70 percent of the indefinite-lived taxable temporary difference would serve as a source of taxable income). However, if the same entity had a DTA associated with land (rather than an NOL), the DTA could only be realized if a sale of the land occurs and the DTL related to the indefinite-lived asset reverses in the same period or within the carryforward or

carryback period. Because it is typically not possible to schedule the reversal of both deferreds within the same period or within the carryforward or carryback period, a DTL related to an indefinite-lived asset would generally not support the realization of an indefinite-lived DTA whose realization is dependent on a sale.

See [3.47](#) for guidance on recognizing deferred taxes for indefinite-lived assets. In addition, see [4.04](#) for guidance on measuring deferred taxes for indefinite-lived assets when different tax rates may apply.

## 4.28 AMT Valuation Allowances

ASC 740-10-55-33 identifies the sources of taxable information that an entity should consider in determining the need for a valuation allowance for a deferred tax benefit on existing AMT credit carryforwards.

Even though AMT credit carryforwards have an indefinite carryforward period (see [4.14](#)), if an entity is currently profitable, there may be circumstances in which the DTA recognized for the tax benefit on existing AMT credit carryforwards should be reduced by a valuation allowance. If an entity continues to generate permanent AMT preference items indefinitely, it may continue to be an AMT taxpayer indefinitely. Thus, realization of AMT credit carryforwards as a reduction of regular tax would not meet the more-likely-than-not recognition threshold in ASC 740. Certain entities that pay taxes at the AMT rate because of permanent differences between regular taxable income and AMTI provide a valuation allowance against the DTA established for an AMT credit carryforward because they expect to be AMT taxpayers indefinitely. The following are examples of permanent differences between regular taxable income and AMTI:

- Tax-exempt interest on certain investments in state and local government securities.
- Percentage depletion for oil and gas producers and other extractive industries.
- Special deductions under Section 833 of the U.S. federal tax law that pertain to certain stock life insurance companies and Blue Cross/Blue Shield entities.
- Loss carryforwards and FTCs that cannot be used to eliminate more than 90 percent of taxes on AMTI.

Realization of a tax benefit from deductible temporary differences and carryforwards is considered more likely than not to the extent that it is available to offset a DTL that will be measured on the basis of the regular tax rate. However, if realization of deductible temporary differences and carryforwards depends on sources of taxable income other than the reversal of “regular” taxable temporary differences, and if the entity will continue to pay AMT indefinitely, a valuation allowance sufficient to eliminate any tax benefit on an AMT credit carryforward existing as of the balance sheet date would be required under ASC 740.

Because ASC 740 requires AMT taxpayers to measure their DTL for all taxable temporary differences on the basis of the applicable tax rate determined under the regular tax system, those entities may be required to record a net DTL at an amount in excess of the expected impact of the reversals (see further discussion below). In other words, corporate taxpayers will measure DTAs, net of the related valuation allowance, to reflect the related AMT impact, but DTLs will be measured at an applicable regular tax rate. Taxpayers will perform such measurements in situations in which the amount of the DTA, as reduced by the valuation allowance, is not sufficient to completely offset the DTL that is established on the basis of the regular tax system.

To the extent that AMT credit carryforwards, as determined for tax purposes, are sufficient to reduce the DTL (computed at the regular tax rate) to the AMT rate of 20 percent, realization is more likely than not and, accordingly, no valuation allowance is necessary. Any excess AMT credits that remain after the allowable portion of the DTL is offset to 20 percent (excess credits) will also be recorded as a DTA.

However, a valuation allowance should be provided to reduce that portion of the DTA to an amount that is more likely than not to be realized. In determining whether realization of the portion of the DTA recognized for the excess credits is more likely than not, an entity will need to assess whether it will continue to be an AMT taxpayer over its life. Thus, if, on the basis of the available evidence about the future, an entity believes it will continue to pay tax based on the AMT system indefinitely, the entity should establish a valuation allowance that is sufficient to reduce the DTA recognized for the excess credit to zero. Therefore, a valuation allowance is necessary in this situation because of the available evidence (i.e., the absence of future regular taxable income) that will enable use of such AMT credits.

## **4.28A Assessing Realization of a DTA for Regular Tax NOL Carryforwards When an Entity Anticipates Paying AMT Perpetually**

The U.S. corporate income tax regime consists of two integrated systems or computations: regular tax and alternative minimum tax (AMT). The AMT system is primarily intended to ensure that taxpayers that are entitled to certain deductions under the regular tax system pay a minimum level of tax on income, excluding such deductions, for the tax year. An entity generally first determines its taxable income under the regular tax system. The entity uses such taxable income (before any NOL carryforward deductions) as the starting point for computing its taxable AMT income (AMTI). It then makes the following types of adjustments to its taxable income under the regular tax system (before any NOL carryforward deductions) to arrive at its AMTI:

- *Timing adjustments* — The entity recognizes the item of income or deduction in different periods when computing regular taxable income and AMTI.
- *Permanent adjustments* — The entity never excludes the item of income or recognizes the item of deduction (generally referred to as “preference items”) in arriving at AMTI.

The entity then determines its tax under the AMT system by multiplying the appropriate AMT rate by AMTI (after reducing AMTI for NOLs and any available exemptions allowed under the AMT system). This amount is then further reduced by credits permitted under the AMT system. The total federal tax liability for each year is the greater of regular tax and the tax calculated under the AMT system (referred to as the “tentative minimum tax” (TMT)).

If the TMT exceeds the regular tax, such excess is the AMT liability for the year. This AMT liability results in a tax credit that can be used to reduce a future regular tax liability to the extent that regular tax exceeds TMT in a future year. AMT credits can be carried forward indefinitely.

An entity that has significant recurring preference items will typically pay tax determined under the AMT system over its life (i.e., it expects that it will never be able to use its AMT credits).

ASC 740-10-55-32(a) requires all taxpayers (including perpetual AMT taxpayers) to measure deferred taxes by applying the regular tax rate to temporary differences and carryforwards calculated by using the regular tax system. ASC 740-10-30-11 expressly prohibits entities from measuring deferred taxes by applying the AMT rate to temporary differences and carryforwards calculated by using the AMT system. However, the AMT system can affect an entity's ability to realize the full amount of its tax benefits under the regular tax system and may require special consideration in the determination of tax expense. This is especially true when the entity has generated NOLs and believes it will pay the AMT perpetually.

An entity that expects to pay the AMT perpetually needs to apply ASC 740-10-30-16 through 30-25 when assessing the likelihood of realizing the tax benefit of a regular tax NOL carryforward.

The following example illustrates how an entity would determine whether a DTA recognized for the tax benefit of regular tax NOL carryforwards should be reduced by a valuation allowance:

### Example 4-15A

Assume the following:

- The entity, a U.S. corporation, has a \$500 NOL carryforward.
- The entity expects future pretax income of \$1,000 over the NOL carryforward period.
- The entity expects to generate deductions that will result in preference items, leading to an increase in AMTI of \$500 over the same period. The entity does not have any minimum tax operating loss carryforwards.
- The entity expects to pay the AMT over its life, primarily because of the preference items resulting in an increase in AMTI.
- The applicable tax rate under the regular tax system is 35 percent.
- The applicable tax rate under the AMT system is 20 percent.
- No originating or reversing temporary differences exist.

In this scenario, the entity would perform a with-and-without analysis to determine how much, if any, benefit it expects to realize from the NOL carryforwards after considering the interaction of the AMT system as follows:

	<b>Regular Tax</b>	<b>AMT</b>	
Future pretax income	\$ 1,000		
Deduction that results in preference item	<u>500</u>		
Regular taxable income	500		
Regular taxable income	500	\$ 500	
Preference Item	<u>0</u>	<u>500</u>	
Taxable income before NOL carryforward	500 A	1,000 A	
NOL deduction	<u>(500)</u>	<u>0</u>	
Taxable income	0 B	1,000 B	
Tax rate	<u>35% C</u>	<u>20% C</u>	
Taxes payable with NOL carryforward (B × C)	\$ 0	\$ 200	
Taxes payable without NOL carryforward (A × C)	\$ 175	\$ 200	

If future taxable income before use of the NOL carryforwards under the regular tax system is assumed to be \$500 (\$1,000 pretax income less \$500 deduction that will result in a preference item), the entity's tax payable under the regular tax system, before use of the NOL carryforwards, would be \$175 ( $\$500 \times 35\%$  percent). However, because of the NOL carryforwards, the entity would not have any current tax payable from the regular tax system but rather would have to pay \$200 of minimum tax ( $\$1,000 \text{ AMTI} \times 20\%$  percent). Accordingly, the NOL carryforwards do not provide the entity with any benefit; with the NOL carryforwards, the entity would pay \$200 of minimum tax, and without them, the entity would still pay \$200 of minimum tax.

Even though there is sufficient regular taxable income to use the \$500 of the NOL carryforwards, the entity's regular tax payable before the benefit from the NOL carryforwards is not expected to exceed the minimum tax liability; therefore, realization of the DTA for the NOL carryforwards is \$0. Consequently, the entity will need to recognize a valuation allowance of \$175 against the NOL carryforward DTA. In doing so, the entity is recognizing a valuation allowance currently for the portion (i.e., 100 percent) of the regular tax NOL DTA that will convert into AMT credit in future periods and require a valuation allowance because the entity will pay the AMT indefinitely.

**Example 4-15B**

Assume the same facts as in Example 4-15A, except that the entity expects to generate preference items, resulting in an increase in AMTI, of only \$400.

	<b>Regular Tax</b>	<b>AMT</b>
Future pretax income	\$ 1,000	
Deduction that results in preference item	<u>400</u>	
Regular taxable income	600	
Regular taxable income	600	\$ 600
Preference Item	<u>0</u>	<u>400</u>
Taxable income before NOL carryforward	600	A
NOL deduction	<u>(500)</u>	<u>0</u>
Taxable income	100	B
Tax rate	<u>35%</u>	<u>20%</u>
Taxes payable with NOL carryforward (B × C)	\$ 35	\$ 200
Taxes payable without NOL carryforward (A × C)	\$ 210	\$ 200

In this scenario, if future taxable income before use of the NOL carryforwards under the regular tax system is assumed to be \$600 (\$1,000 taxable income less \$400 book/tax difference), the entity's tax payable under the regular tax system, before use of the NOL carryforwards, would be \$210 ( $\$600 \times 35\%$ ). However, because of the NOL carryforwards, the entity would not have any current tax payable from the regular tax system but rather would have to pay \$200 of minimum tax ( $\$1,000 \text{ AMTI} \times 20\%$ ). Accordingly, the entity would pay \$200 of minimum tax (saving \$10) with the NOL carryforwards and would pay tax of \$210 under the regular tax system without them.

As with Example 4-15A, although there is sufficient regular taxable income to use the \$500 of the NOL carryforward, the entity's regular tax payable before the benefit from the NOL carryforwards is only expected to exceed the minimum tax liability by \$10; therefore, realization of the DTA for the NOL carryforwards is limited to the \$10. Consequently, the entity will need to recognize a valuation allowance of \$165 [ $(\$500 \times 35\%) - \$10$ ] against the NOL carryforward DTA for the portion of the regular tax NOL DTA that will convert into AMT credit in future periods and will require a valuation allowance because the entity pays the AMT perpetually.

## 4.29 Definition of a Tax-Planning Strategy

The ASC master glossary defines a tax-planning strategy as follows:

An action (including elections for tax purposes) that meets certain criteria [see below] and that would be implemented to realize a tax benefit for an operating loss or tax credit carryforward before it expires.

Tax-planning strategies are considered when assessing the need for and amount of a valuation allowance for deferred tax assets.

ASC 740-10-30-19 states that for an action to be considered a tax-planning strategy, it should be:

1. “[P]rudent and feasible.”
2. One that an entity “ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused.”
3. One that “would result in realization of deferred tax assets.”

ASC 740-10-55-39 clarifies these three criteria:

- For the tax-planning strategy to be prudent and feasible, “[m]anagement must have the ability to implement the strategy and expect to do so unless the need is eliminated in future years.” If the action is prudent but not feasible (or vice versa), it would not meet the definition of a tax-planning strategy. In determining whether an action constitutes a tax-planning strategy, an entity should consider all internal and external factors, including whether the action is economically prudent.
- Regarding criterion 2, strategies management would employ in the normal course of business are considered “implicit in management’s estimate of future taxable income and, therefore, are not tax-planning strategies.”
- Regarding whether the strategy would result in realization of DTAs (criterion 3 above), ASC 740-10-55-39 states, “The effect of qualifying tax-planning strategies must be recognized in the determination of . . . a valuation allowance.” Further, the tax-planning strategy should result in the realization of a DTA, but only if it does not result in another DTA that would not be realized.

Management should have control over implementation of the tax-planning strategy. However, paragraph A107 of the Basis for Conclusions in Statement 109 clarifies that this control does not need to be unilateral. In determining whether a tax-planning strategy is under management’s control, the entity should consider whether, for example, the action is subject to approval by its board of directors and whether approval is reasonably ensured.

Finally, to be considered a possible source of future taxable income, a tax-planning strategy (and any associated taxable income generated from that strategy) must (1) meet the more-likely-than-not recognition threshold and (2) be measured as the largest amount of benefit that is more likely than not to be realized. For more information, see [4.32](#).

Because tax-planning strategies are a possible source of taxable income that an entity must consider when assessing the need for a valuation allowance, an entity must make a reasonable effort to identify qualifying tax-planning strategies. Question 27 of the FASB Staff Implementation Guide to Statement 109 addresses whether management must “make an extensive effort to identify all tax-planning strategies that meet the criteria for tax-planning strategies.” The answer, which was codified in ASC 740-10-55-41, states, in part:

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

[4.30](#) and [4.31](#) contain examples of qualifying and nonqualifying tax-planning strategies.

## 4.30 Examples of Qualifying Tax-Planning Strategies

The objective of some tax-planning strategies is to change the timing or character of taxable items to realize DTAs. This could involve accelerating taxable amounts to use expiring carryforwards or changing the character of a taxable amount from ordinary to capital.

A qualifying tax-planning strategy must meet the criteria in ASC 740-10-30-19. That is, the tax-planning strategy should be (1) "prudent and feasible"; (2) one that an entity "ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused"; and (3) "one that would result in realization of [the DTA]." The following are some possible examples (not all-inclusive) of qualifying tax-planning strategies:

- Selling and subsequent leaseback of certain operating assets.
- Switching certain investments from tax-exempt to taxable securities.
- Filing a consolidated tax return versus separate stand-alone income tax returns.
- Disposing of obsolete inventory that is reported at net realizable value.
- Changing the method of accounting for inventory for tax purposes.
- Selling loans at an amount that is net of their allowance for doubtful accounts.
- Accelerating the funding of certain liabilities if that funding is deductible for tax purposes.
- Switching from deducting R&D costs to capitalizing and amortizing the costs for tax purposes.
- Electing to deduct foreign taxes paid or accrued rather than treating them as creditable foreign taxes.
- Accelerating the repatriation of foreign earnings for which deferred taxes were previously funded.

### Example 4-16

#### Acceleration of Taxable Amounts to Use Carryforward

In 20X2, Entity A generates, for tax purposes, a \$2,000 operating loss that cannot be used in the current tax return. Tax law allows for a one-year carryforward. However, after considering (1) future reversals of existing taxable temporary differences, (2) future taxable income exclusive of reversing taxable temporary differences and carryforwards, and (3) taxable income in the prior carryback years, A must record a valuation allowance for the tax consequences of \$1,000 of future deductions that are not expected to be realized.

However, A has identified a tax-planning strategy that involves selling at book value, and leasing back, plant and equipment. This strategy would accelerate \$600 of taxable amounts (the excess depreciation in prior years) that would otherwise reverse in years beyond the carryforward period. For tax purposes, the sale would accelerate the reversal of the taxable difference (the excess-book-over-tax basis on the date of the sale-leaseback) into taxable income in the year of the sale. After considering the strategy, A must record a valuation allowance at the end of 20X2 only for the \$400 of the operating loss whose realization is not more likely than not.

**Example 4-16**

When considering the sale and leaseback of assets as a tax-planning strategy, it should be reasonable for A to conclude that the fair value of the assets approximates the book value at the time of the sale. If the assets have appreciated, the sale and leaseback would create taxable income (typically considered a capital gain). Conversely, selling the assets at a loss would reduce the taxable income that is created by the strategy. In addition, for the sale and leaseback of assets to meet the criteria for a qualifying tax-planning strategy, future taxable income must otherwise be expected (because the sale and leaseback of assets when the fair value approximates the carrying value does not create additional taxable income). Without future taxable income, the sale and leaseback only postpones the expiration of the DTA. Furthermore, when measuring the valuation allowance necessary (i.e., the impact of future lease payments on taxable income), A must incorporate the future implications of the tax-planning strategy into the determination of the strategy's effects. (See [4.32](#) for more information about measuring the tax benefits of tax-planning strategies.)

**Example 4-17****Switch From Tax-Exempt to Taxable Investments**

In 20X2, Entity B generates \$2,000 of tax credits that cannot be used in the current-year tax return. Tax law permits a one-year credit carryforward to reduce income taxes in 20X3. After considering (1) future reversals of existing taxable temporary differences, (2) future taxable income exclusive of taxable temporary differences and carryforwards, and (3) taxable income in the prior carryback years, B must record a valuation allowance of \$1,000.

However, B has identified a tax-planning strategy in which its investment portfolio of tax-exempt securities could, if sold and replaced with higher-yielding taxable securities, generate sufficient taxable income during 20X3 to enable the use of \$200 of the available tax credit carryforward. Provided that the replacement of tax-exempt securities is prudent and feasible, a valuation allowance is recognized only for the \$800 of tax credit carryforwards whose realization is not more likely than not. In assessing whether the tax-planning strategy is prudent and feasible, B should assess whether the replacement securities offer a better pretax yield than the tax-exempt securities (i.e., if the yield is identical, no benefit is derived from the change in investment and the tax-planning strategy is therefore not prudent).

## **4.31 Examples of Nonqualifying Tax-Planning Strategies**

ASC 740-10-30-19, ASC 740-10-55-39 through 55-48, and ASC 740-10-55-159 through 55-164 provide general guidance on whether actions an entity may take to minimize income taxes in future years qualify as tax-planning strategies under ASC 740-10. Actions that qualify as tax-planning strategies represent one of the four sources of taxable income in the assessment of the need for a valuation allowance against an entity's DTAs. To qualify as a tax-planning strategy under ASC 740-10, an action must meet the following three criteria:

- The action must be prudent and feasible.
- It must be an action that an entity might not ordinarily take but would take to prevent an operating loss or a tax credit carryforward from expiring unused.
- It must result in realization of DTAs.

The objective of the requirement for entities to consider tax-planning strategies is to measure and record deferred tax consequences that are most representative of the outcome expected in future years. See [4.30](#) for examples of actions that generally qualify as tax-planning strategies under ASC 740.

The following actions would generally not qualify as tax-planning strategies because they would not meet one or more of the above criteria:

- Actions that are inconsistent with financial statement assertions. For example, to classify an investment in a debt security as held to maturity, an entity must positively assert that it has the ability and intent to hold the investment until maturity. It would be inconsistent with that assertion for the entity to simultaneously assert as a tax-planning strategy that it would sell securities classified as held to maturity to realize a DTA.

The absence of a positive financial statement assertion does not necessarily preclude an action from qualifying as a tax-planning strategy. For example, an entity does not need to meet all the criteria for held-for-sale classification to assert as a tax-planning strategy that it would sell an appreciated asset to realize a DTA.

An action that is not inconsistent with a positive financial statement assertion must meet the three criteria above to qualify as a tax-planning strategy.

- Selling an entity's principal line of business or selling certain operating assets (e.g., an indefinite-lived trade name) that are core to the business. Such an action would not be considered prudent.
- Selling advanced technology to a foreign government when such a sale is prohibited by statute. Such an action would not be considered feasible.
- Disposing of an unprofitable subsidiary, which is generally not considered an action that an entity "might not ordinarily take" and may not be feasible.
- Funding executive deferred compensation before the agreed-upon payment date. Such a strategy would generally not be considered prudent because, while it would result in reversal of a DTA, it would also result in an acceleration of income tax for the executive(s).
- Moving income from a nontax jurisdiction to a tax jurisdiction solely to realize operating loss carryforwards. This action would result in use of the asset in the jurisdiction receiving the income but not in an overall economic benefit since, irrespective of whether the entity took the action, it would not have incurred tax on the income.

In addition, changing a parent entity's tax status generally would not qualify as a tax-planning strategy because ASC 740-10-25-32 requires that the effect of a change in tax status be recognized as of the date on which the change in tax status occurs.

**Example 4-18****Tax-Planning Strategy That Is Inconsistent With Financial Statement Assertions**

Assume the following:

- An entity is measuring its DTAs and DTLs at the end of 20X2.
- Capital losses of \$2 million were incurred in 20X2.
- Capital losses can only be used to offset capital gains; no capital gains occurred in 20X2.
- The capital gain tax rate is 50 percent.
- The entity has an investment portfolio of debt securities that it has classified as held to maturity in accordance with ASC 320. The portfolio has the following attributes:

Fair market value	\$ 2,000,000*
Tax basis	1,200,000
Book basis	2,500,000

\* Decline due to interest rate increase, not credit.

- An assumption inherent in the preparation of the financial statements is that an OTTI has not occurred in accordance with ASC 320-10-35-33A through 35-33C because (1) the entity does not have the intent to sell any of the securities in the portfolio, (2) it is not more likely than not that the entity will be required to sell any of the securities in the portfolio before recovery, and (3) the entity expects to recover the entire amortized cost basis of the securities in the portfolio.
- Management is considering a tax-planning strategy to sell the debt securities to generate an \$800,000 taxable gain to reduce the valuation allowance that would otherwise be necessary. No cost would be incurred on the sale.

The strategy is inconsistent with the assumptions inherent in the preparation of the financial statements. If the entity assumed the sale of the debt securities to recognize a tax benefit of \$400,000 ( $\$800,000 \times 50\%$ ), such a strategy would conflict with ASC 320's held-to-maturity classification. The strategy may also conflict with the entity's OTTI assumptions (i.e., intent to sell; see ASC 320-10-35-33A) and potentially other financial statement assertions, such as the entity's use of Approach 1, described in **4.24**, to evaluate DTAs on its debt securities' unrealized losses. The tax-planning strategy described above would be inconsistent with the assumption made in the application of Approach 1, which requires the entity to assert its intent and ability to hold the debt security until recovery.

### 4.32 Recognition and Measurement of a Tax-Planning Strategy

ASC 740-10-30-18 states, "Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law." Tax-planning strategies (as defined in ASC 740) are one of four possible sources of taxable income that may be available under the tax law to realize such a tax benefit.

ASC 740-10-30-20 states the following about recognition and measurement of a tax-planning strategy:

When a tax-planning strategy is contemplated as a source of future taxable income to support the realizability of a deferred tax asset, the recognition and measurement requirements for tax positions in paragraphs 740-10-25-6 through 25-7; 740-10-25-13; and 740-10-30-7 shall be applied in determining the amount of available future taxable income.

To be contemplated as a possible source of future taxable income, a tax-planning strategy (and its associated taxable income) must (1) meet the more-likely-than-not recognition threshold and (2) be measured as the largest amount of benefit that is more likely than not to be realized.

Further, regarding measurement of the benefits of a tax-planning strategy, ASC 740-10-30-19 states, in part:

Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance.

See [4.34](#) for examples illustrating the measurement of a valuation allowance when tax-planning strategies are considered.

### 4.33 The “More-Likely-Than-Not” Standard

A key concept underlying the measurement of DTAs is that the amount to be recognized is the amount of DTAs that is “more likely than not” expected to be realized. ASC 740-10-30-5(e) requires that DTAs be reduced “by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.”

A “more-likely-than-not” standard for measuring DTAs could be applied positively or negatively. That is, an asset could be measured on the basis of a presumption that it would be realized, subject to an impairment test, or it could be measured on the basis of an affirmative belief about realization. Because the threshold of the required test is “slightly more than 50 percent,” the results would seem to be substantially the same under either approach. However, some view an affirmative approach as placing a burden of proof on the entity to provide evidence to support measurement “based on the weight of the available evidence.” Regardless of whether an entity views the more-likely-than-not threshold positively or negatively, the entity should fully assess all of the available evidence and be able to substantiate its determination.

Further, the more-likely-than-not threshold for recognizing a valuation allowance is a lower threshold than impairment or loss thresholds found in other sections of the ASC. For example, ASC 450-20-25-2 requires that an estimated loss from a loss contingency be accrued if the loss is **probable** and can be reasonably estimated. Further, ASC 360-10-35-17 requires that an impairment loss of long-lived assets be recognized “only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value.” In paragraphs A95 and A96 of the Basis for Conclusions of Statement 109, the FASB rejected the term “probable” with respect to the measurement of DTAs and believes that the criterion should be “one that produces accounting results that come closest to the expected outcome, that is, realization or nonrealization of the deferred tax asset in future years.” If the same assumptions about future operations are used, this difference in recognition criteria could cause an entity to recognize a valuation allowance against a DTA but not to recognize an asset impairment or a loss contingency.

### 4.34 Examples Illustrating the Measurement of Valuation Allowances When Tax-Planning Strategies Are Involved

Examples 4-19 through 4-21 illustrate the measurement of a valuation allowance in three different scenarios: (1) when no tax-planning strategy is available, (2) when the cost of implementing a tax-planning strategy under ASC 740 has an incremental tax benefit, and (3) when the cost of implementing a tax-planning strategy under ASC 740 has no incremental tax benefit. For all three examples, assume that “cumulative losses in recent years,” as discussed in ASC 740-10-30-21 and [4.36](#), do not exist.

See [4.32](#) for further discussion of recognition and measurement of tax-planning strategies.

**Example 4-19****No Tax-Planning Strategy Is Available**

Assume the following:

- The entity operates in a single tax jurisdiction where the applicable tax rate is 40 percent.
- The measurement date for DTAs and DTLs is in 20X1.
- A \$10,000 operating loss carryforward will expire on December 31, 20X2. No carryback refunds are available.
- Taxable temporary differences of \$2,000 exist at the end of 20X1, \$1,000 of which is expected to reverse in each of years 20X2 and 20X3.
- No qualifying tax-planning strategies to accelerate taxable income to 20X2 are available.
- The following table illustrates, on the basis of historical results and other available evidence, the estimated taxable income exclusive of reversing temporary differences and carryforwards expected to be generated during 20X2:

Estimated taxable income in 20X2	\$ 6,000
Existing taxable temporary differences that will reverse in 20X2	<u>1,000</u>
Estimated taxable income exclusive of reversing temporary differences and carryforwards	<u>\$ 5,000</u>

The following table shows the computation of the DTL, DTA, and valuation allowance at the end of 20X1:

Debit (Credit)
DTL (\$2,000 × 40%)
\$ (800)
DTA (\$10,000 × 40%)
4,000
Valuation allowance
[(\$10,000 – \$6,000) × 40%]
(1,600)

A valuation allowance of \$1,600 is necessary because \$4,000 of the \$10,000 of operating loss carryforward will expire in 20X2.

**Example 4-20****Cost of Tax-Planning Strategy Has an Incremental Tax Benefit**

Assume the following:

- The entity operates in a single tax jurisdiction where the applicable tax rate is 40 percent.
- The measurement date for DTAs and DTLs is in 20X1.
- A \$9,000 operating loss carryforward will expire on December 31, 20X2. No carryback refunds are available.
- Taxable temporary differences of \$10,000 exist at the end of 20X1. The temporary differences result from investments in equipment for which accelerated depreciation is used for tax purposes and straight-line depreciation is used for financial reporting purposes.
- Taxable temporary differences of \$2,000 are expected to reverse in each of years 20X2–20X6.

**Example 4-20 (continued)**

- The following table illustrates, before any qualifying tax-planning strategies are considered and on the basis of historical results and other available evidence, the estimated taxable income exclusive of reversing temporary differences and carryforwards expected to be generated during 20X2:

Estimated taxable income in 20X2	\$ 4,000
Reversal of existing taxable temporary differences	<u>2,000</u>
Estimate of taxable income exclusive of reversing temporary differences	<u>\$ 2,000</u>

- Management has identified a qualifying tax-planning strategy to sell and lease back the equipment in 20X2, thereby accelerating the reversal of the remaining temporary difference of \$8,000 to 20X2.
- The estimated cost attributable to the qualifying strategy is \$1,000.

The following table illustrates the computation of the DTAs and valuation allowance at the end of 20X1:

**Computation of Anticipated Taxable Income**

Operating loss carryforward	\$ (9,000)
Estimated taxable income (excluding legal costs from tax-planning strategy)	4,000
Income from tax-planning strategy	<u>8,000</u>
Anticipated taxable income in excess of loss carryforward	<u>\$ 3,000</u>
Legal and other estimated costs to implement the tax-planning strategy	(1,000)
Future tax benefit of those legal and other expenses ( $\$1,000 \times 40\%$ )	<u>400</u>
Total valuation allowance	<u>\$ (600)</u>
DTA ( $\$9,000 \times 40\%$ )	\$ 3,600
Less: valuation allowance	<u>(600)</u>
Net DTA	<u>\$ 3,000</u>

When the effects of the qualifying tax-planning strategy are taken into account, the total estimated taxable income for 20X2 of \$12,000 (\$4,000 estimated taxable income plus \$8,000 accelerating the reversal of the taxable temporary difference) exceeds the \$9,000 operating loss carryforward. However, in a manner consistent with the guidance in ASC 740-10-55-44 (and as illustrated in ASC 740-10-55-159), a valuation allowance for the cost of the tax-planning strategy, net of any related tax benefit, should reduce the tax benefit recognized. Therefore, a valuation allowance of \$600 would be required. The tax benefit of the cost of the strategy in this example is recognized as a reduction of the valuation allowance because sufficient taxable income is available to cover the cost in 20X2 after the results of the strategy are considered.

**Example 4-21****Cost of Tax-Planning Strategy Has No Incremental Tax Benefit**

Assume the following:

- The entity operates in a single tax jurisdiction where the applicable tax rate is 40 percent.
- The measurement date for DTAs and DTLs is in 20X1.
- A \$10,000 operating loss carryforward will expire on December 31, 20X2. No carryback refunds are available.
- Taxable temporary differences of \$3,000 exist at the end of 20X1. The temporary differences result from investments in equipment for which accelerated depreciation is used for tax purposes and straight-line depreciation is used for financial reporting purposes.
- Taxable temporary differences of \$1,000 are expected to reverse in each of years 20X2–20X4.
- The following table illustrates, before any qualifying tax-planning strategies are considered and on the basis of historical results and other available evidence, the estimated taxable income exclusive of reversing temporary differences and carryforwards expected to be generated during 20X2:

Estimate of taxable income in 20X2	\$ 6,000
Reversal of existing taxable temporary differences	<u>1,000</u>
Estimate of taxable income exclusive of reversing temporary differences	<u>\$ 5,000</u>

- Management has identified a qualifying tax-planning strategy to sell and lease back the equipment in 20X2, thereby accelerating the reversal of \$2,000 of taxable income to 20X2.
- Estimated costs attributable to the qualifying tax-planning strategy are \$500.

The following table illustrates the computation of the DTAs and valuation allowance at the end of 20X1:

**Computation of Anticipated Taxable Income**

Operating loss carryforward	\$ (10,000)
Estimated taxable income	6,000
Income from tax-planning strategy	<u>2,000</u>
Anticipated taxable income deficit	<u>\$ (2,000)</u>
Valuation allowance on anticipated taxable income deficit ( $\$2,000 \times 40\%$ )	(800)
Legal and other estimated costs to implement the tax-planning strategy*	<u>(500)</u>
Total valuation allowance	<u>\$ (1,300)</u>
DTA ( $\$10,000 \times 40\%$ )	\$ 4,000
Less: valuation allowance	<u>(1,300)</u>
Net DTA	<u>\$ 2,700</u>

\* Future tax benefit for these legal and other expenses is \$0 because incurring the costs of \$500 will not provide any incremental tax benefit (i.e., a \$500 deduction for legal and other expenses will not be available to reduce taxes in 20X2).

## 4.35 Determination of the Need for a Valuation Allowance Related to FTCs

In their U.S. tax returns, taxpayers are allowed to elect either to deduct direct foreign taxes incurred on foreign-source earnings or to claim a credit for such taxes. Credits for foreign taxes incurred are subject to certain limitations (e.g., such credits are limited to the amount calculated by using the U.S. statutory rate and cannot be used against U.S. taxes imposed on domestic income). Taxpayers are also permitted to claim a credit for indirect (or deemed-paid) foreign taxes (i.e., taxes included for U.S. tax purposes on the underlying income of a foreign subsidiary or more-than-10-percent investee when the underlying income is remitted as dividends). In this situation, pretax income is grossed up for the amount of taxes credited. If the taxpayer elects not to claim a credit for deemed-paid taxes, the income is not grossed up.

According to the IRC,<sup>3</sup> a taxpayer must choose between **either** deducting or claiming a credit for the foreign taxes that are paid in a particular tax year. The election to claim the credit or deduction is made annually and may be changed at any time while the statute of limitations remains open. In the case of an overpayment as a result of not claiming a credit for foreign taxes, a claim for credit or refund may be filed within 10 years from the time the return is filed or two years from the time the tax is paid, whichever is later.<sup>4</sup>

Creditable foreign taxes paid or deemed paid in a given year give rise to an FTC. An FTC can be either recorded as a reduction in taxes payable (with a corresponding increase in taxable income with respect to deemed-paid taxes) or taken as a tax deduction (for direct-paid taxes) in arriving at taxable income. Any FTCs not currently allowed because of various current-year limitations should be recognized as a DTA. ASC 740-10-30-2(b) states, "The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized."

In determining the need for a valuation allowance, taxpayers should consider tax-planning strategies, which include elections made for tax purposes. ASC 740-10-30-19 states that tax-planning strategies are actions that:

1. Are prudent and feasible
2. An entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused
3. Would result in realization of deferred tax assets.

Furthermore, ASC 740-10-55-23 states, in part:

Measurements [of deferred tax liabilities and assets] are based on elections (for example, an election for loss carryforward instead of carryback) that are expected to be made for tax purposes in future years.

While, given the statute extension, the decision of whether to take a credit or deduct foreign taxes may not be finalized until subsequent periods, the ability to deduct foreign taxes qualifies as a tax-planning strategy and should be taken into account in the determination of the minimum DTA that should be recognized for financial reporting purposes as of any reporting date.

In determining a valuation allowance against the DTA, an entity must compare the annual tax benefit associated with either deducting foreign taxes or claiming them as credits. In some circumstances in which an FTC carryover might otherwise have a full valuation allowance, recovery by way of a deduction may yield some realization through recognition of the federal tax benefit of a deduction. In such circumstances, it is not appropriate for an entity to assume no realization of the FTC solely on the basis of a tax credit election (i.e., leading to a full valuation allowance) when the entity is able to change the

<sup>3</sup> IRC Section 275(a)(4)(A) and Treas. Reg. Section 1.901-1(h)(2).

<sup>4</sup> Treas. Reg. Section 301.6511(d)-3.

election to a deduction in subsequent periods and realize a greater benefit than is provided by claiming a credit for the year in question.

Since the election to claim foreign taxes as either a deduction or a credit is an annual election, the calculation of the appropriate valuation allowance should be determined on the basis of the foreign taxes paid or deemed paid in a given year.

#### Example 4-22

##### **Deduction Benefit Greater Than Credit Benefit**

Entity X, a U.S. entity, paid direct foreign taxes of \$100 in 20X9. On the basis of the applicable limitations, X is permitted to use \$25 of FTC against its 20X9 taxes payable; X is allowed to carry back the remaining \$75 for one year and carry it forward for 10 years, which gives rise to a DTA. The U.S. federal income tax rate is 35 percent.

Entity X must evaluate the realizability of the DTA for the FTC. The maximum valuation allowance will be limited by any benefit that X would realize by amending its 20X9 tax return to take a deduction rather than allowing the remaining \$75 FTC to expire unused. If X has sufficient taxable income to take the deduction in 20X9, the benefit that can be realized by taking a tax deduction would be \$35 (35% tax rate  $\times$  \$100 of foreign taxes paid). A \$25 benefit has already been taken for the FTC through the credit election; therefore, X should at least realize an additional \$10 benefit for the carryforward taxes as a result of the option to take a deduction (\$35 available deduction less the \$25 credit taken in 20X9). Therefore, the maximum valuation allowance that X should consider for the \$75 FTC carryforward is \$65.

#### Example 4-23

##### **Credit Benefit Greater Than Deduction Benefit**

Assume the same facts as in Example 4-22, except that X is permitted to use \$40 of FTC against its 20X9 taxes payable. Since the benefit that can be realized by taking a deduction for the \$100 creditable taxes is \$35 (as calculated in Example 4-22) and \$40 has already been recognized as a benefit in the financial statements, the entire remaining \$60 FTC carryforward may be subject to a valuation allowance if X does not expect to be able to generate sufficient foreign-source income in the future. Note that the valuation allowance cannot reduce the DTA below zero.

#### Example 4-24

##### **Deemed-Paid Taxes**

Entity X, a U.S. entity, receives a distribution of \$300 from its foreign subsidiary, Y, on the basis of Y's underlying income of \$400, taxable at 25 percent in the foreign jurisdiction. The distribution brings with it \$100 of creditable foreign taxes (i.e., \$100 in deemed-paid taxes of X) ( $\$400 \text{ income} \times 25\% \text{ tax rate}$ ). For tax year 20X9, there is a \$400 dividend (consisting of the \$300 distribution and a \$100 gross-up for the deemed-paid taxes associated with the decision to take a credit for the 20X9 foreign income taxes paid by Y). As a result of the FTC limitation, X is permitted to use \$25 of FTC against its 20X9 taxes payable and is allowed to carry back the remaining \$75 for one year and carry it forward for 10 years, which gives rise to a DTA. Entity X did not have a sufficient FTC limitation to use the FTC in the prior year. The U.S. federal income tax rate is 35 percent. Total U.S. federal income tax paid by X in 20X9 would be \$115 ([ $\$400 \text{ dividend} \times 35\% \text{ tax rate}$ ] – \$25 FTC). If X chose to "deduct," rather than credit, the FTC in 20X9, the tax paid would be \$105 ( $\$300 \text{ distribution} \times 35\% \text{ tax rate}$ ).

**Example 4-24 (continued)**

The gross-up under the credit option effectively results in X's paying an additional \$10 in tax in 20X9 related to the foreign-source income ( $[\$100 \text{ deemed-paid taxes} \times 35\% \text{ tax rate}] - \$25 \text{ FTC}$ ). The remaining \$75 of FTC may be used in a future period; however, there are no additional gross-ups in those periods. In evaluating the realizability of the DTA for the \$75 excess FTC, if X no longer expected to realize the FTC, it could benefit from amending the 20X9 tax return for a "deduction" (effectively, this is an exclusion of the gross-up from income and no FTC, rather than a deduction). Electing a deduction would result in a refund of \$10 ( $\$115 - \$105$ ) because of the removal of the gross-up. Accordingly, the maximum valuation allowance is \$65.

Alternatively, if, instead of a \$25 credit limitation, \$75 of FTC could be used in 20X9, the FTC would have given rise to a \$40 benefit in 20X9 ( $[\$100 \times 35\%] - \$75$ ). In evaluating the realizability of the DTA for the \$25 carryforward, X could not benefit from amending the 20X9 tax return for a deduction, since the benefit of the FTC already taken exceeds the tax cost of the gross-up. The deduction would result in a benefit of only \$35 ( $\$100 \times 35\%$ ), compared with the credit of \$75 in 20X9. Accordingly, the maximum valuation allowance in this alternative is \$25.

Note that the decision to deduct, rather than credit, the FTC in a given year applies to both paid and deemed-paid taxes. The benefit obtained from amending a return to deduct paid foreign taxes rather than letting the FTC expire will be offset in part or in full by loss of the benefit on deemed-paid taxes otherwise creditable that year.

### **4.36 Definition of "Cumulative Losses in Recent Years"**

ASC 740-10-30-21 states that "cumulative losses in recent years" are a type of negative evidence for entities to consider in evaluating the need for a valuation allowance. ASC 740 does not define "cumulative losses in recent years." In deliberating whether to define the term, the FASB discussed the possibility of imposing conditions that would require such losses to be (1) cumulative losses for tax purposes that were incurred in tax jurisdictions that were significant to an entity for a specified number of years, (2) cumulative losses for tax purposes that were incurred in all tax jurisdictions in which an entity operated during a specified number of years, (3) cumulative pretax accounting losses incurred in the reporting entity's major markets or its major tax jurisdictions for a specified number of years, and (4) cumulative consolidated pretax accounting losses for a specified number of years. However, the FASB ultimately decided not to define the term.

Because there is no authoritative definition of this term, management must use judgment in determining whether an entity has negative evidence in the form of cumulative losses. In making that determination, management should generally consider the relevant tax-paying component's results before tax from all sources (e.g., amounts recognized in discontinued operations and OCI) for the current year and previous two years, adjusted for certain permanent differences.<sup>5</sup> Use of a "three-year" convention arose, in part, as a result of proposed guidance in the exposure draft on Statement 109. This guidance was omitted in the final standard (codified in ASC 740) because the FASB decided that a "bright line" definition of the term "cumulative losses in recent years" might be problematic. The standard's Basis for Conclusions states that the "Board believes that the more likely than not criterion required by [ASC 740] is capable of appropriately dealing with all forms of negative evidence, including cumulative losses in recent years." A three-year period, however, generally supports the more-likely-than-not recognition threshold because it typically covers several operating cycles of the entity and one-time events in a given cycle do not overly skew the entity's analysis.

<sup>5</sup> While adjustments would typically be made for permanent items such as nondeductible goodwill impairments and meals and entertainment, judgment should be applied since adjustments may not be warranted for other "one-time" tax-only items. In addition, in the case of nondeductible goodwill impairments, an entity should carefully consider the reasons for the impairment and the resulting negative evidence it may represent.

An entity's use of a cumulative-loss determination period other than the current year and two preceding years is acceptable as long as the entity can support its use of such a period. For example, a four-year period or two-year period is acceptable if the entity can demonstrate that it operates in a cyclical business and the business cycles correspond to those respective periods. If a period other than three years is used, entities should consult with their income tax accounting advisers. An entity should apply the period it selects consistently (i.e., in each reporting period).

When determining whether cumulative losses in recent years exist, an entity should generally not exclude nonrecurring items from its results. It may, however, be appropriate for the entity to exclude nonrecurring items when projecting future income in connection with its determination of the amount of the valuation allowance needed. For more information, see [4.41](#).

### **4.37 Consideration of Negative Evidence in the Determination of Whether a Valuation Allowance Is Required**

In determining whether a valuation allowance is necessary, an entity must consider all available positive and negative evidence. The weight to be assigned to a particular piece of positive or negative evidence depends on the extent to which it is objectively verifiable. For example, information about the entity's current financial position and income or loss for recent periods may constitute objectively verifiable evidence, while a long-term forecast of sales and income for a new product may be less objective and verifiable. When negative evidence exists, an entity may find it more difficult to conclude that a valuation allowance is not needed for some or all of the DTA recognized and more positive evidence may be needed as a result. Examples 4-25 through 4-29 illustrate different types of negative evidence that an entity should consider in determining whether a valuation allowance is required.

#### **Example 4-25**

##### **Cumulative Losses in Recent Years**

- An entity has incurred operating losses for financial reporting and tax purposes over the past two years. The losses for financial reporting purposes exceed operating income for financial reporting purposes, as measured cumulatively for the current year and two preceding years.
- A currently profitable entity has a majority ownership interest in a newly formed subsidiary that has incurred operating and tax losses since its inception. The subsidiary is consolidated for financial reporting purposes. The tax jurisdiction in which the subsidiary operates prohibits it from filing a consolidated tax return with its parent. This would be negative evidence for the DTA of the subsidiary in that jurisdiction.

#### **Example 4-26**

##### **A History of Operating Loss or Tax Credit Carryforwards Expiring Unused**

- An entity has generated tax credit carryforwards during the current year. During the past several years, tax credits, which originated in prior years, expired unused. There are no available tax-planning strategies that would enable the entity to use the tax benefit of the carryforwards.
- An entity operates in a cyclical industry. During the last business cycle, it incurred significant operating loss carryforwards, only a portion of which were used to offset taxable income generated during the carryforward period, while the remainder expired unused. The entity has generated a loss carryforward during the current year.

### Example 4-27

#### **Losses Expected in Early Future Years**

- An entity that is currently profitable has a significant investment in a plant that produces its only product. The entity's chief competitor has announced a technological breakthrough that has made the product obsolete. As a result, the entity is anticipating losses over the next three to five years, during which time it expects to invest in production facilities that will manufacture a completely new, but as yet unidentified, product.
- An entity operates in an industry that is cyclical in nature. The entity has historically generated income during the favorable periods of the cycle and has incurred losses during the unfavorable periods. During the last favorable period, the entity lost market share. Management is predicting a downturn for the industry during the next two to three years.

### Example 4-28

#### **Unsettled Circumstances That If Unfavorably Resolved Would Adversely Affect Profit Levels on a Continuing Basis in Future Years**

- During the past several years, an entity has manufactured and sold devices to the general public. The entity has discovered, through its own product testing, that the devices may malfunction under certain conditions. No malfunctions have been reported. However, if malfunctions do occur, the entity will face significant legal liability.
- In prior years, the entity manufactured certain products that required the use of industrial chemicals. The entity contracted with a third party, Company X, to dispose of the by-products. Company X is now out of business, and the entity has learned that the by-products were not disposed of in accordance with environmental regulations. A governmental agency may propose that the entity pay for clean-up costs.

### Example 4-29

#### **A Carryback or Carryforward Period That Is So Brief That It Would Limit Realization of Tax Benefits If (1) a Significant Deductible Temporary Difference Is Expected in a Single Year or (2) the Entity Operates in a Traditionally Cyclical Business**

- An entity operates in a state jurisdiction with a one-year operating loss carryforward period. During the current year, it implemented a restructuring program and recorded estimated closing costs in its financial statements that will become deductible for tax purposes next year. The deductible amounts exceed the taxable income expected to be generated during the next two years.

## **4.38 Cumulative Losses: An Objectively Verifiable Form of Negative Evidence**

When discussing how much weight an entity should place on "cumulative losses in recent years" in evaluating the need for a valuation allowance, paragraph 103 in the Basis for Conclusions of Statement 109 states that "the more likely than not criterion is capable of appropriately dealing with all forms of negative evidence, including cumulative losses in recent years." This paragraph further indicates that the more-likely-than-not criterion "requires positive evidence of sufficient quality and quantity to counteract negative evidence in order to support a conclusion that . . . a valuation allowance is not needed."

Cumulative losses are one of the most objectively verifiable forms of negative evidence. Thus, an entity that has suffered cumulative losses in recent years may find it difficult to support an assertion that a DTA could be realized if such an assertion is based on forecasts of future profitable results rather than an actual return to profitability. In other words, an entity that has cumulative losses is generally prohibited from using an estimate of future earnings to support a conclusion that realization of an existing DTA is more likely than not if such a forecast is not based on objectively verifiable information. An objectively verifiable estimate of future income is based on operating results from the reporting entity's recent history.

### 4.39 Going-Concern Opinion as Negative Evidence

PCAOB AS 2415 and AICPA AU-C Section 570 require an explanatory fourth paragraph in the auditor's report when the auditor concludes that "substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains." In addition, ASC 205-40<sup>6</sup> requires an entity's management to evaluate whether conditions or events raise substantial doubt about the entity's ability to continue as a going concern and, if so, "whether its plans that are intended to mitigate those [relevant] conditions and events, when implemented, will alleviate substantial doubt." In circumstances in which management has identified conditions or events that raise substantial doubt that has not been alleviated by its plans and an explanatory paragraph that has been added to the auditor's report, a valuation allowance would generally be recorded for all DTAs whose realization is not assured by either offsetting existing taxable temporary differences or carryback to open tax years. However, in very limited circumstances, the immediate cause of the going-concern uncertainty may not be directly related to the entity's operations, in which case a full valuation allowance may not be required.

The fact that (1) management has not identified conditions or events that raise substantial doubt, (2) management has identified conditions or events that raise substantial doubt but has determined its plans alleviate the substantial doubt, or (3) a going-concern explanatory paragraph is not included in the auditor's report does not automatically constitute positive evidence about the realization of DTAs. Similarly, when an entity concludes that it must record a valuation allowance for all or part of its DTAs, a going-concern problem may not necessarily exist. For example, an entity that generates sufficient positive cash flows to service its debt and support the book value of its assets (i.e., the entity's assets are not impaired), but that is experiencing financial reporting losses (i.e., recent cumulative losses), would have negative evidence about the realization of DTAs. In this case, the positive evidence may not be sufficient to overcome the negative evidence; thus, the entity would provide a valuation allowance for all or part of its DTAs. However, the auditor may conclude, on the basis of positive cash flows and other factors, that it is not necessary to provide a going-concern reference in the auditor's report, and management may likewise conclude that conditions or events do not raise substantial doubt about the entity's ability to continue as a going concern.

### 4.40 Estimates of Future Income

Whether a valuation allowance is necessary is based on the weight of positive and negative evidence. The examples of negative evidence in ASC 740-10-30-21 are **objectively verifiable**, as this term is used in ASC 740-10-30-23, because they are past events (the only exception to this is losses expected in early future years by a presently profitable entity). Thus, for an entity with objectively verifiable negative evidence to conclude that a valuation allowance is not necessary, objectively verifiable positive evidence must be present.

<sup>6</sup> ASC 205-40 was added by ASU 2014-15, which applies to all entities and is effective for annual periods ending after December 15, 2016, and interim periods thereafter, with early adoption permitted.

When negative evidence is present, an entity usually must estimate future income (positive evidence) in determining the amount of the valuation allowance needed to reduce the DTA to an amount that is more likely than not to be realized. (See [4.41](#) for a further discussion of evaluating future income.) Such estimates should be based on objectively verifiable evidence (e.g., an estimate of future income that does not include reversals of taxable temporary differences and carryforwards and that is based on operating results from the entity's recent history without subjective assumptions). In other words, an entity with negative evidence should look to its recent operating history to determine how much, if any, income exclusive of temporary differences is expected in future years. The entity typically begins this determination by analyzing income or loss for financial reporting purposes during its current year and two preceding years. For more information on cumulative losses in recent years, see [4.36](#) and [4.38](#).

#### **4.41 Effect of Nonrecurring Items on Estimates of Future Income**

The determination of whether a valuation allowance is necessary is based on the weight of positive and negative evidence. When objective and verifiable negative evidence is present (e.g., cumulative losses), an entity usually must develop an estimate of future taxable income or loss that is also considered to be objectively verifiable when determining the amount of the valuation allowance needed to reduce the DTA to an amount that is more likely than not to be realized. In developing that estimate, an entity typically uses income reported for financial reporting purposes during its current year and two preceding years. (For more information, see [4.40](#).)

When estimating future income or loss by using historical income or loss for financial reporting purposes in recent years, an entity should generally not consider the effects of discontinued operations and nonrecurring items. Generally, these items are typically not relevant to or indicative of an entity's ability to generate taxable income in future years. Examples of nonrecurring items that an entity usually excludes from its historical results include:

- One-time restructuring charges that permanently remove fixed costs from future cash flows.
- Large litigation settlements or awards that are not expected to recur in future years.
- Historical interest expense on debt that has been restructured or refinanced.
- Historical fixed costs that have been reduced or eliminated.
- Large permanent differences that are included in pretax accounting income or loss but are not a component of taxable income.
- One-time severance payments related to management changes.

When adjusting historical income or loss for financial reporting purposes to develop an estimate of future income or loss that is generally considered to be objective and verifiable, an entity may also need to consider items occurring after the balance sheet date but before the issuance of the financial statements. For example, a debt refinancing that is in process as of the balance sheet date and consummated before the date of issuance of the financial statements may constitute additional objective and verifiable evidence when an entity is projecting future taxable income, since the entity's normal projections (which would have been used in the absence of the existence of negative evidence in the form of cumulative losses) would routinely have included this as a forecasted item. An entity must use judgment and carefully consider the facts and circumstances in such situations.

Notwithstanding the above, the following items should generally not be considered nonrecurring:

- Unusual loss allowances (e.g., large loan loss or bad-debt loss provisions).
- Poor operating results caused by an economic downturn, government intervention, or changes in regulation.
- Operating losses attributable to a change in the focus or directives of a subsidiary or business unit.
- Onerous effects on historical operations attributable to prior management decisions when a new management team is engaged (excluding any direct employment cost reductions associated with the replacement of the old management team).

#### **4.42 Example Illustrating the Estimation of Future Taxable Income When Negative Evidence in the Form of Cumulative Losses Exists**

In determining whether a valuation allowance is needed, an entity must use judgment and consider the relative weight given to the negative and positive evidence that is available. Further, ASC 740-10-30-23 states that the “weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified.”

When negative evidence in the form of cumulative losses is present, an entity will often be required to estimate future income<sup>7</sup> in determining whether a valuation allowance is needed. Estimates of future income are inherently subjective (i.e., not objectively verifiable) and therefore generally are given less weight in the valuation allowance assessment. Thus, it is typically difficult to overcome negative evidence in the form of cumulative losses<sup>8</sup> solely on the basis of estimates of future income. However, to the extent that such estimates are based on objectively verifiable evidence (e.g., when an estimate is based on operating results from the entity’s recent history, no subjective assumptions have been made, and there is no contrary evidence suggesting that future taxable income would be less than historical results), entities may give more weight to the positive evidence from such estimates.

The following example illustrates how an entity might develop an estimate of future taxable income (excluding reversals of temporary differences and carryforwards) that is based on objectively verifiable historical results when negative evidence in the form of cumulative losses exists:

<sup>7</sup> For more information on developing estimates of future income, see [4.40](#) and [4.41](#).

<sup>8</sup> See [4.38](#) for guidance on how much weight an entity should give to cumulative losses in recent years when evaluating the need for a valuation allowance.

### Example 4-30

Assume the following:

- Entity X, a calendar-year entity, operates in a single tax jurisdiction in which the tax rate is 40 percent.
- Tax losses and tax credits can be carried forward for a period of four years after the year of origination. However, carryback of losses or credits to recover taxes paid in prior years is not permitted.
- As of December 31, 20X3, X has a tax loss carryforward of \$1,000 and a tax credit carryforward of \$600, both of which expire on December 31, 20X7. Thus, to realize its DTA of \$1,000  $[(\$1,000 \times 40\%) + \$600]$  at the end of 20X3, X must generate \$2,500  $(\$1,000 \div 40\%)$  of future taxable amounts through 20X7 — the tax loss and tax credit carryforward period.
- There are (1) no tax-planning strategies available to generate additional taxable income and (2) no taxable temporary differences as of December 31, 20X3.
- Entity X has determined that a three-year period is the appropriate period for which it will assess whether negative evidence in the form of cumulative losses in recent years exists.
- Historical pretax income (loss) is \$100, (\$500), and (\$1,000) for 20X3, 20X2, and 20X1, respectively.
- The following table shows historical income (loss) adjusted for nonrecurring items during the three-year period ending on December 31, 20X3, which X considers when estimating **future income that does not include reversals of temporary differences and carryforwards**:

	Adjusted Historical Results			Three-Year Total
	20X3	20X2	20X1	
Pretax income (loss) — as stated	\$ 100	\$ (500)	\$ (1,000)	\$ (1,400)
Nonrecurring items not indicative of future operations:				
Litigation settlement		1,600		1,600
Interest expense on debt that has been extinguished in 20X3	100	200	200	500
Fixed cost reduction as a result of a completed restructuring	<u>200</u>	<u>300</u>	<u>300</u>	<u>800</u>
Pretax income (loss) — adjusted	<u>\$ 400</u>	<u>\$ 1,600</u>	<u>\$ (500)</u>	<u>\$ 1,500</u>
Average annual adjusted income				<u>\$ 500</u>

**Example 4-30 (continued)**

Because X has positive cumulative earnings when adjusted for nonrecurring items, it might consider adjusted historical earnings as a starting point for estimating future taxable income (excluding reversals of temporary differences and carryforwards). However, the estimation of future income is not simply a "mechanical exercise" in which X would multiply its average adjusted annual income by the number of years remaining in the loss or credit carryforward period. Rather, X should consider adjusting its average historical results for certain positive and negative evidence that is present in the historical period to develop an estimate that is based on objectively verifiable evidence, including, but not limited to:

- Its recent trend in earnings (i.e., the fact that the most recent year's earnings are less than both those from the prior year and the three-year average amounts on an adjusted basis might suggest that the use of average annual income is inappropriate).
- The length and magnitude of pretax losses compared with the length and magnitude of pretax income (e.g., X has a significant cumulative loss and has only recently returned to a minor amount of profitability).
- The causes of its annual losses (e.g., X reported a pretax loss in 20X1 even on an adjusted basis) and cumulative losses.
- Anticipated changes in the business.

The weight given to the positive evidence in the form of X's estimate of future taxable income should be commensurate with the extent to which it is based on objectively verifiable historical results. Entity X would then determine whether a valuation allowance is needed on the basis of all available evidence, both positive and negative.

#### **4.43 Positive Evidence Considered in the Determination of Whether a Valuation Allowance Is Required**

ASC 740-10-30-22 gives the following examples of positive evidence that, when present, may overcome negative evidence in the assessment of whether a valuation allowance is needed to reduce a DTA to an amount more likely than not to be realized:

- a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
- b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
- c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual or infrequent item) is an aberration rather than a continuing condition.

**Example 4-31****Examples of (a) Above**

An entity enters into a noncancelable long-term contract that requires the customer to purchase minimum quantities and that therefore will generate sufficient future taxable income to enable use of all existing operating loss carryforwards.

During the current year, an entity merged with Company L, which operates in a different industry that is characterized by stable profit margins. The tax law does not restrict use of preacquisition NOL carryforwards. Company L's existing contracts will produce sufficient taxable income to enable use of the loss carryforwards.

#### **Example 4-31 (continued)**

##### **Example of (b) Above**

An entity has invested in land that has appreciated in value (i.e., the land is not integral to the entity's business operations). If the land were sold at its current market value, the sale would generate sufficient taxable income for the entity to use all tax loss carryforwards. The entity would sell the land and realize the gain if the operating loss carryforward would otherwise expire unused. After consideration of the tax-planning strategy, the fair value of the entity's remaining net assets exceeds its tax and financial reporting basis.

##### **Example of (c) Above**

An entity incurs operating losses that result in a carryforward for tax purposes. The losses resulted from the disposal of a subsidiary whose operations are not critical to the continuing entity, and the company's historical earnings, exclusive of the subsidiary losses, have been strong.

## **4.44 Additional Examples of Objectively Verifiable Positive Evidence**

ASC 740-10-30-22 lists several examples of positive evidence that, when present, may overcome negative evidence in the assessment of whether a valuation allowance is needed to reduce a DTA to an amount more likely than not to be realized. Examples 4-32 through 4-35<sup>9</sup> illustrate situations in which entities that have had negative evidence have concluded that no valuation allowance is required (or only a small valuation allowance is necessary) as a result of available positive evidence.

#### **Example 4-32**

An entity experienced operating losses from continuing operations for the current year and two preceding years and is expected to return to profitability in the next year. Positive evidence included (1) completed plant closings and cost restructuring that permanently reduced fixed costs without affecting revenues and that, if implemented earlier, would have resulted in profitability in prior periods and (2) a long history during which no tax loss carryforwards expired unused.

#### **Example 4-33**

An entity with a limited history incurred cumulative operating losses since inception; those losses were attributable to the company's highly leveraged capital structure, which included indebtedness with a relatively high interest rate. Positive evidence included a strict implementation of cost containment measures; an increasing revenue base; and a successful infusion of funds from the issuance of equity securities, which were used, in part, to reduce high-cost debt capital.

#### **Example 4-34**

An entity incurred cumulative losses in recent years; the losses were directly attributable to a business segment that met the criteria in ASC 205-20 for classification as a discontinued operation for financial reporting purposes. Positive evidence included a history of profitable operations outside the discontinued segment.

<sup>9</sup> Note that similar examples may not result in a similar conclusion. An entity must use judgment in determining whether a valuation allowance is necessary.

**Example 4-35**

An entity suffered significant losses in its residential real estate loan business. The entity has recently discontinued the issuance of new residential real estate loans, has disposed of all previously held residential real estate loans, and has no intention of purchasing real estate loans in the future. Positive evidence included a history of profitable operations in the entity's primary business, commercial real estate lending.

#### **4.45 Example Illustrating the Determination of a Valuation Allowance When It Is More Likely Than Not That a Portion of Existing Tax Benefits Will Not Be Realized**

Example 4-36 illustrates the determination of the amount of a valuation allowance when four sources of taxable income are considered in accordance with ASC 740-10-30-18 and available positive and negative evidence is present.

**Example 4-36**

Assume the following:

- Entity A is measuring its DTAs and DTLs as of year 20X2.
- The enacted tax rate is 34 percent for all years.
- The deferred tax balance at the beginning of 20X2 is \$0.
- Tax law permits a 3-year carryback and a 15-year carryforward of operating losses.

#### **Computation of the DTA and DTL**

Entity A has identified all temporary differences existing at the end of 20X2. The measurement of DTAs and DTLs is as follows:

	Deferred Tax Consequences			
	Benefit Before Valuation Allowance		Obligation	
	Temporary Difference	Asset at 34%	Temporary Difference	Liability at 34%
Depreciable assets			\$ 35	\$ 12
Deferred compensation	\$ 275	\$ 94		
Restructuring cost accruals	165	56		
Total	<u>\$ 440</u>	<u>\$ 150</u>	<u>\$ 35</u>	<u>\$ 12</u>

#### **Available Evidence**

In assessing whether a valuation allowance is required, A has identified the following evidence:

*Negative*

1. Entity A expects to incur a loss for financial reporting purposes in 20X3.
2. Entity A operates in a traditionally cyclical business.\*

*Positive*

1. Tax benefits have never expired unused.\*
2. Entity A's financial position at the close of 20X2 is strong.\*

---

\* Indicates a source of evidence that can be verified objectively.

**Example 4-36 (continued)****Assessment of Realization**

On the basis of the available evidence, management has concluded that it is more likely than not that some portion of the \$150 of tax benefits from \$440 (\$275 + \$165) of deductions will not be realized in future tax returns.

To determine the amount of valuation allowance required, management has considered four sources of taxable income:

	<b>Amount</b>
1. Estimated future taxable income (during the period in which the deductible temporary differences will reverse) exclusive of reversing taxable temporary differences	\$ 125
2. Taxable income during the carryback period	55
3. Taxable temporary differences related to depreciation	35
4. Tax-planning strategy net of implementation cost	<u>25</u>
	<u>\$ 240</u>

Upon considering the timing, amounts, and character of the four sources of taxable income available for use of existing tax benefits, management concludes that all such income can be used without limitation. For example, all of the taxable temporary differences will reverse during the same period as the deductible temporary items. Therefore, A expects to realize \$240 of \$440 of deductions and will record a valuation allowance of \$68 ( $\$200 \times 34\%$ ) on the \$200 of deductions that is not expected to be realized.

Entity A would record the following journal entry:

**Journal Entry**

DTA	150
DTL	12
Valuation allowance	68
Benefit for income taxes	70

To record DTAs and DTLs at the end of fiscal 20X2 and the tax benefit for the year ended.

The following is an analysis of the facts in the above example:

- Entity A may need to estimate the amount and timing of future income in determining whether it is more likely than not that existing tax benefits for deductible temporary differences and carryforwards will be realized in future tax returns.
- In determining the valuation allowance, A was required to consider (1) the amounts and timing of future deductions or carryforwards and (2) the four sources of taxable income that enable utilization: future taxable income exclusive of reversals of temporary differences, taxable income available for carryback refunds, taxable temporary differences, and tax-planning strategies. If A had been able to conclude that a valuation allowance was not required on the basis of one or more sources, A would not have needed to consider the remaining sources. In this case, A needed to consider all four sources, after which it determined that a valuation allowance was required.
- The assessment is based on all available evidence, both positive and negative.

## 4.46 Reduction of a Valuation Allowance When Negative Evidence Is No Longer Present

ASC 740-10-30-17 states, in part:

All available evidence, both positive and negative, shall be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed.

When an entity concludes that negative evidence (as discussed in ASC 740-10-30-21) exists and that realization of all or a portion of its DTA as of that date is not more likely than not, the entity would recognize a valuation allowance to reduce its DTA to an amount that is more likely than not to be realized. However, circumstances may change over time such that in a subsequent year, the negative evidence discussed in ASC 740-10-30-21 is no longer present.

If an entity has returned to profitability for a sustained period, the entity should assume, in the absence of evidence to the contrary, that favorable operations or conditions will continue in the future. Further, unless the facts and circumstances dictate otherwise, an entity should not limit the estimate of future income to (1) a specific period (on the basis of its policy for assessing negative evidence) or (2) general uncertainties. For example, it would be inappropriate to project taxable income for only three years and assume that taxable income beyond three years would be zero solely on the basis of the uncertainty in projecting taxable income beyond three years (such a projection would be particularly inappropriate if income is projected in connection with other financial statement assertions, such as those about impairment tests). Therefore, the valuation allowance provided in prior years for which negative evidence was present should be eliminated in the period in which the negative evidence ceases to exist.

In a manner consistent with ASC 740-270-25-4, if a change in the beginning-of-the-year valuation allowance is recognized as a result of a change in judgment about the realizability of the related DTA in **future years**, the effect should not be spread throughout the year but should be recognized in the interim period in which the change in judgment occurs. However, if the change in the valuation allowance is necessary as a result of a change in judgment about the realizability of the related DTA in the **current year** (e.g., as a consequence of earning income or incurring losses in the current year), the effect is spread over remaining interim periods in the year as an adjustment to the estimated AETR. See [9.09](#) for further discussion of changes in valuation allowances in interim periods.

### Example 4-37

Assume the following:

- Entity X, a calendar-year company, operates in a single tax jurisdiction with a 40 percent tax rate. Entity X is determining the amount of the valuation allowance to provide against its DTA at the end of 20X4.
- Tax losses can be carried forward for a period of four years after the loss. No carryback of losses to recover taxes paid in prior years is permitted.
- Tax credits can be carried forward for a period of four years after the year of origination. No carryback of credits to recover taxes paid in prior years is permitted.
- As of December 31, 20X4, X has a tax loss carryforward of \$1,000 and a tax credit carryforward of \$600 that expire on December 31, 20X7. Thus, to realize its DTA of \$1,000  $[(\$1,000 \times 40\%) + \$600]$  at the end of 20X4, X must generate \$2,500  $(\$1,000 \div 40\%)$  of future taxable amounts through 20X7 — the tax loss and tax credit carryforward period.
- Assume that (1) there are no tax-planning strategies available to generate additional taxable income; (2) there are no taxable temporary differences as of December 31, 20X4; and (3) there is no ability to recover taxes paid in prior years.

**Example 4-37 (continued)**

- Entity X has determined that a three-year period is the appropriate period for which it will determine whether negative evidence in the form of cumulative losses in recent years exists.
- Entity X will identify objectively verifiable positive evidence by analyzing income or loss for the three-year period ending December 31, 20X4. As part of this evaluation, X will adjust income or losses for the period to eliminate nonrecurring charges and credits that are not indicative of future operations. Using the adjusted amounts, X will estimate future taxable income through the tax loss and tax credit carryforward period prescribed by law on the basis of the average annual historical income for that three-year period.
- Historical pretax income (loss) is 1,200, (\$1,000), \$2,000, and (\$2,000) for 20X4, 20X3, 20X2, and 20X1, respectively.
- The following table shows historical income (loss) adjusted for nonrecurring items during the three-year period ending December 31, 20X4, compared with 20X3, which X uses to determine the adjusted annual historical income when estimating **future income that does not include reversals of temporary differences and carryforwards**:

	Adjusted Historical Results			
	20X4	20X3	20X2	Three Year Total
Pretax income (loss)	\$ 1,200	\$ (1,000)	\$ 2,000	\$ 2,200
Nonrecurring items not indicative of future operations: litigation award			(500)	(500)
Interest expense on debt that has been extinguished in 20X3	150	200	350	
Fixed-cost reduction related to restructuring	300	300	600	
Litigation settlement	_____	1,250	_____	1,250
Adjusted income	<u>\$ 1,200</u>	<u>\$ 700</u>	<u>\$ 2,000</u>	<u>\$ 3,900</u>
Average annual adjusted income ( $\$3,900 \div 3$ )				<u>\$ 1,300</u>

- Because the average adjusted income for the historical three-year period is \$1,300, X can assume, **in the absence of any negative evidence to the contrary**, that it will generate that level of income through the four-year loss and credit carryforward period prescribed under the tax law. Thus, an estimate of taxable income of \$5,200 ( $\$1,300 \times 4$  years) is considered objectively verifiable positive evidence under ASC 740-10-30-23.
- On the basis of this analysis, X determines that a cumulative loss for the three-year period ending December 31, 20X4, does not exist and that, therefore, negative evidence for determining whether a valuation allowance is necessary does not exist. In the absence of available evidence that negative evidence in the form of cumulative losses will continue in the future, X should eliminate the valuation allowance through a credit to income tax expense from continuing operations in 20X4.

## 4.47 Valuation Allowances: Time Frame for Assessing Future Taxable Income

ASC 740-10-30-18 states, in part:

Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law.

An entity should consider as many years as it can to reliably estimate future taxable income on the basis of its specific facts and circumstances. Although subjectivity may increase as the number of years increases, it would generally not be appropriate for an entity to limit the number of years it uses to estimate future taxable income solely on the basis of the subjective nature of estimates. Limiting the period over which future taxable income is estimated could inappropriately result in a smoothing of the income statement impact of changes in a valuation allowance. For example, it would not be appropriate to continue to add a year to the estimate of future taxable income as each year passes so that changes in a valuation allowance occur annually. Rather, in these situations, it may be reasonable to project additional years of taxable income on the basis of historical operating results. In some circumstances, however, there may be a limited number of years over which future taxable income can be estimated because significant changes are expected in the business (e.g., probable future withdrawal from the jurisdiction); in such circumstances, the time frame used would be limited and should not change until a change in facts and circumstances warrants an adjustment.

An entity will consider a number of factors in estimating future taxable income, including the following:

- The reasonableness of management's business plan and its impact on future taxable income, including management's history of carrying out its stated plans and its ability to carry out its plans (given contractual commitments, available financing, or debt covenants).
- The reasonableness of financial projections based on historical operating results.
- The consistency of assumptions in relation to prior periods and projections used in other financial statement estimates (e.g., goodwill impairment analysis).
- Consistency with relevant industry data, including short- and long-term trends in the industry.
- The reasonableness of financial projections when current economic conditions are considered.

Also see [4.21](#) for further considerations related to future events.

## Tax Rates Applicable to Items Not Included in Income From Continuing Operations

### ASC 740-10

**30-26** The reported tax effect of items not included in income from continuing operations (for example, discontinued operations, cumulative effects of changes in accounting principles, and items charged or credited directly to shareholders' equity) that arose during the current fiscal year and before the date of enactment of tax legislation shall be measured based on the enacted rate at the time the transaction was recognized for financial reporting purposes. [EITF 93-13, paragraph Discussion]

## Allocation of Consolidated Tax Expense to Separate Financial Statements of Members

### ASC 740-10

**30-27** The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Subtopic does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Subtopic. A method that allocates current and deferred taxes to members of the group by applying this Topic to each member as if it were a separate taxpayer meets those criteria. In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amount. That may also be the result when there are intra-entity transactions between members of the group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

**30-28** Examples of methods that are not consistent with the broad principles established by this Subtopic include the following:

- a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences
- b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Subtopic (for example, the deferred method that was used before 1989)
- c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense. [FAS 109, paragraph 40]

## 4.48 Subsidiary Financial Statements [Deleted]

See [6.26](#).

## 4.49 Acceptable Methods of Allocating Tax to Separate Financial Statements

ASC 740-10-30-27 requires a group of entities that files a consolidated tax return to allocate the "consolidated amount of current and deferred tax expense . . . among the members of the group when those members issue separate financial statements." ASC 740-10-30-27 does not prescribe a particular method for allocating the expense; rather, it only requires the use of a systematic and rational method that is consistent with the broad principles established by ASC 740.

Several income tax allocation methods may meet the requirements of ASC 740-10-30-27, including the commonly applied parent-company-down and separate-return approaches. At times, the separate-return approach may also be modified for a particular item or component (e.g., realization or apportionment). Question 3 of SAB Topic 1.B.1 (SAB 55) (codified in ASC 225-10-S99-3) states that for public entities, the separate-return approach is preferable to other approaches. See [4.50](#) for additional information. Choosing an income tax allocation method is an accounting policy decision, and the method should be consistently applied.

## **Separate-Return Approach**

Under the separate-return method of allocation, a group member issuing separate financial statements determines current and deferred tax expense or benefit for the period by applying the requirements of ASC 740 as if the group member were required to file a separate tax return. This method can lead to inconsistencies between conclusions reached related to the realizability of DTAs (and the related tax expense or benefit) reflected in (1) the consolidated financial statements and (2) the separate financial statements. For example, the separate financial statements may include a valuation allowance because of insufficient taxable income on a hypothetical separate-return basis, while in the consolidated financial statements (which include other profitable entities), a valuation allowance may not be required. ASC 740 acknowledges that sometimes the sum of the amounts allocated to the individual group members under the separate-return method may not equal the total current and deferred income tax expense or benefit of the consolidated group.

### **Example 4-38**

Parent P has two operating subsidiaries, S1 and S2, both of which are members of the consolidated group. The table below illustrates each subsidiary's taxable income and statutory tax rate for the period. Assume that on a separate-return basis, S1 requires a full valuation allowance against its DTAs and therefore cannot recognize a benefit for its loss of \$100. However, on a consolidated basis, the group has sufficient taxable income to realize a benefit from S1's loss. Income tax expense under the separate-return method would be allocated as follows:

<b>Description</b>	<b>Separate-Return Approach</b>			<b>Sum of Separate-Return Tax Expense</b>	<b>Consolidated</b>	
	<b>P (Stand-Alone)</b>	<b>S1</b>	<b>S2</b>		<b>P</b>	<b>Difference</b>
Taxable income	\$ 300	\$ (100)	\$ 400		\$ 600	
Tax rate	40%	40%	40%		40%	
Current tax expense (benefit)	120	0	160	\$ 280	240	\$ (40)
Deferred tax expense (benefit)	0	0	0	0	0	0
Total tax expense (benefit)	<u>\$ 120</u>	<u>\$ 0</u>	<u>\$ 160</u>	<u>\$ 280</u>	<u>\$ 240</u>	<u>\$ (40)</u>

Note that in this example, as a result of the different conclusions related to realizability of the benefit for S1's loss, the \$280 of tax expense representing the "sum of the parts" of income tax expense allocated in the separate financial statements does not equal the \$240 of tax expense reflected in P's consolidated financial statements.

## **Modifications to the Separate-Return Approach**

Depending on the facts and circumstances, certain modifications to the separate-return approach may also be considered systematic, rational, and consistent with the broad principles of ASC 740. For example, entities often modify the separate-return approach to eliminate the effects of inconsistent conclusions related to realizability.

**Example 4-39**

Assume the same facts as in Example 4-38. Under this modified approach, because the consolidated group has sufficient taxable income in the current year to realize the benefit for S1's loss, S1 would recognize a tax benefit of \$40 as follows:

Description	Separate-Return Approach — Modified				Consolidated	
	P	S1	S2	Sum of Separate- Return Tax Expense	P	Difference
Taxable income	\$ 300	\$ (100)	\$ 400		\$ 600	
Tax rate	40%	40%	40%		40%	
Current tax expense (benefit)*	120	(40)	160	\$ 240	240	\$ 0
Total tax expense (benefit)	\$ 120	\$ (40)	\$ 160	\$ 240	\$ 240	\$ 0

- \* If the consolidated group did not have sufficient taxable income in the current year to realize the benefit for S1's loss but concluded that it would have sufficient taxable income in future years, S1 would have recorded a deferred tax benefit (rather than a current tax benefit) of \$40 in the current year.

Under this approach, it may be necessary to limit the amount of the benefit recorded by S1 to the amount that is actually realizable on a consolidated basis. For example, if state apportionment factors reduced the amount of state tax benefit the consolidated group could realize from S1's loss (i.e., on a stand-alone basis, S1 would have recorded — ignoring valuation allowance considerations — more of a benefit than the consolidated group could realize), the state tax benefit recorded by S1, even under this modified approach, may need to be limited.

Other modifications to the separate-return method might also be appropriate. For example, it may be considered systematic, rational, and consistent with the broad principles in ASC 740 to use consolidated state apportionment factors in the allocation of income tax expense in the separate financial statements of a member rather than determine a separate apportionment factor as would be required under a pure separate-return method. However, this modification may not be appropriate when the consolidated apportionment factor would not be considered rational because of significant differences between the separate member's business and the consolidated group (e.g., a significantly different geographic or sales footprint). To determine whether a particular modification is systematic, rational, and consistent with the broad principles of ASC 740-10, an entity must evaluate the facts and circumstances and apply judgment. Consultation with the entity's accounting advisers is suggested when modifications are being contemplated other than for purposes related to realizability.

If modifications to the separate-return method are made, public entities are generally required to provide a pro forma income statement for the most recent year and interim period reflecting income tax expense/benefit calculated on the separate-return basis.

### *Parent-Company-Down Approach*

An entity often applies the parent-company-down approach by making a pro rata allocation of total current and deferred income tax expense, as determined at the consolidated level, to the group members. For example, the entity might determine each member's pro rata percentage by:

- Comparing each group member's pretax income as a percentage of the total consolidated pretax income.
- Comparing each group member's pretax income adjusted for permanent items as a percentage of the total consolidated pretax income adjusted for permanent items.

#### **Example 4-39A**

This example illustrates how the parent-company-down approach would be applied when consolidated tax expense is allocated to group members on the basis of each group member's relative proportion of (1) consolidated pretax income or loss or (2) consolidated pretax income or loss adjusted for permanent items.

Parent P, a holding company, has two consolidated subsidiaries, S1 and S2. Parent P, S1, and S2 all operate in a tax jurisdiction with a 40 percent tax rate. On a consolidated basis, P has current and deferred tax expense of \$220 for 20X1 that is based on \$600 of pretax book income. The stand-alone results for P, S1, and S2 for 20X1 are as follows:

	<b>Parent</b>		<b>S1</b>		<b>S2</b>			<b>Total</b>
	<b>Amount</b>	<b>Relative Percentage</b>	<b>Amount</b>	<b>Relative Percentage</b>	<b>Amount</b>	<b>Relative Percentage</b>		
Pretax income (loss)	\$ 300	50%	\$ (100)	(17)%	\$ 400	67%	\$ 600	
Permanent items	\$ 100		\$ 50		\$ (200)		\$ (50)	
Pretax income (loss) adjusted for permanent items	\$ 400	73%	\$ (50)	(9)%	\$ 200	36%	\$ 550	
Tax rate	40%		40%		40%		40%	
Consolidated tax								\$ 220

On the basis of the assumptions above, the group members would record the following tax expense in accordance with the allocation method chosen:

	<b>Parent</b>		<b>S1</b>		<b>S2</b>			<b>Total</b>
	<b>Tax Allocated</b>	<b>Relative Percentage</b>	<b>Tax Allocated</b>	<b>Relative Percentage</b>	<b>Tax Allocated</b>	<b>Relative Percentage</b>		
Income tax allocated based on pretax income (loss)	\$ 110	50%	\$ (37)	(17)%	\$ 147	67%	\$ 220	
Income tax allocated based on pretax income (loss) adjusted for permanent items	\$ 160	73%	\$ (20)	(9)%	\$ 80	36%	\$ 220	

#### Example 4-39A (continued)

As depicted above, in the absence of intra-entity profits, total current and deferred tax expense or benefit for the period, as determined at the consolidated level, should equal the sum of the current and deferred income tax expense or benefit allocated to all members of the group for the period (\$220 in this example). When income taxes paid on intra-entity profits have been deferred in the consolidated financial statements under ASC 810-10-45-8 (as would be required, for example, if S2 sold inventory to Parent at a profit during the period, thus incurring income tax expense), ASC 810-10-45-8 would require a deferral of S2's tax expense attributable to the intra-entity profits in the consolidated financial statements. However, that tax expense would not be deferred in S2's separate financial statements. Accordingly, in those situations, total current and deferred tax expense or benefit for the period, as determined at the consolidated parent-company level, would not equal the sum of the current and deferred income tax expense or benefit allocated to all members of the group for the period.

## 4.50 Preferable Allocation Method for Public Entities

For public entities, the separate-return method is the preferable method for allocating taxes among members of a group that file a consolidated tax return because using a different method would require a separate set of financial statements to be maintained. ASC 225-10-S99-3 (formerly Question 3 of SAB Topic 1.B.1) states, in part:

Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. . . . When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.

## 4.51 Change in Application of Tax Allocation Methods

An entity should report the change from one acceptable allocation method to another as a change in accounting principle under ASC 250. However, in accordance with ASC 250-10-45-12, a change in accounting principle is only permitted if the entity "justifies the use of an allowable alternative . . . on the basis that it is preferable."

Under ASC 250-10-45-5, an entity should "report the change . . . through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so." A change in accounting principle would affect only the separate financial statements of the member(s) of the consolidated group. No change would be reflected in the consolidated financial statements of the parent company. SEC registrants that are reporting a change in accounting principle must provide a preferability letter from their independent accountants.

## 4.52 Valuation Allowance in the Separate Financial Statements of a Consolidated Group Member

Sometimes an individual member of a consolidated group will record an income tax benefit for the period in its separate financial statements. In this instance, an entity must determine whether a valuation allowance should be recorded in the separate financial statements of the group member. The DTA is subject to a valuation allowance if the available evidence does not support a conclusion that realization is more likely than not. The following is a discussion of whether a valuation allowance would be needed for an entity that uses the (1) separate-return approach or (2) the parent-company-down approach:

## **Separate-Return Approach**

If the separate-return approach is used to allocate taxes among members of a group that file a consolidated tax return, in the separate financial statements of the group member, the DTA should be realized on the basis of available evidence related to **only** that group member. Thus, if that group member has negative evidence (e.g., cumulative losses in recent years), it would be difficult to support a conclusion that a valuation allowance is not necessary, irrespective of the available evidence (e.g., a history of profitable operations) at the consolidated group level.

## **Parent-Company-Down Approach**

If the parent-company-down approach is used to allocate taxes among members of a group that file a consolidated tax return, the determination of the need for a valuation allowance in the separate financial statements of a group member depends on whether a valuation allowance was recognized in the consolidated financial statements. In other words, if a valuation allowance is required at the parent-company level, a valuation allowance is also required in the financial statements of the stand-alone group member. If no valuation allowance is necessary at the parent-company level, no valuation allowance should be provided in the separate financial statements of the subsidiary.

## **4.52A Accounting for Income Taxes in the Balance Sheet of Separate Financial Statements: DTAs Related to Tax Attributes**

Under ASC 740-10-30-27, an entity may be required to allocate income taxes to the separate financial statements of a member (corporate subsidiary) or nonmember (unincorporated division, branch or disregarded entity) that comprises part of the entity's consolidated income tax return filing group. See [4.49](#) and [4.57](#) for further information about the allocation of income taxes to separate financial statements of members and nonmembers, respectively. Although the separate financial statements may not be those of a separate legal entity, they are nevertheless commonly referred to as the financial statements of a "separate reporting entity."

ASC 740-10-30-27 requires an allocation of current and deferred income tax expense but does not specifically address how current and deferred taxes should be reflected in the balance sheet of the separate reporting entity. In practice, separate financial statements generally include DTAs and DTLs attributable to the separate reporting entity.

A separate reporting entity may have generated significant NOLs, tax credits, or both (i.e., tax attributes) as a result of its stand-alone operations. Had the separate reporting entity filed its own tax return, it may not have been able to use the tax attributes in the year in which they were generated, resulting in NOL and tax credit carryforwards. In these cases, the separate reporting entity would recognize DTAs associated with the tax attribute carryforwards and evaluate them for realizability.

However, these tax attributes may have been used in the consolidated income tax return to offset taxable income from other operations included in the consolidated filing group. Therefore, the tax attributes generated by the separate reporting entity are no longer available to reduce future taxable income. In these situations, the tax attribute carryforwards represent "hypothetical DTAs" in the separate financial statements because they are not actually available to offset future taxable income of the separate reporting entity; however, if the separate reporting entity had filed its own tax return, the tax attributes would be available.

Generally, two approaches exist for accounting for hypothetical DTAs related to tax attribute carryforwards, but an entity should choose and apply one consistently.

Under the first approach, although the deferred tax benefit associated with the tax attributes would still need to be recognized in the income statement of the separate reporting entity (as long as no valuation allowance was needed in the separate financial statements), the balance sheet of the separate financial statements would reflect the “tax return reality” that, since the tax attribute does not legally exist, it cannot be used in future periods to offset taxable income (i.e., it has been used by or distributed to the parent and, accordingly, should be closed to equity).

In subsequent years, the separate reporting entity must continue assessing its ability to realize the benefit of the hypothetical DTA based on positive and negative evidence associated with its stand-alone operations (even though the separate reporting entity does not continue to record the hypothetical DTA). If a valuation allowance was not initially needed on the hypothetical DTA, but was later determined to be necessary in light of new information (or vice versa), the separate reporting entity would be required to record tax expense (or benefit) in the income statement with an offsetting entry in APIC.

In addition, the separate reporting entity would be required to disclose the following:

- The reasons why the hypothetical DTA was not recorded.
- The possible effect of the hypothetical DTA on future tax provisions related to potential changes in the realizability of the unrecorded hypothetical DTA.

Under the second approach, we believe that it would be acceptable to present a hypothetical DTA in the balance sheet of the separate financial statements. This view is premised on the fact that under the separate-return method, income taxes are allocated to the separate reporting entity in accordance with ASC 740 as if the separate reporting entity had filed a separate tax return. If it had, the hypothetical DTA therefore could not have been used by any other entity and thus would be presumed to continue to exist. The hypothetical DTA should be assessed for realizability on the basis of positive and negative evidence related to the operations of only the separate reporting entity, and the separate reporting entity should disclose that the DTA does not legally exist and would be derecognized if the entity were to leave the consolidated tax return filing group.<sup>10</sup>

#### **Example 4-39B**

Parent Co, an SEC registrant, is a U.S. software company with a March 31 year-end. Parent Co has a software services division (“the Division”) for which it is preparing separate financial statements that will be included in a registration statement. The operations of the Division are included in the U.S. federal consolidated income tax return of Parent Co. Parent Co will apply the separate-return method to allocate income taxes to the separate financial statements of the Division.

The Division has been in operation for one year and was profitable on a stand-alone pretax basis, but it generated a tax loss due to accelerated depreciation. The loss was used by Parent Co to reduce consolidated taxable income in the year in which it was generated.

<sup>10</sup> This approach would not have been appropriate if the separate-return method had been modified for realizability and the separate reporting entity would *not* have otherwise had the ability to realize the benefit of the tax attribute DTA on a separate-return basis. In that situation, once the parent has used the tax attribute, realization of the tax attribute in the separate financial statements has already occurred in a manner consistent with the initial conclusion about the recognition of the attribute in the separate financial statements, and it cannot be realized again.

**Example 4-39B (continued)**

In applying the separate-return method, management has determined that the tax loss of the Division would have resulted in an NOL carryforward of \$5 million. Therefore, the NOL carryforward represents a hypothetical DTA because it exists under the separate-return method, but it does not legally exist since it has already been used by Parent Co in its consolidated income tax return. Management also evaluated the positive and negative evidence associated with the Division's operations and concluded that it is more likely than not that the Division will have sufficient future taxable income (on a stand-alone basis) to realize the benefit of the hypothetical DTA. Because the separate-return method is used for allocation of income taxes to the Division, Parent Co may choose whether to record the hypothetical DTA in the Division's separate balance sheet. If Parent Co elects to record the hypothetical DTA, it would record the following entry in the Division's separate financial statements:

NOL DTA	2 million
Deferred tax benefit	2 million
[5 million NOL carryforward × 40% tax rate]	

If it elects not to record the hypothetical DTA, it would record the following entries:

NOL DTA	2 million
Deferred tax benefit	2 million
[5 million NOL carryforward × 40% tax rate]	
Retained earnings	2 million

In either case, management is still required to evaluate in subsequent years whether the benefit associated with the hypothetical DTA continues to be realizable. If, in a future year, management determines that the hypothetical DTA is no longer realizable, it must record a deferred tax expense and a credit to a valuation allowance (if the hypothetical DTA was recorded) or to equity (if the hypothetical DTA was not recorded).

## 4.53 Tax Consequences of Tax-Sharing Agreements That Are Not Acceptable for Financial Reporting Purposes

When the legal tax-sharing agreement that governs the distribution of cash payments and receipts between a consolidated parent entity and its group members is not in line with the "systematic, rational, and consistent" requirements in ASC 740-10-30-27 for allocating taxes among members of a group that file a consolidated return, the tax-sharing agreement need not be amended to conform to those requirements. Instead, for financial reporting purposes, an entity should apply an acceptable method of allocating income tax expense or benefit to a group member that prepares separate financial statements. Any difference between the cash flows that are to be paid or received under the legal tax-sharing agreement and the allocation method used for financial reporting purposes is reported in the separate financial statements of the group members as either a charge to retained earnings or a credit to paid-in capital.

**Example 4-40**

Assume that a parent company, Entity P, a holding company operating in a tax jurisdiction with a 40 percent tax rate, has two operating subsidiaries, S1 and S2, and that the legal tax-sharing agreement states that S1 and S2 will not pay income taxes or receive tax refunds when the consolidated group has no tax liability (expense) or refund (benefit) for the year. Further assume that in 20X1, P has no taxable income or loss, S1 has generated taxable income of \$1,000, and S2 has incurred a taxable loss of \$1,000. Because the tax-sharing agreement does not conform with the "systematic, rational, and consistent" requirements of ASC 740-10-30-27, assume that, for financial reporting purposes, the group has chosen to allocate income taxes to the separate financial statements of S1 and S2 on the basis of the separate-return approach and that the \$1,000 loss incurred by S2 in 20X1 does not constitute negative evidence (e.g., cumulative losses in recent years) as described in ASC 740-10-30-21. Entity P records the following journal entries for the tax consequences in the separate financial statements of S1 and S2 for 20X1:

**Journal Entry: Consolidated Group Member S1**

Income tax expense from continuing operations	400
Income taxes payable	400
Income taxes payable	400
Paid-in capital	400

To reflect forgiveness of the income taxes payable.

**Journal Entry: Consolidated Group Member S2**

DTA	400
Income tax benefit	400
Retained earnings*	400
DTA	400

To record "dividend" to parent.

---

\* See the discussion of alternative approaches for accounting for hypothetical DTAs in separate financial statements prepared by using the separate return method in [4.52A](#). This example assumes that S2 has elected not to record the hypothetical DTA. Under this approach, if S2 did not have retained earnings, the amount could also be recorded as a return of capital.

The tax-sharing agreement or intercorporate tax allocation agreement between the parent and subsidiaries should be documented. The documentation should indicate whether taxes are calculated on a consolidated or "separate return" basis and other relevant matters (e.g., the use of any NOLs or available tax credits, the impact of AMT). Such documentation is appropriate because (1) it provides information about the risks and rewards of the parties to a legally enforceable contract, (2) any tax-sharing agreement can be difficult to apply because of the complexities of the tax law, and (3) it provides audit evidence that supports management's assertions, which serve as the basis for financial statement preparation.

## 4.54 Reporting Acquisition Debt in Separate Financial Statements

Assume that P is the parent of a wholly owned subsidiary, S, which issues separate financial statements, and that P files a consolidated tax return that includes the results of S. Further assume that P incurred term debt on the acquisition of S for which interest expense is being deducted for tax purposes. The legal tax-sharing agreement between P and S specifies that a tax benefit will be allocated to S for the tax consequences of deductible interest expense on the acquisition debt to the extent that the deductions are taken in the consolidated tax return. Although P does not allocate any of the interest expense to S for financial reporting purposes, S does pay dividends to P, in part to provide cash flows for P's debt service obligation.

Further assume that the acquisition debt was “pushed down” to S before the adoption of ASU 2014-17. This push-down does not create a temporary difference in S’s separate financial statements. The FASB staff has informally indicated that, in such circumstances, P should allocate to S’s retained earnings the credit representing the tax benefit of the interest expense determined in accordance with the legal tax-sharing agreement. Income tax expense from continuing operations should not be credited in this situation. This view is based on the belief that allocating the tax consequences attributable to interest expense, the pretax amounts for which neither principal nor interest have been recognized in S’s financial statements, is inconsistent with the broad principles established by ASC 740. As indicated above, the payments made from S to P to service the debt are treated as dividends. Therefore, although there is a basis difference related to the acquisition debt, there is no future tax consequence related to the reversal of that basis difference and, therefore, no temporary difference.

## **4.55 Tax Benefit of the Deductible Interest in the Separate Financial Statements**

In [4.54](#), a situation is described in which acquisition debt is pushed down to the subsidiary. In such circumstances, a question arises regarding how the tax benefit for the deductible interest expense related to the acquisition debt allocated from P to S should be reflected in S’s separate financial statements. If S is not paid the amount of this benefit under its legal tax-sharing agreement with P, the offsetting entry is to equity.

## **4.56 Application of the Separate Return Method in Combined or Carve-Out Financial Statements of Multiple Legal Entities, Multiple Divisions, or Both**

In certain instances, an entity may form a new entity (i.e., a “newco”) to effect a spin-off or sell a segment, product line, or division. The entity may be required to prepare historical separate financial statements for the newco that will appear in an SEC filing. In these situations, the operations that will constitute the newco may have been held in multiple legal entities (and be presented on a combined basis<sup>11</sup>), might have operated as multiple divisions (but not all) of one or more legal entities (and be presented as a single set of carve-out financial statements), or both. Regardless of the legal structure, the newco’s operations may have historically been included in a single consolidated income tax return of the parent company.

In accordance with SAB Topic 1.B.1, current and deferred income taxes must be allocated to the newco’s carve-out financial statements.<sup>12</sup> While the SAB clearly dictates a preference for the separate return method and, in so doing, emphasizes the importance of presenting income tax expense that excludes the registrant’s parent, the SAB does not provide detailed guidance on how to actually apply the separate return method in such situations.

ASC 740-10-30-27 describes the separate return method as a method in which an entity allocates current and deferred tax expense to “members” of the group by applying ASC 740 to “each member as if it were a separate taxpayer.” In carve-out financial statements involving only divisions (i.e., no separate legal entities), it is generally appropriate to use a single separate return method to allocate taxes to the group of divisions within a single legal entity.

However, when multiple members (i.e., subsidiaries) — operating in the same jurisdiction and previously included in the parent’s consolidated tax return — are included in the carve-out financial statements on a combined basis, questions have arisen about whether (1) a “member” refers to a single legal entity, in

<sup>11</sup> Because the newco did not exist in the historical period, no common parent exists in the carve-out financial statements and the financial statements therefore would be prepared on a combined basis rather than on a consolidated basis.

<sup>12</sup> See [4.49](#) for guidance on acceptable methods of allocating income taxes to members of a group.

which case an income tax provision would be allocated to each distinct legal entity and then combined, or (2) the group of entities and divisions that constitutes the newco can be viewed *collectively* as a single member, in which case a single tax provision would be allocated to the group as a whole. In this situation, we believe that there are two acceptable approaches for applying the separate return method to determine the amount of income taxes to be allocated to the combined financial statements.

The first approach is to calculate the tax provision as if the newco had been in existence in all periods presented and had historically filed a separate consolidated tax return for all members in the carve-out financial statements that are taxable in the jurisdiction. This approach is supported by the guidance in ASC 810-10-45-10, which states:

If combined financial statements are prepared for a group of related entities, such as a group of commonly controlled entities, intra-entity transactions and profits or losses shall be eliminated, and noncontrolling interests, foreign operations, different fiscal periods, or **income taxes shall be treated in the same manner as in consolidated financial statements**. [Emphasis added]

Accordingly, if all of the legal entities were previously part of a consolidated income tax return filing, presentation of a combined/consolidated provision in accordance with the same principles would appear to be an acceptable interpretation of this guidance (i.e., treat those entities as one consolidated tax return group in the determination of the taxes to include in the combined financial statements).

Alternatively, because most tax jurisdictions require that there be a common parent for a consolidated tax return to be filed and no common parent is actually included in the combined set of financial statements, we believe that a second acceptable approach is to calculate the tax provision by applying the separate return method to each separate legal entity or group of divisions (formerly within an individual separate legal entity)<sup>13</sup> that constitute the newco. In other words, application of the tax law to the individual members appearing in the separate financial statements would result in a separate tax provision calculation for each member that lacks a common parent in the separate financial statements. These individual tax provisions would then be combined to determine the total amount of taxes to be allocated to the newco. This approach is also consistent with the guidance in ASC 740-10-30-5, which states, in part:

Deferred taxes shall be determined **separately for each tax-paying component** (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. [Emphasis added]

In selecting which approach to apply, an entity should consider the prospective tax elections to be made by the newco after the spin or sale transaction occurs (i.e., whether the newco will file (or be a part of) a consolidated tax return prospectively), since a historical presentation that conforms to that prospective treatment may be more meaningful to financial statement users.

We believe that both approaches would also be acceptable for a combination of disregarded entities (e.g., single member LLCs), since they have separate legal existence that would allow for application of a separate return approach to each individual entity but are treated as divisions for tax purposes, allowing a single return approach. We recommend that entities consult their professional accounting advisers in these circumstances. See [4.59](#) for additional discussion of single member LLCs.

## **4.57 Allocating Income Taxes to Nonmembers in Carve-Out Financial Statements**

ASC 740-10-30-27 states that the “consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements.” However, it does not indicate the treatment for

<sup>13</sup> A separate allocation to individual divisions that operated within a single legal entity is not required.

unincorporated divisions, branches, and disregarded entities, including single member LLCs, that are not considered a “member” of a group that files a consolidated tax return (a “nonmember”).

Income tax expense or benefit allocations **may** be required in the carve-out financial statements of a nonmember (or group of nonmembers), depending on whether these financial statements will be included in a filing with the SEC. If the carve-out financial statements of a nonmember (or group of nonmembers) will be included in a filing with the SEC, an allocation of taxes is generally required under SAB Topic 1.B, irrespective of whether the successor entity is taxable. In this instance, entities often use the separate-return method, because if another method is selected, the SEC will require a pro forma income statement reflecting a tax provision in which the separate-return method is used (see ASC 225-10-S99-3 for further details). In limited instances, the SEC has allowed the omission of a tax provision. For example, if the carve-out financial statements consist of parts of a number of different legal entities, a registrant may be able to demonstrate that it would not be able to determine the historical tax provision. In such circumstances, entities are encouraged to consult with their accounting advisers and preclear the proposed accounting treatment with the SEC staff.

If the carve-out financial statements of a nonmember (or group of nonmembers) will not be included in a filing with the SEC, the entity is generally not required to allocate income taxes to the nonmember (or group of nonmembers), although doing so is generally preferable because it yields more useful information. See [4.59](#) for additional considerations related to single member LLC tax allocations. If income taxes are allocated, the methods for allocating those taxes are the same as the methods used to allocate taxes to subsidiaries (e.g., the separate-return method or the parent-company-down approach). See [4.49](#) for more information about acceptable allocation methods.

#### **4.57A Accounting for Taxable Temporary Differences Resulting From Investments in Foreign Subsidiaries and Foreign Corporate Joint Ventures in Separate Financial Statements Prepared by Using the Separate Return Method**

In accordance with ASC 740-10-30-27, an entity may be required to allocate income taxes to the separate financial statements of a member (corporate subsidiary) or nonmember (unincorporated division, branch, or disregarded entity) of a group that files a consolidated income tax return. Such separate financial statements may be required in connection with an initial public offering, a spin-off, or a sale, or to comply with debt covenants. See [4.49](#) and [4.57](#) for further information about the allocation of income taxes to members and nonmembers, respectively.

While the guidance in ASC 740-10-30-27 requires an allocation of current and deferred income tax expense to the separate financial statements, it does not specifically address how current and deferred taxes should be reflected in the balance sheet of the separate financial statements. However, separate financial statements generally include DTAs and DTLs related to the assets and liabilities presented in the separate financial statements of the member or nonmember.

ASC 740-30-25-18 indicates that a DTL should not be recognized for an “excess of the amount for financial reporting over the tax basis [i.e., ‘outside basis difference’] of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration” unless **“it becomes apparent that those temporary difference will reverse in the foreseeable future”** (emphasis added). There is, however, also a rebuttable presumption under ASC 740-30-25-3 that all undistributed earnings will be transferred by a subsidiary to its parent. This rebuttable presumption may be overcome if the criteria of ASC 740-30-25-17 are met (i.e., sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely).

The determination of whether a DTL should be recognized (e.g., whether the rebuttable presumption is or is not overcome) 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 is first made at the parent's level on a consolidated basis and takes into account all of the consolidated entity's relevant facts and circumstances.

When the investment in the foreign subsidiary or corporate joint venture is owned by the separate reporting entity and is included in the separate financial statements of that entity, the separate financial statements prepared by using the separate return method<sup>14</sup> must also include an assertion with respect to whether the temporary difference will reverse in the foreseeable future. Questions often arise about whether the assertion in the separate financial statements prepared by using the separate return method should be the same as the assertion made in the consolidated financial statements related to that same investment or whether, instead, the separate reporting entity must perform an independent analysis that takes into account only the separate reporting entity's operations, facts, and circumstances.

Preparing an independent analysis that takes into account only the facts and circumstances of the separate reporting entity is consistent with the separate return method. However, we believe that because the separate reporting entity is controlled by its parent, if the separate reporting entity's facts and circumstances are considered, consideration of the consolidated filing group's plans for reinvestment, cash needs, and so forth is inherently required in the determination of whether the outside basis taxable temporary difference will reverse in the foreseeable future. Therefore, in most cases, if a separate analysis is performed, the separate reporting entity would reach the same conclusion in both the current and historical periods presented in the separate financial statements as that reached by the parent regarding the corresponding periods in the consolidated financial statements. It would thus generally be unnecessary for the separate reporting entity to perform a separate analysis.

For example, assume that U.S. Parent (USP) owns 100 percent of U.S. Subsidiary (USS, a member of USP's consolidated U.S. tax return) and USS is preparing separate financial statements by using the separate return method. Assume further that USS owns an investment in Foreign Corporation A and Foreign Corporation A has undistributed earnings. USP has significant cash needs on a consolidated basis and therefore cannot assert that the undistributed earnings of A will be indefinitely reinvested, so it records a DTL in its consolidated financial statements. Even if USS could demonstrate that, on its own, it did not (and does not) have significant cash needs in the United States, it would record a DTL in its separate financial statements because a decision by USP to repatriate A's undistributed earnings to meet USP's consolidated cash needs would result in Subsidiary USS's incurring U.S. income tax (i.e., it would be difficult to support a conclusion that the outside basis taxable temporary difference will not reverse in the foreseeable future given USP's cash needs and its control over USS's operations).

Alternatively, assume that USP has demonstrated (and continues to demonstrate) on a consolidated basis that it does not have significant cash needs and therefore has asserted that the undistributed earnings of A will be indefinitely reinvested. USS, on its own, did not and does not generate sufficient cash flows to meet its debt obligations without contributions from USP. USP has historically provided and has the ability and intent to continue providing the necessary contributions for the foreseeable future. Because USP had (and continues to have) the ability and intent to provide funding to USS, USS would not have to record a DTL related to its investment in A in its separate financial statements. However, USS must carefully consider the facts and circumstances and use significant professional

<sup>14</sup> It may be appropriate in some circumstances to modify the separate return method (see [4.49](#)). We would not generally expect the types of modifications to the separate return method that are described in [4.49](#) to affect the applicability of the guidance in this section to separate financial statements.

judgment to determine the appropriate period, if any, in which to record the DTL in the separate financial statements.

If management believes that the facts and circumstances suggest that it is appropriate for the separate financial statements and the consolidated financial statements to contain different conclusions, consultation with the company's accounting advisers is strongly encouraged.

Regardless of the conclusions reached, disclosure would be required in the separate financial statements of the company's accounting for outside basis deferred taxes on investments in foreign corporations and joint ventures.

#### **4.57B Accounting for Income Taxes in the Balance Sheet of Separate Financial Statements: Unrecognized Tax Benefits and Current Taxes Payable or Receivable**

In accordance with ASC 740-10-30-27, an entity may be required to allocate income taxes to the separate financial statements of a member (corporate subsidiary) or nonmember (unincorporated division, branch, or disregarded entity) of a group that files a consolidated income tax return. Such separate financial statements may be required in connection with an initial public offering, a spin-off, or a sale, or to comply with debt covenants. See [4.49](#) and [4.57](#) for further information about the allocation of income taxes to members and nonmembers, respectively. While the separate financial statements may not be those of a separate legal entity, they are nevertheless commonly referred to as the financial statements of a "separate reporting entity."

When income tax expense is allocated to the separate reporting entity under the separate return method and (1) such allocation results in an income tax payable or receivable or (2) the allocation includes an expense related to an UTB, questions can arise about whether and, if so, how such a payable or receivable and the UTB liability should be reflected in the balance sheet.<sup>15</sup>

This section does not apply to accounting for income taxes payable and UTB liabilities in the balance sheet of separate reporting entities to which income tax expense is allocated by means of a method other than the separate return method.

A separate reporting entity to which income tax expense was allocated under the separate return method should initially reflect income taxes payable and UTB liabilities in the balance sheet in the same manner as if it had prepared a separate return. This view is premised on the facts that (1) under U.S. federal tax law, members (corporate subsidiaries) of a consolidated filing group are severally liable for all tax positions taken in the consolidated return and (2) while nonmembers (unincorporated divisions, branches, or disregarded entities included in the entity's consolidated income tax return) are not severally liable for tax positions taken in the consolidated return because they are not regarded as separate entities for income tax purposes, the presentation of payables and UTB liabilities in the separate financial statements of nonmembers is consistent with the separate return method. The separate reporting entity would then derecognize the payable or UTB liability (1) once it makes a payment (presumably to its parent under the terms of the tax sharing arrangement) to settle the payable or UTB liability or (2) once the payable or UTB liability is settled by the parent directly with the taxing authority. If the payable or UTB liability is settled by the parent directly with the taxing authority, the separate reporting entity would derecognize the liability with a corresponding entry to equity. Adjustments to the payable or UTB liability because of changes in facts and circumstances (i.e., unrelated to payment of the obligations) would generally be accounted for under the income tax provision.

<sup>15</sup> The concepts in this section would be equally applicable to income taxes payable and receivable. However, for ease of discussion throughout the remainder of this section, we refer only to income taxes payable.

However, in circumstances in which a tax sharing agreement exists between the separate reporting entity and its parent or other members of the consolidated filing group (or both), we believe that it would also be acceptable for the separate reporting entity to immediately adjust, through equity, the recorded amount of income taxes payable or UTB liabilities to reflect only the amount the separate reporting entity would be required to pay (presumably to its parent). For example, a tax sharing agreement between a parent and a separate reporting entity that is a member (corporate subsidiary) of the consolidated return group may specify that the member is not liable for the tax consequences of tax positions taken in the consolidated return related to its business. The tax sharing agreement might also specify that the separate reporting member must reimburse the parent for income taxes paid for an amount different from that determined by using the separate return method. We believe that in each scenario it would be acceptable to adjust the UTB and payable to an amount consistent with what the separate reporting entity would ultimately have to pay (presumably to its parent) under the tax sharing agreement. Any such adjustment would be recorded through equity.

#### **4.58 Disclosure Requirements When an Unincorporated Division's Statement of Revenues and Expenses Is Presented in a Public Filing [Deleted]**

See [6.26A](#).

#### **4.59 Single Member LLC Tax Allocation**

For federal income tax purposes, an LLC (see ASC 272) with only one member (a "single member LLC") can be classified as a regarded entity (i.e., a corporation) or can be disregarded as an entity separate from its owner.<sup>16</sup> An LLC that is itself subject to federal, foreign, state, or local taxes based on income should account for such taxes in accordance with ASC 740. ASC 272 does not address the appropriate accounting for single member LLCs that are disregarded for tax purposes.

In a manner similar to how a corporate division's income is included in a consolidated group income tax return, the income of a single member LLC is included in the income tax return of its taxable owner. However, unlike a **member** of a group that files a consolidated tax return (which would be subject to the provisions of ASC 740-10-30-27), a single member LLC that is disregarded for tax purposes generally is not severally liable for the current and deferred income taxes of its taxable owner provided that it maintains its separate and distinct corporate existence. Accordingly, while recognizing an allocation of current and deferred income taxes in the separate financial statements of a single member LLC would certainly be acceptable by analogy to ASC 740-10-30-27, we do not believe that it is required except in the circumstances outlined in the paragraph below. If income taxes are not allocated, practitioners should ensure that they have a complete understanding of the business purpose of the structure and the user(s) of the financial statements, and the single member LLC should disclose in the notes to the separate financial statements that no allocation of income taxes has been made and the reasons why.

If the financial statements of the single member LLC are to be included in an SEC filing, however, such financial statements are required to comply with the guidance in ASC 225-10-S99-3 (i.e., Question 3 of SAB Topic 1.B.1). For more information, see [4.61](#). Similarly, if a contractual tax-sharing agreement exists between the single member LLC and its taxable owner, the existence of that contractual agreement would generally suggest that the single member LLC should be treated no differently than a corporate member of the consolidated tax return (i.e., the single member LLC is now contractually liable for a portion of its owner's tax obligations). Accordingly, the single member LLC should recognize an allocation of income taxes in its separate financial statements in accordance with ASC 740-10-30-27.

<sup>16</sup> While the entity is disregarded for federal income tax purposes, it continues to be regarded as an entity for all other purposes.

If a contractual tax-sharing agreement is inconsistent with the broad principles established by ASC 740, the single member LLC must use an allocation method appropriate for financial reporting purposes (e.g., separate-return method) to determine the tax expense (or benefit) to be allocated in its separate financial statements. Any difference between the tax expense (or benefit) allocated by using the allocation method for financial reporting purposes and the payments to be made to (or received from) the taxable owner under the agreement should be reported in the separate financial statements of the single member LLC as either a charge or a credit to member equity. In addition, the single member LLC should comply with the disclosure requirements in ASC 740-10-50-17 in its separate financial statements. Concluding that a single member LLC is similar to a corporate member is not an assessment of whether income taxes are attributable to that entity in accordance with ASC 740-10-55-227 through 55-229. Rather, such a conclusion constitutes the application of the presentation guidance in ASC 740-10-30-27.

## **4.60 Change From Single Member LLC to Multiple Member LLC (or Vice Versa)**

If a single member LLC becomes a multiple member LLC or vice versa, the change is considered a change in tax status that should be accounted for in accordance with ASC 740-10-25-32 through 25-34. If an additional member invests in a former single member LLC and the now multiple member LLC does not elect to be treated as an association or corporation, any DTAs and DTLs of the former single member LLC should be eliminated with an offsetting entry to income from continuing operations. Similarly, if an entity that was once a multiple member LLC qualifies for treatment as a single member LLC, the LLC should consider the need to provide for income taxes in accordance with ASC 740-10-30-27, as discussed in [4.59](#). Any offsetting entry to record DTAs or DTLs in the separate financial statements of the single member LLC should be to income from continuing operations.

## **4.61 Publicly Held Single Member LLC**

Under ASC 225-10-S99-3 (formerly Question 3 of SAB Topic 1.B), when a member of a consolidated tax group prepares its separate financial statements, a registrant should use the separate-return method to calculate its tax provision as if the member had filed a tax return separate from its member and other affiliates.

ASC 225-10-S99-3 does not modify the accounting for income taxes described in [4.59](#) for a single member LLC that becomes a publicly held LLC. If a single member LLC consummates a successful IPO as a nontaxable entity (e.g., partnership), no income tax recognition is required. If, before an IPO, a single member LLC receives an allocation of current and deferred income taxes from its taxable owner, either under a legal tax-sharing agreement or because it is joint and severally liable, income tax recognition would cease at the time of the IPO when the entity becomes a nontaxable entity. However, appropriate pro forma disclosures would be necessary.

## **Interest and Penalties on Unrecognized Tax Benefits**

### **ASC 740-10**

**30-29** Paragraph 740-10-25-56 establishes the requirements under which an entity shall accrue interest on an underpayment of income taxes. The amount of interest expense to be recognized shall be computed by applying the applicable statutory rate of interest to the difference between the tax position recognized in accordance with the requirements of this Subtopic for tax positions and the amount previously taken or expected to be taken in a tax return. [FIN 48, paragraph 15]

**30-30** Paragraph 740-10-25-57 establishes both when an entity shall record an expense for penalties attributable to certain tax positions as well as the amount.

## Information Affecting Measurement of Tax Positions

### ASC 740-10

**35-2** Subsequent measurement of a tax position meeting the recognition requirements of paragraph 740-10-25-6 shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Paragraph 740-10-30-7 explains that the reporting date is the date of the entity's most recent statement of financial position. A tax position need not be legally extinguished and its resolution need not be certain to subsequently measure the position. Subsequent changes in judgment that lead to changes in measurement shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period. [FIN 48, paragraph 12]

**35-3** Paragraph 740-10-25-15 requires that a change in judgment that results in a change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs. [FIN 48, paragraph 13] Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.

### 4.62 Use of Aggregation and Offsetting in Measuring a Tax Position

An entity may not employ aggregation or offsetting techniques that specifically apply to multiple tax positions when measuring the benefit associated with a tax position. Each tax position must be considered and measured independently, regardless of whether the related benefit is expected to be negotiated with the tax authority as part of a broader settlement involving multiple tax positions.

### 4.63 Measurement: Weighing of Information

In determining the largest amount of tax benefit that is more than 50 percent likely to be realized upon ultimate settlement with a tax authority, an entity should weigh information that is objectively verifiable more heavily than that which is not. The amount of tax benefit to recognize in financial statements should be based on reasonable and supportable assumptions. Some information used to determine the amount of tax benefit to be recognized in financial statements (amounts and probabilities of the outcomes that could be realized upon ultimate settlement) will be objectively determined, while other amounts will be determined more subjectively. The weight given to the information should be commensurate with the extent to which the information can be objectively verified. Examples of objectively determined information include the amount of deduction reported in an entity's as-filed tax return or the amount of deduction for a similar tax position examined by, or sustained in settlement with, the tax authority in the past.

### 4.64 Measuring a Tax Position — Assigning Probabilities in a Cumulative-Probability Assessment

The benefit recognized for a tax position that meets the recognition threshold is measured on the basis of the largest amount of benefit that is more than 50 percent likely to be realized. ASC 740-10-30-7 states, in part:

Measurement of a tax position . . . shall consider the amounts and probabilities of the outcomes that could be realized upon [ultimate] settlement using the facts, circumstances, and information available at the reporting date.

Because of the level of uncertainty associated with a tax position, an entity may need to perform a cumulative-probability assessment of the possible estimated outcomes when applying the measurement criterion, as discussed in [4.66](#).

Because ASC 740 does not prescribe how to assign or analyze the probabilities of individual outcomes of a recognized tax position, this process involves judgment. Ultimately, an entity must consider all available information about the tax position to form a reasonable, supportable basis for its assigned probabilities. Factors an entity should consider in forming the basis for its assigned probabilities include, but are not limited to, the amount reflected (or expected to be reflected) in the tax return, the entity's past experience with similar tax positions, information obtained during the examination process, closing and other agreements, and the advice of experts. An entity should maintain the necessary documentation to support its assigned probabilities.

In any of the following circumstances, an entity may need to obtain third-party expertise to assist with measurement:

- The tax position results in a large tax benefit.
- The tax position relies on an interpretation of law that the entity lacks expertise in.
- The tax position arises in connection with an unusual, nonrecurring transaction or event.
- The range of potential sustainable benefits is widely dispersed.
- The tax position is not addressed specifically in the tax law and requires significant judgment and interpretation.

## **4.65 Cumulative-Probability Table**

ASC 740-10-30-7 states, "Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon settlement" with the tax authority.

It is expected that an entity will prepare a cumulative-probability table (see ASC 740-10-55-103 for an example) or similar supporting documentation in instances in which there is more than one possible settlement outcome associated with a tax position. Although such a table is not required, it is one documentation tool that can help management assess the level of uncertainty related to the outcomes of various tax positions and demonstrate that the amount of tax benefit recognized complies with ASC 740-10-30-7.

## **4.66 Cumulative-Probability Approach Versus Best Estimate**

In the determination of the amount of tax benefit that will ultimately be realized upon settlement with the tax authority, cumulative probability is not equivalent to best estimate. While the best estimate is the single expected outcome that is more probable than all other possible outcomes, the cumulative-probability approach is based on the largest amount of tax benefit with a greater than 50 percent likelihood of being realized upon ultimate settlement with a tax authority.

The table in Example 4-41 illustrates this difference. Under the cumulative-probability approach, the largest amount of tax benefit with a greater than 50 percent likelihood of being realized is \$30, while the best estimate is \$40 (the most probable outcome at 31 percent). An entity must use the cumulative-probability approach when measuring the amount of tax benefit to record under ASC 740-10-30-7.

## 4.67 Example Illustrating the Measurement of the Benefit of an Uncertain Tax Position

Example 4-41 illustrates the measurement of the benefit of an uncertain tax position.

### Example 4-41

An entity takes a \$100 tax deduction in its 20X7 tax return, which reduces its current tax liability by \$40. The entity concludes that there is a greater than 50 percent chance that, if the tax authority were to examine the tax position, it would be sustained as filed. Accordingly, the tax deduction meets the more-likely-than-not recognition threshold.

Although the tax position meets the more-likely-than-not recognition threshold, the entity believes it would negotiate a settlement if the tax position were challenged by the tax authority. On the basis of these assumptions, the entity determines the following possible outcomes and probabilities:

Possible Estimated Outcome	Individual Probability of Occurring	Cumulative Probability of Occurring
\$ 40	31%	31%
\$ 30	20%	51%
\$ 20	20%	71%
\$ 10	20%	91%
\$ 0	9%	100%

Accordingly, the entity should (1) recognize a tax benefit of \$30 because this is the largest benefit that has a cumulative probability of greater than 50 percent and (2) record a \$10 liability for UTBs (provided that the tax position does not affect a DTA or DTL).

## 4.68 Measurement of Tax Positions That Are Considered Binary

A tax position is considered binary when there are only two possible outcomes (e.g., full deduction or 100 percent disallowance). Because tax authorities are often permitted — in lieu of litigation — to negotiate a settlement with taxpayers for positions taken in their income tax returns, very few tax positions are, in practice, binary.

In certain circumstances, however, it may be acceptable to evaluate the amount of benefit to recognize as if the position was binary (e.g., when the tax position is so fundamental to the operation of an entity's business that the entity is unwilling to compromise). Since such circumstances are expected to be rare, an entity should use caution in determining whether a tax position should be considered binary with respect to measuring the amount of tax benefit to recognize.

If a tax position is considered binary and meets the more-likely-than-not threshold for recognition, it is appropriate to consider only two possible outcomes for measurement purposes: the position is sustained or the position is lost. ASC 740-10-30-7 states, in part:

A tax position that meets the more-likely-than-not recognition threshold shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon settlement using the facts, circumstances, and information available at the reporting date.

While such situations are rare, when a tax position is considered binary and meets the more-likely-than-not recognition threshold in ASC 740-10-30-7, that tax position should be measured at the largest amount that is more than 50 percent likely to be realized, which would generally be the “as filed” position (i.e., full benefit). When a full tax benefit is recognized for a tax position that is considered binary and no unrecognized tax benefit is presented in the tabular unrecognized tax benefit reconciliation, an entity should consider disclosing additional information for such tax positions that could have a significant effect on the entity’s financial position, operations, or cash flows.

## 4.69 Uncertainty in Deduction Timing

A deduction taken on an entity’s tax return may be certain except for the appropriate timing of the deduction under the tax law in the applicable jurisdiction. In such cases, the recognition threshold is satisfied and the entity should consider the uncertainty in the appropriate timing of the deduction in measuring the associated tax benefit in each period.

### Example 4-42

Assume the following:

- An entity purchases equipment for \$1,000 in 20X7.
- The entity’s earnings before interest, depreciation, and taxes are \$1,200 in years 20X7–20Y1.
- For book purposes, the equipment is depreciated ratably over five years.
- For tax purposes, the entity deducts the entire \$1,000 in its 20X7 tax return.
- The entity has a 40 percent tax rate and is taxable in only one jurisdiction.
- There is no half-year depreciation rule for accounting or tax purposes.
- For simplicity, interest and penalties on tax deficiencies are ignored.

In applying the recognition provisions of ASC 740-10-25-5, the entity has concluded that it is certain that the \$1,000 equipment acquisition cost is ultimately deductible under the tax law. Thus, the tax deduction of the tax basis of the acquired asset would satisfy the recognition threshold in ASC 740-10-25-6. In measuring the benefit associated with the deduction, the entity concludes that the largest amount that is more than 50 percent likely to be realized in a negotiated settlement with the tax authority is \$200 per year for five years (the tax life is the same as the book life).

Exclusive of interest and penalties, the entity’s current-year tax benefit is unaffected because the difference between the benefit taken in the tax return and the benefit recognized in the financial statements is a temporary difference.

However, although interest and penalties are ignored in this example for simplicity, ASC 740-10-25-56 requires an entity to recognize interest and penalties on the basis of the provisions of the relevant tax law. In this case, the entity would begin accruing interest in 20X8. Therefore, even though this is a timing difference, the accrual of interest (and penalties, if applicable) will have an impact on the profit and loss.

The 20X7 tax return reflects a \$400 reduction in the current tax liability for the \$1,000 deduction claimed. For book purposes, the entity will recognize a balance sheet credit of \$320  $[(\$1,000 - \$200) \times 40\%]$  for UTBs associated with the deduction claimed in year 1. The liability for UTBs will be extinguished over the succeeding four years at \$80 ( $\$200 \times 40$  percent) per year. The entity would record the following journal entries, excluding interest and penalties, for the tax effects of the purchased equipment:

**Example 4-42 (continued)**

	<b>20X7</b>	<b>20X8</b>	<b>20X9</b>	<b>20Y0</b>	<b>20Y1</b>	<b>Totals</b>
Depreciation	\$ 1,200	\$ 1,200	\$ 1,200	\$ 1,200	\$ 1,200	\$ 6,000
Interest	(200)	(200)	(200)	(200)	(200)	(1,000)
	<u>\$ 1,000</u>	<u>\$ 1,000</u>	<u>\$ 1,000</u>	<u>\$ 1,000</u>	<u>\$ 1,000</u>	<u>\$ 5,000</u>
Adjust for tax depreciation as filed	<u>(800)</u>	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>	<u>—</u>
	<u><u>\$ 200</u></u>	<u><u>\$ 1,200</u></u>	<u><u>\$ 1,200</u></u>	<u><u>\$ 1,200</u></u>	<u><u>\$ 1,200</u></u>	<u><u>\$ 5,000</u></u>
Current tax provision	80	480	480	480	480	2,000
Current tax provision — adjusted for uncertainty	320	(80)	(80)	(80)	(80)	—
Deferred tax provision	—	—	—	—	—	—
Interest and penalties	—	—	—	—	—	—
Total tax provision	<u>400</u>	<u>400</u>	<u>400</u>	<u>400</u>	<u>400</u>	<u>2,000</u>
	<u><u>\$ 600</u></u>	<u><u>\$ 600</u></u>	<u><u>\$ 600</u></u>	<u><u>\$ 600</u></u>	<u><u>\$ 600</u></u>	<u><u>\$ 3,000</u></u>
	40%	40%	40%	40%	40%	40%
Taxable income — as filed	\$ 200	\$ 1,200	\$ 1,200	\$ 1,200	\$ 1,200	\$ 5,000
Taxable income — adjusted for uncertainty	1,000	1,000	1,000	1,000	1,000	5,000
Current tax liability — as filed	80	480	480	480	480	—
Current tax liability — adjusted for uncertainty	400	400	400	400	400	—
Underpayment (repayment) of tax	320	(80)	(80)	(80)	(80)	—
<b>Journal Entries</b>	<b>20X7</b>	<b>20X8</b>	<b>20X9</b>	<b>20Y0</b>	<b>20Y1</b>	
Current tax provision	\$ 80	\$ 480	\$ 480	\$ 480	\$ 480	\$ 480
Cash or current tax liability	(80)	(480)	(480)	(480)	(480)	(480)
ASC 740 tax provision	320	—	—	—	—	—
Current UTB liability	(80)	—	—	—	—	—
Long-term UTB liability	(240)	—	—	—	—	—
Current UTB liability	—	80	80	80	80	80
Cash or increase in current tax liability	—	(80)	(80)	(80)	(80)	(80)
Cash or reduction in current tax liability	—	80	80	80	80	80
ASC 740 provision	—	(80)	(80)	(80)	(80)	(80)
Long-term UTB liability	—	80	80	80	80	—
Current UTB liability	—	(80)	(80)	(80)	(80)	—

**Example 4-42 (continued)**

	<b>20X7</b>	<b>20X8</b>	<b>20X9</b>	<b>20Y0</b>	<b>20Y1</b>
Income taxes paid	\$ 80	\$ 480	\$ 480	\$ 480	\$ 480
Beginning of the year	—	(320)	(240)	(160)	(80)
Gross increases — prior-year positions	—	—	—	—	—
Gross decreases — prior-year positions	—	—	—	—	—
Increases in UTBs — current-year positions	(320)	—	—	—	—
Settlements with tax authorities	—	80	80	80	80
Reductions due to statute lapse	—	—	—	—	—
End of year	<u>\$ (320)</u>	<u>\$ (240)</u>	<u>\$ (160)</u>	<u>\$ (80)</u>	<u>\$ —</u>

At the end of each year, the entity, if an SEC registrant, would include its total liabilities for UTBs in the tabular disclosure of contractual obligations required by SEC Regulation S-K, Item 303(a)(5), in "Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet Under GAAP." In that table, allocation of the total liabilities for UTBs to "Payments due by period" would be based on the scheduled repayments (\$80 per year for the next four years in the above example).

## 4.70 Measurement of Uncertain Tax Positions in Transfer Pricing Arrangements

Transfer pricing relates to the pricing of intra-entity and related-party transactions involving transfers of tangible property, intangible property, services, or financing between affiliated entities. These transactions include transfers between domestic or international entities, such as (1) U.S. to foreign, (2) foreign to foreign, (3) U.S. to U.S., and (4) U.S. state to state.

The general transfer pricing principle is that the pricing of a related-party transaction should be consistent with the pricing of similar transactions between independent entities under similar circumstances (i.e., an arm's-length transaction). Transfer pricing tax regulations are intended to prevent entities from using intra-entity charges to evade taxes by inflating or deflating the profits of a particular jurisdiction the larger consolidated group does business in. Even if a parent corporation or its subsidiaries are in tax jurisdictions with similar tax rates, an entity may have tax positions that are subject to the recognition and measurement principles in ASC 740-10-25-6 and ASC 740-10-30-7.

An entity's exposure to transfer pricing primarily occurs when the entity includes in its tax return the benefit received from a related-party transaction that was not conducted as though it was at arm's length. A UTB results when one of the related parties reports either lower revenue or higher costs than it can sustain (depending on the type of transaction). While a benefit is generally more likely than not to result from such a transaction (e.g., some amount will be allowed as an interest deduction, royalty expense, or cost of goods sold), the amount of benefit is often uncertain because of the subjectivity of valuing the related-party transaction.

An entity must perform two steps in applying ASC 740 to all uncertain tax positions within its scope: (1) recognition and (2) measurement. The requirements of ASC 740 in the context of transfer pricing arrangements, including related considerations and examples, are outlined below.

## ***Determination of the Unit of Account***

Before applying the recognition and measurement criteria, an entity must identify all material uncertain tax positions and determine the appropriate unit of account for assessment. A tax position encompasses “[a]n allocation or a shift of income between jurisdictions” (i.e., a transfer pricing arrangement). Therefore, intra-entity and related-party transactions under transfer pricing arrangements are within the scope of ASC 740.

Further, tax positions related to transfer pricing generally should be evaluated individually, since two entities and two tax jurisdictions are involved in each transaction. Such an evaluation should be performed even when the transaction is supported by a transfer pricing study prepared by one of the entities. Generally, there would be at least two units of account. For example, the price at which one entity will sell goods to another entity will ultimately be the basis the second entity will use to determine its cost of goods sold. See [3.30](#) for more information about determining the unit of account.

## ***Recognition***

ASC 740-10-25-6 indicates that the threshold for recognition has been met “when it is more likely than not, based on the technical merits, that the position will be sustained upon examination.” While an entity should apply the recognition threshold and guidance in ASC 740 to tax positions in a transfer pricing arrangement, such tax positions will generally meet the recognition threshold if a transaction has taken place to generate the tax positions and some level of benefit will therefore be sustained. For example, assume that a U.S. parent entity receives a royalty for the use of intangibles by a foreign subsidiary that results in taxable income for the parent and a tax deduction for the foreign subsidiary. The initial tax filing (income in the receiving jurisdiction and expense/deduction in the paying jurisdiction) typically meets the more-likely-than-not recognition threshold on the basis of its technical merits, since a transaction between two parties has occurred. However, because there are two entities and two tax jurisdictions involved, the tax jurisdictions could question whether the income is sufficient, whether the deduction is excessive, or both. Such factors should be considered during the measurement phase as part of the determination of what the tax jurisdictions are more likely than not to accept on the basis of the technical merits.

## ***Measurement***

After an entity has assessed the recognition criteria in ASC 740 and has concluded that it is more likely than not that the tax position taken will be sustained upon examination, the entity should measure the associated tax benefit. This measurement should take into account all relevant information, including tax treaties and arrangements between tax authorities. As discussed above, each tax position should be assessed individually and a minimum of two tax positions should be assessed for recognition and measurement in each transfer pricing transaction.

For measurement purposes, ASC 740-10-30-7 requires that the tax benefit be based on the amount that is more than 50 percent likely to be realized upon settlement with a tax jurisdiction “that has full knowledge of all relevant information.” Intra-entity or transfer pricing assessments present some unique measurement-related challenges that are based on the existence of tax treaties or other arrangements (or the lack of such arrangements) between two tax jurisdictions.

Measurement of uncertain tax positions is typically based on facts and circumstances. The following are some general considerations (not all-inclusive):

- *Transfer pricing studies* — An entity will often conduct a transfer pricing study with the objective of documenting the appropriate arm's-length pricing for the transactions. The entity should consider the following when using a transfer pricing study to support the tax positions taken:
  - The qualifications and independence of third-party specialists involved (if any).
  - The type of study performed (e.g., benchmarking analysis, limited or specified method analysis, U.S. documentation report, OECD report).
  - The specific transactions and tax jurisdictions covered in the study.
  - The period covered by the study.
  - The reasonableness of the model(s) and the underlying assumptions used in the study (i.e., comparability of companies or transactions used, risks borne, any adjustments made to input data).
  - Any changes in the current environment, including new tax laws in effect.
- *Historical experience* — An entity should consider previous settlement outcomes of similar tax positions in the same tax jurisdictions. Information about similar tax positions, in the same tax jurisdictions, that the entity has settled in previous years serves as a good indicator of the expected settlement of current positions.
- *Applicability of tax treaties or other arrangements* — An entity should consider whether a tax treaty applies to a particular tax position and, if so, how the treaty would affect the negotiation and settlement with the tax authorities involved.
- *Symmetry of positions* — Even though each tax position should be evaluated individually for appropriate measurement, if there is a high likelihood of settlement through "competent-authority" procedures under the tax treaty or other agreement, an entity should generally use the same assumptions about such a settlement to measure both positions (i.e., the measurement assumptions are similar, but the positions are not offset). Under the terms of certain tax treaties entered into by the United States and other foreign jurisdictions, competent authority is a mutual-agreement procedure between countries that is designed to relieve companies of double taxation created by transfer pricing adjustments to previously filed returns.

An entity should carefully consider whether the tax jurisdictions involved strictly follow the arm's-length principle. For example, Brazil has a mandated statutory margin that may or may not equate to what is considered arm's length by another reciprocal taxing jurisdiction. Other jurisdictions that may not strictly follow the arm's-length principle include China and India. In such situations, it may be inappropriate for an entity to assume symmetry of positions when measuring the positions.

Example 4-43 illustrates the above considerations. See [5.09](#) for a discussion of balance sheet presentation in transfer pricing arrangements under ASC 740.

#### Example 4-43

Assume that a U.S. entity licenses its name to its foreign subsidiary in exchange for a 2 percent royalty on sales. This example focuses on the two separate tax positions that the entity has identified in connection with the royalty transaction. For tax purposes, the U.S. entity recognizes royalty income in its U.S. tax return and the foreign subsidiary takes a tax deduction for the royalty expense in its local-country tax return. Both positions are deemed uncertain, since the respective tax authorities may either disallow a portion of the deduction (deeming it to be excessive) or challenge the royalty rate used in this intra-entity transaction (deeming it to be insufficient). The entity should evaluate both tax positions under the recognition and measurement criteria of ASC 740. In this example, the “more-likely-than-not” recognition threshold is considered met since a transaction has occurred between the two parties and it is therefore more likely than not that the U.S. entity has income and the foreign subsidiary has a deduction.

The U.S. entity believes that if the IRS examines the tax position, it will most likely conclude that the royalty rate should have been higher to be in line with an arm's-length transaction. In the absence of any consideration of relief through an international tax treaty, the lowest royalty rate that the entity believes is more than 50 percent likely to be accepted by the IRS is 5 percent, on the basis of historical experience and recent transfer pricing studies. A higher royalty rate would not only trigger an increase in taxable income for the U.S. entity but would also result in double taxation of the additional royalty for the amount that is in excess of the deduction claimed by the foreign subsidiary (i.e., 3 percent in this instance — calculated as the 5 percent estimated arm's-length amount less the original 2 percent recorded in the transaction). If there is a tax treaty between the United States and the relevant foreign tax jurisdiction, that treaty will typically include procedures that provide for competent-authority relief from double taxation. Under such an agreement, the two tax authorities would agree at their discretion on an acceptable royalty rate in each jurisdiction. One tax authority would make an adjustment (i.e., increasing deduction and reducing taxable income) that would require a consistent transfer pricing adjustment (i.e., increasing revenue and taxable income) in the related party's tax jurisdiction.

In this example, management concludes that it is appropriate to recognize relief from double taxation because of the expected outcome of competent-authority procedures and further has represented that the entity will incur the cost of pursuing a competent-authority process. Therefore, the U.S. entity records a liability that would result from resolution of the double taxation of this non-arm's-length transaction if the original 2 percent royalty rate is increased through application of the competent-authority process. Management of the U.S. entity believes that a royalty rate of 3.5 percent is the lowest percentage that is more than 50 percent likely to be accepted by the two tax jurisdictions under such a treaty on the basis of their historical experience. Because there is a high likelihood of settlement through the competent-authority process, the foreign subsidiary should also use this assumption when measuring the tax position to ensure symmetry of the two tax positions under ASC 740. Note that this example focuses on one tax position in each jurisdiction; there may be other tax positions related to this transfer pricing arrangement that would have to be similarly analyzed.

## Changes in Tax Laws or Rates

### ASC 740-10

**35-4** Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. [FAS 109, paragraph 27] A change in tax laws or rates may also require a reevaluation of a valuation allowance for deferred tax assets.

## 4.71 Change in Tax Law That Allows an Entity to Monetize an Existing DTA or Tax Credit in Lieu of Claiming the Benefit in the Future

A tax authority may enact a tax law that allows entities to monetize an existing DTA before the asset would otherwise be realized as a reduction of taxes payable. For example, a recent law in the United States allowed entities to claim a refundable credit for their AMT carryforward and research credits in lieu of claiming a 50 percent bonus depreciation on qualified property placed in service during a particular period.

ASC 740-10-35-4 states the following regarding an entity's assessment of how it should account for a change in tax law that allows it to monetize an **existing** DTA in lieu of claiming that credit as a reduction of income taxes payable in a future period:

Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. A change in tax laws or rates may also require a reevaluation of a valuation allowance for deferred tax assets.

In addition, ASC 740-10-45-15 indicates that “[w]hen deferred tax accounts are adjusted . . . for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date.”

Accordingly, the entity must adjust its DTAs and DTLs, along with any related valuation allowances, in the first period in which the law was enacted if the entity expects to realize the asset by electing the means provided by the newly enacted tax law. Because the adjustment results from a change in tax law, the entity should recognize it as a discrete item in the interim period in which the law was enacted rather than apportioning it among interim periods through an adjustment to the AETR.

For example, an entity may have a valuation allowance for a particular DTA because it was not more likely than not that the asset would have been realizable before the change in tax law occurred. However, the new tax law provides the entity a means of realizing the DTA. The reduction of the valuation allowance will affect the income tax provision in the first period in which the law was enacted. If, however, no valuation allowance is recognized for the entity's DTA, the reduction in the DTA (a deferred tax expense) is offset by the cash received from monetizing the credits (a current tax benefit). Therefore, in this case, the reduction of the DTA does not affect the income tax provision.

See [9.10](#) for further guidance on accounting for changes in tax laws or rates in an interim period.

See [2.04](#) for guidance on whether refundable tax credits are within the scope of ASC 740 and are accordingly classified within income tax expense/benefit in the financial statements.

## Deferred Credit Arising From Asset Acquisitions That Are Not Business Combinations

### ASC 740-10

**35-5** A deferred credit may arise under the accounting required by paragraph 740-10-25-51 when an asset is acquired outside of a business combination. Any deferred credit arising from the application of such accounting requirements shall be amortized to income tax expense in proportion to the realization of the tax benefits that gave rise to the deferred credit. [EITF 98-11, paragraph Discussion]

# Chapter 5 — Presentation

This chapter provides guidance on presentation matters discussed in the Other Presentation Matters section of the *Income Taxes: Overall* subtopic (ASC 740-10-45). Matters discussed in the Other Presentation section of other subtopics in ASC 740 are discussed in other chapters within this Roadmap. The 200 area of the Codification also comprises several presentation-related topics; however, those topics are not discussed in this chapter because, although they provide general guidance on presentation that may apply to income tax accounting, they do not provide specific guidance on the classification and presentation of income tax accounts.

On November 20, 2015, the FASB issued ASU 2015-17, which requires entities to present DTAs and DTLs as noncurrent in a classified balance sheet. The ASU simplifies the current guidance, which requires entities to separately present DTAs and DTLs as current and noncurrent in a classified balance sheet. The ASU is effective for public entities in fiscal years beginning after December 15, 2016, and in interim periods within those years. For entities other than public business entities, the new guidance will apply in annual periods beginning after December 15, 2017, and in interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for all entities for interim or annual financial statements that have not been issued. In addition, entities are permitted to apply the amendments either prospectively or retrospectively. Upon adoption, the following sections of this chapter will no longer be relevant:

- [5.01 — Current/Noncurrent Classification of DTLs and DTAs.](#)
- [5.04 — Valuation Allowance: Classification in a Classified Balance Sheet.](#)
- [5.05 — Accounting for the Tax Effects of a Change in Tax Accounting Method.](#)

## Statement of Financial Position Classification of Income Tax Accounts

### ASC 740-10

**45-1** This Section provides guidance on statement of financial position and income statement classification and presentation matters applicable to all of the following:

- a. Statement of financial position classification of income tax accounts
- b. Income statement presentation of certain measurement changes to income tax accounts
- c. Income statement classification of interest and penalties
- d. Presentation matters related to investment tax credits under the deferral method.

**ASC 740-10 (continued)****Pending Content (Transition Guidance: ASC 220-10-65-4)**

**45-1** This Section provides guidance on statement of financial position, income statement and statement of shareholder equity classification, and presentation matters applicable to all the following:

- a. Statement of financial position classification of income tax accounts
- b. Income statement presentation of certain measurement changes to income tax accounts
- c. Income statement classification of interest and penalties
- d. Presentation matters related to investment tax credits under the deferral method.
- e. Statement of shareholder equity reclassification of certain income tax effects from accumulated other comprehensive income. [ASU 2018-02, paragraph 4]

**45-2** See Subtopic 740-20 for guidance on the intraperiod allocation of total income tax expense (or benefit).

**45-3** Topic 210 provides general guidance for classification of accounts in statements of financial position. The following guidance addresses classification matters applicable to income tax accounts and is incremental to the general guidance.

**Deferred Tax Accounts**

**45-4** In a classified statement of financial position, an entity shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. [FAS 109, paragraph 41]

**Pending Content (Transition Guidance: ASC 740-10-65-4)**

**45-4** In a classified statement of financial position, an entity shall classify deferred tax liabilities and assets as noncurrent amounts. [FAS 109, paragraph 41]

**45-5** The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis. [FAS 109, paragraph 41]

**Pending Content (Transition Guidance: ASC 740-10-65-4)**

**45-5** Paragraph superseded by Accounting Standards Update No. 2015-17.

**45-6** For a particular tax-paying component of an entity and within a particular tax jurisdiction, all current deferred tax liabilities and assets shall be offset and presented as a single amount and all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an entity shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the entity or to different tax jurisdictions. [FAS 109, paragraph 42]

**Pending Content (Transition Guidance: ASC 740-10-65-4)**

**45-6** For a particular tax-paying component of an entity and within a particular tax jurisdiction, all deferred tax liabilities and assets, as well as any related valuation allowance, shall be offset and presented as a single noncurrent amount. However, an entity shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the entity or to different tax jurisdictions. [FAS 109, paragraph 42]

## ASC 740-10 (continued)

### Deferred Tax Accounts Related to an Asset or Liability

**45-7** A deferred tax liability or asset for a temporary difference that is related to an asset or liability shall be classified as current or noncurrent based on the classification of the related asset or liability.

#### Pending Content (Transition Guidance: ASC 740-10-65-4)

**45-7 Editor's Note:** Paragraph 740-10-45-7 will be superseded upon transition, together with its heading:

### Deferred Tax Accounts Related to an Asset or Liability

Paragraph superseded by Accounting Standards Update No. 2015-17.

**45-8** A temporary difference is related to an asset or liability if reduction of the asset or liability causes the temporary difference to reverse. As used here, the term *reduction* includes amortization, sale, or other realization of an asset and amortization, payment, or other satisfaction of a liability. [FAS 37, paragraph 4]

#### Pending Content (Transition Guidance: ASC 740-10-65-4)

**45-8** Paragraph superseded by Accounting Standards Update No. 2015-17.

### Deferred Tax Accounts Not Related to an Asset or Liability

**45-9** A deferred tax liability or asset that is not related to an asset or liability for financial reporting (see paragraphs 740-10-25-24 through 25-26), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal date of the temporary difference. [FAS 109, paragraph 41]

#### Pending Content (Transition Guidance: ASC 740-10-65-4)

**45-9 Editor's Note:** Paragraph 740-10-45-9 will be superseded upon transition, together with its heading:

### Deferred Tax Accounts Not Related to an Asset or Liability

Paragraph superseded by Accounting Standards Update No. 2015-17.

**45-10** A deferred tax liability or asset for a temporary difference may not be related to an asset or liability because there is no associated asset or liability or reduction of an associated asset or liability will not cause the temporary difference to reverse. The classification required by the preceding paragraph disregards any additional temporary differences that may arise and is based on the criteria used for classifying other assets and liabilities. [FAS 37, paragraph 4]

#### Pending Content (Transition Guidance: ASC 740-10-65-4)

**45-10** Paragraph superseded by Accounting Standards Update No. 2015-17.

**ASC 740-10 (continued)*****Tax Accounts, Other Than Deferred*****Unrecognized Tax Benefits**

**45-10A** Except as indicated in paragraphs 740-10-45-10B and 740-10-45-12, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, shall be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. [ASU 2013-11, paragraph 2]

**45-10B** To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit shall be presented in the financial statements as a liability and shall not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and shall be made presuming disallowance of the tax position at the reporting date. [ASU 2013-11, paragraph 2]

**45-11** An entity that presents a classified statement of financial position shall classify an unrecognized tax benefit that is presented as a liability in accordance with paragraphs 740-10-45-10A through 45-10B as a current liability to the extent the entity anticipates payment (or receipt) of cash within one year or the operating cycle, if longer. [ASU 2013-11, paragraph 2]

**45-12** An unrecognized tax benefit presented as a liability shall not be classified as a deferred tax liability unless it arises from a taxable temporary difference. [FIN 48, paragraph 18] Paragraph 740-10-25-17 explains how the recognition and measurement of a tax position may affect the calculation of a temporary difference.

**Offsetting**

**45-13** The offset of cash or other assets against the tax liability or other amounts owing to governmental bodies is not acceptable except as noted in paragraphs 210-20-45-6 and 740-10-45-10A through 45-10B. [APB 10, paragraph 7]

**Related Implementation Guidance and Illustrations**

- [Accounting Change for Tax Purposes](#) [ASC 740-10-55-77].
- [Method of Reporting Construction Contracts Differs for Tax and Book](#) [ASC 740-10-55-78].
- [Example 27: Accounting Change for Tax Purposes](#) [ASC 740-10-55-205].
- [Example 28: Unremitted Earnings of Foreign Subsidiaries](#) [ASC 740-10-55-208].

## 5.01 Current/Noncurrent Classification of DTLs and DTAs

**Applicable before the adoption of ASU 2015-17 — see the [introduction to this chapter for more information](#).**

An entity that presents a classified balance sheet must classify DTLs and DTAs as either current or noncurrent on the basis of the financial accounting classification of the related liability or asset for which a temporary difference exists. For example, temporary differences related to inventory and vacation accruals will be classified as current because these balances are also classified as current in the financial statements. Conversely, a temporary difference related to property, plant, and equipment should be classified as noncurrent to mirror the classification of the underlying assets in the financial statements. The fact that a portion of the temporary difference may reverse in the current year as a result of depreciation would not affect the current/noncurrent determination. A DTA or DTL that is not related to an asset or liability for financial reporting purposes, such as the deferred tax consequences related to an operating loss or a tax credit carryforward, is classified in accordance with the DTA's or DTL's expected reversal or utilization date. Each tax-paying component (e.g., a subsidiary filing a separate return) within

each tax jurisdiction (e.g., the United States and United Kingdom or New York and California) should be classified separately.

Within each of the separate tax-paying components in a jurisdiction, the current DTAs and DTLs are offset and presented as a single amount; the noncurrent deferred taxes are treated similarly. Offsetting is not permitted for different tax-paying components or for different tax jurisdictions. Because the right to offset amounts related to different tax jurisdictions or components is prohibited, a balance sheet may present current and noncurrent DTAs along with current and noncurrent DTLs.

Similarly, an entity with a nonclassified balance sheet (i.e., the assets and liabilities are not grouped by current and noncurrent status) is prohibited from netting across different tax-paying components and jurisdictions and, therefore, will often report DTAs along with DTLs.

See [5.05](#) for specific classification issues associated with deferred income taxes resulting from a change in a tax-accounting method.

## **5.02 Presentation of Deferred Federal Income Taxes Associated With Deferred State Income Taxes**

ASC 740-10-55-20 states:

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

It is not appropriate to net the federal effect of a state DTL or DTA against the state deferred tax. ASC 740 generally requires separate identification of temporary differences and related deferred taxes for each tax-paying component of an entity in each tax jurisdiction, including U.S. federal, state, local, and foreign tax jurisdictions.<sup>1</sup> ASC 740-10-45-6 states the following regarding the offsetting of DTAs and DTLs:

For a particular tax-paying component of an entity and within a particular tax jurisdiction, all current deferred tax liabilities and assets shall be offset and presented as a single amount and all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. **However, an entity shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the entity or to different tax jurisdictions.** [Emphasis added]

For example, assume that Company A has a state DTL of \$100 related to a fixed asset and that this DTL represents taxes that will need to be paid when the fixed asset is recovered at its financial reporting carrying amount. The future state taxes will result in a \$100 deduction on the U.S. federal income tax return, and a DTA of \$35 ( $\$100 \text{ deduction} \times 35\% \text{ tax rate}$ ) should be recognized for that future deduction. In this example, Company A should report a \$100 state DTL and separately report a \$35 federal DTA. It would not be appropriate to report a "net of federal tax benefit" state DTL of \$65.

In addition to improper presentation of DTAs and DTLs in the balance sheet, improperly netting the federal effect of state deferred taxes against the state deferred taxes themselves can result in, among other things, (1) an improper assessment of whether a valuation allowance is necessary in a particular jurisdiction or (2) improper disclosures related to DTAs and DTLs.

<sup>1</sup> As described in ASC 740-10-30-5, a tax-paying component is an individual entity or group of entities that is consolidated for tax purposes.

## 5.03 Recognition of Changes in Indemnification Assets Under a Tax Indemnification Arrangement

Business combinations commonly involve tax indemnification arrangements between the former parent and the acquirer of a subsidiary in which the parent partly or fully indemnifies the acquirer for tax uncertainties related to uncertain tax positions taken by the subsidiary in periods before the sale of the subsidiary.

ASC 805 addresses the accounting for indemnifications in a business combination. Specifically, ASC 805-20-25-27 states that the "acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts." ASC 805-20-30-19 further elaborates on indemnifications provided for uncertain tax positions:

[A]n indemnification may relate to an asset or a liability, for example, one that results from an uncertain tax position that is measured on a basis other than acquisition-date fair value. . . . [I]n those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

Therefore, if the subsidiary (after the acquisition) has UTBs determined in accordance with ASC 740, and if the related tax positions are indemnified by the former parent, the subsidiary could recognize an indemnification asset on the basis of the indemnification agreement and the guidance in ASC 805-20-25-27 and ASC 805-20-30-19. ASC 805-20-35-4 also provides guidance on subsequent measurement of indemnification assets.

### Example 5-1<sup>2</sup>

Company P sells its subsidiary (Company S) to an unrelated party in January 20X9. Before the sale, P and S were separate companies and filed separate income tax returns. In connection with the sale, P and S enter into an indemnification agreement in which P will partially indemnify S for the settlement of S's uncertain tax positions related to periods before the sale (i.e., P and S will share 40 percent and 60 percent of the settlement, respectively). Specifically, if S settles an uncertain tax position with the tax authority for \$100, S would be reimbursed \$40 by P. However, S remains the primary obligor for its tax positions since it filed separate returns before the sale.

Assume that, upon the sale, S has recorded a liability of \$100 for UTBs. On the basis of its specific facts and circumstances, S determines that recording a receivable (i.e., an indemnification asset) for the indemnification agreement is appropriate in accordance with ASC 805. At the time of the acquisition and subsequently, S concluded that, in the absence of collectibility concerns, the indemnification receivable should be accounted for under the same accounting model as that used for the related liability and subsequently adjusted for any changes in the liability. Company S also concluded that the indemnification receivable should not be recorded net of the related UTBs because it does not meet the criteria for offsetting in ASC 210-20. (See [2.05](#) for an example illustrating the accounting for the guarantor side of the indemnification agreement.) Therefore, at the time of the acquisition, S recorded an indemnification receivable (an "indemnification asset") of \$40, which equals the amount that it expects to recover from P as a result of the indemnification agreement.

The potential payments to be received under the indemnification agreement are not income-tax-related items because the amounts are not due to or from a tax jurisdiction. Rather, they constitute a contractual agreement between the two parties regarding each party's ultimate tax obligations. If S settled its uncertain tax positions with the tax authority, and P was unable to pay S the amount due under the indemnification agreement, S's liability to the tax authority would not be altered or removed.

SEC Regulation S-X, Rule 5-03(b)(11), notes that a company should include "only taxes based on income" in the income statement line item under the caption "income tax expense." Accordingly, any adjustment to the indemnification asset should be included in an "above the line" income statement line item. If S determined that P was unable to pay its \$40 obligation, S would impair the indemnification asset and record the associated expense outside of "income tax expense."

Similar issues may arise when a subsidiary is spun off from its parent. See [3.20A](#) for considerations involving UTBs in a spin-off transaction.

## 5.04 Valuation Allowance: Classification in a Classified Balance Sheet

**Applicable before the adoption of ASU 2015-17 — see the [introduction to this chapter for more information](#).**

An entity that prepares a classified balance sheet must use a pro rata approach to allocate any valuation allowance between the gross DTAs (both current and noncurrent), irrespective of which DTA is believed to require a valuation allowance. The FASB decided that such an approach would help eliminate the complexity that sometimes results when an entity determines exactly which DTAs would or would not be realized.

It is not appropriate to use a specific identification method to allocate a valuation allowance between current and noncurrent DTAs in a classified statement of financial position. For example, assume that an entity has two deductible temporary differences — the first related to a current asset and the second related to a noncurrent liability. If available evidence supports a conclusion that realization of the tax benefit for the deductible temporary difference associated with the asset that is classified in the balance sheet as current is more likely than not, but realization of the tax benefit for the deductible temporary

<sup>2</sup> Entities should not use this example as a basis for recording an indemnification receivable since they would need additional facts to reach such a conclusion. Rather, entities must evaluate their own facts and circumstances and use significant judgment when determining the appropriateness of such a receivable. Any receivable recorded should be adjusted to reflect collection risk, as appropriate.

difference associated with the liability classified in the balance sheet as noncurrent is not more likely than not, the amount of valuation allowance recognized should not be allocated to only the noncurrent DTA. Rather, such a valuation allowance should be allocated to the current and noncurrent DTA on the basis of the ratio of the gross DTA in each classification.

### Example 5-2

#### Classification of DTLs, DTAs, and a Valuation Allowance in a Classified Balance Sheet

Assume the following:

- An entity was formed in 20X2 and operates in a single tax jurisdiction in which the applicable tax rate is 40 percent.
- Available evidence supports a conclusion that a \$100,000 valuation allowance is required.
- No portion of the \$250,000 tax loss carryforward that exists at the end of 20X2 is expected to be realized during the next operating cycle.

DTAs and DTLs are determined as follows:

	Deferred Tax Consequences			
	Tax Asset		Tax Obligation	
	Temporary Difference/ Carryforward	Asset at 40%	%	Temporary Difference Liability at 40%
Current assets and liabilities:				
Inventory			\$ 37,500	\$ 15,000
Receivables	\$ 375,000	\$ 150,000		
Deferred revenue	125,000	<u>50,000</u>		
Total current		<u>200,000</u>	40%	<u>15,000</u>
Noncurrent assets and liabilities:				
Securities portfolio (loss in OCI)	300,000	120,000		
Pension obligation	200,000	80,000		
Plant and equipment			50,000	20,000
Other sources				
Tax loss carryforward	250,000	<u>100,000</u>		
Total noncurrent		<u>300,000</u>	60%	<u>20,000</u>
Total current and noncurrent before valuation allowance		500,000	100%	35,000
Valuation allowance		(100,000)		
Total current and noncurrent		<u>\$ 400,000</u>		<u>\$ 35,000</u>

The following are the entity's financial statements for 20X2:

#### Balance Sheet (Select Accounts)

Current assets – deferred tax (\$200,000 – \$15,000) – (\$100,000 × 0.40)	\$ 145,000
Noncurrent assets – deferred tax (\$300,000 – \$20,000) – (\$100,000 × 0.60)	\$ 220,000

**Example 5-2 (continued)**

The approximate tax effect of each type of temporary difference and carryforward that gave rise to the entity's DTAs and DTLs and the change in valuation allowance would be disclosed under ASC 740-10-50 as follows:

	Deferred Tax Consequences as of December 31, 20X2*	
	Assets	Liabilities
Nondeductible accruals for uncollected receivables	\$ 150,000	\$ —
Revenue deferred for financial reporting purposes	50,000	—
Inventory costs capitalized for tax purposes	—	(15,000)
Less valuation allowance	(40,000)	—
Current	160,000	(15,000)
Nondeductible accrual for adjustment of AFS securities	120,000	—
Nondeductible pension accrual	80,000	—
Tax loss carryforwards	100,000	—
Accelerated depreciation for tax purposes	—	(20,000)
Less valuation allowance	(60,000)	—
Noncurrent	240,000	(20,000)
Total	\$ 400,000	\$ (35,000)

\* The current and noncurrent portion of the tax effect of temporary differences and carryforwards is not a required disclosure under ASC 740. The information has been presented in this manner for illustrative purposes only.

## 5.05 Accounting for the Tax Effects of a Change in Tax Accounting Method

**Applicable before the adoption of ASU 2015-17 — see the [introduction to this chapter for more information](#).**

For U.S. income tax purposes, an entity will report income and deductions on the basis of its adopted income tax accounting methods. Unless the entity affirmatively changes its method(s), it is required to continue using the income tax accounting method(s) adopted. An entity may determine that it will affirmatively change its income tax accounting methods, perhaps from one permissible federal income tax accounting method to another. Alternatively, an entity may change from an impermissible method to a permissible method under the tax law. Changing an income tax accounting method may require advance written consent (a "manual" change), or it may be deemed approved upon the filing of a Form 3115 (an "automatic" change).

When a reporting entity makes a change to its adopted income tax accounting method, it must, under Section 481(a) of the Internal Revenue Code, treat a positive adjustment as an increase in taxable income that is generally recognized over four tax years. A negative adjustment is treated as a deduction recognized in the year of change.

In substance, a positive Section 481(a) adjustment results in a deferred revenue item for tax purposes with no corresponding amount for book purposes. Therefore, the positive Section 481(a) adjustment represents a taxable temporary difference, and the related tax consequences should be accounted for

as a DTL in a manner consistent with the classification guidance in ASC 740-10-55-77, which refers to the tax effects of the accounting change as a DTA or DTL and states, in part:

The deferred tax liability or asset associated with an accounting change for tax purposes would be classified like the associated asset or liability if reduction of that associated asset or liability will cause the temporary difference to reverse. If there is no associated asset or liability or if the temporary difference will reverse only over a period of time, the deferred tax liability or asset would be classified based on the expected reversal date of the specific temporary difference.

Generally, the temporary difference caused by a Section 481(a) adjustment will not be reversed on the basis of the settlement of the associated liability or recovery of the associated asset. Rather, the taxable temporary difference will reverse over a three-year period (i.e., the first year of the four-year adjustment is included immediately in taxable income, and the remaining adjustment will be included in taxable income in the following three tax years), as required by the tax code, and should be classified as current or noncurrent on that basis. See [5.01](#) for more information about classifying DTLs and DTAs as current or noncurrent.

### Example 5-3

An entity filed a change in accounting method with the IRS in 20X5 to revise the depreciable life of certain capital assets from 7 years to 15 years. The resulting positive Section 481(a) adjustment, which represents previously claimed depreciation deductions, was approximately \$300 million, and will be included in the entity's future taxable income ratably over a four-year period beginning in 20X5 on the basis of the requirements of the tax code.

In each annual period, \$75 million (calculated as \$300 million ÷ 4 years) of the Section 481(a) adjustment will reverse, increasing taxable income. The \$75 million that will be taxable in 20X5 should be reflected as an increase to the current tax liability or a decrease in an NOL DTA of \$26.25 million (\$75 million × tax rate of 35%). In accordance with ASC 740-10-45-9, the DTL related to the remaining Section 481(a) adjustment should be classified between current and noncurrent on the basis of the expected reversal date of the temporary difference.

(All amounts in millions)	As of 12/31/X5	As of 12/31/X6	As of 12/31/X7	As of 12/31/X8
Current income taxes payable*	\$ 26.25	\$ 26.25	\$ 26.25	\$ 26.25
Current deferred taxes	26.25	26.25	26.25	—
Noncurrent deferred taxes payable	<u>52.50</u>	<u>26.25</u>	<u>—</u>	<u>—</u>
Total	<u>\$ 105.00</u>	<u>\$ 78.75</u>	<u>\$ 52.50</u>	<u>\$ 26.25</u>

\* Reduced for any estimated tax payments made during the fiscal year.

## 5.06 Balance Sheet Classification of the Liability for UTBs

The ASC master glossary defines a UTB 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."

ASC 740-10-25-16 states:

The amount of benefit recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability is created (or the amount of a net operating loss carryforward or amount refundable is reduced) for an unrecognized tax benefit because it represents an entity's potential future obligation to the taxing authority for a tax position that was not recognized under the requirements of [ASC 740-10-25-6].

Further, ASC 740-10-45-11 states that an entity should "classify an unrecognized tax benefit that is presented as a liability in accordance with paragraphs 740-10-45-10A through 45-10B as a current

liability to the extent the entity anticipates payment (or receipt) of cash within one year or the operating cycle, if longer."

On the basis of this guidance, an entity will generally classify a liability associated with a UTB as a noncurrent liability because the period between the filing of the tax return and the final resolution of an uncertain tax position with the tax authority will generally extend over several years. An entity should classify as a current liability only those cash payments that management expects to make within the next 12 months to settle liabilities for UTBs.

In addition, an entity should only reclassify a liability from noncurrent to current when a change in the balance of the liability is expected to result from a payment of cash within one year or the operating cycle, if longer. For example, the portion of the liability for a UTB that is expected to reverse because of the expiration of the statute of limitations within the next 12 months would not be reclassified as a current liability. In these situations, the entity should consider the disclosure requirements in ASC 740-10-50-15 and 50-15A.

## **5.07 Financial Statement Display of Future Obligations to Tax Authorities Under Regulation S-X, Rule 5-02**

SEC Regulation S-X, Rule 5-02, provides guidance on the required line items of a balance sheet and any additional disclosures required on the face of the balance sheet or in the notes to the financial statements. The classification of a liability for UTBs could result in different disclosure requirements, such as whether this type of liability should be included in the tabular disclosure of contractual obligations.

On the basis of informal discussions with the SEC staff, a liability for UTBs should be classified as an "other current liability" or "other long-term liability" to comply with Regulation S-X, Rule 5-02. Because the SEC staff does not consider this liability a "contingent liability," disclosures for contingencies would not be required. However, an entity must follow the disclosure requirements outlined in ASC 740-10-50.

## **5.08 Interaction of UTBs and Tax Attributes**

U.S. tax law requires that an entity's taxable income be reduced by any available NOL carryforwards and carrybacks in the absence of an affirmative election to forgo the NOL carryback provisions. The Internal Revenue Service cannot require a taxpayer to cash-settle a disallowed uncertain tax position if sufficient NOLs or other tax carryforwards are available to eliminate the additional taxable income. Similarly, a taxpayer may not choose when to use its NOL carryforwards; rather, the taxpayer must apply NOL carryforwards and carrybacks in the first year in which taxable income arises. NOLs that are available but not used to reduce taxable income may not be carried to another period.

Assume that an entity takes, or expects to take, a \$200 deduction in the U.S. federal jurisdiction related to an UTB in its current-year tax return and for which the entity records an UTB of \$70 (35 percent tax rate  $\times$  \$200) in its financial statements. This UTB would be settled as of the reporting date without the payment of cash because of the application of available tax NOL carryforwards of \$1,000 in the U.S. federal jurisdiction for which the entity has recognized a \$350 DTA.

As discussed in ASC 740-10-45-10A and 45-10B, the entity's balance sheet should reflect the UTB as a reduction of the entity's NOL carryforward DTAs. Under ASC 740-10-45-10A, an entity must present a UTB, or a portion of a UTB, in its balance sheet "as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward" except when:

- An NOL or other carryforward is not available under the governing tax law to settle taxes that would result from the disallowance of the tax position.
- The entity does not intend to use the DTA for this purpose (provided that the tax law permits a choice).

If either of these conditions exists, an entity should present a UTB as a liability and not net the UTB with a DTA.

The assessment of whether to net the UTB with a DTA should be performed as of the reporting date (i.e., on a hypothetical-return basis). The entity should not evaluate whether the DTA will expire or be used before the UTB is settled. However, the entity must consider whether there are any limitations on the use of the DTA in the relevant tax jurisdiction.

Therefore, if the UTP of \$200 is not sustained, the entity may use its \$1,000 NOL carryforward to offset such UTP, thus resulting in a \$70 reduction to the existing NOL carryforward DTA of \$350. That is, the entity would present a net DTA of \$280.

## **5.09 Balance Sheet Presentation of UTBs Resulting From Transfer Pricing Arrangements**

Transfer pricing relates to the pricing of intra-entity and related-party transactions involving transfers of tangible property, intangible property, services, or financing between affiliated entities. These transactions include transfers between domestic or international entities, such as (1) U.S. to foreign, (2) foreign to foreign, (3) U.S. to U.S., and (4) U.S. state to state.

The general transfer pricing principle is that the pricing of a related-party transaction should be consistent with the pricing of similar transactions between independent entities under similar circumstances (i.e., an arm's-length transaction). Transfer pricing tax regulations are intended to prevent entities from using intracompany charges to evade taxes by inflating or deflating the profits of a particular jurisdiction the larger consolidated group does business in. Even if a parent corporation or its subsidiaries are in tax jurisdictions with similar tax rates, an entity may have tax positions that are subject to the recognition and measurement principles in ASC 740-10-25-6 and ASC 740-10-30-7.

An entity's exposure to transfer pricing primarily occurs when the entity includes in its tax return the benefit received from a related-party transaction that was not conducted as though it was at arm's length. A UTB results when one of the related parties reports either lower revenue or higher costs than it can justify or support (depending on the type of transaction). While a benefit is generally more likely than not to result from such a transaction (e.g., some amount will be allowed as an interest deduction, royalty expense, or cost of goods sold), the amount of benefit is often uncertain because of the subjectivity of valuing the related-party transaction.

An entity must apply ASC 740 to its transfer pricing arrangements. Sometimes an entity with a transfer pricing arrangement may not be able to fully recognize a tax benefit in one jurisdiction but may recognize a tax benefit in the related party's jurisdiction on the basis of the assertion that the entity has "competent-authority" procedures available and will request that those procedures be applied if one of the tax authorities were to propose an adjustment. Under the terms of certain tax treaties entered into by the United States and other foreign jurisdictions, competent authority is a mutual agreement procedure between countries that is designed to relieve companies of double taxation created by transfer pricing adjustments to previously filed tax returns. Typically, double-tax cases are resolved under the principles of the transfer pricing guidelines established by the OECD. If an entity elects to take a tax issue to a competent authority for resolution, the manner in which the double-taxation issue is resolved is at the discretion of the respective jurisdictions' competent authorities. To avoid double taxation, one tax authority makes an adjustment (i.e., reduces a cost and increases taxable income) that would require a consistent transfer pricing adjustment (i.e., reducing revenue and decreasing taxable income) in the related party's tax jurisdiction. However, there is no guarantee that an agreement between the jurisdictions will be reached and that double taxation will be avoided. See [4.70](#) for a detailed discussion of the application of transfer pricing arrangements under ASC 740.

In some cases, if two governments follow the OECD's transfer pricing guidelines to resolve substantive issues related to transfer pricing transactions between units of the same entity, an asset could be recognized in one jurisdiction because of the application of competent-authority procedures and a liability could be recognized for UTBs from another tax jurisdiction that arose because of transactions between the entity's affiliates not being considered at arm's length.

In this case, an entity should present the liability for UTBs and the tax benefit on a gross basis in its balance sheet. In addition, a public entity would only include the gross liability for UTBs in the tabular reconciliation disclosure. However, in the disclosure required by ASC 740-10-50-15A(b), the public entity would include the liability for UTBs and the tax benefit on a net basis in the amount of UTBs that, if recognized, would affect the ETR.

## **5.10 Presentation of Professional Fees**

Entities often incur costs for professional services (e.g., attorney and accountant fees) related to the implementation of tax strategies, the resolution of tax contingencies, assistance with the preparation of the income tax provision in accordance with ASC 740, or other tax-related matters.

It is not appropriate for an entity to include such costs as income tax expense or benefit in the financial statements. ASC 740 defines income tax expense (or benefit) as the sum of current tax expense (benefit) and deferred tax expense (benefit), neither of which would include fees paid to professionals in connection with tax matters.

Further, SEC Regulation S-X, Rule 5-03(b)(11), specifies that an entity should include only taxes based on income within the income tax expense caption in the income statement. Therefore, it is inappropriate to include professional fees within the income tax caption.

## Income Statement Presentation of Certain Measurement Changes to Income Tax Accounts

### ASC 740-10

**45-14** The following guidance addresses the presentation on the income statement of the effect of changes in deferred tax accounts caused by the following types of changes:

- a. Changes in tax laws or rates
- b. Changes in the tax status of an entity
- c. Changes that impact the valuation allowance for deferred tax assets
- d. Changes related to assets acquired outside of a business combination.

#### ***Changes in Tax Laws or Rates***

**45-15** When deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date. [FAS 109, paragraph 27]

**45-16** Paragraph 740-10-25-48 provides the recognition guidance when a tax law retroactively changes tax rates. In such cases, the cumulative tax effect is included in income from continuing operations.

**45-17** Paragraph 740-10-30-26 provides the measurement guidance for a change in tax rates on items not included in income from continuing operations that arose during the current fiscal year and prior to the date of enactment. In such cases, the tax effect of a retroactive change in enacted tax rates on current or deferred tax assets and liabilities related to those items is included in income from continuing operations in the period of enactment. [EITF 93-13, paragraph Discussion]

**45-18** Paragraph 740-10-25-47 requires that the effect of a change in tax laws or rates be recognized at the date of enactment. Accordingly, if an entity were adopting a new accounting standard as of a date prior to the enactment date, the effect of the change in tax laws or rates would not be recognized in the cumulative effect of adopting the standard, but would be recognized in income from continuing operations for the period that includes the enactment date. This would be true regardless of whether the change was retroactive to the earlier date. [EITF D-30]

#### ***Changes in the Tax Status of an Entity***

**45-19** When deferred tax accounts are recognized or derecognized as required by paragraphs 740-10-25-32 and 740-10-40-6 due to a change in tax status, the effect of recognizing or derecognizing the deferred tax liability or asset shall be included in income from continuing operations. [FAS 109, paragraph 28]

#### ***Changes That Impact the Valuation Allowance for Deferred Tax Assets***

**45-20** The effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years ordinarily shall be included in income from continuing operations. The only exceptions are changes to valuation allowances of certain tax benefits that are adjusted within the measurement period as required by paragraph 805-740-45-2 related to business combinations and the initial recognition (that is, by elimination of the valuation allowances) of tax benefits related to the items specified in paragraph 740-20-45-11(c) through (f). The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations as required by paragraphs 740-20-45-2 and 740-20-45-8. [FAS 109, paragraph 26]

**45-21** Changes in valuation allowances due to changed expectations about the realization of deferred tax assets caused by transactions among or with shareholders shall be included in the income statement. A write-off of a preexisting deferred tax asset that an entity can no longer realize as a result of a transaction among or with its shareholders shall similarly be charged to the income statement. The same net effect results from eliminating a deferred tax asset and increasing a valuation allowance to 100 percent of the amount of the related deferred tax asset. [EITF 94-10, paragraph Discussion]

### ASC 740-10 (continued)

#### ***Changes Related to Assets Acquired Outside of a Business Combination***

**45-22** Paragraph 740-10-25-51 addresses the accounting when an asset is acquired outside of a business combination and the tax basis of the asset differs from the amount paid and identifies related examples. In the event that the accounting results in the recognition of a deferred tax asset and if, subsequent to the acquisition, it becomes more likely than not that some or all of the acquired deferred tax asset will not be realized, the effect of such adjustment shall be recognized in continuing operations as part of income tax expense. A proportionate share of any remaining unamortized deferred credit balance arising from the accounting required in that paragraph shall be recognized as an offset to income tax expense. The deferred credit shall not be classified as part of deferred tax liabilities or as an offset to deferred tax assets.

**45-23** Income tax uncertainties that exist at the date of acquisition of the asset shall be accounted for in accordance with this Subtopic.

**45-24** As indicated in paragraph 740-10-25-51, subsequent accounting for an acquired valuation allowance (for example, the subsequent recognition of an acquired deferred tax asset by elimination of a valuation allowance established at the date of acquisition of the asset) would be in accordance with paragraphs 805-740-25-3 through 25-4 and 805-740-45-2. [EITF 98-11, paragraph Discussion]

For more information, see [3.54](#), [3.58](#), and [3.59](#).

## Income Statement Classification of Interest and Penalties

### ASC 740-10

**45-25** Interest recognized in accordance with paragraph 740-10-25-56 may be classified in the financial statements as either income taxes or interest expense, based on the accounting policy election of the entity. Penalties recognized in accordance with paragraph 740-10-25-57 may be classified in the financial statements as either income taxes or another expense classification, based on the accounting policy election of the entity. Those elections shall be consistently applied. [FIN 48, paragraph 19]

## 5.11 Classification of Interest and Penalties in the Financial Statements

ASC 740-10-45-25 permits an entity, on the basis of its accounting policy election, to classify interest in the financial statements as either income taxes or interest expense and to classify penalties in the financial statements as either income taxes or another expense classification. The election must be consistently applied. An entity's accounting policy for classification of interest may be different from its policy for classification of penalties. For example, interest expense may be recorded above the line as part of interest expense and penalties may be recorded below the line as part of income tax expense.

An SEC registrant that changes its financial statement classification of interest and penalties should provide the disclosures specified by ASC 250-10-50-1 through 50-3. Such a change in accounting principle should be retrospectively applied beginning with the first interim period in the year of adoption. In addition, the SEC staff has indicated that a preferability letter is required for classification changes.

An entity's balance sheet classification related to the accruals for interest and penalties (as part of accrued liabilities or as part of the liability for UTBs) must be consistent with the income statement classification (above the line or below the line). For example, an entity that classifies interest as a component of interest expense should classify the related accrual for interest as a component of accrued expenses. Likewise, an entity that classifies interest as a component of income tax expense should classify the related accrual for interest as a component of the liability for UTBs; however the amounts are classified, they should be presented separate of the UTB in the tabular rollforward required by ASC 740-10-50-15A.

## Investment Tax Credits Under the Deferral Method

### ASC 740-10

**45-26** Paragraph 740-10-25-46 describes two acceptable methods for recognizing the benefit of investment tax credits. The following guidance addresses presentation matters related to one of those methods, the deferral method.

#### ***Statement of Financial Position***

**45-27** The reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) may be preferable in many cases. However, it is equally appropriate to treat the credit as deferred income, provided it is amortized over the productive life of the acquired property. [APB 2, paragraph 14]

#### ***Income Statement***

**45-28** It is preferable that the statement of income in the year in which the allowable investment credit arises should be affected only by the results which flow from the accounting for the credit set forth in paragraph 740-10-25-46. Nevertheless, reflection of income tax provisions, in the income statement, in the amount payable (that is, after deduction of the allowable investment credit) is appropriate provided that a corresponding charge is made to an appropriate cost or expense (for example, to the provision for depreciation) and the treatment is adequately disclosed in the financial statements of the first year of its adoption. [APB 2, paragraph 15]

### Pending Content (Transition Guidance: ASC 220-10-65-4)

#### **Statement of Shareholder Equity Reclassification of Certain Income Tax Effects from Accumulated Other Comprehensive Income**

**45-29** Paragraph 220-10-45-12A provides guidance on the reclassification of certain income tax effects of items within accumulated other comprehensive income to retained earnings. That guidance results from H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act). [ASU 2018-02, paragraph 4]

# Chapter 6 — Disclosure

This chapter outlines the income tax accounting disclosures that entities are required to provide in the notes to, and on the face of, the financial statements. [Appendix D, "Sample Disclosures of Income Taxes,"](#) provides disclosure examples that may be helpful as the requirements outlined in this chapter are considered. Disclosure requirements related to certain special areas are addressed in other chapters of this Roadmap as follows:

- [Chapter 8, "Other Considerations or Special Areas,"](#) contains guidance on required disclosures for unrecognized DTLs related to investments in subsidiaries and corporate joint ventures.
- [Chapter 9, "Interim Reporting,"](#) contains guidance on required disclosures within interim financial statements.
- [Chapter 11, "Business Combinations,"](#) contains guidance on required disclosures for the effects of a business combination on an entity's valuation allowance.
- [Chapter 13, "Qualified Affordable Housing Project Investments,"](#) contains guidance on required disclosures for entities that have investments in qualified affordable housing projects.

## Statement of Financial Position-Related Disclosures

### ASC 740-10

**50-2** The components of the net deferred tax liability or asset recognized in an entity's statement of financial position shall be disclosed as follows:

- a. The total of all deferred tax liabilities measured in paragraph 740-10-30-5(b)
- b. The total of all deferred tax assets measured in paragraph 740-10-30-5(c) through (d)
- c. The total valuation allowance recognized for deferred tax assets determined in paragraph 740-10-30-5(e).

The net change during the year in the total valuation allowance also shall be disclosed. [FAS 109, paragraph 43]

**50-3** An entity shall disclose both of the following:

- a. The amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes
- b. Any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be credited directly to contributed capital (see paragraph 740-20-45-11). [FAS 109, paragraph 48]

**50-4** In the event that a change in an entity's tax status becomes effective after year-end in Year 2 but before the financial statements for Year 1 are issued or are available to be issued (as discussed in ASC 855-10-25), the entity's financial statements for Year 1 shall disclose the change in the entity's tax status for Year 2 and the effects of that change, if material. [QA 109, paragraph 11]

**50-5** An entity's temporary difference and carryforward information requires additional disclosure. The additional disclosure differs for public and nonpublic entities.

**ASC 740-10 (continued)*****Public Entities***

**50-6** A public entity shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances). [FAS 109, paragraph 43]

**50-7** See paragraph 740-10-50-16 for disclosure requirements applicable to a public entity that is not subject to income taxes.

***Nonpublic Entities***

**50-8** A nonpublic entity shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type. [FAS 109, paragraph 43]

## **6.01 Required Level of Detail**

When disclosing gross DTAs and DTLs, an entity should separately disclose deductible and taxable temporary differences. An entity can determine individual disclosure items by looking at financial statement captions (e.g., property, plant, and equipment) or by subgroup (e.g., tractors, trailers, and terminals for a trucking company) or individual asset. An entity should look to the level of detail in its general accounting records (e.g., by property subgroup) but is not required to quantify temporary differences by individual asset. The level of detail used should not affect an entity's net deferred tax position but will affect its footnote disclosure of gross DTAs and DTLs.

## **6.02 Definition of "Significant" With Respect to Disclosing the Tax Effect of Each Type of Temporary Difference and Carryforward That Gives Rise to DTAs and DTLs**

ASC 740-10-50-6 requires that a public entity disclose "the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances)." Neither ASC 740-10-50 nor SEC Regulation S-X defines "significant," as used in this paragraph. However, the SEC staff has indicated that, to meet this requirement, public entities should disclose all components that equal or exceed 5 percent of the gross DTA or DTL.

## **6.03 Disclosure of Worthless Tax Benefits**

ASC 740-10-50-6 requires that a public entity disclose "the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances)." Questions have arisen about whether it is appropriate to write off a DTA and its related valuation allowance when an entity believes that realization is not possible in future tax returns (e.g., situations in which an entity with a foreign loss carryforward discontinues operations in a foreign jurisdiction in which the applicable tax law does not impose an expiration period for loss carryforward benefits).

Paragraph 156 of the Basis for Conclusions of Statement 109 states:

Some respondents to the Exposure Draft stated that disclosure of the amount of an enterprise's total deferred tax liabilities, deferred tax assets, and valuation allowances is of little value and potentially misleading. It might be misleading, for example, to continue to disclose a deferred tax asset and valuation allowance of equal amounts for a loss carryforward after operations are permanently terminated in a particular tax jurisdiction. The Board believes that it need not and should not develop detailed guidance for when to cease disclosure of the existence of a worthless asset. Some financial statement users, on the other hand, stated that disclosure of

the total liability, asset, and valuation allowance as proposed in the Exposure Draft is essential for gaining some insight regarding management's decisions and changes in decisions about recognition of deferred tax assets. Other respondents recommended significant additional disclosures such as the extent to which net deferred tax assets are dependent on (a) future taxable income exclusive of reversing temporary differences or even (b) *each* of the four sources of taxable income cited in paragraph 21. After reconsideration, the Board concluded that disclosure of the total amounts as proposed in the Exposure Draft is an appropriate level of disclosure.

Therefore, while an entity is generally required to disclose the total amount of its DTLs, DTAs, and valuation allowances, there is no detailed guidance for when to cease disclosure of the existence of a worthless tax benefit, and the entity needs to use judgment. In the above example, it is appropriate to write off the DTA if the entity will not continue operations in that jurisdiction in the future. However, if operations are to continue, it is not appropriate to write off the DTA and valuation allowance, regardless of management's assessment about future realization.

## 6.04 Change in Tax Status to Taxable: Financial Reporting Considerations

In certain situations, an entity may be required to disclose, in the financial statements included in an SEC filing, pro forma information regarding a change in tax status. One example would be an entity (e.g., an S corporation) that changes its tax status in connection with an IPO. The financial statements presented in the registration statement on Form S-1 for the periods in which the entity was a nontaxable entity are not restated for the effect of income tax. Rather, the entity must provide pro forma disclosures to illustrate the effect of income tax on those years.

Therefore, certain income tax reporting considerations may arise when an SEC registrant changes its status from nontaxable to taxable. Paragraph 3410.1 of the SEC Financial Reporting Manual (FRM) states:

If the issuer was formerly a Sub-Chapter S corporation ("Sub-S"), partnership or similar tax exempt enterprise, pro forma tax and EPS data should be presented on the face of historical statements for the periods identified below:

- a. If necessary adjustments include more than adjustments for taxes, limit pro forma presentation to latest fiscal year and interim period
- b. If necessary adjustments include only taxes, pro forma presentation for all periods presented is encouraged, but not required.

The pro forma information should be prepared in accordance with SEC Regulation S-X, Rule 11-02. The tax rate used for the pro forma calculations should normally equal the "statutory rate in effect during the periods for which the pro forma income statements are presented," as stated in Section 3270 of the FRM. However, Section 3270 also indicates that "[c]ompanies are allowed to use different rates if they are factually supportable and disclosed."

If an entity chooses to provide pro forma information for all periods presented under option (b) above, the entity should continue to present this information in periods after the entity becomes taxable to the extent that the earlier comparable periods are presented.

With respect to the pro forma financial information, any undistributed earnings or losses of a Sub-S are viewed as distributions to the owners immediately followed by a contribution of capital to the new taxable entity. ASC 505-10-S99-3 states that these earnings or losses should therefore be reclassified to paid-in capital.

See [6.06](#) for a discussion of whether disclosure should be based on the temporary differences that existed as of the first day of the entity's fiscal year or on temporary differences that exist as of the date of a change in tax status.

## Income-Statement-Related Disclosures

### ASC 740-10

**50-9** The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

- a. Current tax expense (or benefit)
- b. Deferred tax expense (or benefit) (exclusive of the effects of other components listed below)
- c. Investment tax credits
- d. Government grants (to the extent recognized as a reduction of income tax expense)
- e. The benefits of operating loss carryforwards
- f. Tax expense that results from allocating certain tax benefits directly to contributed capital
- g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the entity
- h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. For example, any acquisition-date income tax benefits or expenses recognized from changes in the acquirer's valuation allowance for its previously existing deferred tax assets as a result of a business combination (see paragraph 805-740-30-3). [FAS 109, paragraph 45]

**50-10** The amount of income tax expense (or benefit) allocated to continuing operations and the amounts separately allocated to other items (in accordance with the intraperiod tax allocation provisions of paragraphs 740-20-45-2 through 45-14 and 852-740-45-3) shall be disclosed for each year for which those items are presented. [FAS 109, paragraph 46]

### Related Implementation Guidance and Illustrations

- [Income-Tax-Related Disclosures](#) [ASC 740-10-55-79].
- [Example 29: Disclosure Related to Components of Income Taxes Attributable to Continuing Operations](#) [ASC 740-10-55-212].

## 6.05 Disclosure of the Components of Deferred Tax Expense

ASC 740-10-50-9 requires entities to disclose significant components of income tax expense or benefit that are attributable to continuing operations for each year presented in the financial statements. One of those components is deferred tax expense (or benefit).

It is sometimes possible for the total deferred tax expense or benefit for the year reported in the footnotes to the financial statements to equal the change between the beginning-of-year and end-of-year balances of deferred tax accounts (i.e., assets, liabilities, and valuation allowance) on the balance sheet. However, in many circumstances, the effects of changes in deferred tax balances do not affect the total tax provision. Examples of such circumstances include, but are not limited to, the following:

- If a business combination has occurred during the year, DTLs and DTAs, net of any related valuation allowance, are recorded as of the acquisition date as part of acquisition accounting. There would be no offsetting effect to the income tax provision.
- If a single asset is purchased (other than as part of a business combination) and the amount paid is different from the tax basis attributable to the asset, the tax effect should be recorded as an adjustment to the carrying amount of the related asset in accordance with ASC 740-10-25-51.

- For consolidated subsidiaries in foreign jurisdictions for which the functional currency is the same as the parent's reporting currency but income taxes are assessed in the local currency, deferred tax balances should be remeasured in the functional currency as transaction gains or losses or, if considered more useful, as deferred tax benefit or expense, as described in ASC 830-740-45-1.
- For consolidated subsidiaries in foreign jurisdictions for which the local currency is the functional currency and income taxes are assessed in the local currency, deferred tax balances should be translated into the parent's reporting currency through the CTAs account. The reevaluations of the deferred tax balances are not identified separately from reevaluations of other assets and liabilities.

In addition, other changes in deferred tax balances might result in an increase or a decrease in the total tax provision but are allocated to a component of current-year activity other than continuing operations (e.g., discontinued operations and the items in ASC 740-20-45-11 such as OCI).

## 6.06 Disclosure of the Tax Effect of a Change in Tax Law, Rate, or Tax Status

ASC 740-10-50-9(g) requires an entity to disclose, in a footnote or on the face of the financial statements, the tax consequences of adjustments of a DTL or DTA for enacted changes in tax laws or rates or a change in the tax status of the entity.

Measurement of the tax effects of enacted changes in tax laws or rates or of a change in tax status as of an interim date (as required by ASC 740-10-50-9(g)) is sometimes complex because accounting for income taxes in interim periods under ASC 740-270 is based on estimates of the tax consequences that an entity is expected to incur for its full fiscal year (e.g., an integral approach rather than a discrete approach).

An entity may disclose the tax consequences of changes in tax laws or rates or a tax status change on the face of its income statement as a separate line item component (e.g., a subtotal) that, in the aggregate, equals the total amount of income tax expense (benefit) allocated to income (loss) from continuing operations for each period presented. However, the entity should not present the effects of these changes on the face of the income statement or in the footnotes in terms of per share earnings (loss) amounts available to common shareholders, because such disclosure would imply that the normal EPS disclosures required by ASC 260 are not informative or are misleading.

## Income Tax Expense Compared to Statutory Expectations

### ASC 740-10

**50-11** The reported amount of income tax expense may differ from an expected amount based on statutory rates. The following guidance establishes the disclosure requirements for such situations and differs for public and nonpublic entities.

#### **Public Entities**

**50-12** A public entity shall disclose a reconciliation using percentages or dollar amounts of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The statutory tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed. [FAS 109, paragraph 47]

#### **Nonpublic Entities**

**50-13** A nonpublic entity shall disclose the nature of significant reconciling items but may omit a numerical reconciliation.

**ASC 740-10 (continued)*****All Entities***

**50-14** If not otherwise evident from the disclosures required by this Section, all entities shall disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented. [FAS 109, paragraph 47]

## 6.07 Evaluating Significance of Reconciling Items in the Rate Reconciliation

Reporting entities often pay income taxes in multiple jurisdictions other than the domestic federal jurisdiction (e.g., domestic state and local jurisdictions, foreign federal and foreign local or provincial jurisdictions), and the applicable income tax rates vary in each jurisdiction. Further, tax laws often differ from financial accounting standards; therefore, permanent differences can arise between pretax income for financial reporting purposes and taxable income.

Therefore, a reporting entity's income tax expense cannot generally be determined for a period by simply applying the domestic federal statutory tax rate to the reporting entity's pretax income from continuing operations for financial reporting purposes. ASC 740-10-50-12 states:

A public entity shall disclose a reconciliation using percentages or dollar amounts of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The statutory tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed.

A nonpublic entity shall disclose the nature of significant reconciling items but may omit a numerical reconciliation.

This is often referred to as the “rate reconciliation” disclosure requirement. The SEC staff frequently comments on rate reconciliation disclosures.

ASC 740-10-50 does not define the term “significant.” However, SEC Regulation S-X, Rule 4-08(h), states that as part of the reconciliation, public entities should disclose all reconciling items that individually make up 5 percent or more of the computed amount (i.e., income before tax multiplied by the applicable domestic federal statutory tax rate).

Reconciling items may be aggregated in the disclosure if they are individually less than 5 percent of the computed amount. Reconciling items that are individually equal to or greater than 5 percent of the computed amount should not be netted against other offsetting reconciling items into a single line item that is itself less than 5 percent.

Rule 4-08(h) states that public entities can omit this reconciliation in the following circumstances:

[When] no individual reconciling item amounts to more than five percent 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 five percent of such computed amount, no reconciliation need be provided unless it would be significant in appraising the trend of earnings.

Because Rule 4-08(h) does not apply to nonpublic entities, such entities must often use judgment in determining whether they need to disclose the nature of a particular reconciling item or items.

## 6.07A Appropriate Federal Statutory Rate for Use in the Rate Reconciliation of a Foreign Reporting Entity

ASC 740-10-50-12 requires a public entity to disclose a reconciliation of current-year income tax expense to the amount of income tax expense that would have resulted from applying the domestic federal statutory tax rates to pretax income from continuing operations. ASC 740-10-50-13 requires nonpublic entities to disclose the nature of significant reconciling items, but nonpublic entities are not required to provide a numerical reconciliation. See [6.07](#) for a discussion of the rate reconciliation disclosure required by ASC 740-10-50-12 and 50-13.

ASC 740-10-50-12 indicates that the federal statutory income tax rate a foreign reporting entity (i.e., the parent of the consolidated group that is not domiciled in the United States) should use when preparing the rate reconciliation disclosure should be based on application of "domestic federal statutory tax rates" to pretax income from continuing operations. SEC Regulation S-X, Rule 4-08(h)(2), states, in part:

Where the reporting person is a foreign entity, the income tax rate in that person's country of domicile should normally be used in making the above computation, but different rates should not be used for subsidiaries or other segments of a reporting entity.

As noted, the appropriate rate for public entities is normally the federal rate in the reporting entity's jurisdiction of domicile. That rate should be applied to pretax income from continuing operations of all subsidiaries or other segments of the reporting entity, even if most of the operations are located outside that jurisdiction.<sup>1</sup> Rule 4-08(h)(2) also notes that if the rate used differs from the U.S. federal corporate income tax rate (e.g., because the reporting entity is domiciled in a foreign jurisdiction), "the rate used and the basis for using such rate shall be disclosed."

Question 1 in paragraph 5 of SAB Topic 6.I (also codified in ASC 740-10-S99-1(5)), provides an exception to the general rule, and states:

**Question 1:** Occasionally, reporting foreign persons may not operate under a normal income tax base rate such as the current U.S. Federal corporate income tax rate. What form of disclosure is acceptable in these circumstances?

**Interpretive Response:** In such instances, reconciliations between year-to-year effective rates or between a weighted average effective rate and the current effective rate of total tax expense may be appropriate in meeting the requirements of Rule 4-08(h)(2). A brief description of how such a rate was determined would be required in addition to other required disclosures. Such an approach would not be acceptable for a U.S. registrant with foreign operations. Foreign registrants with unusual tax situations may find that these guidelines are not fully responsive to their needs. In such instances, registrants should discuss the matter with the staff.

The use of a rate other than the federal rate in the reporting entity's jurisdiction of domicile could be subject to challenge and, accordingly, consultation is encouraged in these situations.

While Rule 4-08(h) does not apply to nonpublic entities, we believe that it would generally be appropriate for a nonpublic entity to determine the domestic federal statutory rate in a manner consistent with how a public reporting entity determines it.

## 6.07B Computing the "Foreign Rate Differential" in the Rate Reconciliation

Reporting entities often pay income taxes in multiple jurisdictions other than the domestic federal jurisdiction (e.g., domestic state and local jurisdictions, foreign federal and foreign local or provincial jurisdictions), and the applicable income tax rates vary in each jurisdiction. Therefore, a reporting entity's income tax expense cannot generally be determined for a period by simply applying the domestic federal statutory tax rate to the reporting entity's pretax income from continuing operations for financial reporting purposes.

<sup>1</sup> This would apply to (or **include**) a tax inversion.

ASC 740-10-50-12 requires public entities to disclose a reconciliation of the “reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations.” This is often referred to as the “rate reconciliation” disclosure requirement.

SEC Regulation S-X, Rule 4-08(h), requires an entity to show “the estimated dollar amount of each of the underlying causes for the difference.” (See [6.07](#) for a discussion of how a reporting entity should evaluate the significance of various reconciling items.) However, the unit of account for various reconciling items is not always clear. For example, an entity with foreign operations will commonly include a reconciling item referred to as a “foreign rate differential.” Because it is often unclear what the foreign rate differential reconciling line should include, diversity in practice exists.

ASC 740 does not require a reporting entity to include a specific number or type of reconciling items in the rate reconciliation. Reconciling items will vary on the basis of the reporting entity’s facts and circumstances. However, the SEC staff frequently comments on rate reconciliation disclosures that are not clear and transparent. We believe that a line in the rate reconciliation described as the foreign rate differential should generally only include the effects on an entity’s effective tax rate of differences between the domestic federal statutory tax rate and the income tax rate in the applicable foreign jurisdiction(s), multiplied by pretax income from continuing operations in each respective foreign jurisdiction. A reporting entity should likewise evaluate its other reconciling items to ensure that they clearly communicate to financial statement users the events and circumstances affecting the reporting entity’s effective tax rate.

## Unrecognized Tax Benefits-Related Disclosures

### ASC 740-10

#### [All Entities]

**50-15** All entities shall disclose all of the following at the end of each annual reporting period presented: . . .

- c. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position
- d. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
  - 1. The nature of the uncertainty
  - 2. The nature of the event that could occur in the next 12 months that would cause the change
  - 3. An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.
- e. A description of tax years that remain subject to examination by major tax jurisdictions. [FIN 48, paragraph 21]

## **ASC 740-10 (continued)**

### **[Public Entities]**

**50-15A** Public entities shall disclose both of the following at the end of each annual reporting period presented:

- a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:
  1. The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period
  2. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period
  3. The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities
  4. Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.
- b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. [ASU 2009-06, paragraph 5]

See Example 30 (paragraph 740-10-55-217) for an illustration of disclosures about uncertainty in income taxes.

### **Related Implementation Guidance and Illustrations**

- [Example 30: Disclosure Relating to Uncertainty in Income Taxes](#) [ASC 740-10-55-217].

## **6.08 Periodic Disclosures of UTBs**

Both ASC 740-10-50-15 and 50-15A appear to require entities to provide disclosures at the end of each annual reporting period presented. Accordingly, entities should present the information required by ASC 740-10-50-15 and 50-15A for each applicable period. For example, if a public entity were to present three years of income statements and two years of balance sheets, the disclosures listed in ASC 740-10-50-15 and 50-15A would be required for each year in which an income statement is presented.

## **6.09 Disclosure of Expiration of Statute of Limitations**

ASC 740-10-50-15(d) requires an entity to disclose information “[f]or 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.”

A scheduled expiration of the statute of limitations within 12 months of the reporting date is subject to the disclosure requirements in ASC 740-10-50-15(d). If the statute of limitations is scheduled to expire within 12 months of the date of the financial statements and management believes that it is reasonably possible that the expiration of the statute will cause the total amounts of UTBs to significantly increase or decrease, the entity should disclose the required information.

## **6.10 Disclosure Requirements for Effectively Settled Tax Positions**

There are no specific disclosure requirements for tax positions determined to be effectively settled as described in ASC 740-10-25-10. However, the requirements in ASC 740-10-50-15(d) should not be overlooked. Under these requirements, an entity must disclose tax positions for which it is reasonably possible that the total amounts of UTBs will significantly increase or decrease within 12 months of the reporting date.

**Example 6-1**

A calendar-year-end entity is currently undergoing an audit of its 20X4 tax year. The 20X4 tax year includes tax positions that did not meet the more-likely-than-not recognition threshold. Therefore, the entity recognized a liability for the UTBs associated with those tax positions. The entity believes that the tax authority will complete its audit of its 20X4 tax year during 20X8. It also believes that it is reasonably possible that the tax positions within that tax year will meet the conditions to be considered effectively settled. When preparing its ASC 740-10-50-15(d) disclosure as of December 31, 20X7, the entity should include the estimated decrease of its UTBs for the tax positions taken in 20X4 that it believes will be effectively settled.

## **6.11 Disclosure of UTBs That Could Significantly Change Within 12 Months of the Reporting Date**

ASC 740-10-50-15(d) requires annual disclosure of certain information about an entity's uncertain tax 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." Sometimes, the total amount of a UTB will change without affecting the income statement (e.g., a UTB may be expected to be settled in an amount equal to its carrying value). In other cases, a change in the total amount of a UTB will affect the income statement (e.g., the tax benefit will be recognized because the applicable statute of limitations has expired). Further, UTBs may be attributable to either permanent differences, which affect income tax if adjusted, or temporary differences, which do not affect income tax if adjusted.

The ASC 740-10-50-15(d) disclosure is intended to provide financial statement users with information about future events (such as settlements with the tax authority or the expiration of the applicable statute of limitations) that may result in significant changes to the entity's total UTBs within 12 months of the reporting date. "Total UTBs" would be those reflected in the tabular reconciliation required by ASC 740-10-50-15A. The disclosure should not be limited to UTBs for which it is reasonably possible that the significant changes will affect the income statement or to UTBs associated with permanent differences.

**Example 6-2**

An entity identifies an uncertain tax position and measures the UTB at \$40 million as of the reporting date of year 1. The tax authorities are aware of the uncertain tax position, and the entity expects that it is reasonably possible to settle the amount in the fourth quarter of year 2 for between \$20 million and \$60 million and that the potential change in UTB would be significant. In this example, the entity's ASC 740-10-50-15(d) financial statement disclosure for year 1 should report that because of an anticipated settlement with the tax authorities, it is reasonably possible that the amount of UTBs may increase or decrease by \$20 million.

**Example 6-3**

An entity identifies an uncertain tax position and measures the UTB at \$40 million as of the reporting date of year 1. The tax authorities are aware of the uncertain tax position, and while the entity expects to settle the amount for \$40 million in the fourth quarter of year 2, it is reasonably possible that the entity could sustain the position. The uncertain tax position is a binary position with only zero or \$40 million as potential outcomes. In this example, provided that the change in UTB would be significant, the entity's ASC 740-10-50-15(d) financial statement disclosure for year 1 should state that it is reasonably possible that a decrease of \$40 million in its UTB obligations could occur within 12 months of the reporting date because of an anticipated settlement with the tax authorities.

#### Example 6-4

On January 1 of year 1, an entity (1) incurs \$10 million of costs related to maintaining equipment and (2) claims a deduction for repairs and maintenance for the entire amount of the costs incurred in its tax return filed for year 1. It is more likely than not that the tax law requires the costs to be capitalized and depreciated over a five-year period. As of the reporting date in year 1, the entity recognized an \$8 million liability for a UTB associated with the deductions taken for tax purposes in year 1. Management believes that the \$8 million liability will be reduced by \$2 million per year over the next four years as the entity forgoes claiming depreciation for the asset previously deducted. In this example, provided that the change in UTB would be significant, the entity's ASC 740-10-50-15(d) financial statement disclosure for year 1 should state that it is reasonably possible that a decrease of \$2 million will occur within 12 months of the reporting date. The entity should continue to disclose such information in subsequent years until the liability balance is reduced to zero (provided that the entity does not expect a more accelerated reversal of the UTB resulting from an audit of the year of deduction).

While ASC 740-10-50-15(d) does not require disclosure of whether a reasonably possible change in UTB will affect tax expense, an entity may consider disclosing the amounts of the expected change that will affect tax expense and the amounts that will not.

### 6.12 Interim Disclosure Considerations Related to UTBs That Will Significantly Change Within 12 Months

The ASC 740-10-50-15(d) disclosure is required as of the end of each annual reporting period presented. However, material changes since the end of the most recent fiscal year-end should be disclosed in the interim financial statements in a manner consistent with SEC Regulation S-X, Article 10.

Therefore, in updating the ASC 740-10-50-15(d) disclosure for interim financial reporting, an entity must consider changes in expectations from year-end as well as any events not previously considered at year-end that may occur within 12 months of the current interim reporting date and that could have a material effect on the entity. This effectively results in a "rolling" 12-month disclosure. For example, an entity that is preparing its second-quarter disclosure for fiscal year 20X7 should consider any events that may occur in the period from the beginning of the third quarter of fiscal year 20X7 to the end of the second quarter of fiscal year 20X8 to determine the total amounts of UTBs for which a significant increase or decrease is reasonably possible within 12 months of the reporting date.

### 6.13 Amounts Included in the Tabular Reconciliation of UTBs

ASC 740-10-50-15A(a) requires public entities to disclose a "tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period." In some cases, the beginning and ending amounts in the tabular disclosure equal the amount recorded as a liability for the UTBs in the balance sheet. However, that is not always the case, since the reconciliation must include, on a comprehensive basis, all UTBs that are recorded in the balance sheet, not just the amount that is classified as a liability. In other words, the reconciliation should include an amount recorded as a liability for UTBs and amounts that are recorded as a reduction in a DTA, a current receivable, or an increase in a DTL. (See [5.08](#) for an example of a UTB recorded as a reduction in a DTA.)

### 6.14 Separate Disclosure of Interest Income, Interest Expense, and Penalties

Interest income, interest expense, and penalties should be disclosed separately. In addition, an entity should disclose interest income, interest expense, and penalties gross without considering any tax effects. In accordance with ASC 740-10-50-19, an entity should also disclose its policy for classification of interest and penalties.

## **6.15 Disclosure of Interest and Penalties Recorded in the Tabular Reconciliation of UTBs**

ASC 740-10-45-25 allows an entity to make a policy election regarding its classification of interest and penalties recognized in accordance with ASC 740-10-25-56 or 25-57. Interest can be classified as either income tax expense or interest expense, and penalties can be classified as either income tax expense or other expense. An entity's balance sheet classification should be consistent with its income statement classification. An entity that classifies interest or penalties as a component of income tax expense should classify the related accrual as a component of the liability for UTBs.

Interest and penalties that are classified as part of income tax expense in the statement of operations, and that are therefore classified as a component of the liability for UTBs in the statement of financial position, should not be included by public entities in the tabular reconciliation of UTBs under ASC 740-10-50-15A(a).

An entity's policy election for interest and penalties under ASC 740-10-45-25 does not affect the disclosures under ASC 740-10-50-15A.

## **6.16 Presentation of Changes Related to Exchange Rate Fluctuations in the Tabular Reconciliation**

Exchange rate fluctuations are not changes in judgment regarding recognition or measurement and are not considered as part of the settlement when a tax position is settled. Therefore, in the tabular reconciliation, increases or decreases in UTBs caused by exchange rate fluctuations should not be combined with other types of changes; rather, they should be presented as a separate line item (a single line item is appropriate).

## **6.17 Disclosure of Fully Reserved DTAs in the Reconciliation of UTBs**

Public entities with NOLs and a full valuation allowance would be required to disclose amounts in their tabular disclosure for positions that, if recognized, would manifest themselves as DTAs that cannot be recognized under ASC 740-10. The general recognition and measurement provisions should be applied first; the remaining balance should then be evaluated for realizability in accordance with ASC 740-10-30-5(e).

### **Example 6-5**

A public entity has a \$1 million NOL carryforward. Assume a 40 percent tax rate. The entity records a \$400,000 DTA, for which management applies a \$400,000 valuation allowance because it does not believe it is more likely than not that the entity will have income of the appropriate character to realize the NOL. Management concludes that the tax position that gave rise to the NOL will more likely than not be realized on the basis of its technical merits. The entity concludes that the benefit should be measured at 90 percent. The entity would need to reduce the DTA for the NOL and the related valuation allowance to \$360,000, which represents 90 percent of the benefit. In addition, the entity would include a UTB of \$40,000 in the tabular disclosure under ASC 740-10-50-15A(a).

## 6.18 Items Included in the Tabular Disclosure of UTBs From Uncertain Tax Positions May Also Be Included in Other Disclosures

ASC 740-10-50-15A(a) indicates that the tabular reconciliation of the total amounts of UTBs should include the “gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period” or a current period. Increases and decreases in the estimate that occur in the same year can be reflected on a net basis in the tabular reconciliation. However, if these changes in estimate are significant, it may be appropriate to disclose them on a gross basis elsewhere in the footnotes to the financial statements. For example, if a public entity did not recognize any tax benefit for a significant position taken in the second quarter (and therefore recognized a liability for the full benefit), but subsequently recognizes the full benefit in the fourth quarter (and therefore derecognizes the previously recorded liability), the entity would be expected to disclose the significant change in estimate in the footnotes to the financial statements.

For a change to a tax position that does not relate to a change in estimate but to a legal extinguishment such as a settlement, an entity should present, in separate captions, the UTB and the settlement amount on a gross basis in the tabular reconciliation.

### Example 6-6

Assume that (1) a public entity records a liability for a \$1,000 UTB related to a position taken in a state tax return and (2) the public entity's federal tax rate is 35 percent. The additional state income tax liability associated with the unrecognized state tax deduction results in a state income tax deduction on the federal tax return, creating a federal benefit of \$350 ( $\$1,000 \times 35\%$ ). The public entity would only include the gross \$1,000 unrecognized state tax benefit in the tabular reconciliation. However, in accordance with ASC 740-10-50-15A(b), it would include \$650 in the amount of UTBs that, if recognized, would affect the ETR.

## 6.19 Disclosure of the Settlement of a Tax Position When the Settlement Amount Differs From the UTB

In some cases, cash that will be paid as part of the settlement of a tax position differs from the unrecognized recorded tax benefit related to that position. The difference between the UTB and the settlement amount should be disclosed in line 1 of the reconciliation, which includes the gross amounts of increases and decreases in the total amount of UTBs related to positions taken in prior periods. The cash that will be paid to the tax authority to settle the tax position would then be disclosed in line 2 of the reconciliation, which contains amounts of decreases in UTBs related to settlements with tax authorities.

### Example 6-7

Entity A has recorded a UTB of \$1,000 as of December 31, 20X7 (the end of its fiscal year). During the fourth quarter of fiscal year 20X8, Entity A settles the tax position with the tax authority and makes a settlement payment of \$800 (recognizing a \$200 benefit related to the \$1,000 tax position). Entity A's tabular reconciliation disclosure as of December 31, 20X8, would show a decrease of \$200 in UTBs from prior periods (line 1) and a decrease of \$800 in UTBs related to settlements (line 3). A “current taxes payable” for the settlement amount of \$800 should be recorded until that amount is paid to the tax authority.

## 6.20 Consideration of Tabular Disclosure of UTBs in an Interim Period

ASC 740-10-50-15A(a) requires public entities to provide a “tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period.”

Although such presentation is not specifically required in an interim period, if a significant change from the prior annual disclosure occurs, management should consider whether a tabular reconciliation or other qualitative disclosures would inform financial statement users about the occurrence of significant changes or events that have had a material impact since the end of the most recently completed fiscal year. Management should consider whether to provide such disclosure in the notes to the financial statements if it chooses not to provide a tabular reconciliation.

For entities subject to SEC reporting requirements, management should consider the disclosure requirements of Form 10-Q, which include providing disclosures about significant changes from the most recent fiscal year in estimates used in preparation of the financial statements.

## 6.21 Presentation in the Tabular Reconciliation of a Federal Benefit Associated With Unrecognized State and Local Income Tax Positions

As described in [3.42](#), the recognition of a UTB may indirectly affect deferred taxes. For example, a DTA for a federal benefit may be created if the UTB is related to a state tax position. If an evaluation of the tax position results in an entity's increasing its state tax liability, the entity should record a DTA for the corresponding federal benefit. However, the UTB related to a state or local income tax position should be presented by a public entity on a gross basis in the tabular reconciliation required by ASC 740-10-50-15A(a).

## 6.22 Disclosure of UTBs That, If Recognized, Would Affect the ETR

ASC 740-10-50-15A(b) requires public entities to disclose the “total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.”

The disclosure under ASC 740-10-50-15A(b) is required if recognition of the tax benefit would affect the ETR from “continuing operations” determined in accordance with ASC 740. However, the SEC staff expects public entities to provide supplemental disclosure of amounts that significantly affect other items outside continuing operations (e.g., goodwill or discontinued operations).

## 6.23 Example of UTBs That, If Recognized, Would Not Affect the ETR

Certain UTBs, if recognized, would not affect the ETR and would be excluded from the ASC 740-10-50-15A(b) disclosure requirements. Example 6-8 illustrates a situation involving such UTBs.

### Example 6-8

An entity expenses \$10,000 of repair and maintenance costs for book and tax purposes. Upon analyzing the tax position, the entity believes, on the basis of the technical merits, that the IRS will more likely than not require the entity to capitalize and depreciate the cost over five years. The entity has a 40 percent applicable tax rate. The entity would recognize a \$3,200 ( $\$8,000 \times 40\%$ ) DTA for repair cost not allowable in the current period ( $\$2,000$  would be allowable in the current period for depreciation expense) and a liability for the UTB. Because of the impact of deferred tax accounting, the disallowance of the shorter deductibility period would not affect the ETR but would accelerate the payment of cash to the tax authority to an earlier period. Therefore, the entity recognizes a liability for a UTB and a DTA, both affecting the balance sheet, with no net impact on overall tax expense.

## 6.24 Disclosure of Liabilities for UTBs in the Contractual Obligations Table

SEC Regulation S-K, Item 303(a)(5), requires registrants to include in the MD&A section a tabular disclosure of all known contractual obligations, such as long-term debt, capital and operating lease obligations, purchase obligations, and other liabilities recorded in accordance with U.S. GAAP.

A registrant should include the liability for UTBs in the tabular disclosure of contractual obligations in MD&A if it can make reasonably reliable estimates about the period of cash settlement of the liabilities. For example, if any liabilities for UTBs are classified as a current liability in a registrant's balance sheet, the registrant should include that amount in the "Less than 1 year" column of its contractual obligations table. Similarly, the contractual obligations table should include any noncurrent liabilities for UTBs for which the registrant can make a reasonably reliable estimate of the amount and period of related future payments (e.g., uncertain tax positions subject to an ongoing examination by the respective tax authority for which settlement is expected to occur after the next operating cycle).

Often, however, the timing of future cash outflows associated with some liabilities for UTBs is highly uncertain. In such cases, a registrant (1) might be unable to make reasonably reliable estimates of the period of cash settlement with the respective tax authority (e.g., UTBs for which the statute of limitations might expire without examination by the respective tax authority) and (2) could exclude liabilities for UTBs from the contractual obligations table or disclose such amounts within an "other" column added to the table. If any liabilities for UTBs are excluded from the contractual obligations table or included in an "other" column, a footnote to the table should disclose the amounts excluded and the reason for the exclusion.

## Public Entities Not Subject to Income Taxes

### ASC 740-10

**50-16** A public entity that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the entity's assets and liabilities. [FAS 109, paragraph 43]

## 6.25 Tax Bases in Assets

The disclosure requirement described in ASC 740-10-50-16 above applies to any public entity for which income is taxed directly to its owners, including regulated investment companies (mutual funds), public partnerships, and Subchapter S corporations with public debt.

The reference to "tax bases" in ASC 740-10-50-16 is meant to include the partnership's or other entity's tax basis in its (net) assets. The FASB's rationale for this information is based on the belief that financial statement users would benefit from knowing the approximate tax consequence in the event the flow-through entity changes its tax status and becomes a taxable entity in the future.

## Entities With Separately Issued Financial Statements That Are Members of a Consolidated Tax Return

### ASC 740-10

**50-17** An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

- a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented
- b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented. [FAS 109, paragraph 49]

## 6.26 Disclosures Required in the Separate Financial Statements of a Member of a Consolidated Tax Return

ASC 740-10-50-17 requires the following disclosures in the separately issued financial statements of a member of a group that files a consolidated tax return:

- a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented.
- b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented.

The SEC staff has indicated in SAB Topic 1.B.1 (codified in ASC 225-10-S99) that it “believes that it is material to investors to know what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return with its parent.” For this reason, the SEC staff has indicated that the separate-return method of allocation is preferable and that, if it is not used to prepare financial statements of a member that will be included in a public filing, the SEC staff will require a pro forma income statement reflecting a tax provision calculated on a separate-return basis.

The disclosures required by ASC 740-10-50-17 help financial statement users understand how current and deferred income taxes were allocated, as required by ASC 740-10-30-27, to a member in its separate financial statements. The disclosures also help inform users on how that allocation method differs, if at all, from the terms of any tax-sharing agreements of the member, its parent, and its affiliates.

However, the disclosures do not provide information needed to help financial statement users understand “what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return with its parent.” For example, the disclosures required by ASC 740-10-50-17 do not describe either the (1) nature of DTAs and DTLs, NOLs, and tax credit carryforwards or (2) uncertain tax positions of the consolidated return group that are attributable to the assets, liabilities, operations, and tax positions of the member.

Therefore, while it is not clear in ASC 740-10-50-17, we believe that the separate financial statements of a member of a consolidated return that will be included in a filing with the SEC should generally provide the disclosures required by ASC 740-10-15-17 *in addition to* the disclosures required by ASC 740-10-50-2 through 50-16, particularly in situations in which a method other than the parent-company-down approach is used to compute the tax allocation included in the financial statements.

If a member's separate financial statements will not be included in a filing with the SEC, the disclosures required by ASC 740-10-50-17 may be provided *in lieu* of those required by ASC 740-10-50-2 through 50-16. However, we do not believe that this is preferable for the reasons above. Further, such financial statements may need to provide income tax disclosures other than those specifically required by ASC 740-10-50-17 when, for example, income tax matters affecting a group member are critical to users' understanding of the financial statements. The circumstances under which additional disclosures should be provided in such financial statements is a matter of judgment, and consultation with the member's accounting advisers is recommended.

## **6.26A Disclosure Requirements When Abbreviated Financial Statements Are Presented in a Public Filing**

SEC Regulation S-X, Rule 3-05, requires registrants to furnish financial statements of certain businesses acquired or to be acquired. In certain circumstances, it may not be practicable to prepare full financial statements or carve-out financial statements, such as when the acquiree is a small portion or product line of a much larger business and separate financial records were not maintained.

When abbreviated financial statements are prepared, it may be appropriate not to include an allocation of income taxes in the acquired business's statements of (1) assets acquired and liabilities assumed and (2) revenues and expenses.

When abbreviated financial statements of a business acquired or to be acquired are furnished with no income tax allocation, an entity should disclose in the footnotes to the historical abbreviated statements that no allocation of income tax has been made. It may also be appropriate to include an explanatory paragraph in the independent accountant's report that (1) indicates that no income tax expense or benefit has been recognized in the statement of revenues and expenses and (2) provides a reference to the appropriate footnote that further discusses the matter.

## **Policy-Related Disclosures**

### **ASC 740-10**

**50-18** Alternative acceptable policy choices available to an entity require disclosure as follows.

#### ***Interest and Penalty Recognition Policies***

**50-19** An entity shall disclose its policy on classification of interest and penalties in accordance with the alternatives permitted in paragraph 740-10-45-25 in the notes to the financial statements. [FIN 48, paragraph 20]

#### ***Investment Tax Credit Recognition Policy***

**50-20** Paragraph 740-10-25-46 identifies the deferral method and the flow-through method as acceptable methods of accounting for investment tax credits. Whichever method of accounting for the investment credit is adopted, it is essential that full disclosure be made of the method followed and amounts involved, when material. [APB 4, paragraph 11]

## Other Disclosures

### ASC 740-10

**50-21** In addition to disclosures required by this Subtopic, disclosures regarding estimates meeting certain criteria are established in paragraph 275-10-50-8 for nongovernmental entities. See Example 31 (paragraph 740-10-55-218) for an illustration of disclosure relating to the realizability of a deferred tax asset under the requirements of Topic 275.

#### Related Implementation Guidance and Illustrations

- [Example 31: Disclosure Relating to Realizability Estimates of Deferred Tax Asset](#) [ASC 740-10-55-218].

## 6.27 Disclosing the Effects of Income Tax Uncertainties in a Leveraged Lease

ASC 840-30-35-42 indicates that a change or projected change in the timing of cash flows related to income taxes generated by a leveraged lease is a change in an important assumption that affects the periodic income recognized by the lessor for that lease. Accordingly, the lessor should apply the guidance in ASC 840-30-35-38 through 35-41 and ASC 840-30-35-45 through 35-47 whenever events or changes in circumstances indicate that a change in timing of cash flows related to income taxes generated by a leveraged lease has occurred or is projected to occur.

In addition, ASC 840-30-35-44 states, “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.”

Leveraged leases are within the scope of ASC 740. Accordingly, a lessor in a leveraged lease should apply the disclosure provisions of ASC 740-10-50 that would be relevant to the income tax effects for leveraged leases, including associated uncertainties and effects of those uncertainties.

Lessors in a leveraged lease should also be mindful of the SEC observer’s comment in EITF Issue 86-43 (codified in ASC 840-30), which indicates that when an entity applies the leverage lease guidance in ASC 840-30-35-38 through 35-41 because the after-tax cash flows of the leveraged lease have changed as a result of a change in tax law, the cumulative effect on pretax income and income tax expense, if material, should be reported as separate line items in the income statement. Because ASC 840-30-35-42 through 35-44 clarify that the timing of the cash flows related to income taxes generated by a leveraged lease is an important assumption — just as a change in tax rates had always been — this guidance should be applied by analogy.

## SEC Staff Disclosure Guidance

### ASC 740-10 — SEC Materials

**S99-1** The following is the text of SAB Topic 6.I, Accounting Series Release 149 — Improved Disclosure of Income Tax Expense (Adopted November 28, 1973 and Modified by ASR 280 Adopted on September 2, 1980).

**Facts:** ASR 149 and 280 amend Regulation S-X to include:

1. Disclosure of tax effect of timing differences comprising deferred income tax expense.
2. Disclosure of the components of income tax expense, including currently payable and the net tax effects of timing differences.
3. Disclosure of the components of income [loss] before income tax expense [benefit] as either domestic or foreign.
4. Reconciliation between the statutory Federal income tax rate and the effective tax rate. [SAB Topic 6.I, paragraph Facts]

#### 1. Tax Rate

**Question 1:** In reconciling to the effective tax rate should the rate used be a combination of state and Federal income tax rates? [SAB Topic 6.I, paragraph 1 Q1]

**Interpretive Response:** No, the reconciliation should be made to the Federal income tax rate only. [SAB Topic 6.I, paragraph 1 Q1 Response]

**Question 2:** What is the “applicable statutory Federal income tax rate”? [SAB Topic 6.I, paragraph 1 Q2]

**Interpretive Response:** The applicable statutory Federal income tax rate is the normal rate applicable to the reporting entity. Hence, the statutory rate for a U.S. partnership is zero. If, for example, the statutory rate for U.S. corporations is 22% on the first \$25,000 of taxable income and 46% on the excess over \$25,000, the “normalized rate” for corporations would fluctuate in the range between 22% and 46% depending on the amount of pretax accounting income a corporation has.

#### 2. Taxes of Investee Company

**Question:** If a registrant records its share of earnings or losses of a 50% or less owned person on the equity basis and such person has an effective tax rate which differs by more than 5% from the applicable statutory Federal income tax rate, is a reconciliation as required by Rule 4-08(g) necessary?

**Interpretive Response:** Whenever the tax components are known and material to the investor’s (registrant’s) financial position or results of operations, appropriate disclosure should be made. In some instances where 50% or less owned persons are accounted for by the equity method of accounting in the financial statements of the registrant, the registrant may not know the rate at which the various components of income are taxed and it may not be practicable to provide disclosure concerning such components.

It should also be noted that it is generally necessary to disclose the aggregate dollar and per-share effect of situations where temporary tax exemptions or “tax holidays” exist, and that such disclosures are also applicable to 50% or less owned persons. Such disclosures should include a brief description of the factual circumstances and give the date on which the special tax status will terminate. See Topic 11.C. [SAB Topic 6.I, paragraph 2 Q Response]

#### 3. Net of Tax Presentation

**Question:** What disclosure is required when an item is reported on a net of tax basis (e.g., extraordinary items, discontinued operations, or cumulative adjustment related to accounting change)? [SAB Topic 6.I, paragraph 3 Q]

**Interpretive Response:** When an item is reported on a net of tax basis, additional disclosure of the nature of the tax component should be provided by reconciling the tax component associated with the item to the applicable statutory Federal income tax rate or rates. [SAB Topic 6.I, paragraph 3 Q Response]

#### 4. Loss Years

**Question:** Is a reconciliation of a tax recovery in a loss year required? [SAB Topic 6.I, paragraph 4 Q]

**Interpretive Response:** Yes, in loss years the actual book tax benefit of the loss should be reconciled to expected normal book tax benefit based on the applicable statutory Federal income tax rate. [SAB Topic 6.I, paragraph 4 Q Response]

**ASC 740-10 — SEC Materials (continued)****5. Foreign Registrants**

**Question 1:** Occasionally, reporting foreign persons may not operate under a normal income tax base rate such as the current U.S. Federal corporate income tax rate. What form of disclosure is acceptable in these circumstances? [SAB Topic 6.I, paragraph 5 Q1]

**Interpretive Response:** In such instances, reconciliations between year-to-year effective rates or between a weighted average effective rate and the current effective rate of total tax expense may be appropriate in meeting the requirements of Rule 4-08(h)(2). A brief description of how such a rate was determined would be required in addition to other required disclosures. Such an approach would not be acceptable for a U.S. registrant with foreign operations. Foreign registrants with unusual tax situations may find that these guidelines are not fully responsive to their needs. In such instances, registrants should discuss the matter with the staff. [SAB Topic 6.I, paragraph 5 Q1 Response]

**Question 2:** Where there are significant reconciling items that relate in significant part to foreign operations as well as domestic operations, is it necessary to disclose the separate amounts of the tax component by geographical area, e.g., statutory depletion allowances provided for by U.S. and by other foreign jurisdictions? [SAB Topic 6.I, paragraph 5 Q2]

**Interpretive Response:** It is not practicable to give an all-encompassing answer to this question. However, in many cases such disclosure would seem appropriate. [SAB Topic 6.I, paragraph 5 Q2 Response]

**7. Tax Expense Components v. "Overall" Presentation**

**Facts:** Rule 4-08(h) requires that the various components of income tax expense be disclosed, e.g., currently payable domestic taxes, deferred foreign taxes, etc. Frequently income tax expense will be included in more than one caption in the financial statements. For example, income taxes may be allocated to continuing operations, discontinued operations, extraordinary items, cumulative effects of an accounting change and direct charges and credits to shareholders' equity. [SAB Topic 6.I, paragraph 7 Facts]

**Question:** In instances where income tax expense is allocated to more than one caption in the financial statements, must the components of income tax expense included in each caption be disclosed or will an "overall" presentation such as the following be acceptable?

The components of income tax expense are:

Currently payable (per tax return):

Federal	\$350,000
Foreign	150,000
State	50,000
Deferred:	
Federal	125,000
Foreign	75,000
State	<u>50,000</u>
	<u>\$800,000</u>

Income tax expense is included in the financial statements as follows:

Continuing operations	\$600,000
Discontinued operations	(200,000)
Extraordinary income	300,000
Cumulative effect of change in accounting principle	<u>100,000</u>
	<u>\$800,000</u>

[SAB Topic 6.I, paragraph 7 Q]

**Interpretive Response:** An overall presentation of the nature described will be acceptable. [SAB Topic 6.I, paragraph 7 Q Response]

## ASC 740-10 — SEC Materials (continued)

### SAB Topic 11.C, Tax Holidays

**S99-2** The following is the text of SAB Topic 11.C, Tax Holidays.

**Facts:** Company C conducts business in a foreign jurisdiction which attracts industry by granting a "holiday" from income taxes for a specified period. [SAB Topic 11.C, paragraph Facts]

**Question:** Does the staff generally request disclosure of this fact? [SAB Topic 11.C, paragraph Question]

**Interpretive Response:** Yes. In such event, a note must (1) disclose the aggregate dollar and per share effects of the tax holiday and (2) briefly describe the factual circumstances including the date on which the special tax status will terminate. [SAB Topic 11.C, paragraph Question Interpretive Response]

## ASC 235-10 — SEC Materials

**S99-1** The following is the text of Regulation S-X Rule 4-08, General Notes to Financial Statements.

If applicable to the person for which the financial statements are filed, the following shall be set forth on the face of the appropriate statement or in appropriately captioned notes. The information shall be provided for each statement required to be filed, except that the information required by paragraphs (b), (c), (d), (e) and (f) shall be provided as of the most recent audited balance sheet being filed and for paragraph (j) as specified therein. When specific statements are presented separately, the pertinent notes shall accompany such statements unless cross-referencing is appropriate.

[Omitted paragraphs]

(h) Income tax expense.

(1) Disclosure shall be made in the income statement or a note thereto, of (i) the components of income (loss) before income tax expense (benefit) as either domestic or foreign; (ii) the components of income tax expense, including (A) taxes currently payable and (B) the net tax effects, as applicable, of timing differences (indicate separately the amount of the estimated tax effect of each of the various types of timing differences, such as depreciation, warranty costs, etc., where the amount of each such tax effect exceeds five percent of the amount computed by multiplying the income before tax by the applicable statutory Federal income tax rate; other differences may be combined).

NOTE: Amounts applicable to United States Federal income taxes, to foreign income taxes and the other income taxes shall be stated separately for each major component. Amounts applicable to foreign income (loss) and amounts applicable to foreign or other income taxes which are less than five percent of the total of income before taxes or the component of tax expense, respectively, need not be separately disclosed. For purposes of this rule, foreign income (loss) is defined as income (loss) generated from a registrant's foreign operations, i.e., operations that are located outside of the registrant's home country.

(2) Provide a reconciliation between the amount of reported total income tax expense (benefit) and the amount computed by multiplying the income (loss) before tax by the applicable statutory Federal income tax rate, showing the estimated dollar amount of each of the underlying causes for the difference. If no individual reconciling item amounts to more than five percent 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 five percent of such computed amount, no reconciliation need be provided unless it would be significant in appraising the trend of earnings. Reconciling items that are individually less than five percent of the computed amount may be aggregated in the reconciliation. The reconciliation may be presented in percentages rather than in dollar amounts. Where the reporting person is a foreign entity, the income tax rate in that person's country of domicile should normally be used in making the above computation, but different rates should not be used for subsidiaries or other segments of a reporting entity. When the rate used by a reporting person is other than the United States Federal corporate income tax rate, the rate used and the basis for using such rate shall be disclosed.

**ASC 235-10 — SEC Materials (continued)**

(3) Paragraphs (h)(1) and (2) of this section shall be applied in the following manner to financial statements which reflect the adoption of FASB ASC Topic 740, Income Taxes.

- (i) The disclosures required by paragraph (h)(1)(ii) of this section and by the parenthetical instruction at the end of paragraph (h)(1) of this section and by the introductory sentence of paragraph (h)(2) of this section shall not apply.
- (ii) The instructional note between paragraphs (h)(1) and (2) of this section and the balance of the requirements of paragraphs (h)(1) and (2) of this section shall continue to apply. [Regulation S-X, 210.4-08, paragraph (h)(3)(ii)]

## **6.27A Disclosure of the Components of Income (or Loss) Before Income Tax Expense (or Benefit) as Either Foreign or Domestic — Branches and Intra-Entity Transactions**

SEC Regulation S-X, Rule 4-08(h), requires public companies to include in their financial statements a disclosure of the domestic and foreign components of income (or loss) before income tax expense (or benefit).

Rule 4-08(h) defines foreign income or loss as income or loss generated from a registrant's "foreign operations" (i.e., operations that are located outside the registrant's home country). Conversely, domestic income or loss is income or loss generated from a registrant's operations located inside the registrant's home country.

While providing this disclosure is often straightforward, it may be difficult in certain circumstances to determine (1) the source of the income or loss (i.e., foreign or domestic) or (2) the period or manner in which to reflect the income or loss in the disclosure. In particular, it can be challenging to classify income as foreign or domestic when a portion of a registrant's pretax income or loss is generated by a branch or when intra-entity transactions occur between different tax-paying components within the consolidated group.

### **Branches**

A U.S. parent may create an entity in a foreign jurisdiction that is regarded (e.g., as a corporation) in its foreign jurisdiction but then cause that foreign corporation to elect to be disregarded for U.S. federal income tax purposes (commonly referred to as a branch). Because the foreign corporation is disregarded for U.S. federal income tax purposes, the U.S. parent includes the foreign entity's taxable income or loss in its U.S. federal taxable income. The foreign corporation's profits are taxed simultaneously in the foreign jurisdiction in which it operates (i.e., the foreign corporation will file a tax return in the foreign jurisdiction in which it operates) and in the U.S. (because the entity's taxable income or loss will be included in the U.S. parent's U.S. federal taxable income). Taxes paid by the foreign corporation in the foreign jurisdiction may be deducted on the U.S. parent's return or claimed as a FTC, subject to certain limitations.

The foreign corporation is treated like a branch of its U.S. parent for U.S. income tax purposes, which does not change the fact that the profits of the foreign entity are generated from operations located outside the United States. The profits and losses of the foreign entity are considered foreign income or loss in the disclosure of domestic and foreign components of pretax income or loss in the U.S. parent's financial statements.

## ***Intra-Entity Transactions***

Intra-entity transactions between different tax-paying components within the consolidated group often result in tax consequences in each member's respective taxing jurisdiction in the period in which the transaction occurs. However, the pretax effects of these transactions are eliminated in consolidation for accounting purposes. Accounting for the tax consequences of an intra-entity transaction depends on the nature of the transaction.

### **Intra-Entity Transactions — Not Subject to ASC 740-10-25-3(e)**

We believe that the primary purpose of the disclosure of the components of pretax income or loss as either domestic or foreign is to give the users of financial statements an ability to relate the domestic and foreign tax provisions to their respective pretax amounts. Therefore, when an intra-entity transaction results in taxable income in one component and deductible losses in another component, and those pretax amounts are eliminated in consolidation, we believe that the disclosure of the foreign and domestic components of pretax income or loss is generally more meaningful if the components are "grossed up" since the grossed-up amounts correspond more closely to the actual amounts of domestic and foreign tax expense and benefit.

However, because Rule 4-08(h) is not explicit and simply requires disclosure of "the components of income (loss) before income tax expense (benefit)," we believe that "net" presentation, with appropriate disclosure in the income tax rate reconciliation, would also be acceptable.

Consider the following example:

#### **Example 6-8A**

Assume the following facts:

- Company P is an SEC registrant and is domiciled and operates in the United States, which has a 35 percent tax rate.
- Company S is a wholly owned foreign subsidiary of P and is domiciled and operating in jurisdiction B, which has a 50 percent tax rate.
- Company P's consolidated financial statements are prepared under U.S. GAAP and include S.
- Company P and S enter into a cost-sharing arrangement under which S reimburses P for 50 percent of certain costs incurred by P to further the development of Product X, a product that S licenses to third parties.
- Assume that none of the amounts paid qualify for capitalization.
- For the year 20X5, P records \$100 of income under the cost-sharing arrangement, and S records \$100 of development expense.
- Company P pays \$35 of income tax on the cost-sharing income it receives in 20X5 and S receives an income tax benefit of \$50 from the development expense it incurs.

The cost-sharing payment is eliminated in P's 20X5 consolidated financial statements. However, the income tax expense incurred by P and the income tax benefit received by S are recognized in P's consolidated financial statements in 20X5. Therefore, provided that P discloses the grossed-up amounts of the domestic and foreign components of pretax income or loss, P would include \$100 of cost-sharing income in the disclosure of domestic income or loss, and \$100 of development expense in the disclosure of foreign income or loss. This disclosure corresponds to an applicable amount of domestic and foreign tax expense and benefit, respectively, which is also recognized and disclosed in 20X5.

### *Intra-Entity Transactions — Subject to ASC 740-10-25-3(e)*

ASC 740-10-25-3(e) and ASC 810-10-45-8 require deferral of the recognition of income taxes paid on intra-entity profits from the sale of assets for which intra-entity profits are eliminated in consolidation. For these types of transactions, we believe that it is appropriate to include an allocation of the consolidated pretax income or loss to the foreign and domestic components in the year in which the asset is sold outside the consolidated group (e.g., for inventory) or as the asset is consumed (e.g., for a fixed asset).

Consider the following example:

#### **Example 6-8B**

Assume the same facts as those in Example 6-8A above, but instead of entering into a cost-sharing agreement:

- During 20X5, P sells inventory with a historical cost basis for both book and tax purposes of \$200 to S for \$300, and the inventory is on hand at year-end.
- Company P pays tax of \$35 in the United States on this intra-entity profit of \$100.
- The inventory is sold outside the consolidated group at a price of \$350 in the following year (20X6).

In 20X5 the \$100 gain on the intra-entity sale is eliminated in consolidation, and the related tax is deferred under ASC 740-10-25-3(e) and ASC 810-10-45-8. The intra-entity gain of \$100 that is eliminated in 20X5 should not be included in the disclosure of the 20X5 pretax domestic and foreign income or loss.

In 20X6, when the inventory is sold outside the consolidated group, a profit before income taxes of \$150 is recorded in the consolidated financial statements (\$100 of which is related to profits previously taxed in the United States, and \$50 of which is related to profits taxed in jurisdiction B). In 20X6, \$100 of income from the sale should be reported as domestic income, and \$50 of income from the sale should be reported as foreign income. This corresponds to an applicable amount of domestic and foreign tax expense, which is also recognized and disclosed in 20X6.

### **Non-GAAP Measures — Treatment of Tax Adjustments**

For additional information on non-GAAP measures, see Deloitte's *A Roadmap to Non-GAAP Financial Measures*.

In certain circumstances, a registrant may reflect a non-GAAP measure after taxes and therefore show the tax adjustments when reconciling a non-GAAP measure to the appropriate GAAP measure. C&DI Question 102.11 indicates that the tax expense impact for a performance measure should be consistent with the amount of non-GAAP income since adjusting revenue or income before income tax could affect the tax expense or benefits assumed in the calculation of the tax provision. For example, suppose that a registrant has a \$200 million GAAP loss for the most recent fiscal year, which resulted in a 3 percent tax rate. After making various reconciling adjustments, if the registrant presents a non-GAAP adjusted income measure of \$400 million, the SEC staff may comment if the registrant uses the same 3 percent effective tax rate to compute the tax provision.

If a non-GAAP measure is a liquidity measure, adjusting the GAAP tax amount to present taxes paid in cash may be acceptable.

Registrants should present adjustments gross of tax and should disclose how the tax adjustments were determined.

## C&DIs — Non-GAAP Financial Measures

### Question 102.11

**Question:** How should income tax effects related to adjustments to arrive at a non-GAAP measure be calculated and presented?

**Answer:** A registrant should provide income tax effects on its non-GAAP measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, adjustments to arrive at a non-GAAP measure should not be presented "net of tax." Rather, income taxes should be shown as a separate adjustment and clearly explained. [May 17, 2016]

### Example 6-8C

To illustrate the discrete effect of taxes on individual adjustments in the reconciliation, the registrant may present the tax effect of all adjustments as a single line in the reconciliation as follows:

Net income	\$	XYZ
Add: Stock-based compensation		XX
Restructuring charges		YY
Less: Tax effect of adjustments		<u>ZZ</u>
Adjusted net income	\$	<u>UVW</u>

The registrant should clearly disclose how it determined the tax effect. Other alternative presentations may be appropriate as long as the gross amount of adjustments are disclosed. For example, a registrant could disclose the relevant information about the gross amount of the adjustment and the tax amount in parentheses (e.g., stock-based compensation \$10 million less the amount of taxes \$3 million) to arrive at the net amount (e.g., \$7 million) and could provide similar disclosure for the restructuring charges.

When calculating a non-GAAP measure, a registrant should be mindful of how the adjustments made to a GAAP measure affect income tax expense. As indicated above, a registrant's adjustment of revenue or income before tax expense could affect the tax expense or benefits assumed in the calculation of the tax provision and therefore could have an impact on the tax computation in the reconciliation.

**ASC 323-740 — SEC Materials****S50 Disclosure*****Income Taxes of Equity Method Investee***

**S50-1** See paragraph 323-740-S99-1, SAB Topic 6.I.2, for SEC Staff views on disclosures pertaining to the income taxes of an equity method investee. [SAB Topic 6.I, paragraph 2Q]

**S99 SEC Materials*****SAB Topic 6.I.2, Taxes of Investee Company***

**S99-1** The following is the text of SAB Topic 6.I.2, Taxes of Investee Company.

Question: If a registrant records its share of earnings or losses of a 50% or less owned person on the equity basis and such person has an effective tax rate which differs by more than 5% from the applicable statutory Federal income tax rate, is a reconciliation as required by Rule 4-08(g) [paragraph 235-10-S99-1] necessary? [SAB Topic 6.I, paragraph 2Q]

Interpretive Response: Whenever the tax components are known and material to the investor's (registrant's) financial position or results of operations, appropriate disclosure should be made. In some instances where 50% or less owned persons are accounted for by the equity method of accounting in the financial statements of the registrant, the registrant may not know the rate at which the various components of income are taxed and it may not be practicable to provide disclosure concerning such components.

It should also be noted that it is generally necessary to disclose the aggregate dollar and per-share effect of situations where temporary tax exemptions or "tax holidays" exist, and that such disclosures are also applicable to 50% or less owned persons. Such disclosures should include a brief description of the factual circumstances and give the date on which the special tax status will terminate. See Topic 11.C [paragraph 740-10-S99-2]. [SAB Topic 6.I, paragraph 2Q Response]

# Chapter 7 — Intraperiod Tax Allocation

ASC 740 prescribes an accounting model, known as “intraperiod tax allocation,” for allocating an entity’s total annual income tax provision among continuing operations and the other components of an entity’s financial statements (i.e., discontinued operations, extraordinary items, OCI, and shareholders’ equity). Although it may appear simple, this model is one of the more challenging aspects of income tax accounting. This chapter provides insights (including illustrations) into some of the complexities associated with intraperiod tax allocation.

## New in the 2018 Edition:

The following new guidance has been added to Chapter 7:

### [7.25 — Accounting for the Tax Effects of Contributions to Pass-Through Entities in Control-to-Control Transactions.](#)

## Allocation of Income Tax Expense or Benefit for the Year

### ASC 740-20

**45-1** This guidance addresses the requirements to allocate total income tax expense or benefit. Subtopic 740-10 defines the requirements for computing total income tax expense or benefit for an entity. As defined by those requirements, total income tax expense or benefit includes current and deferred income taxes. After determining total income tax expense or benefit under those requirements, the intraperiod tax allocation guidance is used to allocate total income tax expense or benefit to different components of comprehensive income and shareholders’ equity.

**45-2** Income tax expense or benefit for the year shall be allocated among:

- a. Continuing operations
- b. Discontinued operations [FAS 109, paragraph 35]
- c. Subparagraph superseded by Accounting Standards Update No. 2015-01
- d. Other comprehensive income
- e. Items charged or credited directly to shareholders’ equity. [FAS 109, paragraph 35]

**ASC 740-20 (continued)**

**45-3** The tax benefit of an operating loss carryforward or carryback (other than for the exceptions related to the carryforwards identified at the end of this paragraph) shall be reported in the same manner as the source of the income or loss in the current year and not in the same manner as the source of the operating loss carryforward or taxes paid in a prior year or the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. The only exception is the tax effects of deductible temporary differences and carryforwards that are allocated to shareholders' equity in accordance with the provisions of paragraph 740-20-45-11(c) through (f). [FAS 109, paragraph 37]

**45-4** Paragraph 740-10-45-20 requires that changes in the beginning of the year balance of a valuation allowance caused by changes in judgment about the realization of deferred tax assets in future years are ordinarily allocated to continuing operations. That paragraph also identifies certain exceptions to that allocation guidance related to business combinations and the items specified in paragraph 740-20-45-11(c) through (f). The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations using the general allocation methodology presented in this Section. [FAS 109, paragraph 26]

**45-5** See Section 740-20-55 for examples of the allocation of total tax expense or benefit to continuing operations, the effect of a tax credit carryforward, and an allocation to other comprehensive income. [FAS 109, paragraph 38]

## 7.01 Intraperiod Tax Allocation: General Rule

ASC 740-20-45-7 states that the “tax effect of pretax income . . . from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations” (in other words, the tax effect allocated to items that are not part of continuing operations is generally their incremental tax effect; see [7.06](#) for an exception to this general rule).

First, total tax expense or benefit for the period is computed by adding the deferred tax expense or benefit for the period (determined by computing the change in DTLs and DTAs during the period) to the current tax expense or benefit for the period. The computation of total tax expense includes (1) the effects of all taxable income or loss items, regardless of the source of the taxable income or loss, and (2) the effect of all changes in the valuation allowance, except those changes required by ASC 740-20-45-3 (listed above), ASC 805-740-45-2 (regarding changes during the measurement period), or ASC 852-740-45-3 (regarding quasi-reorganizations).

Second, tax expense or benefit related to income from continuing operations is computed as the tax effect of the pretax income or loss from continuing operations for the period plus or minus the tax effects of the four items identified in ASC 740-20-45-8. The treatment of one of those items, “[c]hanges in circumstances that cause a change in judgment about the realization of deferred tax assets in future years,” requires further elaboration. One example is a change in facts or circumstances that causes a change in the estimate of future taxable income considered in the determination of the valuation allowance. In this situation, the practical effect of the requirement is that almost all changes in valuation allowance will be included in income from continuing operations. The only changes in valuation allowance that would not be included in income from continuing operations are (1) those changes addressed by ASC 740-20-45-11(c)-(f), ASC 805-740-45-2, or ASC 852-740-45-3 (see [7.04](#)) and (2) any increases or decreases in the valuation allowance recognized that are solely attributable to income or loss recognized in the current year in a category other than income from continuing operations in accordance with ASC 740-20-45-3.

The difference between total income tax expense or benefit and income tax expense or benefit allocated to income from continuing operations is the incremental effect of items other than income from continuing operations. That incremental effect is allocated among those items in accordance with ASC 740-20-45-14. See ASC 740-20-55-14 for an example illustrating the effect of a valuation allowance on intraperiod tax allocation.

## **7.02 Intraperiod Tax Allocation: Application Level**

ASC 740-20 does not explicitly state how the intraperiod tax allocation guidance should be applied when there are multiple tax-paying components. However, ASC 740-20-45-1 specifies that ASC 740-10 "defines the requirements for computing total income tax expense or benefit for an entity." In addition, ASC 740-10-30-5 states, in part:

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

Therefore, by analogy, entities should apply the intraperiod tax allocation guidance to each tax-paying component; that is, they should apply it at the tax-return level within each taxing jurisdiction.

### **Allocation to Continuing Operations**

#### **ASC 740-20**

**45-6** This guidance addresses the allocation methodology for allocating total income tax expense or benefit to continuing operations. The amount of income tax expense or benefit allocated to continuing operations may include multiple components. The tax effect of pretax income or loss from current year continuing operations is always one component of the amount allocated to continuing operations.

**45-7** The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations. That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets. [EITF D-032, paragraph] Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [FAS 109, paragraph 140]

**ASC 740-20 (continued)**

**45-8** The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of:

- a. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (see paragraph 740-10-45-20 for a discussion of exceptions to this allocation for certain items)
- b. Changes in tax laws or rates (see paragraph 740-10-35-4)
- c. Changes in tax status (see paragraphs 740-10-25-32 and 740-10-40-6)
- d. Tax-deductible dividends paid to shareholders (except as set forth in paragraph 740-20-45-11(e) for dividends paid on unallocated shares held by an employee stock ownership plan or any other stock compensation arrangement).

The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraphs 740-20-45-12 and 740-20-45-14. [FAS 109, paragraph 35]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**45-8** The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of:

- a. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (see paragraph 740-10-45-20 for a discussion of exceptions to this allocation for certain items)
- b. Changes in tax laws or rates (see paragraph 740-10-35-4)
- c. Changes in tax status (see paragraphs 740-10-25-32 and 740-10-40-6)
- d. Tax-deductible dividends paid to shareholders.

The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraphs 740-20-45-12 and 740-20-45-14. [FAS 109, paragraph 35]

**45-9** See Example 1 (paragraph 740-20-55-1) for an example of the allocation of total tax expense or benefit to continuing operations.

**Related Implementation Guidance and Illustrations**

- [Example 1: Allocation to Continuing Operations](#) [ASC 740-20-55-1].
- [Example 3: Allocation of the Benefit of a Tax Credit Carryforward](#) [ASC 740-20-55-15].

## 7.03 Intraperiod Tax Allocation: Application of the “With” and “Without” Rules

ASC 740-20-45-7 states that the tax attributable to continuing operations is generally calculated without regard to the tax effects of any items of income, expense, gain, or loss outside of continuing operations. The exception to using this incremental (or “without”) approach is in situations in which there is a loss from continuing operations and a gain in another financial statement component. (See [7.06](#) for more information.) ASC 740-20-45-8 clarifies that the calculation of the amount to be allocated to continuing operations should reflect all applications of changes in tax laws or rates (and tax credits and special deductions by analogy).

When calculating taxes allocable to continuing operations, an entity should exclude any amounts recognized for UTBs that relate to tax positions for items outside of continuing operations in the period in which the UTB is initially recorded.

**Example 7-1**

Company X has \$3,000 of income from continuing operations and \$1,000 of loss from discontinued operations during the current year. All of the \$3,000 of income from continuing operations qualifies for the domestic production activities deduction under Section 199 of the IRC (considered a special deduction under ASC 740-10-55-27 through 55-30), which is calculated as 9 percent of net income. There are no other differences between book and tax income. The tax rate is 40 percent.

When determining the tax attributable to continuing operations, X should include the effects of the Section 199 special deduction without considering the loss from discontinued operations. Accordingly, X would perform the following "with" and "without" calculations:

	<b>Without Loss From Discontinued Operations</b>	<b>With Loss From Discontinued Operations (in Accordance With the Tax Return)</b>	<b>Difference</b>
Income from continuing operations	\$ 3,000	\$ 2,000	
Section 199 special deduction	<u>(270)</u>	<u>(180)</u>	
<b>Taxable income</b>	<b><u>2,730</u></b>	<b><u>1,820</u></b>	
Tax rate	40%	40%	
<b>Income tax per component</b>	<b><u>\$ 1,092</u></b>	<b><u>\$ 728</u></b>	<b><u>\$ (364)*</u></b>
Tax provision — continuing operations	\$ 1,092		
Tax provision — discontinued operations	<u>(364)</u>		
<b>Total income tax expense</b>	<b><u>\$ 728</u></b>		

\* Difference is due to the lost Section 199 tax benefit, calculated as follows:

Discontinued operations pre-tax	\$ (1,000)
Tax rate	40%
Expected income tax benefit	\$ (400)
Section 199 benefit lost	<u>36</u>
Tax provision – discontinued operations	<u>\$ (364)</u>

## 7.04 Intraperiod Tax Allocation of Changes in Valuation Allowances

As discussed in [7.01](#), when performing an intraperiod tax allocation, an entity generally must first determine income tax allocated to continuing operations. Under ASC 740, the entity typically should include the effect of changes in valuation allowances in income from continuing operations. Causes of changes in valuation allowances could include (1) the expiration of a reserved carryforward (in which the valuation allowance is reduced similarly to the way in which a write-off of a reserved account receivable reduces the reserve for bad debts), (2) changes in judgment about the realizability of beginning-of-the-year DTAs because of current-year income from continuing operations or income expected in future years of any type, and (3) the generation of deductible temporary differences and carryforwards in the current year that are not more likely than not to be realized. A change in valuation allowance that results from the expiration of a reserved carryforward (see item (1) above) would not affect total tax expense and therefore would not affect intraperiod tax allocation.

An entity would not allocate changes in valuation allowances related to items (2) and (3) to income from continuing operations in the following situations:

- If the change in valuation allowance of an acquired entity's DTA occurs within the measurement period and results "from new information about facts and circumstances that existed at the acquisition date," the change in valuation allowance is recorded as an increase or a decrease in goodwill in accordance with ASC 805-740-45-2.
- Reductions in the valuation allowance established at the time the deductible temporary difference or carryforward occurred (resulting in the initial recognition of benefits) that are related to the following (referred to in ASC 740-20-45-11(c)-(f)) should be allocated directly to OCI or related components of shareholders' equity:
  1. A "decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock.)"
  2. "Expenses for employee stock options recognized differently for financial reporting and tax purposes (as required by Subtopic 718-740)." See ASC 718-740-30-1 and 30-2 for more information.<sup>1</sup>
  3. "Dividends that are paid on unallocated shares held by an employee stock ownership plan and that are charged to retained earnings."<sup>2</sup>
  4. "Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization," with limited exceptions.
- Other than those listed above, any changes in the valuation allowance recognized solely because of income or losses recognized in the current year in a category other than income from continuing operations (in that case, the effect of the change in valuation allowance is allocated to that other category — for example, a discontinued operation).

Regarding the last bullet point, when it is difficult for an entity to determine whether a change in valuation allowance is due solely to one item, the effect of any change in the valuation allowance should be allocated to income from continuing operations. This premise is based on the guidance in ASC 740, which requires that income tax allocated to continuing operations be determined first and that the effects of all changes in valuation allowances (with the exception of the items listed in the first two bullet points above) that are attributable to changes in judgments about realizability in future years (regardless of the income category causing the change in judgment) be allocated to income from continuing operations.

<sup>1</sup> On March 30, 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. The ASU supersedes this guidance. See the [introduction](#) to Chapter 10 for effective date information and see [ASU 2016-09 FAQs](#) for frequently asked questions (FAQs) related to implementation of ASU 2016-09.

<sup>2</sup> See footnote 1.

## 7.05 Changes in Valuation Allowances Resulting From Items Other Than Continuing Operations

ASC 740-10-45-20 states, "The effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in **future years** ordinarily shall be included in income from continuing operations" (emphasis added). The only changes in valuation allowances that would not be included in income from continuing operations are for the tax effects of:

- DTAs that are allocated to OCI or to related components of shareholders' equity for the items identified in ASC 740-20-45-11(c)–(f). These tax effects are related to changes in contributed capital; share-based payment tax benefits; dividends paid on unallocated shares held by an ESOP; and deductible temporary differences and carryforwards that existed as of the date of a quasi-reorganization. (For more information, see [7.04](#).)
- Any increases or decreases in the valuation allowance that are attributable solely to income or loss recognized in the current year in a category other than income from continuing operations, unless the entity has reported a loss from continuing operations. This exception in ASC 740-20-45-7 requires entities to consider all items in determining the amount of tax benefit to be allocated to continuing operations. (For more information, see [7.06](#).)

When a change in valuation allowance is directly attributable to an item of income or loss other than continuing operations (e.g., discontinued operations, foreign currency translation adjustments, unrealized gains or losses on a securities portfolio held for sale), the tax consequence may be allocated to that other category of income or loss.

### Example 7-2

At the beginning of 20X1, Entity X, a company operating in a tax jurisdiction with a 40 percent tax rate, has a \$1,000 tax credit carryforward with no temporary differences. The tax credit carryforward was generated by operating losses in prior years by Subsidiary A and is reflected as a DTA of \$1,000 less a full valuation allowance.

During 20X1, X disposes of A for a gain of \$3,000. Loss from continuing operations is \$500. Income from discontinued operations, including the \$3,000 gain, is \$2,000. Because the gain on the sale resulted in income from discontinued operations in the current year, management expects to realize the tax credit carryforward in the current year. Therefore, the release of the valuation allowance would be allocated to discontinued operations.

### Example 7-3

At the beginning of 20X3, Entity Y, a company operating in a tax jurisdiction with a 40 percent tax rate, has a \$2,000 tax credit carryforward with no temporary differences. The tax credit carryforward was generated by operating losses in prior years by Subsidiary B and is reflected as a DTA of \$2,000 less a full valuation allowance.

During 20X3, Y's management enters into a definitive agreement to sell B for an anticipated gain of \$5,000. However, the deal does not close until the first quarter of 20X4; thus, the gain is not recognized until the transaction is closed. Entity Y had \$200 in income from continuing operations. In addition, management concludes that the DTA is realizable on the basis of the weight of all available evidence, including projections of future taxable income.

In this example, the release of the entire valuation allowance would be allocated to continuing operations because there was a change in judgment about the realizability of the related DTA in future years (i.e., because the gain on the sale was deferred until the following year).

## 7.06 Intraperiod Tax Allocation When There Is a Loss From Continuing Operations in the Current Period

ASC 740-20-45-7 provides an exception to the general intraperiod allocation guidance under ASC 740-20 for an entity that has a current-year loss from continuing operations.

ASC 740-20-45-7 states:

The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations.

**The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations.**

That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [Emphasis added]

When applying the exception in ASC 740-20-45-7, an entity is not required to combine pretax income or loss from all sources other than continuing operations. ASC 740-20-45-7 indicates that the purpose of this exception is to achieve consistency with the approach in ASC 740-10, under which entities consider the tax consequences of taxable income expected in future years in assessing the realizability of DTAs. However, ASC 740-20 does not provide any further implementation guidance on the manner in which items of comprehensive income other than income from continuing operations should be taken into consideration when there is more than one such component. Accordingly, we believe that there are two acceptable approaches, which are discussed below. The approach an entity selects is an accounting policy election that should be applied consistently.

### ***The Individual-Component Approach***

Under this approach, when an entity applies the guidance in ASC 740-20-45-7, it can allocate an income tax benefit to the loss from continuing operations if any individual component of comprehensive income or loss (other than the loss from continuing operations) is positive after factoring in jurisdiction, character, and the amount that is subject to tax (see additional discussion below). Under this approach, the individual component would be defined as a category other than continuing operations (e.g., a gain from discontinued operations or OCI). The total current-year tax expense or benefit from all current-year sources of income or loss (which may be zero) is then allocated between continuing operations and only those individual components of current-year comprehensive income other than continuing operations that are sources of income. To perform this allocation, an entity should use the amount of book income or loss reported for each component of comprehensive income or loss.

### ***The Net Approach***

Under the net approach, an entity allocates a tax benefit to a loss from continuing operations only when the net of all components of comprehensive income or loss other than the loss from continuing operations is positive (i.e., results in income). This approach is consistent with the general guidance in ASC 740-20-45-8, which requires that, after determining the amount allocable to continuing operations, the entity allocate the “remainder” (which implies that those items should be aggregated) to items other than continuing operations in accordance with ASC 740-20-45-12 and ASC 740-20-45-14. In addition, as noted in ASC 740-20-45-7, the purpose of this exception is to achieve consistency with the approach in ASC 740-10, under which entities consider the tax consequences of all taxable income that is expected in future years in assessing the realizability of DTAs.

## Considerations

Regardless of the approach selected, an entity should also determine whether the component of income other than continuing operations represents a source of income under ASC 740-20-45-7. For example, the entity should consider:

- The character (capital vs. ordinary) of both the loss from continuing operations and the components of comprehensive income other than continuing operations (see [7.08](#)).
- Whether a gain in OCI related to foreign currency translation is a source of income under ASC 740-20-45-7. A foreign currency gain would not be a source of income if the entity applies the indefinite reversal exception in ASC 740-30 to its investment in the foreign subsidiary.
- Its policy regarding adjustments to reclassify losses out of accumulated OCI or loss into net income or loss (see [7.07](#)).

An entity should apply its selected approach consistently to all periods and taxpaying components.

### Example 7-4

Assume the following:

- An entity has incurred losses for financial and income tax reporting purposes in recent years and, accordingly, has recognized significant NOL carryforwards for which the DTA, net of its valuation allowance, is zero at the beginning of the year.
- The entity does not have positive verifiable evidence to support a valuation allowance release at the end of each year presented.
- The entity reflects a zero total income tax provision for the year because of the need to establish a full valuation allowance against all of its DTAs at the end of the year.
- The applicable jurisdiction tax rate for all items is 40 percent.

The scenarios below are based on the above assumptions and illustrate application of the individual-component approach and the net approach.

#### Scenario A:

	Individual-Component Approach			Net Approach		
	Pretax	Allocated Tax Benefit (Expense)	Net of Tax	Pretax	Allocated Tax Benefit (Expense)	Net of Tax
Net loss from continuing operations	\$ (1,000)	\$ 400	\$ (600)	\$ (1,000)	\$ —	\$ (1,000)
Net loss from discontinued operations	(1,000)		(1,000)	(1,000)	—	(1,000)
OCI	1,000	(400)	600	1,000	—	1,000
Comprehensive loss	<u>\$ (1,000)</u>	<u>\$ —</u>	<u>\$ (1,000)</u>	<u>\$ (1,000)</u>	<u>\$ —</u>	<u>\$ (1,000)</u>

Scenario A illustrates that under the individual-component approach, even though there is no incremental tax effect from discontinued operations and other comprehensive loss (because of the entity's NOL and full valuation allowance established against its DTAs), income tax benefit is allocated to continuing operations, income tax expense is correspondingly allocated to OCI (which is the only other "intraperiod allocation" component in the current year), and no income tax expense or benefit is allocated to discontinued operations. There is no incremental tax effect, regardless of whether there are multiple items of income or loss, or there is a single item of income other than a continuing-operations loss, because the financial statement reporting effect of applying the ASC 740-20-45-7 exception is simply a mechanical intraperiod allocation of the entity's total current-year income tax provision of zero.

**Example 7-4 (continued)****Scenario B:**

	Individual-Component Approach			Possible Methods of Allocating Income Tax Benefit (Expense) When Applying the Net Approach	
	Pretax	Allocated Tax Benefit (Expense)	Net of Tax	Allocated Tax Benefit (Expense) Option #1	Allocated Tax Benefit (Expense) Option #2
Net loss from continuing operations	\$ (1,000)	\$ 400	\$ (600)	\$ 240	\$ 240
Net loss from discontinued operations	(400)	—	(400)	—	160
OCI	1,000	(400)	600	(240)	(400)
Comprehensive loss	<u>\$ (400)</u>	<u>\$ —</u>	<u>\$ (400)</u>	<u>\$ —</u>	<u>\$ —</u>

Scenario B illustrates that there may be multiple possible methods of allocating income tax benefit and expense when the net approach is applied.

Examples 7-5 and 7-6 have been deleted.

### 7.06A Application of ASC 740-20-45-7 to Amounts Credited Directly to APIC

Certain debt instruments are bifurcated into debt and equity for financial reporting purposes (e.g., those containing a beneficial conversion feature). Generally, the equity component is recognized as a credit to APIC with a corresponding debit to debt discount. When the debt instruments are not bifurcated for income tax purposes, the tax basis of these debt instruments would be higher than the financial reporting basis. If the difference is determined to be a taxable temporary difference, then a DTL is recognized for the difference. The expense related to recognizing the DTL would generally be allocated to APIC under the intraperiod tax allocation rules. However, when an entity has a valuation allowance against its DTAs, and the taxable temporary difference on the debt instruments is considered a source of taxable income of the appropriate character and timing, the recognition of the DTL would lead to a reversal of the valuation allowance, resulting in no net tax expense or benefit. This outcome is consistent with the application of the “with” and “without” rules discussed in [7.03](#).

However, as discussed in [7.06](#), because the entity has a valuation allowance against its DTAs and would not otherwise recognize a tax benefit for a loss from continuing operations, the exception in ASC 740-20-45-7 to the general intraperiod tax allocation rule requires that “all items (for example, discontinued operations, other comprehensive income and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations.”

In applying the exception, entities have had questions about what the term “all items” includes. The words “and so forth” would seem to indicate that the Board intended “all items” to include items in addition to discontinued operations and other comprehensive income. However, it is unclear whether “all items” refers to all items discussed in ASC 740-20-45-2 or whether the exception should be limited to those items that affect comprehensive income (i.e., items recognized directly in equity such that a net incremental income tax benefit is included in comprehensive income).

We believe that there are two acceptable approaches to applying the exception in ASC 740-20-45-7 and the question of whether "all items" includes APIC items.

### **Approach 1**

"All items" should include APIC items. Since the guidance in ASC 740-20-45-7 is an exception to the general intraperiod tax allocation rule in ASC 740-20, the exception should apply to all financial statement components to which the general rule applies, including continuing operations, discontinued operations, other comprehensive income and items charged or credited directly to shareholders' equity, as outlined in ASC 740-20-45-2.

### **Approach 2**

"All items" should not include APIC items. ASC 740-20-45-7 indicates that the exception is consistent with the approach in ASC 740-10 under which an entity considers the tax consequences of taxable income expected in future years in assessing the realizability of DTAs. When determining income sources available outside continuing operations to absorb a tax loss from continuing operations, the entity should only consider amounts included in comprehensive income. The ASC master glossary defines "comprehensive income," in part, as follows:

The change in equity (net assets) of a business entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period **except those resulting from investments by owners and distributions to owners.** [Emphasis added]

When a debt instrument is bifurcated into debt and equity for financial reporting purposes, the amount recognized in APIC for the equity component is treated as a transaction with the owners and is therefore excluded from comprehensive income. Applying the exception to items not included in comprehensive income would result in the recognition of a net incremental income tax benefit in comprehensive income.

## **7.06B Application of ASC 740-20-45-7 to Foreign Currency Exchange Gains**

Foreign currency exchange gains and losses recorded in OCI represent foreign currency translation adjustments of an entity's foreign operations, as well as transaction gains and losses on intercompany loans that are considered long-term in nature ("translation adjustments"). Translation adjustments are recognized for operations of foreign subsidiaries and foreign branches when the functional currency differs from the reporting currency. The translation adjustments may be related to capital, earnings that have not been taxed by the U.S. parent's tax jurisdiction, or earnings that have been previously taxed by the U.S. parent's tax jurisdiction. While translation adjustments do not typically enter into the measure of taxable income in the foreign jurisdiction (e.g., when the tax return is prepared in the functional currency of the foreign subsidiary or branch), if they are related to foreign subsidiaries, they affect the financial reporting carrying value ("outside book basis") in the investment in the foreign subsidiary. In accordance with ASC 830-30-45-21, deferred taxes are not recognized for translation adjustments related to foreign subsidiaries to which the indefinite reversal exception applies.

Under the intra-period allocation exception in ASC 740-20-45-7, foreign currency exchange gains recorded in OCI should not be included in the measure of income outside continuing operations under the intraperiod allocation exception if the translation adjustments result in an outside basis difference in a foreign subsidiary or foreign corporate joint venture (that is essentially permanent in nature) whose earnings are asserted to be indefinitely reinvested.

As discussed in [3.07](#), ASC 830-30-45-21 states that if “deferred taxes are not provided for unremitted earnings of a subsidiary, in those instances, deferred taxes shall not be provided on translation adjustments.” Accordingly, under the intraperiod allocation exception, a foreign currency exchange gain that is part of an outside taxable temporary difference that would not normally result in a recognition of tax should not result in an allocation of tax to that item.

These requirements are similar to the guidance in ASC 740-30-25-13, which indicates that in assessing the need for a valuation allowance for a DTA, an entity should not consider future taxable income related to an investment in a foreign subsidiary for which the entity does not recognize a DTL related to a taxable outside basis difference because of the exception in ASC 740-30-25-18.

## **7.07 Consideration of Credit Entries for Reclassification Adjustments That Are Recorded in OCI During the Reporting Period When the General Intraperiod Tax Allocation Rule Is Applied**

Generally, an entity should exclude credit entries for reclassification adjustments that are recorded in OCI during the reporting period when applying ASC 740-20-45-7 to determine income within OCI. The guidance in ASC 740-20-45-7 supports this premise, stating, in part:

That modification of the incremental approach **is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets**. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [Emphasis added]

In other words, regarding the determination of the amount of income tax benefit that should be allocated to continuing operations when there is a loss from continuing operations, ASC 740-20-45-7 requires a reporting entity to consider whether there are other sources of taxable income outside of continuing operations in the current year. This approach is consistent with the general approach in ASC 740-10 that an entity would apply to determine whether a valuation allowance is required against DTAs (i.e., the reporting entity would consider the tax consequences of taxable income expected in future years in assessing the realizability of DTAs). A credit in OCI created by the reclassification of a realized loss to continuing operations does not represent potential future taxable income; therefore, the exception is not applicable in such circumstances. Under this premise, an entity should similarly exclude debit entries for reclassification adjustments that are recorded in OCI that would otherwise reduce other gains in OCI that would provide a source of income.

We are aware of an alternative approach in practice under which an entity does not distinguish between credits resulting from reclassification adjustments and other gains in OCI. Using this approach, an entity would look to the total amount of the adjustment recorded in OCI during the period when applying ASC 740-20-45-7. This view is supported by [7.06](#), which states, in part, that when performing the allocation:

[A]n entity **should use the amount of book income or loss reported** for each component of comprehensive income or loss. [Emphasis added]

Further, ASC 220 indicates that the purpose of reclassification adjustments is to properly state comprehensive income for a period. Therefore, because reclassification adjustments are a component of book comprehensive income (a gain in OCI that offsets the loss in continuing operations), an entity would consider these adjustments along with other components of OCI when applying ASC 740-20-45-7 under the alternative approach described above. Entities should consult with their accounting advisers before applying this alternative approach.

## 7.08 Implications of the Character of Income (or Loss) When the Exception to the General Intraperiod Tax Allocation Rule Is Applied

7.06 describes an exception to the general rule that the tax effects of items other than income from continuing operations are computed as the incremental tax effects of those items. Specifically, the exception applies to a situation in which an entity has a loss from continuing operations and income related to other items such as discontinued operations.

Intraperiod allocation is required for each tax-paying component (see 7.02). ASC 740-20-45-7 specifies that an entity should apply the exception to determine the amount of tax benefit that should be allocated to a loss **from continuing operations**. It does not specify that the entity must consider the character of the income or loss. Therefore, if an entity has overall income from continuing operations in a particular tax-paying component, it is not required to apply ASC 740-20-45-7 to a capital loss in that tax-paying component as if the capital loss were a separate tax-paying component.

However, in certain instances, it would be acceptable for an entity to establish an accounting policy under which the ordinary income and capital loss within continuing operations are treated as separate tax-paying components. For example, this policy election might be appropriate in a taxing jurisdiction where an entity cannot offset capital losses against ordinary income. In this circumstance, the ordinary income and capital losses may be considered, in essence, separate tax-paying components — as if separate tax returns were filed for ordinary and capital items. Thus, the ASC 740-20-45-7 exception would be applied separately to the ordinary income and capital loss even though they aggregate to overall income from continuing operations.

In any case, an entity that applies ASC 740-20-45-7 must always take into consideration the character of income outside of continuing operations when determining the amount of tax benefit to be allocated to a loss within continuing operations (either an overall loss or a capital loss being evaluated under the policy election described above). For example, in a jurisdiction where an entity cannot offset capital losses against ordinary income, ordinary income outside of continuing operations should not be used as a basis for recognizing a tax benefit for a capital loss within continuing operations.

### Example 7-7

In a tax jurisdiction that has a 40 percent tax rate and does not allow the offset of capital losses against ordinary income, an entity had \$300 of income from continuing operations, which consisted of \$1,000 of ordinary income offset by a \$700 capital loss. The entity also had a gain of \$600 on AFS recorded as a component of OCI. The following table illustrates the separate application of the approaches described above:

	If Character Is Not Considered	If Character Is Considered
Income from continuing operations	\$ 300	\$ 300
Tax expense	(400)	(160)*
Net income	(100)	140
Capital gain (AFS securities)	600	600
Tax expense	0	(240)
OCI (net of tax)	600	360
Total comprehensive income	\$ 500	\$ 500

\*  $(1,000 \times 40\%) - (600 \times 40\%)$ .

## 7.09 Intraperiod Tax Allocation: Treatment of Certain Out-of-Period Adjustments

Generally, an entity will account for the tax effects of a transaction in the same period in which (1) the related pretax income or loss is included in a component of comprehensive income or (2) equity is adjusted. “Out-of-period” adjustments occur when a tax expense or benefit is recognized in an annual period after the original transaction occurs. Examples of out-of-period adjustments include (1) when the DTAs or DTLs related to prior-period transactions are remeasured (e.g., the applicable enacted tax rate changes); (2) when a DTA that arose from a transaction in a prior period becomes realizable on the basis of income expected in future periods such that a valuation allowance is no longer necessary; or (3) when unrecognized DTAs or DTLs are no longer subject to one of the exceptions in ASC 740-30.

ASC 740-20 provides guidance on the intraperiod tax allocation of certain out-of-period adjustments; however, it is silent regarding the treatment of other out-of-period adjustments. ASC 740-20 provides guidance on changes in beginning-of-the-year valuation allowances on the basis of realization in future years; changes in tax laws and tax rates; and changes in an entity’s tax status. In each of these instances, the related tax effects should be allocated to income from continuing operations, as stated in ASC 740-20-45-4, ASC 740-10-45-15, and ASC 740-10-45-19, respectively.

ASC 740 does not provide guidance on how to allocate the tax effects of certain out-of-period adjustments. In such cases, it is usually appropriate for the entity to analogize to the guidance in ASC 740-20 on out-of-period adjustments. Thus, an entity should generally allocate the tax effects of out-of-period adjustments that are not specifically addressed in ASC 740-20 to income from continuing operations.

There may be out-of-period adjustments, such as presentation of discontinued operations, for which intraperiod allocation guidance exists in another Codification topic. In those situations, it may be appropriate to apply the presentation guidance from that topic. See the discussion in [7.10](#) and [7.11](#) regarding the reporting of tax effects of components that are classified as discontinued operations and the interaction of the guidance on intraperiod income tax accounting.

### Example 7-8

#### Change in an Indefinite Reinvestment Assertion

Entity X has a profitable foreign subsidiary, A; X has asserted that A’s undistributed earnings are indefinitely reinvested, and, accordingly, that the indefinite reversal criteria in ASC 740-30-25-17 are met. Therefore, X has not recorded a DTL in connection with the financial-reporting-over-tax basis difference for the investment in A (the outside basis difference). Further, A’s functional currency is its local currency; thus, any resulting translation differences in consolidation by X are accounted for in OCI.

In a subsequent year, X changes its intent to indefinitely reinvest the prior earnings of A. Thus, X must recognize a DTL for the related part of the outside basis difference. The resulting tax expense is recorded as an expense in the current period. The tax expense related to the outside basis difference is generally allocated to continuing operations by analogy to the out-of-period guidance in ASC 740-20 and because “backward tracing” is not permitted under ASC 740. However, the tax expense allocated to continuing operations should be based on a computation in which no current-year change in the foreign currency exchange rates is assumed (i.e., the tax effect of prior-period income is based on the exchange rate at the beginning of the year, and the tax effect of the current-period income is based on the exchange rate used in translating that income). In accordance with ASC 740-20-45-11(b), any difference between the preceding tax effect and the actual amount recognized would be recognized as the tax effect of the current-period currency translation adjustment.

### Example 7-9

#### Change in State Apportionment Rate

Entity A, a U.S. entity, operates in multiple state jurisdictions and uses state apportionment factors to allocate DTAs and DTLs to various states in accordance with the income tax laws of each state. (See [4.07](#) for a further discussion of state apportionment.)

During a subsequent annual period, Entity A experiences a change in its business operations that will affect the apportionment rate used in the state of X (i.e., there has been a change in the state footprint, but not in the enacted tax rate). Entity A's deferred taxes are remeasured by using the different apportionment rate expected to apply in the period in which the deferred taxes are expected to be recovered or settled. The related tax effects of the change in DTAs and DTLs would generally be allocated to income from continuing operations in accordance with the intraperiod allocation guidance in ASC 740-20.

## 7.10 Intraperiod Tax Allocation: Tax Benefit From a Worthless Stock Deduction

Section 165(g)(3) of the IRC allows a loss on worthless securities to be deducted (referred to as a worthless stock deduction) against a domestic corporation's ordinary income if the corporation (foreign or domestic) whose securities are worthless is "affiliated" with the domestic corporation.

Section 165(g)(3) of the IRC states, in part:

- [A] corporation shall be treated as affiliated with the taxpayer only if —
- (A) the taxpayer owns directly stock in such corporation meeting the requirements of section 1504(a)(2), and
  - (B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents . . . , dividends, interest . . . , annuities, and gains from sales or exchanges of stocks and securities [i.e., the gross receipts test].

If the gross receipts criterion in (B) above is not met, the loss on worthless securities is a capital loss.

An entity that is a domestic corporation may decide to sell a component that meets the requirements in ASC 205-20 for measurement and display as a discontinued operation. Concurrently, the entity may also change its legal structure or make elections for tax purposes that result in the generation of a worthless stock deduction.

If the worthless stock deduction partially or entirely results from historical operating losses on the component that is presented as a discontinued operation, it may be appropriate to allocate a portion or all of the tax benefit from the worthless stock deduction to discontinued operations. ASC 205-20 notes that the income statement of a component should include the results of operations in discontinued operations for the current and prior periods. In applying this guidance, an entity could allocate the worthless stock deduction to discontinued operations because the entity must present all income statement activity related to a component qualifying for treatment as a discontinued operation in a section of the income statement that is separate from continuing operations.

Alternatively, the intraperiod tax allocation guidance in ASC 740-20 generally requires that an entity allocate the income tax effects of certain items to income from continuing operations. Such items include (1) changes in valuation allowances that are attributable to changes in judgments about future realization (see ASC 740-20-45-4), (2) changes in tax laws and tax rates (see ASC 740-10-45-15), and (3) changes in tax status (see ASC 740-10-45-19).

The guidance in ASC 205-20 on presentation of discontinued operations and the intraperiod tax allocation guidance in ASC 740-20 may appear to conflict regarding the allocation of the tax effects of income tax items related to operations that are presented as discontinued operations and that are not specifically addressed in ASC 740. Accordingly, there are two acceptable views on allocating a worthless stock deduction:

- If the tax benefit of a worthless stock deduction is the result of historical operating losses on the component that is presented as a discontinued operation, that benefit can be allocated<sup>3</sup> to either discontinued operations or income from continuing operations.
- If an entity concludes that the worthless stock deduction does not relate to the operating results of the component that is presented in discontinued operations, the entire tax benefit should be allocated to income from continuing operations.

See [8.20](#) for a discussion of recognition of a DTA related to a subsidiary presented as a discontinued operation.

#### Example 7-10

Entity Y, a U.S. entity, owns 100 percent of H, a foreign holding company that holds three operating companies. The three operating companies have historically generated losses, resulting in a difference between Y's book basis and the U.S. tax basis in the investment in H. This outside basis difference gives rise to a DTA that has historically not been recognized, since the difference was not expected to reverse in the foreseeable future in accordance with ASC 740-30-25-9.

In 20X1, Y sells one of the operating companies (Company 1) and presents it as a discontinued operation in the consolidated financial statements in accordance with ASC 205-20-45-1. Concurrently with the sale of Company 1, Y elected to treat H as a disregarded entity for tax purposes (i.e., nontaxable status) by "checking the box." For tax purposes, this election is considered a deemed liquidation. The liquidated liabilities of H are in excess of the liquidated assets; therefore, the investment in H is considered worthless and Y can claim a related deduction for tax purposes in the U.S. tax jurisdiction.

The benefit recognized in connection with the worthless stock deduction is a result of the historical losses incurred at the three operating companies. Without these losses in prior years, the deemed liquidation of H would not have resulted in a tax deduction and a benefit would not have been recognized. The tax consequence of this benefit should be allocated between the three operating companies, one of which — Company 1 — is presented in discontinued operations. Accordingly, it would be appropriate for Y to present the benefit from the losses related to Company 1 in discontinued operations and the benefit from losses related to Companies 2 and 3 in income from continuing operations.

An acceptable alternative would be for Y to allocate the entire benefit to income from continuing operations.

## 7.11 Intraperiod Allocation of “Out-of-Period” Tax Effects of UTBs That Originated in Discontinued Operations

ASC 740-10-30-3 defines total income tax expense (or benefit) for the year as the sum of deferred tax expense (or benefit) and income taxes currently payable or refundable. Total income tax expense also includes the tax expense or tax benefit in the current period that is associated with applying the recognition and measurement criteria to tax positions, which can result in UTBs. After determining the total income tax expense (or benefit), an entity applies the intraperiod tax allocation guidance in ASC 740-20-45 to allocate the total income tax expense (or benefit) among continuing operations, discontinued operations, OCI, and items charged or credited directly to a component of shareholders' equity.

<sup>3</sup> Allocating a portion or all of the tax effects of the worthless stock deduction to discontinued operations is based on specific Codification guidance (i.e., ASC 205); therefore, it would not be appropriate to analogize to other situations.

Generally, an entity will account for the tax effects of a transaction in the same period in which (1) the related pretax income or loss is included in a component of comprehensive income or (2) equity is adjusted. “Out-of-period” adjustments occur when a tax expense or benefit is recognized in an annual period after the original transaction occurs. Examples of out-of-period adjustments include (1) the DTAs or DTLs related to prior-period transactions are remeasured (e.g., the applicable enacted tax rate changes); (2) a DTA that arose from a transaction in a prior period becomes realizable on the basis of income expected in future periods such that a valuation allowance is no longer necessary; or (3) when unrecognized DTAs or DTLs are no longer subject to one of the exceptions in ASC 740-30.

ASC 740-20 provides guidance on the intraperiod tax allocation of certain out-of-period adjustments but is silent on the treatment of other out-of-period adjustments. ASC 740-20 provides guidance on changes in beginning-of-the-year valuation allowances on the basis of realization in future years, changes in tax laws and tax rates, and changes in an entity’s tax status. In each of these instances, the related tax effects should be allocated to income from continuing operations, as stated in ASC 740-20-45-4, ASC 740-10-45-15, and ASC 740-10-45-19, respectively.

**7.09** provides general interpretive guidance on intraperiod allocation of out-of-period adjustments for which ASC 740-20 does not provide explicit guidance. However, we believe that special consideration is required when the out-of-period adjustment is related to pretax items of income or loss recorded in discontinued operations.

In some tax jurisdictions, when a parent disposes of a component that was included in the parent’s income tax return, the parent might retain the obligation for UTBs that arose from and were directly related to the operations of the component while it was still part of the parent’s tax return (including UTBs related to the disposal transaction itself). The parent may classify the results of operations of the component in periods before the disposal as discontinued operations. After the disposal, the parent may need to adjust the amount of the UTB. The tax effect of the adjustment to the UTB represents an out-of-period adjustment in the period in which the parent records it.

As discussed in **7.09**, while ASC 740 is silent on the treatment of this specific out-of-period adjustment, it would be acceptable to analogize to the guidance in ASC 740-20-45-8 for the out-of-period items that are described. In this view, the tax expense or benefit resulting from the out-of-period adjustment to the UTB would not be “backwards traced” to discontinued operations and the tax expense or benefit would instead be included in continuing operations.

Alternatively, an entity could consider the general guidance in ASC 205-20-45 that applies to discontinued operations (guidance that generally focuses on pretax income). ASC 205-20-45-4 and 45-5 state (the paragraphs reflect the revisions made by ASU 2014-08):

Adjustments to amounts previously reported in discontinued operations in a prior period shall be presented separately in the current period in the discontinued operations section of the statement where net income is reported.

Examples of circumstances in which those types of adjustments may arise include the following:

- a. The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser
- b. The resolution of contingencies that arise from and that are directly related to the operations of the discontinued operation before its disposal, such as environmental and product warranty obligations retained by the seller
- c. The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction. A settlement is directly related to the disposal transaction if there is a demonstrated direct cause-and-effect relationship and the settlement occurs no later than one year following the disposal transaction, unless it is delayed by events or circumstances beyond an entity’s control (see paragraph 205-20-45-1G).

ASC 205 does not distinguish between pretax adjustments and adjustments to income taxes.

In connection with the implementation of FIN 48 (codified in ASC 740), informal discussions were held with the FASB staff regarding a situation in which the application of ASC 205 would result in a different presentation than the application of ASC 740. Specifically, the FASB staff was asked whether income tax expense or benefit arising from the remeasurement of a UTB related to a discontinued operation should be reflected in (1) continuing operations in a manner consistent with the general prohibition on backwards tracing implicit in ASC 740-20-45 or (2) discontinued operations in a manner consistent with ASC 205. The FASB staff indicated that it was aware of both presentations in practice and that an entity should elect one of them as an accounting policy and apply it consistently.

#### **Example 7-11**

An entity recorded a UTB classified as a noncurrent liability in connection with a tax position related to the character (capital vs. ordinary) of the gain from the disposal of a component. The income tax expense for recording the UTB was reflected in discontinued operations in accordance with the intraperiod tax allocation guidance in ASC 740-20. In a subsequent year, the statute of limitations expired and the entity recognized a tax benefit when the UTB was derecognized.

In determining where the benefit should be allocated, the entity could apply the guidance in ASC 740-20-45, which prohibits backwards tracing of out-of-period adjustments, to record the benefit in continuing operations. Alternatively, the entity could record the benefit in discontinued operations under ASC 205-20-45-4 even though this benefit may be the only item in discontinued operations in that reporting period. The approach chosen is considered an accounting policy election and should be consistently applied.

### **7.12 Tax Benefits for Dividends Paid to Shareholders: Recognition**

In certain tax jurisdictions, an entity may receive a tax deduction for dividend payments made to shareholders. ASC 740-20-45-8 specifies that tax benefits received for these deductions should be recognized as a reduction of income tax expense at the time of the dividend distribution. The rationale for this conclusion is based on the belief that, in substance, a tax deduction for the payment of those dividends represents an exemption from taxation of an equivalent amount of earnings. However, an exception to this accounting treatment is discussed in [7.23](#).

### **7.13 Income Tax Accounting Considerations Related to When a Subsidiary Is Deconsolidated**

The deconsolidation of a subsidiary may result from a variety of circumstances, including a sale of 100 percent of an entity's interest in the subsidiary. The sale may be structured as either a "stock sale" or an "asset sale." A stock sale occurs when a parent sells all of its shares in a subsidiary to a third party and the subsidiary's assets and liabilities are transferred to the buyer.

An asset sale occurs when a parent sells individual assets (and liabilities) to the buyer and retains ownership of the original legal entity. In addition, by election, certain stock sales can be treated for tax purposes as if the subsidiary sold its assets and was subsequently liquidated.

Upon a sale of a subsidiary, the parent entity should consider the income tax accounting implications for its income statement and balance sheet.

## ***Income Statement Considerations***

ASC 810-10-40-5 provides a formula for calculating a parent entity's gain or loss on deconsolidation of a subsidiary, which is measured as the difference between:

- a. The aggregate of all of the following:
  1. The fair value of any consideration received
  2. The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized
  3. The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.
- b. The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets.

### **Asset Sale**

When the net assets of a subsidiary are sold, the parent will present the gain or loss on the net assets (excluding deferred taxes) in pretax income and will present the reversal of any DTAs or DTLs associated with the assets sold (the inside basis differences<sup>4</sup>) and any tax associated with the gain or loss on sale in income tax expense (or benefit).

### **Stock Sale**

As with an asset sale, when the shares of a subsidiary are sold, the parent will present the gain or loss on the net assets in pretax income. One acceptable approach to accounting for the reversal of deferred taxes (the inside basis differences<sup>5</sup>) is to include the reversal in the computation of the pretax gain or loss on the sale of the subsidiary; under this approach, the only amount that would be included in income tax expense (or benefit) would be the tax associated with the gain or loss on the sale of the shares (the outside basis difference<sup>6</sup>). The rationale for this view is that any future tax benefits (or obligations) of the subsidiary are part of the assets acquired and liabilities assumed by the acquirer with the transfer of shares in the subsidiary and the carryover tax basis in the assets and liabilities. Other approaches may be acceptable depending on the facts and circumstances.

If the subsidiary being deconsolidated meets the requirements in ASC 205 for classification as a discontinued operation, the entity would need to consider the intraperiod guidance on discontinued operations in addition to this guidance. In addition, see [8.20](#) for a discussion of outside basis differences in situations in which the subsidiary is presented as a discontinued operation.

## ***Balance Sheet Considerations***

Entities with a subsidiary (or component) that meets the held-for-sale criteria in ASC 360 should classify the assets and liabilities associated with that component separately on the balance sheet as "held for sale." The presentation of deferred tax balances associated with the assets and liabilities of the subsidiary or component classified as held for sale is determined on the basis of the method of the expected sale (i.e., asset sale or stock sale) and whether the entity presenting the assets as held for sale is transferring the basis difference to the buyer.

<sup>4</sup> See [3.04](#) for the meaning of "inside" and "outside" basis differences.

<sup>5</sup> See footnote 4.

<sup>6</sup> See footnote 4.

Deferred taxes associated with the stock of the component being sold (the outside basis difference<sup>7</sup>) should not be presented as held for sale in either an asset sale or a stock sale since the acquirer will not assume the outside basis difference.

## Asset Sale

In an asset sale, the tax bases of the assets and liabilities being sold will not be transferred to the buyer. Therefore, the deferred taxes related to the assets and liabilities (the inside basis differences<sup>8</sup>) being sold should not be presented as held for sale; rather, they should be presented along with the consolidated entity's other deferred taxes.

## Stock Sale

In a stock sale, the tax bases of the assets and liabilities being sold generally are carried over to the buyer. Therefore, the deferred taxes related to the assets and liabilities (the inside basis differences<sup>9</sup>) being sold should be presented as held for sale and not with the consolidated entity's other deferred taxes.

## 7.14 Fresh-Start Accounting: Subsequent Increase or Decrease in a Valuation Allowance

ASC 852-10 requires an entity emerging from Chapter 11 bankruptcy protection to adopt a new reporting basis ("fresh-start accounting") for its assets and liabilities if certain criteria are met. Any subsequent increase in the valuation allowance after the date fresh-start accounting is first applied is reported as a component of income tax expense from continuing operations.

ASC 852-740-45-1 states that a reduction in a valuation allowance for a tax benefit that was not recognizable as of the plan confirmation date should be reported as a reduction in income tax expense. Therefore, a subsequent adjustment (increase or decrease) to a valuation allowance established as of the date of fresh-start reporting should be reported as either an increase or a decrease in income tax expense.

Similarly to other income tax transition provisions related to the adoption of Statement 141(R), the change in accounting for the reduction of valuation allowances established upon adoption of fresh-start reporting applies to all changes after the effective date of Statement 141(R), regardless of the date of adoption of fresh-start reporting. Therefore, these reporting requirements could affect the accounting for entities that adopted fresh-start reporting before Statement 141(R)'s effective date.

## 7.15 Subsequent Changes in Valuation Allowances for Pre-Quasi-Reorganization Tax Benefits

After a quasi-reorganization, an entity may conclude that a valuation allowance should be recognized or increased for a DTA attributable to pre-quasi-reorganization benefits that were recognized in a prior period. This charge to establish or increase the valuation allowance is reported as a component of income tax expense from continuing operations.

<sup>7</sup> See [footnote 4](#).

<sup>8</sup> See [footnote 4](#).

<sup>9</sup> See [footnote 4](#).

## 7.16 Subsequent Recognition of Tax Benefits From a Quasi-Reorganization

With very infrequent exceptions, the general rule in ASC 852-740-45-3 states that the subsequent recognition of “tax benefits of deductible temporary differences and carryforwards [that existed] as of the date of a quasi-reorganization . . . shall be reported as a direct addition to contributed capital.” The only exception is for entities (1) that adopted Statement 96 before adopting Statement 109 (codified in ASC 740) and (2) for which the quasi-reorganization involved only the elimination of the deficit in retained earnings, with a reduction in contributed capital. In that situation, the subsequent recognition of the tax benefit of the deductible temporary difference and carryforwards that existed as of the date of the quasi-reorganization should be recognized in the income tax provision and then classified from retained earnings to contributed capital.

## Allocations to Items Other Than Continuing Operations

### ASC 740-20

**45-10** This guidance identifies specific items outside of continuing operations that require an allocation of income tax expense or benefit. It also establishes the methodology for allocation. That methodology differs depending on whether there is only one item other than continuing operations or whether there are multiple items other than continuing operations.

**45-11** The tax effects of the following items occurring during the year shall be charged or credited directly to other comprehensive income or to related components of shareholders' equity:

- a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error. Paragraph 250-10-45-8 addresses the effects of a change in accounting principle, including any related income tax effects.
- b. Gains and losses included in comprehensive income but excluded from net income (for example, translation adjustments accounted for under the requirements of Topic 830 and changes in the unrealized holding gains and losses of securities classified as available-for-sale as required by Topic 320).
- c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock). [FAS 109, paragraph 36]
- d. Expenses for employee stock options recognized differently for financial reporting and tax purposes as required by Subtopic 718-740. [FAS 109, paragraph 36] An employee stock ownership plan and a stock option plan are analogous. Both are compensatory arrangements and both sometimes result in tax deductions for amounts that are not presently recognized as compensation expense in the financial statements under existing generally accepted accounting principles (GAAP). The tax benefits of both are reported as a credit to shareholders' equity. [FAS 109, paragraph 144]
- e. Dividends that are paid on unallocated shares held by an employee stock ownership plan and that are charged to retained earnings. [FAS 109, paragraph 36] This is different from a tax deduction received for the payment of dividends on allocated shares held by an employee stock ownership plan that represents, in substance, an exemption from taxation of an equivalent amount of earnings for which the tax benefit shall be recognized as a reduction of tax expense and shall not be allocated directly to shareholders' equity. [FAS 109, paragraph 145]
- f. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization. [FAS 109, paragraph 36]
- g. All changes in the tax bases of assets and liabilities caused by transactions among or with shareholders shall be included in equity including the effect of valuation allowances initially required upon recognition of any related deferred tax assets. Changes in valuation allowances occurring in subsequent periods shall be included in the income statement. [EITF 94-10, paragraph Discussion]

**ASC 740-20 (continued)****Pending Content (Transition Guidance: ASC 718-10-65-4)**

**45-11** The tax effects of the following items occurring during the year shall be charged or credited directly to other comprehensive income or to related components of shareholders' equity:

- a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error. Paragraph 250-10-45-8 addresses the effects of a change in accounting principle, including any related income tax effects.
- b. Gains and losses included in comprehensive income but excluded from net income (for example, translation adjustments accounted for under the requirements of Topic 830 and changes in the unrealized holding gains and losses of securities classified as available-for-sale as required by Topic 320).
- c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock). [FAS 109, paragraph 36]
- d. Subparagraph superseded by Accounting Standards Update No. 2016-09.
- e. Subparagraph superseded by Accounting Standards Update No. 2016-09.
- f. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization. [FAS 109, paragraph 36]
- g. All changes in the tax bases of assets and liabilities caused by transactions among or with shareholders shall be included in equity including the effect of valuation allowances initially required upon recognition of any related deferred tax assets. Changes in valuation allowances occurring in subsequent periods shall be included in the income statement. [EITF 94-10, paragraph Discussion]

## **ASC 740-20 (continued)**

### **Single Item of Allocation Other Than Continuing Operations**

**45-12** If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations shall be allocated to that item.

**45-13** See Example 2 (paragraph 740-20-55-8) for an example of the allocation of total tax expense or benefit to continuing operations and one other item.

### **Multiple Items of Allocation Other Than Continuing Operations**

**45-14** If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

- a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items.
- b. Apportion the tax benefit determined in (a) ratably to each net loss item.
- c. Determine the amount that remains, that is, the difference between the amount to be allocated to all items other than continuing operations and the amount allocated to all net loss items.
- d. Apportion the tax expense determined in (c) ratably to each net gain item. [FAS 109, paragraph 38]

## **Presentation of Deferred Tax Assets Relating to Losses on Available-for-Sale Debt Securities**

### **Pending Content (Transition Guidance: ASC 825-10-65-2)**

**45-15** An entity that recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may at the same time conclude that it is more likely than not that some or all of that deferred tax asset will not be realized. In that circumstance, the entity shall report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt securities because the valuation allowance is directly related to the unrealized holding loss on the available-for-sale securities. The entity shall also report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt securities if the entity concludes on the need for a valuation allowance in a later interim period of the same fiscal year in which the deferred tax asset is initially recognized. [QA 115, paragraph 54]

### **Pending Content (Transition Guidance: ASC 825-10-65-2)**

**45-16** An entity that does not need to recognize a valuation allowance at the same time that it establishes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may, in a subsequent fiscal year, conclude that it is more likely than not that some or all of that deferred tax asset will not be realized. In that circumstance, if an entity initially decided that no valuation allowance was required at the time the unrealized loss was recognized but in a subsequent fiscal year decides that it is more likely than not that the deferred tax asset will not be realized, a valuation allowance shall be recognized. The entity shall include the offsetting entry as an item in determining income from continuing operations. The offsetting entry shall not be included in other comprehensive income. [QA 115, paragraph 56]

**ASC 740-20 (continued)****Pending Content (Transition Guidance: ASC 825-10-65-2)**

**45-17** An entity that recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may, at the same time, conclude that a valuation allowance is warranted and in a subsequent fiscal year makes a change in judgment about the level of future years' taxable income such that all or a portion of that valuation allowance is no longer warranted. In that circumstance, the entity shall include any reversals in the valuation allowance due to such a change in judgment in subsequent fiscal years as an item in determining income from continuing operations, even though initial recognition of the valuation allowance affected the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt securities. If, rather than a change in judgment about future years' taxable income, the entity generates taxable income in the current year (subsequent to the year the related deferred tax asset was recognized) that can use the benefit of the deferred tax asset, the elimination (or reduction) of the valuation allowance is allocated to that taxable income. Paragraph 740-10-45-20 provides additional information. [QA 115, paragraph 57]

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

**45-18** An entity that has recognized a deferred tax asset relating to other deductible temporary differences in a previous fiscal year may at the same time have concluded that no valuation allowance was warranted. If in the current year an entity recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities that arose in the current year and at the same time concludes that a valuation allowance is warranted, management shall determine the extent to which the valuation allowance is directly related to the unrealized loss and the other deductible temporary differences, such as an accrual for other postemployment benefits. The entity shall report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt securities only to the extent the valuation allowance is directly related to the unrealized loss on the available-for-sale securities that arose in the current year. [QA 115, paragraph 55]

**Related Implementation Guidance and Illustrations**

- [Example 2: Allocations of Income Taxes to Continuing Operations and One Other Item](#) [ASC 740-20-55-8].
- [Example 4: Allocation to Other Comprehensive Income](#) [ASC 740-20-55-18].

## ASC 320-10

### **Presentation of Deferred Tax Assets Relating to Losses on Available-for-Sale Securities**

**45-3** An entity that recognizes a deferred tax asset relating only to a net unrealized loss on available-for-sale securities may at the same time conclude that it is more likely than not that some or all of that deferred tax asset will not be realized. In that circumstance, the entity shall report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt securities and equity securities because the valuation allowance is directly related to the unrealized holding loss on the available-for-sale securities. The entity shall also report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt and equity securities if the entity concludes on the need for a valuation allowance in a later interim period of the same fiscal year in which the deferred tax asset is initially recognized.

[QA 115, paragraph 54]

### **Pending Content (Transition Guidance: ASC 825-10-65-2)**

**45-3 Editor's Note:** Paragraph 320-10-45-3 will be superseded upon transition, together with its heading:

### **Presentation of Deferred Tax Assets Relating to Losses on Available-for-Sale Securities**

Paragraph superseded by Accounting Standards Update No. 2016-01.

**45-4** An entity that does not need to recognize a valuation allowance at the same time that it establishes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may, in a subsequent fiscal year, conclude that it is more likely than not that some or all of that deferred tax asset will not be realized. In that circumstance, if an entity initially decided that no valuation allowance was required at the time the unrealized loss was recognized but in a subsequent fiscal year decides that it is more likely than not that the deferred tax asset will not be realized, a valuation allowance shall be recognized. The entity shall include the offsetting entry as an item in determining income from continuing operations. The offsetting entry shall not be included in other comprehensive income. [QA 115, paragraph 56]

### **Pending Content (Transition Guidance: ASC 825-10-65-2)**

**45-4** Paragraph superseded by Accounting Standards Update No. 2016-01.

**ASC 320-10 (continued)**

**45-5** An entity that recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may, at the same time, conclude that a valuation allowance is warranted and in a subsequent fiscal year makes a change in judgment about the level of future years' taxable income such that all or a portion of that valuation allowance is no longer warranted. In that circumstance, the entity shall include any reversals in the valuation allowance due to such a change in judgment in subsequent fiscal years as an item in determining income from continuing operations, even though initial recognition of the valuation allowance affected the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt and equity securities. If, rather than a change in judgment about future years' taxable income, the entity generates taxable income in the current year (subsequent to the year the related deferred tax asset was recognized) that can use the benefit of the deferred tax asset, the elimination (or reduction) of the valuation allowance is allocated to that taxable income. Paragraph 740-10-45-20 provides additional information. [QA 115, paragraph 57]

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

**45-5** Paragraph superseded by Accounting Standards Update No. 2016-01.

**45-6** An entity that has recognized a deferred tax asset relating to other deductible temporary differences in a previous fiscal year may at the same time have concluded that no valuation allowance was warranted. If in the current year an entity recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities that arose in the current year and at the same time concludes that a valuation allowance is warranted, management shall determine the extent to which the valuation allowance is directly related to the unrealized loss and the other deductible temporary differences, such as an accrual for other postemployment benefits. The entity shall report the offsetting entry to the valuation allowance in the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt and equity securities only to the extent the valuation allowance is directly related to the unrealized loss on the available-for-sale securities that arose in the current year. [QA 115, paragraph 55]

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

**45-6** Paragraph superseded by Accounting Standards Update No. 2016-01.

## 7.17 Tax Consequences of Securities Classified as Held to Maturity, Trading, and Available for Sale

ASC 320-10 addresses the accounting and reporting for (1) investments in equity securities that have readily determinable fair values and (2) all investments in debt securities. Under ASC 320-10-25-1, an entity must classify and account for such investments in one of the following three ways:

- Debt securities that the entity has the positive intent and ability to hold until maturity are classified as HTM and are reported at amortized cost.
- Debt and equity securities that are bought and held principally to be sold in the near term are classified as trading securities and are reported at fair value, with any unrealized gains and losses included in earnings.
- Debt and equity securities not classified as either HTM or trading are classified as AFS and are reported at fair value, with unrealized gains and losses excluded from earnings and reported in OCI.

## ***Held-to-Maturity Securities***

Use of the amortized cost method of accounting for debt securities that are HTM often creates taxable or deductible temporary differences because, for financial reporting purposes, any discount or premium is amortized to income over the life of the investment. However, the cost method used for tax purposes does not amortize discounts or premiums. For example, because the amortization of a discount increases the carrying amount of the debt security for financial reporting purposes, a taxable temporary difference results when the tax basis in the investment remains unchanged under the applicable tax law. Accounting for the deferred tax consequences of any resultant temporary differences created by the use of the amortized cost method is relatively straight forward because both the pretax impact caused by the amortization of a discount or premium and its related deferred tax consequences are recorded in the income statement during the same period.

When the amortized cost method creates a deductible temporary difference, realization of the resultant DTA must be assessed. A valuation allowance is necessary to reduce the related DTA to an amount whose realization is more likely than not. The tax consequences of valuation allowances and any subsequent changes necessary to adjust the DTA to an amount that is more likely than not to be realized are generally charged or credited directly to income tax expense or benefit from continuing operations (exceptions to this general rule are discussed in ASC 740-20-45-3). This procedure produces a normal ETR for income tax expense from continuing operations. Since the preceding discussion pertains to HTM securities, the resulting income and losses are reported in continuing operations rather than OCI.

## ***Trading Securities***

Trading securities that are reported at fair value create taxable and deductible temporary differences when the cost method is used for income tax purposes. For example, a taxable temporary difference is created when the fair value of an investment and its corresponding carrying amount for financial reporting purposes differ from its cost for income tax purposes. Accounting for the deferred tax consequences of any temporary differences resulting from marking the securities to market for financial reporting purposes is charged or credited directly to income tax expense or benefit from continuing operations.

When mark-to-market accounting creates a deductible temporary difference, realization of the resulting DTA must be assessed. A DTA is reduced by a valuation allowance, if necessary, so that the net amount represents the tax benefit that is more likely than not to be realized. The tax consequences of establishing a valuation allowance and any subsequent changes that may be necessary are generally charged or credited directly to income tax expense or benefit from continuing operations (exceptions to this general rule are discussed in ASC 740-20-45-3). This procedure produces a normal ETR for income tax expense from continuing operations.

## ***AFS Securities***

Securities classified as AFS are marked to market as of the balance sheet date, which creates taxable and deductible temporary differences whenever the cost method is used for income tax purposes. For example, a DTL will result from taxable temporary differences whenever the fair value of an AFS security is in excess of the amount of its cost basis as determined under tax law. ASC 320-10-35-1 indicates that unrealized holding gains and losses must be excluded from earnings and reported as a net amount in OCI. In addition, ASC 740-20-45-11 provides guidance on reporting the tax effects of unrealized holding gains and losses. ASC 740-20-45-11(b) requires that the tax effects of gains and losses that occur during the year that are included in comprehensive income but excluded from net income (i.e., unrealized gains and losses on AFS securities) are also charged or credited to OCI. Example 7-12 illustrates this concept.

On January 5, 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new guidance requires that entities, upon the effective date of the ASU (generally after December 15, 2017, for public entities), carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and limited liability companies, at fair value through net income (FVTNI). The guidance above reflects U.S. GAAP before adoption of ASU 2016-01.

#### **Example 7-12**

Assume that at the beginning of the current year, 20X1, Entity X has no unrealized gain or loss on an AFS security. During 20X1, unrealized losses on AFS securities are \$1,000 and the tax rate is 40 percent. As a result of significant negative evidence available at the close of 20X1, X concludes that a 50 percent valuation allowance is necessary. Therefore, X records a \$400 DTA and a \$200 valuation allowance. Accordingly, the carrying amount of the AFS portfolio is reduced by \$1,000, OCI is reduced by \$800, and a \$200 net DTA (a DTA of \$400 less a valuation allowance of \$200) is recognized at the end of 20X1.

### **7.18 AFS Securities: Methods of Accounting for Deferred Taxes**

In February 2018, the FASB issued ASU 2018-02, which addresses the reclassification of certain tax effects from AOCI. The section below has not been updated to reflect the guidance in the ASU. For information on the application of ASU 2018-02, see [FAQ B-76 through FAQ B-83](#) in [Appendix B](#).

Assume that an entity has a portfolio of AFS securities and that during 20X1, their fair value has declined such that unrealized holding losses are incurred and reported in OCI. Available evidence supports a conclusion that a full valuation allowance is necessary as of the end of the year. In 20X2, the entity's estimate of future income, excluding temporary differences and carryforwards, changes. Accordingly, these circumstances have caused a change in judgment about the realizability of the related DTA in future years and a valuation allowance is no longer necessary at the close of 20X2. The elimination of the valuation allowance is reported as a reduction in income tax expense from continuing operations in 20X2 because the change is directly attributable to a change in estimate about income or loss in future years (see ASC 740-10-45-20). Also, assume that in 20X3, the fair value of the securities increases such that the unrealized loss previously reported in OCI is eliminated and the securities are sold at no gain or loss. OCI is increased for the market value increase net of any related tax consequences. When applying the incremental approach, a reduction in a prior loss is treated as income in the current period.

The FASB staff has informally indicated that, in the situation described above, whether an entity should eliminate the deferred tax consequences that remain in AOCI (a component of equity) at the end of 20X3 depends on whether the entity is using the security-by-security approach or the portfolio approach. The tax consequences reported under the security-by-security approach may sometimes be different from those reported under the portfolio approach.

#### **Security-by-Security Approach**

Under the security-by-security approach, the tax consequences of unrealized gains and losses that are reported in OCI are tracked on a security-by-security basis. In the situation described above, because of the sale there is zero cumulative pretax unrealized gain or loss on the AFS security at the end of 20X3 and because no tax effect was originally recorded in OCI, the credit to eliminate the gross deferred tax effect remaining in AOCI at the close of 20X3 is balanced by recognizing an equal amount of income tax expense from continuing operations during 20X3.

## **Portfolio Approach**

The portfolio approach involves a strict period-by-period cumulative incremental allocation of income taxes to the change in unrealized gains and losses reflected in OCI. Under this approach, the net cumulative tax effect is ignored. The net change in unrealized gains or losses recorded in AOCI under this approach would be eliminated only on the date the entire inventory of AFS securities is sold or otherwise disposed of.

## **7.19 AFS Securities: Valuation Allowance for Unrealized Losses**

In accordance with ASC 740-20-45-11(b), the tax consequences of changes in the amount of unrealized holding gains or losses from AFS securities generally are charged or credited to OCI (see [7.18](#)). An entity will sometimes recognize a valuation allowance to reduce a DTA for an unrealized loss on AFS securities to an amount that is more likely than not to be realized and then subsequently increase or decrease the valuation allowance related to changes in the fair value of such securities.

ASC 320-10-45-3 through 45-6 address the initial and subsequent accounting for valuation allowances related to unrealized losses on AFS securities (i.e., such valuation allowances would be recognized as a component of OCI or as an item in the determination of income from continuing operations).

## **7.20 AFS Securities: Valuation Allowance Changes Not Recorded Directly in Shareholders' Equity**

In February 2018, the FASB issued ASU 2018-02, which addresses the reclassification of certain tax effects from AOCI. The section below has not been updated to reflect the guidance in the ASU. For information on the application of ASU 2018-02, see [FAQ B-76 through FAQ B-83](#) in [Appendix B](#).

Sometimes the effect of an increase or a decrease in a valuation allowance that was initially established to reduce a DTA for an unrealized loss on an AFS security is not allocated to OCI. If changes in a valuation allowance are caused by a transaction, event, or set of circumstances that is not directly attributable to either an increase or a decrease in the holding gains or losses on an AFS security, an entity must analyze the cause to determine how the tax consequence of the change should be reported. This conclusion is based on guidance from ASC 740, as described below.

ASC 740-10-45-20 states, in part:

The effect of a change in the **beginning-of-the-year** balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years ordinarily shall be included in income from continuing operations. . . . The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations as required by paragraphs 740-20-45-2 and 740-20-45-8. [Emphasis added]

In addition, ASC 740-20-45-8 concludes that the "amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of . . . [c]hanges in circumstances that cause a change in judgment about the realization of deferred tax assets in future years."

Further, ASC 740-20-45-3 requires that the "tax benefit of an operating loss carryforward or carryback . . . be reported in the same manner as the source of the income or loss in the current year and not in the same manner as the source of the operating loss carryforward or taxes paid in a prior year or the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year." The only exceptions are identified in ASC 740-20-45-11.

Example 7-13 illustrates this concept.

**Example 7-13**

Assume that at the beginning of the current year, 20X1, Entity X has no unrealized gain or loss on an AFS security. During 20X1, unrealized losses on AFS securities are \$1,000 and the tax rate is 40 percent. As a result of significant negative evidence available at the close of 20X1, X concludes that a 50 percent valuation allowance is necessary. Therefore, X records a \$400 DTA and a \$200 valuation allowance. Accordingly, the carrying amount of the AFS portfolio is reduced by \$1,000, OCI is reduced by \$800, and a \$200 net DTA (a DTA of \$400 less a valuation allowance of \$200) is recognized at the end of 20X1.

During 20X2, (1) additional unrealized losses of \$2,000 on AFS securities are incurred and (2) a change in circumstances causes a change in judgment about the realizability of tax benefits. Assume that the change relates to an increase in the fair value of X's investments in land, which gives rise to a \$3,000 source of future capital gain income, and that X would sell appreciated land if faced with the possibility of having a capital loss carryforward expire unused. Because a change in circumstances has caused a change in judgment about the amount of the DTA that will more likely than not be realized, no valuation allowance is necessary at the end of 20X2. Thus, as of the end of 20X2, the carrying amount of the AFS portfolio is reduced by a total of \$3,000 (\$1,000 + \$2,000), the DTA is increased to a total of \$1,200 (\$400 + \$800), the valuation allowance is eliminated, the total unrealized loss (net of tax) on AFS securities recorded in AOCI is \$2,000  $[(\$800 + \$2,000) - (\$2,000 \times 40\%)]$ , and income tax expense from continuing operations for 20X2 is credited (reduced) for the \$200 change in the beginning-of-the-year valuation allowance.

As a result of the requirement to record the effects of changes in the beginning-of-the-year valuation allowance in income tax expense from continuing operations, the net-of-tax amount of cumulative unrealized losses on AFS securities included in AOCI at the end of 20X2 does not equal the sum of the cumulative pretax amount from unrealized losses of \$3,000 less the cumulative tax consequences of \$1,200 related to such items ( $\$3,000 \times 40\%$ ). If an entity uses the portfolio approach to account for unrealized gains or losses, any differential caused by this requirement (\$200 in this example) will remain in AOCI until substantially all of the entity's securities in the AFS portfolio are sold. If, however, an entity uses the specific identification method, any differential created by this requirement will diminish over time as the securities that were on hand at the time the valuation allowance was originally established are sold.

## **7.21 Assessing Realization of Tax Benefits From Unrealized Losses on AFS Securities**

Future realization of tax benefits, whether tax loss carryforwards or deductible temporary differences, ultimately depends on the existence of sufficient taxable income of the appropriate character (e.g., ordinary or capital gain) within the carryback and carryforward periods prescribed under tax law. For most entities, the assessment of the realization of tax benefits from unrealized losses on an AFS debt securities portfolio will often depend on the inherent assumptions used for financial reporting purposes concerning the ultimate recovery of the carrying amount of the portfolio.

ASC 740-10-25-20 concludes that an “assumption inherent in an entity's statement of financial position prepared in accordance with [U.S. GAAP] is that the reported amounts of assets and liabilities will be recovered and settled, respectively.” Thus, an entity ordinarily assumes that the recovery of the carrying amount of its AFS debt securities portfolio is the portfolio's fair value as of each balance sheet date. Whenever an unrealized holding loss exists, recovery at fair value would result in a capital loss deduction. Because U.S. federal tax law for most entities requires utilization of capital losses only through offset of capital gains, an entity would need to assess whether realization of the loss is more likely than not on the basis of available evidence. Evidence the entity would consider might include (1) the available capital loss carryback recovery of taxes paid in prior years and (2) tax-planning strategies to sell appreciated capital assets that would generate capital gains income. In this situation, the entity should evaluate such available evidence to determine whether it is more likely than not that it would have, or could generate, sufficient capital gain income during the carryback and carryforward periods prescribed under tax law.

Under certain circumstances, however, an entity might assume that recovery of its debt security investment portfolio classified as AFS will not result in a capital loss. This assumption is based on the fact that, to avoid sustaining a tax loss, an entity could choose to hold the securities until maturity, provided that their decline in fair value results from market conditions and not a deterioration of the credit standing of the issuer. If an entity proposes to rely on such an assumption, the validity of that assertion should be assessed on the basis of the entity's ability to hold investments until maturity. Factors that are often relevant to this assessment include, but are not limited to, the investor's current financial position, its recent securities trading activity, its expectations concerning future cash flow or capital requirements, and the conclusions reached in regulatory reports. The circumstances under which an entity applying ASC 740 could assume recovery of the carrying amount of a portfolio of debt securities classified as AFS without incurring a loss are expected to be infrequent.

An assumption that an entity will not incur a tax consequence for unrealized losses on its equity security investments classified as AFS is not appropriate because market changes in the fair value of equity securities are not within the unilateral control of an investor entity.

See [4.24](#) for further discussion of DTAs from unrealized losses on AFS debt securities.

On January 5, 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new guidance clarifies that, upon the effective date of the ASU (generally after December 15, 2017, for public entities), an entity should "evaluate the need for a valuation allowance on a [DTA] related to [AFS] securities in combination with the entity's other [DTAs]." Therefore, upon adoption of the new guidance, Approach 1 described in [4.24](#) will no longer be acceptable.

## **7.21A Application of ASC 740-20-45-7 to Recoveries of Losses in Accumulated OCI**

A credit or gain may be recognized in OCI on a debt security that is classified as AFS but that remains in an overall loss position.

### **Example 7-13A**

Entity A purchases a debt security on January 1, 20X1 for \$1,000. The security is classified as held for sale for financial reporting purposes. During 20X1, the security declines in value so that its carrying amount for financial reporting purposes is \$800 on December 31, 20X1. The unrealized loss of \$200 is recognized in OCI in accordance with ASC 320. During 20X2, the security increases in value, and an unrealized gain of \$150 is recognized in OCI. As a result, the security's financial reporting carrying amount increases to \$950.

If the \$150 unrealized gain recognized in OCI in 20X2 is not taxed currently, there are two acceptable approaches on whether A should include it in the measure of income outside of continuing operations when applying the intraperiod allocation exception given that the security is still in a net loss position of \$50. The approach an entity selects is an accounting policy election that should be applied consistently.

**Example 7-13A (continued)****Approach 1 — Make No Distinction Between Credits on Securities in a Net Loss Position and Those in a Net Gain Position**

Under this approach, rather than distinguishing between credits on securities in a net loss position and credits on securities in a net gain position, A would look only to the total amount of unrealized gains or losses recorded in OCI during the period when applying ASC 740-20-45-7. This approach is consistent with ASC 740-20-45-7, which states, in part:

The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations.

Note that [7.07](#) discusses how a reporting entity should consider credits in OCI that are the result of reclassification adjustments when it applies ASC 740-20-45-7. An entity that applies the alternative approach described in [7.07](#) (i.e., an entity that does not distinguish between credits that represent gains and those that represent reclassification adjustments) generally should apply Approach 1 to determine the effects of unrealized gains on AFS debt securities when it is applying ASC 740-20-45-7.

**Approach 2 — Do Not Include Credits on Securities That Represent Recovery of Previous Net Losses**

Under this approach, A would not consider an unrealized gain recognized in OCI in the current year as a potential source of future income when applying the intraperiod allocation exception if the security remains in a net loss position. The guidance in ASC 740-20-45-7 that provides the FASB's rationale for including "all items" supports this premise, stating, in part:

That modification of the incremental approach **is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets**. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [Emphasis added]

In other words, when a security remains in a net loss position even after a current-year unrealized gain, there is no taxable income expected in future years that would serve as a source of income for the current-year loss from continuing operations. This is substantiated by the fact that there is a DTA for a deductible temporary difference on the security since the tax basis is greater than the book basis. If the security in the example above is sold at the financial reporting amount of \$950, there is a taxable loss and no gain; hence, nothing serves as a source of income that would benefit the current-year continuing operations loss.

### Example 7-13B

Assume the following:

- Entity B:
  - Determined, in 20X0, that a valuation allowance is needed to reduce its DTA to an amount that is more likely than not to be realized, or zero.
  - Has a year-to-date pretax loss and is anticipating a pretax loss for the year for which no tax benefit can be recognized.
  - Has a portfolio of four equity securities that are classified as AFS for financial reporting purposes and, therefore, the unrealized gains or losses are recognized in OCI in accordance with ASC 320.
  - Purchased each equity security on January 1, 20X1 for \$1,000.
- During 20X1, a net unrealized gain of \$50 on AFS securities is recognized in OCI.
- During 20X2, a net unrealized gain of \$150 is recognized in OCI.

	<b>Cost</b>	<b>Year 1 Gain/ (Loss)</b>	<b>December 31, 20X1</b>	<b>Year 2 Gain/ (Loss)</b>	<b>December 31, 20X2</b>
Security 1	\$ 1,000	\$ 100	\$ 1,100	\$ 100	\$ 1,200
Security 2	1,000	(30)	970	50*	1,020
Security 3	1,000	(100)	900	50**	950
Security 4	1,000	80	1,080	(50)	1,030
Total	<u>\$ 4,000</u>	<u>\$ 50</u>	<u>\$ 4,050</u>	<u>\$ 150</u>	<u>\$ 4,200</u>

\* Security 2 year 2 gain includes \$30 recovery of unrealized losses from prior year.

\*\* Security 3 year 2 gain Includes \$50 recovery of unrealized losses from prior year.

If B selects Approach 1, the amount of gain it should include in the measure of income outside of continuing operations when applying the intraperiod allocation exception in ASC 740-20-45-7 for the two years would be determined on the basis of the following amounts:

<b>Year 1 Gain/(Loss)</b>	<b>Year 2 Gain/(Loss)</b>
\$ 50	\$ 150

If B selects Approach 2, the amount of gain it should include in the measure of income outside of continuing operations when applying the intraperiod allocation exception in ASC 740-20-45-7 for the two years would be determined on the basis of the following amounts:

<b>Year 1 Gain/(Loss)</b>	<b>Year 2 Gain/(Loss)</b>
\$ 50	\$ 70

## 7.22 Holding Gains and Losses Recognized for Both Financial Reporting and Tax Purposes

Assume that an entity has an AFS portfolio of marketable securities that is being accounted for in accordance with ASC 320-10. Thus, unrealized gains and losses are recorded in OCI, net of any related tax consequences. For tax purposes, the entity has elected under the tax law to include **unrealized** gains and losses on securities portfolios in the determination of taxable income or loss.

When an unrealized loss is incurred and the loss deductions are included in the determination of taxable income or loss in the tax return, the tax consequences for financial reporting purposes should be considered (1) in the year the unrealized loss is incurred and (2) in the year the securities are sold. Example 7-14 illustrates this concept.

#### **Example 7-14**

Assume the following:

- For financial reporting purposes, unrealized gains and losses on AFS securities are recorded in OCI, net of any tax consequences, in accordance with ASC 740-20-45-11(b).
- Company X elects to include unrealized gains and losses on securities portfolios in the determination of taxable income or loss (this election is permitted by the tax law).
- At the end of 20X1, the unrealized loss on AFS securities is \$5 million, all of which was incurred during the current year.
- The tax rate for 20X1 and 20X2 is 30 percent.
- Pretax income and taxable income, excluding the unrealized loss for 20X1 and 20X2 are \$5 million and zero, respectively.
- The market value of the portfolio, determined at the end of 20X1 (i.e., an unrealized loss of \$5 million), does not change through the end of 20X2.
- Company X records in income a pretax loss of \$5 million on the sale of the portfolio on the last day of 20X2; taxable income is zero for 20X2.

Company X must record the following journal entries:

#### **Journal Entries Year 1**

Unrealized loss on investments (OCI)	5,000,000
Investment portfolio	5,000,000

To record the unrealized loss on AFS securities in OCI.

Income tax expense — continuing operations	1,500,000
Taxes currently payable	1,500,000

To record the taxes payable on \$5 million of taxable income exclusive of losses on the security portfolio, which are reported in OCI.

Taxes currently payable	1,500,000
Unrealized loss on investment (OCI)	1,500,000

To record the tax consequences of losses on securities portfolio in 20X1 — computed based on mark-to-market accounting as elected under tax law.

**Example 7-14 (continued)****Journal Entries Year 2**

Realized loss on sale of investments (P&L)	5,000,000
Unrealized loss on investment (OCI)	5,000,000
To record the pretax loss on sale of the investment portfolio in 20X2.	
Unrealized loss on investments (OCI)	1,500,000
Income tax benefit — continuing operations	1,500,000
To record the tax consequences of the reclassification out of AOCI and into net income of the loss on sale of the securities portfolio in 20X2.	

**7.23 Treatment of Tax Benefit for Dividends Paid on Shares Held by an ESOP**

On March 30, 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. The following guidance is applicable for entities who have not adopted the new guidance. See [Chapter 10, "Share-Based Compensation,"](#) for guidance on adopting ASU 2016-09.

U.S. federal tax law permits a tax deduction for dividends that are paid on an entity's capital stock held by an ESOP.

ASC 740-20-45-11(e) states that the tax benefits of dividends paid on **unallocated** shares held by an ESOP that are charged to retained earnings should be credited to retained earnings. Tax benefits related to **allocated** ESOP shares are recognized as a reduction of income tax expense from continuing operations.

This conclusion is based on the belief that an ESOP is analogous to a stock option plan. Both are compensatory arrangements, and both sometimes result in tax deductions for amounts that are not presently recognized as compensation expense for financial reporting purposes.

For example, assume that an ESOP has a loan from Company S, its sponsor (employer loan), and holds unallocated shares of S's common stock. Company S has a loan from a third party to finance its loan to the ESOP (indirect loan). Under ASC 718-40-25-9, S would not recognize its loan to the ESOP and related interest income in the financial statements. In addition, in accordance with ASC 718-40-25-16, S would not record dividends on unallocated shares as dividends for financial reporting purposes (i.e., not recorded in retained earnings). However, S receives a tax deduction for dividends paid on its unallocated shares of common stock held by the ESOP.

The tax benefit of tax-deductible dividends on unallocated shares paid to the ESOP that are not recorded in retained earnings should be recorded as a reduction of income tax expense allocated to continuing operations. ASC 718-740-45-7 states, in part:

Under the requirements of paragraph 740-20-45-11(e), the tax benefit of tax-deductible dividends on unallocated employee stock ownership plan shares that are charged to retained earnings shall be credited to shareholders' equity. However, because dividends on unallocated shares would not be charged to retained earnings under the requirements of paragraph 718-40-25-16, the tax benefit of tax-deductible dividends on unallocated employee stock ownership plan shares would not be credited to shareholders' equity.

Note that this guidance does not specify how an entity should account for the tax benefit of dividends on unallocated shares, other than to clearly state that ASC 740-20-45-11(e) does not apply. Dividends paid on unallocated shares may, depending on the terms of the ESOP, be used for employee compensation or debt service. The tax benefit of dividends paid on unallocated shares, used for either employee compensation or interest expense recognized in continuing operations, should be allocated to the continuing-operations tax provision.

In the absence of direct guidance to the contrary, the tax benefit of dividends on unallocated shares used to reduce debt principal should also be allocated to the continuing-operations tax provision. This approach is consistent with the “liability method” concepts inherent in ASC 740, as well as the guidance in ASC 718-740-45-7 on the tax benefit of tax-deductible dividends on allocated ESOP shares.

## 7.24 Tax Consequences of Transactions Among (and With) Shareholders

Certain transactions **among** shareholders affect the tax attributes of an entity itself. The following are examples of such transactions:

- Heavy trading in a company’s stock by major shareholders over a period of several years.
- An investor that has a 45 percent interest in a company acquires an additional 10 percent of that company and consolidates the company but does not use pushdown accounting.
- An investor buys 70 percent of a company and consolidates the company but does not use pushdown accounting.
- An investor buys 100 percent of a company (in a nontaxable business combination) and consolidates the company but does not use pushdown accounting.

Note that the term “nontaxable business combination,” as used in ASC 740, means a business combination in which the target company’s tax bases in its assets and liabilities carry over to the combined entity.

Certain transactions **with** shareholders (i.e., transactions between a company and its shareholders) have the same effect. The following are examples of such transactions:

- An IPO.
- A stock offering one year after an IPO.
- Conversion of convertible debt into equity in accordance with the stated terms of the debt agreement.
- Conversion of debt into equity in a troubled debt restructuring.
- A recapitalization in which preferred stock is exchanged for common stock (i.e., no new equity is raised, on a net basis).
- A recapitalization in which new debt is incurred and the proceeds are used to purchase treasury stock.

Certain transactions **among or with** shareholders may also change the tax bases of the company's assets and liabilities. The following are examples of such transactions:

- An investor buys 100 percent of the outstanding stock of a company (in a business combination) and now consolidates the company but does not use pushdown accounting. The transaction is treated as the purchase of assets for tax purposes, and assets and liabilities are adjusted to fair value for tax purposes (which may either increase or decrease the tax basis).
- A parent company sells 100 percent of the stock of a subsidiary in an IPO. For financial reporting purposes, the carrying amounts of the subsidiary's assets and liabilities in its separate financial statements are the historical carrying amounts reflected in the parent company's consolidated financial statements. However, the transaction is structured so that, for tax purposes, the transaction is taxable and the subsidiary adjusts its bases in its assets and liabilities to fair value (the proceeds from the IPO) for tax purposes. Therefore, the subsidiary now has new temporary differences that are related to its assets and liabilities.

Changes in valuation allowances, write-offs of DTAs, and the tax consequences of changes in tax bases of assets and liabilities caused by transactions among or with a company's shareholders may be recognized either in the income statement or directly in equity, depending on the nature of the change.

In accordance with ASC 740-10-45-21, the following should be charged to the income statement:

- "Changes in valuation allowances due to changed expectations about the realization of deferred tax assets caused by transactions among or with shareholders."
- "A write-off of a preexisting deferred tax asset that an entity can no longer realize as a result of a transaction among or with its shareholders."
- In addition, in accordance with ASC 740-20-45-11(g), the following should be charged directly to equity:
  - The effects of "changes in the tax bases of assets and liabilities caused by transactions among or with shareholders."
  - The "effect of valuation allowances initially required upon recognition of any related deferred tax assets" as a result of "changes in the tax bases of assets and liabilities caused by transactions among or with shareholders." However, subsequent changes in valuation allowances should be charged to the income statement.

Because ASC 740-20-45-11 applies to all changes in the tax bases of assets and liabilities, this guidance also applies to tax-deductible goodwill.

## **7.25 Accounting for the Tax Effects of Contributions to Pass-Through Entities in Control-to-Control Transactions**

ASC 810-10-45-22 provides examples of transactions in which a parent's ownership in a subsidiary changes but the parent retains control of the subsidiary. Specifically:

- A "parent purchases additional ownership interests in its subsidiary."
- A "parent sells some of its ownership interests in its subsidiary."
- A "subsidiary reacquires some of its ownership interests" held by a nonaffiliated entity.
- A "subsidiary issues additional ownership interests" to a nonaffiliated entity.

When the parent maintains control over the subsidiary, the parent accounts for changes in its ownership interest as equity transactions. See [8.13](#).

Generally, a “pass-through” or “flow-through” entity (e.g., a partnership or a multimember limited liability company that has not elected to be taxed as a corporation) is not subject to income tax; rather, its earnings are attributed to its investors, who pay tax on such income. As a result, the pass-through entity’s investors must provide tax in accordance with their investment in the pass-through entity. Two acceptable approaches have developed in practice for measuring the DTA or DTL to be recognized for an outside basis difference related to an investor’s investment in a consolidated pass-through or flow-through entity: (1) the “outside basis approach” and (2) the “look-through approach.” See [8.06](#).

When there are subsequent contributions by either the controlling interest or the noncontrolling interest to the pass-through entity, recognition of a gain or loss in equity by the controlling shareholder will typically create an additional basis difference that will need to be addressed (i.e., the controlling interest’s basis for financial and income tax reporting purposes may change by different amounts). Further, in the United States, under the look-through approach, additional complexities can arise because of the applicable income tax regulations governing the allocation to partners of items of income, gain, loss, or deduction.<sup>10</sup> For example, such transactions can often result in residual outside basis differences (i.e., the investor’s outside tax basis will not equal its share of the inside tax basis) that will usually not be deductible or taxable until a sale or taxable liquidation of the partnership (e.g., distribution of cash following a sale of the partnership’s assets).

Typically, an investor accounts for changes in the measurement of deferred taxes on its investment in a pass-through entity that result from a control-to-control transaction in equity in accordance with the intraperiod tax allocation guidance in ASC 740-20-45-11. If the investor uses the look-through approach in measuring deferred taxes on its investment in the pass-through entity, such changes would include the impact of any residual outside basis difference. If the residual outside basis difference represents future deductible amounts, the investor must consider its policy on applying ASC 740-30-25-9, by analogy, to its investment in the pass-through entity. See [8.06](#) for additional discussion.

### Example 7-15

On January 1, 20X9, Company A contributes a recently acquired business (net assets including cash, subject to debt) with a fair value and financial reporting and income tax bases of \$20 million to Partnership P for an 80 percent interest in P, and Company B contributes cash of \$5 million for a 20 percent interest in P. Partnership P is a pass-through entity and is not subject to income taxes in any jurisdiction in which it operates. Company A uses the look-through approach in measuring deferred taxes with respect to investments in consolidated pass-through entities. At the time of the contribution, A’s outside basis for financial and income tax reporting purposes are \$20 million and \$20 million, respectively. Company B’s and A’s share of inside bases held by the investment upon formation were as follows:

	Total		B's Basis		A's Basis		
	Book	Tax	Book	Tax	Book	Tax	Difference
Cash	10.0	10.0	2.0	2.0	8.0	8.0	—
PP&E	10.0	10.0	2.0	2.0	8.0	8.0	—
Intangibles	15.0	15.0	3.0	3.0	12.0	12.0	—
Liabilities	(10.0)	(10.0)	(2.0)	(2.0)	(8.0)	(8.0)	—
Total	<u>25.0</u>	<u>25.0</u>	<u>5.0</u>	<u>5.0</u>	<u>20.0</u>	<u>20.0</u>	—

<sup>10</sup> Treasury regulations promulgated under Section 704(c) of the Internal Revenue Code account for the difference between the fair value and the adjusted tax basis in property at the time they are contributed to the partnership. In addition, such regulations can result in adjustments in certain other situations, including when the fair value of property owned by the partnership is in excess of its adjusted tax basis at the time of a contribution to the partnership.

### Example 7-15 (continued)

During 20X9, P generates \$12.5 million of income through normal operations for both financial and income tax reporting purposes and makes no distributions. Company A's outside basis for financial and income tax reporting purposes are \$30 million and \$30 million, respectively. Company B's and A's share of inside bases held by the investment were as follows:

	Total		B's Basis		A's Basis		
	Book	Tax	Book	Tax	Book	Tax	Difference
Cash	27.5	27.5	5.5	5.5	22.0	22.0	—
PP&E	8.0	8.0	1.6	1.6	6.4	6.4	—
Intangibles	12.0	12.0	2.4	2.4	9.6	9.6	—
Liabilities	(10.0)	(10.0)	(2.0)	(2.0)	(8.0)	(8.0)	—
Total	<u>37.5</u>	<u>37.5</u>	<u>7.5</u>	<u>7.5</u>	<u>30.0</u>	<u>30.0</u>	<u>—</u>

As of December 31, 20X9, P has appreciated in value to \$80 million; assume such appreciation is attributable entirely to P's goodwill. Further assume that on December 31, 20X9, B contributes an additional \$20 million to P. The contribution decreases A's ownership to 64 percent,<sup>11</sup> which results in A's having a financial reporting basis of \$36.8 million<sup>12</sup> in its investment in P. As a result of the contribution, A must recognize a control-to-control gain of \$6.8 million (\$36.8 million – \$30 million) for financial statement reporting purposes; essentially A transitions from owning 80 percent of P's \$37.5 million net book value<sup>13</sup> to owning 64 percent of P's \$57.5 million net book value after the contribution.

Immediately after the \$20 million contribution by the noncontrolling interest holders, B's and A's shares of inside bases held by the investment would be as follows:

	Total		B's Basis		A's Basis		
	Book	Tax	Book	Tax	Book	Tax	Difference
Cash	47.5	47.5	17.1	17.1	30.4	30.4	—
PP&E	8.0	8.0	2.9	2.9	5.1	5.1	—
Intangibles	12.0	12.0	4.3	4.3	7.7	7.7	—
Goodwill	—	—	6.8	—	(6.8)	6.8	6.8
Liabilities	(10.0)	(10.0)	(3.6)	(3.6)	(6.4)	(6.4)	—
Total	<u>57.5</u>	<u>57.5</u>	<u>20.7</u>	<u>27.5</u>	<u>36.8</u>	<u>30.0</u>	<u>6.8</u>

However, the contribution does not affect A's tax basis in its investment in P, which creates a taxable temporary difference of \$6.8 million and a DTL of \$2.7 million. In this case, the allocation method chosen in accordance with the applicable income tax regulations will affect only whether the \$6.8 million becomes taxable over time through certain partnership allocations<sup>14</sup> or not until the ultimate sale or taxable liquidation of the partnership; in either case, a DTL is required.

<sup>11</sup> (80 percent × \$80 million [fair value of the company]) ÷ (\$80 million [fair value of the company] + \$20 million contribution) = 64 percent.

<sup>12</sup> (\$37.5 million + \$20 million) × 64 percent = \$36.8 million.

<sup>13</sup> \$25 million (initial GAAP basis) + \$12.5 million (20X9 income) = \$37.5 million.

<sup>14</sup> Internal Revenue Code Section 704(c), as noted in [footnote 10](#), applies to reverse IRC Section 704(c) layers created as a result of a revaluation. Upon the contribution of \$20 million by B, the partners revalued the partnership property. Under IRC Section 704(c), use of the "remedial method" will generally result in the \$6.8 million's becoming taxable over time, whereas use of the "traditional method" will generally result in the \$6.8 million's becoming taxable upon the ultimate sale or taxable liquidation of the partnership since the goodwill has no tax basis in the hands of the partnership.

**Example 7-15 (continued)**

Assume a 40 percent tax rate. Company A will make the following consolidated journal entry to recognize the contribution made by the noncontrolling interest holders:

Cash	20,000,000
APIC	4,100,000
Noncontrolling interest	13,200,000
DTL	2,700,000

**Example 7-16**

Assume the same facts as in Example 7-15 above, except that on December 31, 20X9, Company A (not B) contributes an additional \$20 million to Partnership P. The contribution increases A's ownership to 84 percent.<sup>15</sup> As a result of the contribution, A must recognize a "control-to-control loss" of \$1.7 million (A has paid a \$1.7 million premium above book value to acquire the additional interest); essentially A transitions from owning 80 percent of P's \$37.5 million net book value<sup>16</sup> to owning 84 percent of P's \$57.5 million net book value after the contribution. Company A's basis in P for financial reporting purposes increases by \$18.3 million; however, its basis for income tax reporting purposes increases by the entire \$20 million contribution, resulting in a deductible temporary difference of \$1.7 million.

Because there is a difference between the fair value and adjusted tax basis of the property owned by the partnership at the time of A's additional contribution, consideration needs to be given to whether, as a matter of tax law, A will be allocated deductions equal to the fair value of its contribution of \$20 million. If the partnership's allocation method (the "remedial method" in this case since the goodwill has no tax basis in the hands of the partnership) under the applicable income tax regulations will allocate such deductions to A, A should record a DTA for the deductible temporary difference given that such a difference will close through normal business operations. Company A's outside book and tax basis are \$48.3 million and \$50 million, respectively. Company B's and A's share of inside bases held by the investment would be as follows:

	Total		B's Basis		A's Basis		
	Book	Tax	Book	Tax	Book	Tax	Difference
Cash	47.5	47.5	7.6	7.6	39.9	39.9	—
PP&E	8.0	8.0	1.3	1.3	6.7	6.7	—
Intangibles	12.0	12.0	1.9	1.9	10.1	10.1	—
Goodwill	—	—	—	(1.7)	—	1.7	(1.7)
Liabilities	(10.0)	(10.0)	(1.6)	(1.6)	(8.4)	(8.4)	—
Total	<u>57.5</u>	<u>57.5</u>	<u>9.2</u>	<u>7.5</u>	<u>48.3</u>	<u>50.0</u>	<u>(1.7)</u>

Assume a 40 percent tax rate. The resulting entry to record the control-to-control loss in equity would be as follows:

DTA	700,000
APIC	1,000,000
Noncontrolling interest	1,700,000

<sup>15</sup>  $(80 \text{ percent} \times \$80 \text{ million [fair value of the company]}) + \$20 \text{ million contribution} \div (\$80 \text{ million [fair value of the company]} + \$20 \text{ million contribution}) = 84 \text{ percent}$ .

<sup>16</sup>  $\$25 \text{ million (initial GAAP basis)} + \$12.5 \text{ million (20X9 income)} = \$37.5 \text{ million}$ .

**Example 7-16 (continued)**

If the partnership's allocation method will not allocate A deductions equal to its \$20 million contribution (i.e., the "traditional method" in this case since the goodwill has no tax basis in the hands of the partnership), such a deductible temporary difference will reverse only upon P's sale or taxable liquidation. Company A should consider the application of ASC 740-30-25-9, by analogy, to such a residual temporary difference. A summary of A's outside basis and related look-through temporary differences in its investment in such a case would be as follows:

	Total		B's Basis		A's Basis		
	Book	Tax	Book	Tax	Book	Tax	Difference
Cash	47.5	47.5	7.6	7.6	39.9	39.9	—
PP&E	8.0	8.0	1.3	1.3	6.7	6.7	—
Intangibles	12.0	12.0	1.9	1.9	10.1	10.1	—
Liabilities	(10.0)	(10.0)	(1.6)	(1.6)	(8.4)	(8.4)	—
Residual						1.7	(1.7)
Total	<u>57.5</u>	<u>57.5</u>	<u>9.2</u>	<u>9.2</u>	<u>48.3</u>	<u>50.0</u>	<u>(1.7)</u>

Applying ASC 740-30-25-9 by analogy, A will record the entry for the control-to-control loss as follows:

APIC	1,700,000
Noncontrolling interest	1,700,000

# Chapter 8 — Other Considerations or Special Areas

This chapter provides accounting and disclosure guidance on specific exceptions in ASC 740 related to investments in subsidiaries and corporate joint ventures, including guidance on the (1) tax consequences of undistributed earnings of subsidiaries, (2) change in ownership basis of subsidiaries, and (3) recognition of certain DTAs and DTLs. The recognition chapter of this Roadmap provides helpful guidance on the definitions of subsidiaries and corporate joint ventures (see [3.02](#)) and the recognition criteria for deferred taxes. This chapter also covers presentation and disclosure issues not discussed in other chapters of this Roadmap.

## Background and Scope

### ASC 740-30

**05-1** Subtopic 740-10 addresses the majority of tax accounting issues. That Subtopic addresses the majority of differences between the financial reporting (or book) basis and tax basis of assets and liabilities (basis differences) and the requirements to record deferred income taxes on those differences. It also identifies specific and limited exceptions to the otherwise required recognition of deferred taxes on basis differences.

**05-2** This Subtopic provides the required accounting and disclosure guidance for certain of the specific limited exceptions identified in Subtopic 740-10 to the requirements to record deferred taxes on specific basis differences related to investments in subsidiaries and corporate joint ventures arising from undistributed earnings or other causes.

**05-3** The accounting addressed in this section represents, in some situations, an exception to the otherwise required comprehensive recognition of deferred income taxes for temporary differences.

**05-4** A domestic or foreign subsidiary remits earnings to a parent entity after the parties consider numerous factors, including the following:

- a. Financial requirements of the parent entity
- b. Financial requirements of the subsidiary
- c. Operational and fiscal objectives of the parent entity, both long-term and short-term
- d. Remittance restrictions imposed by governments
- e. Remittance restrictions imposed by lease or financing agreements of the subsidiary
- f. Tax consequences of the remittance.

## ASC 740-30 (continued)

**05-5** Remittance of earnings of a subsidiary may sometimes be indefinite because of the specific long-term investment plans and objectives of the parent entity. Even in the absence of long-term investment plans, the flexibility inherent in the U.S. Internal Revenue Code may permit a parent entity to postpone income taxes on the earnings of a subsidiary for an extended period or may permit the ultimate distribution to be taxed at special rates applicable to the nature of the distribution. Other circumstances may indicate that the earnings will probably be remitted in the foreseeable future. However, the parent entity may control the events that create the tax consequences in either circumstance. [APB 23, paragraph 8]

**05-6** Corporate joint ventures are of two kinds: those essentially permanent in duration and those that have a life limited by the nature of the venture or other business activity. [APB 23, paragraph 15]

**05-7** Unless characteristics indicate a limited life, a corporate joint venture has many of the characteristics of a subsidiary. The investors usually participate in the management of the joint venture, consider the factors set forth in paragraph 740-30-05-4, and agree (frequently before forming the venture) as to plans for long-term investment, for utilizing the flexibility inherent in the U.S. Internal Revenue Code, and for planned remittances. [APB 23, paragraph 16]

### Overall Guidance

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 740-10-15, with specific transaction qualifications noted below.

### Transactions

**15-2** The guidance in this Subtopic applies to basis differences arising from investments in subsidiaries and corporate joint ventures.

**15-3** The basis differences addressed in this Subtopic represent situations where there are exceptions to the general requirements established in the Overall Subtopic for the comprehensive recognition of deferred income taxes on temporary differences.

**15-4** There are other exceptions to the comprehensive recognition of deferred income taxes on temporary differences specifically addressed in other Subtopics. However; the provisions of this Subtopic shall not be applied to analogous types of temporary differences. [FAS 109, paragraph 31]

## Undistributed Earnings of Subsidiaries and Corporate Joint Ventures

### ASC 740-30

**25-1** This Section provides guidance on the accounting for specific temporary differences related to investments in subsidiaries and corporate joint ventures, including differences arising from undistributed earnings. In certain situations, these temporary differences may be accounted for differently from the accounting that otherwise requires comprehensive recognition of deferred income taxes for temporary differences.

**25-2** Including undistributed earnings of a subsidiary (which would include the undistributed earnings of a domestic international sales corporation eligible for tax deferral) in the pretax accounting income of a parent entity either through consolidation or accounting for the investment by the equity method results in a temporary difference. [APB 23, paragraph 9]

**25-3** It shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent entity. Accordingly, the undistributed earnings of a subsidiary included in consolidated income shall be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free. [APB 23, paragraph 10]

**ASC 740-30 (continued)**

**25-4** The principles applicable to undistributed earnings of subsidiaries in this Section also apply to tax effects of differences between taxable income and pretax accounting income attributable to earnings of corporate joint ventures that are essentially permanent in duration and are accounted for by the equity method. Certain corporate joint ventures have a life limited by the nature of the venture, project, or other business activity. Therefore, a reasonable assumption is that a part or all of the undistributed earnings of the venture will be transferred to the investor in a taxable distribution. Deferred taxes shall be recorded, in accordance with the requirements of Subtopic 740-10 at the time the earnings (or losses) are included in the investor's income. [APB 23, paragraph 17]

**25-5** A deferred tax liability shall be recognized for both of the following types of taxable temporary differences:

- a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992
- b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 740-30-25-18 for a corporate joint venture that is essentially permanent in duration. [FAS 109, paragraph 32]

Paragraphs 740-30-25-9 and 740-30-25-18 identify exceptions to the accounting that otherwise requires comprehensive recognition of deferred income taxes for temporary differences arising from investments in subsidiaries and corporate joint ventures.

**25-6** Paragraph 740-30-25-18 provides that a deferred tax liability is not recognized for either of the following:

- a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 740-30-25-17
- b. Undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992, and that meet the criteria in paragraph 740-30-25-17. The criteria in that paragraph do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and as required by the preceding paragraph, a deferred tax liability shall be recognized if the undistributed earnings are a taxable temporary difference. [APB 23, paragraph 10]

## 8.01 Definition of Foreign and Domestic Investments

ASC 740-10-25-3(a)(1) contains an exception to the requirement to provide a DTL for the "excess of the amount for financial reporting over the tax basis of an investment in a **foreign** subsidiary or a **foreign** corporate joint venture" (emphasis added), while ASC 740-30-25-7 contains an exception to the requirement to provide a DTL for the "excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned **domestic** subsidiary" (emphasis added). Accordingly, it is important to determine whether to treat an entity as a foreign or domestic entity.

An entity should determine whether an investment is foreign or domestic on the basis of the relationship of the investee to the tax jurisdiction of its immediate parent rather than the relationship of the investee to the ultimate parent of the consolidated group. This determination should be made from the "bottom up" through successive tiers of consolidation. At each level, it is necessary to determine whether the subsidiaries being consolidated are foreign or domestic with respect to the consolidating entity. A subsidiary that is treated as a domestic subsidiary under the applicable tax law of its immediate parent would be considered a domestic subsidiary under ASC 740. Examples 8-1 through 8-5 illustrate this concept.

#### Example 8-1

A U.S. parent entity, P, has a majority-owned U.S. subsidiary, S1, which has two investments: (1) a majority ownership interest in a foreign entity, FS1, and (2) an ownership interest in a foreign corporate joint venture, FJV1. In preparing its consolidated financial statements, S1 consolidates FS1 and applies the equity method of accounting to its investment in FJV1. Under ASC 740, S1 would consider its investments in FS1 and FJV1 to be in a **foreign subsidiary** and **foreign corporate joint venture**, respectively. Parent P would treat S1 as a domestic subsidiary when consolidating S1.

#### Example 8-2

A U.S. parent entity, P, has a majority ownership interest in a subsidiary (chartered in a foreign country), FS, which has two investments: (1) a majority ownership interest in another entity, S1, and (2) an ownership interest in another corporate joint venture entity, S2. Both S1 and S2 are located in the same foreign country in which FS is chartered. Subsidiary FS would consider S1 and S2 a domestic subsidiary and domestic corporate joint venture, respectively, in determining whether to recognize deferred taxes on the outside basis difference of FS's investments in S1 and S2. Parent P would consider FS a foreign subsidiary.

#### Example 8-3

A non-U.S. parent entity, FP, prepares U.S. GAAP financial statements and has two investments: (1) a majority-owned investment in a U.S. entity, US1, and (2) an investment in a corporate joint venture, JVUS1, located in the United States. In preparing its consolidated financial statements, FP would consider US1 and JVUS1 a **foreign subsidiary** and a **foreign corporate joint venture**, respectively.

#### Example 8-4

A non-U.S. entity, FP2, prepares U.S. GAAP financial statements and has two investments: (1) a majority-owned investment in another entity, S1, and (2) an investment in a corporate joint venture, JV1. Both S1 and JV1 are located in the same foreign country in which FP2 is chartered. In preparing its consolidated financial statements, FP2 would consider S1 and JV1 a **domestic subsidiary** and a **domestic corporate joint venture**, respectively.

#### Example 8-5

A U.S. parent entity, P, has a majority ownership interest in a subsidiary (chartered in a foreign country), FS, that has two investments: (1) a majority ownership interest in another entity, S1, located in the same foreign country in which FS is chartered, and (2) an investment in a corporate joint venture located in the United States, JVUS1. Subsidiary FS would consider S1 a **domestic subsidiary** and would consider JVUS1 a **foreign corporate joint venture** in determining whether to recognize deferred taxes on the outside basis difference of its investments in S1 and JVUS1.

## 8.02 Accounting for Temporary Differences Related to an Investment in a Corporation

How an investor should apply the guidance in ASC 740-30 on temporary differences related to investments depends on the level of controlling financial interest that the investor has in another entity. The term "controlling," as used in this context, is derived from the conditions for consolidation in ASC 810-10-15-8, which states, in part, the "usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly

or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation."

Accordingly, ASC 740-30-25-5(a) applies to investors that own more than 50 percent of the voting capital of a domestic subsidiary and assumes that the subsidiary would be consolidated in accordance with ASC 810. In addition, note the following:

- ASC 740-30-25-5(b) applies to investors that own 50 percent or less of the voting capital of a subsidiary and assumes that the subsidiary would be accounted for as an equity investment under ASC 323.
- ASC 740-30-25-7 states that it applies only to more-than-50-percent-owned domestic subsidiaries. However, an entity will need to use judgment to determine whether a recognition exception applies to a subsidiary that is consolidated under the VIE guidance when less than 50 percent of the voting interest is owned by the investor. See [8.05](#) for considerations related to the VIE model in ASC 810-10 in the evaluation of whether to recognize a DTL.
- ASC 740-30-25-9 through 25-13 also apply to more-than-50-percent-owned subsidiaries (foreign or domestic) but do not apply to 50-percent-or-less-owned foreign or domestic investees. However, an entity will need to use judgment to determine whether a recognition exception applies to a subsidiary that is consolidated by applying the VIE guidance when less than 50 percent of the voting interest is owned by the investor. See [8.03](#) for consideration of the VIE model in ASC 810-10 in the evaluation of whether to recognize a DTL.

The following table summarizes the types of investments and the relevant guidance:

<b>Investment</b>	<b>DTA Considerations</b>	<b>DTL Considerations</b>
<ul style="list-style-type: none"> <li>• Domestic subsidiary</li> <li>• Domestic corporate joint venture that is essentially permanent in nature</li> </ul>	<p>Under ASC 740-30-25-9, a DTA is recognized for the "excess of the tax basis over the amount for financial reporting . . . only if it is apparent that the temporary difference will reverse in the foreseeable future."</p>	<p>Under ASC 740-30-25-5, recognition of a DTL depends on when the excess of the financial reporting basis over the tax basis of the investment arose:</p> <ul style="list-style-type: none"> <li>• If the outside basis difference arose in fiscal years beginning on or before December 15, 1992, no DTL should be recorded unless the temporary difference will reverse in the foreseeable future.</li> <li>• If the entity is a more-than-50-percent-owned subsidiary and the outside basis difference arose in fiscal years beginning after December 15, 1992, a DTL is recorded under ASC 740-30-25-7 unless the investment can be recovered in a tax-free manner without significant cost and the entity expects to use this means of recovery.</li> </ul>

(Table continued)

<b>Investment</b>	<b>DTA Considerations</b>	<b>DTL Considerations</b>
• Foreign subsidiary • Foreign corporate joint venture that is essentially permanent in nature	Under ASC 740-30-25-9, a DTA is recognized for the "excess of the tax basis over the amount for financial reporting . . . only if it is apparent that the temporary difference will reverse in the foreseeable future."	Under ASC 740-30-25-18, a DTL should not be recognized on the excess of the financial reporting basis over the tax basis of an investment unless it becomes apparent that the temporary difference will reverse in the foreseeable future (i.e., the indefinite reversal criteria are not met).
Equity method investee (generally, ownership of less than 50 percent but more than 20 percent) that is not a corporate joint venture	A DTA is recognized for the excess of the tax basis of the investment over the amount for financial reporting and must be assessed for realizability (in most jurisdictions, the loss would be capital in character).	A DTL is recorded on the excess of the financial reporting basis over the tax basis of the investment.
Cost method investee	Generally, a DTA is recognized for the excess of the tax basis of the investment over the amount for financial reporting (if applicable) and must be assessed for realizability (in most jurisdictions, the loss would be capital in character).	Generally, a DTL is recorded on the excess of the financial reporting basis over the tax basis of the investment (if applicable).

## 8.03 Unremitted Earnings of a Foreign Subsidiary When There Is an Overall Deductible Outside Basis Difference

ASC 740-30-25-18(a) states that an entity would not recognize a DTL 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" unless the temporary difference will reverse in the foreseeable future. It is presumed that the unremitted earnings in a foreign subsidiary will be distributed to its parent and that the outside basis temporary difference will reverse unless the indefinite reversal criteria of ASC 740-30-25-17 are met.

Further, ASC 740-30-25-9 states that a DTA "shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary . . . only if it is apparent that the temporary difference will reverse in the foreseeable future."

In certain circumstances, a foreign subsidiary may have positive cumulative unremitted earnings but the tax basis of the parent's investment in the foreign subsidiary may be greater than its book basis (e.g., if the foreign subsidiary has cumulative undistributed earnings but the parent has an even larger foreign currency translation loss on its investment in the foreign subsidiary). In this case, a distribution of the unremitted earnings would generally result in a reduction in the book basis of the parent's investment in the foreign subsidiary without a corresponding reduction in the tax basis, further increasing the amount by which the tax basis exceeds the book basis.

An entity should not record a DTL for unremitted earnings when there is an overall deductible outside basis difference (i.e., tax basis greater than financial reporting basis) in a foreign subsidiary and the entity intends to remit the foreign earnings. Although the entity may incur a tax liability when the unremitted earnings are repatriated, a DTL should only be recognized for an overall outside basis taxable temporary difference. Since the tax basis in the foreign subsidiary exceeds the financial reporting carrying amount, the recovery of the financial reporting carrying amount would result in a taxable loss rather than a taxable gain. To establish a DTL in these circumstances, an entity would need to bifurcate the outside

basis difference into two components — a deductible temporary difference related to items other than unremitted earnings and a taxable temporary difference associated with unremitted earnings. We do not believe that such a bifurcation is contemplated or discussed in ASC 740.

The conclusion above would not necessarily apply when more than one temporary difference is identified (e.g., when the parent holds both shares and an intra-entity loan issued by a foreign subsidiary). See [8.07](#) for more information.

### Example 8-6

Entity A has a wholly owned subsidiary, Entity B, located in X, a foreign jurisdiction. Entity A's outside tax basis in B is \$1,000 (\$1,000 tax capital), and its outside financial reporting basis in B is \$900 (\$1,000 book capital, \$200 cumulative undistributed earnings, and \$300 cumulative translation loss). The amount of B's E&P is \$200. Entity A would not record a DTL for its investment in B since A has a deductible temporary difference in B. Further, A would not recognize a DTA for its deductible temporary difference in B unless it becomes apparent that the deductible temporary difference will reverse in the foreseeable future. A distribution of the \$200 earnings would result in a decrease in the outside financial reporting basis in B that is equal to the \$200 distributed. The outside tax basis would continue to be \$1,000 after the distribution (since the distribution was out of the \$200 of E&P and therefore is taxable), resulting in a net increase in the deductible outside basis difference that is equal to the \$200 reduction in the outside financial reporting basis.

The current-year tax expense recorded when the actual distribution occurs can be viewed as attributable to A's inability to record a DTA on the outside basis related to the deductible temporary difference (i.e., there is an increase in the deductible temporary difference that is subject to the exception under ASC 740-30-25-9) rather than to the lack of establishing a DTL in a prior period.

## 8.03A Outside Basis Difference in a Foreign Subsidiary — Subpart F Income

ASC 740-30-25-18(a) indicates that a DTL should not be recognized for an "excess of the amount for financial reporting over the tax basis [outside basis difference] of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration" *unless it becomes apparent that the temporary difference will reverse in the foreseeable future*. Further, there is a rebuttable presumption under ASC 740-30-25-3 that all undistributed earnings will be transferred by a subsidiary to its parent. This rebuttable presumption may be overcome if the criteria of ASC 740-30-25-17 are met (i.e., sufficient evidence shows the subsidiary has invested or will invest the undistributed earnings indefinitely).

Under U.S. tax law, a U.S. parent is generally not taxed on the earnings of a foreign subsidiary until those earnings are actually distributed to the U.S. parent (or the U.S. parent receives proceeds from a sale or taxable liquidation of the subsidiary). However, under Subpart F of the Internal Revenue Code, a U.S. parent may be taxed on specified income of a foreign subsidiary (commonly referred to as Subpart F income) when earned by the foreign subsidiary (e.g., certain types of passive income are treated as Subpart F income). When recognized for tax-reporting purposes by the U.S. parent, Subpart F income increases the outside tax basis in a foreign subsidiary. Likewise, when recognized for book purposes by the foreign subsidiary (and thus in the U.S. parent's consolidated financial statements), Subpart F income increases the U.S. parent's book basis in the foreign subsidiary.

Subpart F income may result in taxable income for the U.S. parent in the same amount and same period as that in which the income is recognized by the foreign subsidiary for financial reporting purposes. In such cases, current taxable income would be recognized in the period in which the income is recognized for financial reporting purposes, and there would generally be no change in the U.S. parent's outside basis difference in the foreign subsidiary (i.e., because the book basis and tax basis both generally increase by an equal amount). However, Subpart F income may be taxed in a later period than the

period in which the income is recognized for financial reporting purposes. In these cases, there will be an increase in the parent's book basis in the subsidiary attributable to Subpart F income recognized for financial reporting purposes with no change in the corresponding tax basis. This section does not apply to situations involving Subpart F income that will not be immediately taxable as a result of other circumstances (e.g., a situation in which the Subpart F income is deferred when there is a deficit in E&P, but will become includable when the foreign subsidiary in question has positive earnings).

A U.S. parent that, according to ASC 740-30-25-18(a), does not recognize a DTL on its outside basis taxable temporary difference in a foreign subsidiary should generally recognize a DTL for the portion of the outside basis difference that corresponds to amounts already recognized for financial reporting purposes by the foreign subsidiary that will be treated as Subpart F income when considered to be earned for tax reporting purposes (i.e., amounts within the foreign subsidiary that would give rise to taxable temporary differences under U.S. tax law).

The portion of the outside basis taxable temporary difference that corresponds to an inside Subpart F temporary difference should be treated as though it is apparent that it will reverse "in the foreseeable future" and will thus require the recognition of a DTL. Since Subpart F income is often related to passive types of income, in most cases neither the U.S. parent nor the foreign subsidiary can control when it will become taxable to the U.S. parent. Therefore, a deferred tax expense and outside basis DTL should be recognized in the period in which the income is recognized for financial reporting purposes. This is true even if the U.S. parent does not intend to distribute the associated earnings of the foreign subsidiary.

For example, a U.S. parent may own a foreign subsidiary that, in turn, owns an equity method investment. The U.S. parent's investment (book basis) in the foreign subsidiary increases by the amount of equity method income recognized by the subsidiary, which increases the outside basis difference in the investment in the foreign subsidiary (since the U.S. parent's tax basis would not be affected by undistributed earnings of an equity investee). Generally, when the foreign subsidiary sells the equity method investee, or receives a distribution from the equity method investee, the gain or distribution will be treated as Subpart F income that must be recognized immediately by the U.S. parent. Further, the foreign subsidiary, as an equity investor, has no control over when it might receive a dividend from the equity investee, and therefore the outside basis difference in the foreign subsidiary that is attributable to the unremitted earnings of the equity method investee should not be considered eligible to be treated as indefinitely reinvested. Accordingly, a DTL should be recognized for that portion of the outside basis difference that will reverse when the equity investee pays a dividend, triggering recognition of Subpart F income by the U.S. parent and increasing its tax basis in the foreign subsidiary (which has the effect of reversing the corresponding outside basis difference).

## **8.03B Outside Basis Difference in a Foreign Subsidiary — “Deferred” Subpart F Income**

[8.03A](#) discusses Subpart F income that will be immediately taxable when considered earned for tax reporting purposes. However, sometimes Subpart F income will actually be deferred, even after it has been earned for tax reporting purposes ("deferred Subpart F income") because of certain U.S. tax limitations. For example, the amount of currently taxable Subpart F income of any controlled foreign corporation (CFC) for any taxable year may not exceed such CFC's E&P for the year. Accordingly, while such amounts may be deferred and recaptured in a future year, current-year Subpart F income is limited to actual E&P earnings.

Assume, for example, that Company Y, a CFC, earns \$100 of Subpart F income and generates a non-Subpart F loss of \$40 in year 1. Company Y earns \$200 of Subpart F income in each of years 2 and 3, \$10 of non-Subpart F income in year 2, and \$100 of non-Subpart F income in year 3. Because Y's E&P

is \$60 in year 1, the amount of Subpart F income attributable to Y in year 1 that Y's U.S. shareholder must include in its year 1 taxable income is limited to \$60. However, in year 2, Y's U.S. shareholder must include \$10 of Y's deferred Subpart F income from year 1. Likewise, in year 3, the U.S. shareholder must include the remaining \$30 of Company Y's deferred Subpart F income from year 1 that was not taxed in years 1 and 2. Thus, all the deferred Subpart F income from year 1 is recaptured.

If the existence of deferred Subpart F income suggests that some part of the outside basis difference will reverse in the foreseeable future, a DTL should be recorded. However, the mere existence of deferred Subpart F earnings does not automatically suggest that a part of the outside basis difference will reverse in the foreseeable future. Rather, all the facts and circumstances must be assessed. For example, if a recovery and settlement of the subsidiary's assets and liabilities were to give rise to the taxation of the deferred Subpart F income, a DTL would be recognized provided that the amount of the deferred Subpart F income does not exceed the outside basis difference in the foreign subsidiary.

If an entity uses the financial reporting carrying amounts of the assets and liabilities to determine whether some part of the outside basis difference would be expected to reverse in the foreseeable future, the DTL recognized would only take into account the tax consequences associated with events that already have occurred and been reported in the financial statements. When additional events, such as future earnings, must occur (e.g., when the recovery of assets and settlement of liabilities alone does not result in the E&P needed to make all the deferred Subpart F income taxable to the U.S. parent), no DTL would be recognized until the financial statements include such future earnings. To assess the effect of recovering assets and settling liabilities, the entity might need to schedule the recovery or settlement. For example, the recovery of certain assets would result in E&P and the settlement of certain liabilities would result in reductions in E&P; however, it could become apparent that the outside basis difference will reverse in the foreseeable future when the entity expects assets to be recovered before the liabilities are settled.

## **8.04 “Unborn” Foreign Tax Credits**

When a U.S. company has concluded that the earnings of one or more of its foreign subsidiaries will not be indefinitely reinvested, the U.S. parent must recognize a DTL related to the portion of the outside basis difference for which reversal is foreseeable. Under U.S. federal tax law, when the U.S. parent receives a dividend from a foreign subsidiary, the parent is permitted to treat itself as having paid the foreign taxes that were paid by the foreign subsidiary. The parent does this by grossing up the taxable amount of the dividend by an amount equal to the related taxes. An FTC is allowed in an amount equal to this gross-up; such a credit is commonly referred to as a “deemed paid” credit. In certain circumstances, a deemed-paid FTC may exceed the U.S. taxes on the grossed-up dividend and, when the dividend is actually paid, such an excess FTC (commonly referred to as a “hyped credit”) will be available to offset U.S. taxes otherwise payable on unrelated foreign source income in the year of the dividend (or to offset U.S. taxes on foreign source income in prior or subsequent tax years by carryback or carryforward of the excess FTCs). Alternatively, instead of claiming an FTC, the U.S. parent can choose to deduct the foreign taxes by not grossing up the taxable amount of the dividend on its U.S. federal tax return.

A DTA should not be recognized for the anticipated excess FTCs that will arise in a future year when the foreign subsidiary pays the dividend. The anticipated excess FTC that will arise in a future period when the dividend is paid is considered to be “unborn.” The example below illustrates the circumstances that can lead to an “unborn” FTC.

**Example 8-7****Terms Used**

- *FC* — Functional currency (in this example, the local currency is the functional currency).
- *E&P* — Earnings and profits (similar to retained earnings, but generally measured by using a tax concept of profit).
- *Tax pool* — The cumulative taxes paid in connection with the E&P. The pool is (1) measured in U.S. dollars (USD) by translating the amount payable each year at the average exchange rate for the year and (2) reduced by the amounts lifted (i.e., considered to be “born”) with prior dividends.

**Sub A****Facts**

Outside basis taxable temporary difference in Sub A	\$400
Portion of outside basis difference that is not indefinitely reinvested (in FC)	100
Total E&P (in FC)	400
Distribution as % of total E&P	0.25
Tax pool (in USD)	\$1,000
Exchange rate (USD equivalent of 1.0 FC)	1.1

As of the most recent reporting date, the parent has identified \$110 (or 100 in FC) that Sub A will distribute in a future period.

**Computation of U.S. Tax on Future Dividend**

USD amount to be received	\$ 110
Foreign taxes deemed paid (% of E&P distributed × the tax pool)	250
U.S. taxable income recognized	360
U.S. tax rate	35%
U.S. tax liability before FTC	(126)
FTC	250
Excess FTC	\$ 124

When Sub A distributes 100 of FC in a future period, the U.S. parent will receive \$110 (based on the reporting-date exchange rate). If the U.S. parent deducted foreign taxes in the year of the distribution, it would simply report the \$110 as taxable income and determine the related tax liability — that is, it would not separately claim a deduction for deemed-paid foreign taxes. However, in this example, the U.S. parent has determined that it will claim an FTC for the foreign taxes paid by Sub A. Under U.S. tax law, the dividend received will be grossed up for the taxes paid by Sub A in connection with its earnings. In this example, Sub A has cumulative E&P of 400 of LC. Because it is distributing 100 of LC, it is distributing 25 percent of its total E&P. Therefore, 25 percent of the cumulative tax pool is treated as associated with the 100 of LC being distributed. To be entitled to claim the \$250 as an FTC, the U.S. parent must gross up the \$110 received for the related taxes (25 percent of the tax pool of \$1,000, or \$250). Such gross-ups are required by Section 78 of the IRC and are often referred to as “Section 78 gross-ups” for this reason. Since the U.S. parent is now paying tax on an amount that corresponds to Sub A’s pretax income that is being distributed, the U.S. parent is entitled to claim the Section 78 gross-up amount as an FTC. In this example, the resulting \$250 of FTC is greater than the U.S. tax on Sub A’s pretax income of \$126. The excess amount is an “unborn” hyped FTC related to Sub A. The U.S. parent did not actually pay the \$250 of foreign taxes but is deemed to have paid those taxes, and the first moment it is deemed to have paid those taxes is when the dividend is received from Sub A.

ASC 740-10-55-24 states that the “[c]omputation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related dividends received deductions or FTCs, and taxes that would be withheld from the dividend.” Thus, it requires a U.S. parent to consider available FTCs when determining the DTL related to a distribution of unremitted earnings from a foreign subsidiary.

In Example 8-7 above, we do not believe that a DTA should be established for the \$124 of “unborn” FTC, since the “unborn” FTC does not meet the definition of a DTA. The glossary in ASC 740-10-20 defines “deferred tax asset” as the “deferred tax consequences attributable to deductible temporary differences and carryforwards.”

Further, the glossary in ASC 740-10-20 defines “carryforward,” in part, as follows:

Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations.

The “unborn” FTC cannot be recognized as a DTA related to a carryforward since such an amount is not a tax credit “available for utilization” on a tax return that is carried forward for use on subsequent tax returns because it exceeds statutory limitations. In other words, for an FTC to be recognized as a “carryforward” DTA, the tax return must first show FTCs as being carried forward. The \$124 in this example has the potential to become a carryforward if it is not fully used in the year in which Sub A pays the dividend. However, as of the current reporting date, there is only a plan to remit from Sub A in the foreseeable future (it is therefore necessary to measure the DTL related to the taxable temporary difference in Sub A). Until the period that includes the remittance causing the excess FTC to be “born,” no DTA should be recognized, but the DTL related to the investment in Sub A could be reduced to zero after taking the expected FTC into consideration.

## **8.05 Consideration of the VIE Model in ASC 810-10 in the Evaluation of Whether to Recognize a DTL**

For VIEs, an analysis of voting rights may not be effective in the determination of control. Under the VIE model in ASC 810-10, a reporting entity could be determined to have a controlling financial interest in a VIE, and thus consolidate the VIE, if the reporting entity has (1) the power to direct the activities that most significantly affect the VIE’s economic performance and (2) the obligation to absorb losses of (or right to receive benefits from) the VIE that could potentially be significant to the VIE. A reporting entity that consolidates a VIE is known as the primary beneficiary.

When accounting for a VIE under ASC 740, the reporting entity must consider both inside and outside basis differences. See [3-04](#) for a discussion of inside and outside basis differences and some common examples.

ASC 740-30-25-6 through 25-8 and ASC 740-30-25-17 and 25-18 discuss (1) when an outside basis difference is considered a temporary difference and (2) exceptions to the recognition of a DTL on certain outside basis differences. ASC 740-30-25-9 through 25-14 discuss the recognition of DTAs on outside basis differences. (See [8.02](#) for a summary of the application of ASC 740-30.) The exceptions to recognizing a DTL on outside basis differences may apply to certain foreign or domestic subsidiaries. See [8.01](#) for a discussion of foreign versus domestic subsidiaries.

When determining whether an exception to recording an outside basis difference applies to the primary beneficiary’s investment in a VIE, the reporting entity should carefully consider the facts and circumstances. The primary beneficiary should not assume that its controlling financial interest (through which it has the power to direct the activities that most significantly affect the VIE’s economic

performance) also gives it the power to direct all of the activities of the VIE that are relevant to the determination of whether an exception to recording an outside basis difference is applicable (e.g., when and if the VIE will distribute earnings, the manner in which the primary beneficiary will recover its investment, and so forth). Provided that the criteria for an exception are met, a primary beneficiary of a VIE may apply the outside basis exceptions.<sup>1</sup> However, meeting some of these exceptions may be challenging. When determining which party has the power to control decisions regarding the distribution of earnings, for example, an entity should consider how the VIE is controlled (i.e., through contract or governing documents rather than voting interests) and the rights of other parties to the arrangement.

## **8.06 Tax Consequences of Investments in Pass-Through or Flow-Through Entities**

Generally, “pass-through” or “flow-through” entities (e.g., partnerships and limited liability companies that have not elected to be taxed as corporations) are not taxable. Rather, the earnings of such entities “pass through” or “flow-through” to the entities’ owners and are therefore reported by the owners in accordance with the governing tax laws and regulations. See ASC 740-10-55-226 through 55-228 for examples illustrating when income taxes are attributed to a pass-through entity or its owners.

Further, while ASC 740 does provide for certain exceptions to the recognition of deferred taxes for basis differences related to investments in certain subsidiaries, those exceptions historically have not been applied to pass-through or flow-through entities since those types of entities were not subsidiaries as defined before the issuance of ASU 2010-08. Rather, at the time Statement 109 (now ASC 740) was originally issued, APB Opinion 18 (now ASC 323) defined a subsidiary as “a corporation which is controlled, directly or indirectly, by another corporation.”

An investor in a pass-through or flow-through entity should determine the deferred tax consequences of its investment. Because pass-through or flow-through entities are not subject to tax, an investor should not recognize deferred taxes on the book and tax basis differences associated with the underlying assets and liabilities of the entity (i.e., “inside basis differences”) regardless of how the investor accounts for its interest in the entity (e.g., consolidation, equity method, or cost method). Rather, because any taxable income or tax losses resulting from the recovery of the financial reporting carrying amount of the investment will be recognized and reported by the investor, the investor’s temporary difference should be determined by reference to the investor’s tax basis in the investment itself.

Often, this outside basis difference will fully reverse as the underlying assets and liabilities are recovered and settled, respectively. However, differences can exist between the investor’s share of inside tax basis and the investor’s outside tax basis in the investment, leading to a temporary difference that will generally not reverse as a result of the operations of the entity (a “residual” temporary difference). Nonetheless, because that residual temporary difference will still ultimately be recognized as additional taxable income or loss upon the dissolution of the partnership (if the dissolution is taxable) or will be attached to the assets distributed in liquidation of the investor’s interest (if the dissolution is nontaxable), the recognition of deferred taxes related to an investment in a pass-through or flow-through entity should always take into account (and reconcile back to) the entirety of the outside basis difference.

Two acceptable approaches have developed in practice for **measuring** the DTA or DTL to be recognized for an outside basis difference related to an investor’s investment in a **consolidated** pass-through or flow-through entity: (1) the “outside basis approach” and (2) the “look-through approach.”

<sup>1</sup> While the exception in ASC 740-30-25-7 refers to a “more-than-50-percent-owned domestic subsidiary,” the exception was written at a time when the usual condition for control was ownership of a majority (over 50 percent) of the outstanding voting stock. Accordingly, we believe that an entity is not automatically prohibited from applying that exception simply because it owns less than 50 percent of the VIE.

Under the outside basis approach, measurement of the DTA or DTL is based on the entirety of the investor's outside basis difference in the pass-through or flow-through entity investment without regard to any of the underlying assets or liabilities. While it is easy to perform this computation, application of the outside basis approach can result in certain additional practice issues. For example, an outside basis difference would generally be considered capital in character under a "pure" outside basis approach because such an approach assumes that (1) the investment will be recovered when it is disposed of in its entirety and (2) the interest in a pass-through or flow-through entity is capital in nature. However, as discussed above, the recovery and settlement of the pass-through or flow-through entity's individual assets and liabilities through normal operations of the entity will result in (1) reversal of the temporary difference before the investor disposes of the investment and/or (2) the pass-through of income or loss to the owner that is ordinary rather than capital in character. Among other things, the assumed timing of reversal and the character of the resulting income or loss may have an effect on the investor's conclusions about the tax rate to be applied to the temporary difference and whether a valuation allowance against the investor's DTAs is needed. Accordingly, for the reasons noted above, even those applying an outside basis approach for measurement may consider the recovery and settlement of the pass-through or flow-through entity's underlying assets and liabilities, respectively, when assessing character and scheduling.

Under the look-through approach, the investor would "look through" and notionally match up its outside temporary difference with its share of inside temporary differences for purposes of (1) applying ASC 740's exceptions to deferred tax accounting and (2) determining the character (capital versus ordinary) and resulting reversal patterns used for assessing the applicable tax rate or realizability of DTAs. Only the residual difference (if any) would take its character and reversal pattern exclusively from the investment itself. For example, under this approach, the portion of the investor's outside basis temporary difference that is notionally attributed to "inside" nondeductible goodwill or the pass-through entity's own investment in a foreign corporate subsidiary (with unremitted earnings that are indefinitely reinvested) would be identified and the applicable exception in ASC 740 would be applied (i.e., no DTL would be recorded for that portion of the investor's outside basis temporary difference).

The look-through approach recognizes that because the pass-through or flow-through entity is consolidated, (1) the assets and liabilities of the pass-through or flow-through entity are actually being reported by the investor in the investor's financial statements and (2) the investor is the actual taxpayer when the pass-through or flow-through entity's underlying assets and liabilities are recovered and settled, respectively. Accordingly, **measuring** the outside basis difference under the look-through approach results in the recognition of deferred taxes in a manner consistent with the characteristics of the underlying assets and liabilities that will be individually recovered and settled, respectively.

When the look-through approach is applied, however, any residual difference between the total of the investor's share of the pass-through or flow-through entity's inside tax basis and the investor's outside tax basis related to the investment would still need to be taken into account. As noted above, while this component of the outside basis difference often would not become taxable or deductible until sale or liquidation of the entity, a DTA or DTL would generally be recorded because there is no available exception to apply. In some instances, however, it may be appropriate to apply, by analogy, the exception to recognizing a DTA in ASC 740-30-25-9. While it is more difficult to perform computations under the look-through approach than under the outside basis approach, application of the look-through approach can potentially alleviate some of the aforementioned practice issues regarding character and scheduling that result from applying the outside basis approach.

The approach selected to measure the deferred tax consequences of an investment in a pass-through or flow-through entity would be considered an accounting policy that should be consistently applied to all similar investments. In addition, given the complexities associated with applying either alternative, consultation with appropriate accounting advisers is encouraged in these situations.

## **8.07 Parent's Deferred Tax Considerations When Intra-Entity Loans That Are of a Long-Term-Investment Nature Are Not Denominated in the Functional Currency**

In accordance with ASC 830-20-35-4, intra-entity loans to foreign subsidiaries that are of a long-term-investment nature and whose repayment is not foreseeable are treated as part of the overall net investment in the foreign subsidiary. If either the parent or the subsidiary has a different functional currency than the currency in which the loan is denominated, it will have foreign currency exposure related to fluctuations in the exchange rate. In a manner consistent with the loan's "part of the net investment" characterization, ASC 830-20-35-3(b) requires that any loan-related pretax foreign exchange gain or loss that would have been classified as a foreign currency transaction gain or loss in the income statement be recognized in the CTA account within OCI.

If the loan is denominated in the subsidiary's functional currency, any gain or loss related to fluctuations in the exchange rate will reside with the parent. If the loan is denominated in the parent's functional currency, any gain or loss related to fluctuations in the exchange rate will reside with the foreign subsidiary. In either case, as noted above, the gain or loss is recognized as part of the CTA account within OCI.

When a loan that is of a long-term-investment nature is denominated in the subsidiary's functional currency and the parent will have an exchange-related gain or loss, the parent should not automatically apply the exception to the recognition of a DTL under ASC 740-30-25-18 (related to a taxable basis difference in a *foreign* subsidiary whose reversal is not foreseeable) or the exception to the recognition of a DTA under ASC 740-30-25-9 (related to a deductible temporary difference in *any* subsidiary that is not expected to reverse in the foreseeable future). Rather, an entity must consider applicable tax law and, if the taxable or deductible temporary difference related to the loan is expected to reverse in the foreseeable future, the entity should generally recognize deferred taxes (i.e., either a DTL or a DTA), setting aside "unit of account" considerations (see additional discussion under "Unit of Account" below).

For example, when the loan has a fixed term but it is asserted that repayment is not foreseeable, a representation is being made that the loan either will be extended when it would otherwise mature or will be contributed to the equity of the subsidiary. If either of those actions will result in the recognition of an unrealized foreign-exchange-related gain or loss for tax purposes, an entity should generally recognize a DTL or DTA (setting aside "unit of account" considerations). In other words, since both the loan's maturity date and the date on which the related temporary difference will reverse are known, it appears that the related temporary difference (whether taxable or deductible) will reverse in the foreseeable future. Since the temporary difference is certain to reverse on a known date, the exceptions that might apply when the reversal of the temporary difference is not foreseeable should not be applied.

### ***Unit of Account***

The fact that the loan is considered under ASC 830 as part of the overall net investment in the foreign subsidiary raises an interesting question about the identification of the appropriate "unit of account." For example, if the U.S. parent has a foreign-exchange-related gain or loss (the loan is denominated in the functional currency of the subsidiary) and there is a taxable temporary difference related to the loan but a deductible temporary difference related to the parent's investment in the subsidiary's shares (as a result of losses in the subsidiary), the overall basis difference (viewed as a single unit of account) might net to a deductible temporary difference (i.e., the subsidiary's losses exceed the loan-related exchange gain). The reverse can also occur, in which case a taxable temporary difference related to the shares and a deductible temporary difference related to the loan would net to an overall taxable temporary difference for the single unit of account.

We believe that, in such instances, an entity should establish an accounting policy to address the “opposite direction” circumstances described above. One acceptable alternative would be for the entity to consider the loan and share temporary differences as distinct units of account, allowing a deferred tax to be recognized for the loan-related temporary difference irrespective of the overall temporary difference. According to this alternative, two distinct assets are recognized as existing under the tax law (the loan and the shares), each with its own separate and distinct basis difference. The other acceptable alternative would be to consider the overall temporary difference as a single unit of account for which deferred tax would only be recognized for the loan-related temporary difference if it is (1) in the same direction as the overall temporary difference and (2) limited to the greater of the overall temporary difference or the loan-related temporary difference. According to this alternative, the loan is considered part of the net investment in the subsidiary under ASC 830 (i.e., there is only one investment balance for book purposes).

Note that the “unit of account” question primarily arises when the temporary difference related to the loan is in the opposite direction of the overall temporary difference (including the loan). This question can also arise when the loan-related temporary difference exceeds the overall temporary difference (including the loan). When the temporary difference related to the loan and the overall temporary difference are in the same direction *and* the overall temporary difference exceeds the loan-related amount, the DTL or DTA would be recognized under either accounting policy.

In accordance with ASC 740-20-45-11(b), any deferred income tax expense or benefit related to an unrealized exchange gain or loss with respect to the loan would be allocated to the CTA account within OCI.

See [12.06](#) for a discussion of the deferred tax considerations related to an intra-entity loan denominated in the parent’s functional currency.

## **Equity Method Investee Considerations**

### **8.08 Tax Effects of Investor Basis Differences Related to Equity Method Investments**

ASC 323-10-35-13 requires entities to account for the “difference between the cost of an [equity method] investment and the amount of underlying equity in net assets of an investee . . . as if the investee were a consolidated subsidiary.” Entities therefore determine any difference between the cost of an equity method investment and the investor’s share of the fair values of the investee’s individual assets and liabilities by using the acquisition method of accounting in accordance with ASC 805. These differences are known as “investor basis differences” and result from the requirement that investors allocate the cost of the equity method investment to the individual assets and liabilities of the investee. Like business combinations, investor basis differences may give rise to deferred tax effects (additional inside basis differences). To accurately account for its equity method investment, an investor would consider these inside basis differences in addition to any outside basis difference in its investment.

See [3.04](#) for guidance on inside and outside basis differences.

In accordance with ASC 323-10-45-1, equity method investments are presented as a single consolidated amount. Accordingly, tax effects attributable to the investor basis differences become a component of this single consolidated amount and are **not** presented separately in the investor’s financial statements as individual current assets and liabilities or DTAs and DTLs. In addition, to accurately measure those tax assets and liabilities, the investor should use ASC 740 to analyze the uncertain tax positions of the investee. The investor’s share of investee income or loss may ultimately need to be adjusted for investor basis differences, including those for income taxes.

### Example 8-8

Assume that Company A, a nonpublic entity, acquires an equity method investment in Partnership Q, a pass-through entity. Partnership Q has taken numerous tax positions with varying levels of uncertainty. Company A is able to obtain the financial statements of Q to properly account for its investment under ASC 323. However, Q does not apply ASC 740 because it asserts that under the laws and regulations of the tax jurisdiction, the income taxes are attributed to its partners. Company A is not a general partner or managing member and may find it challenging to obtain the information necessary to apply the guidance on income tax uncertainty in ASC 740.

An entity in a situation similar to that in the above example will need to work with the pass-through entity, its general partner/managing member, or both, to obtain the information necessary to accurately account for the pass-through entity's tax positions in accordance with ASC 740.

## 8.09 Deferred Tax Consequences of an Investment in an Equity Method Investment (a 50-Percent-or-Less-Owned Investee)

The determination of how investors that hold 50 percent or less of the voting capital of an investee should recognize the deferred tax consequences for an outside basis difference as a result of equity method accounting depends on whether (1) the outside basis difference is a potential DTL (an excess of the financial reporting basis over the tax basis) or potential DTA (an excess of the tax basis over the financial reporting basis) and (2) if a potential DTL, whether the difference relates to a domestic or foreign corporate joint venture.

See [3.04](#) for guidance on the definition of "outside" basis differences. See [8.01](#) for guidance on the definition of foreign and domestic investments. Also see [8.05](#) for considerations of VIEs.

### Potential DTL: Domestic Investee

Equity investors that hold less than a majority of the voting capital of an investee do not possess majority voting power and, therefore, generally cannot control the timing and amounts of dividends, in-kind distributions, taxable liquidations, or other transactions and events that may result in tax consequences for investors. Therefore, for a 50 percent-or-less-owned investee, whenever the carrying amount of the equity investment for financial reporting purposes exceeds the tax basis in the stock or equity units of a domestic investee, a DTL is recognized in the balance sheet of the investor (in the absence of the exception in ASC 740-30-25-18(b)). An entity should consider the guidance in ASC 740-10-55-24 when measuring the DTL. The DTL is measured by reference to the expected means of recovery. For example, if recovery is expected through a sale or other disposition, the capital gain rate may be appropriate, and if recovery is expected through dividend distributions, the ordinary tax rate may be appropriate.

### Potential DTL: Foreign Investee

ASC 740-30-25-5(b) requires equity investors that hold less than a majority of the voting capital of a foreign investee to recognize a DTL for the excess amount for financial reporting purposes over the tax basis of a foreign equity method investee that is not a corporate joint venture that is essentially permanent in duration. The indefinite reversal criterion in ASC 740-30-25-17 applies only to a consolidated foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. A related topic is discussed in [8.21](#).

## **Potential DTA: Foreign and Domestic Investee**

ASC 740-30-25-9 does not apply to 50-percent-or-less-owned foreign or domestic investees that are not corporate joint ventures that are permanent in duration. Therefore, equity investors that hold a noncontrolling interest in an investment that is not a corporate joint venture that is essentially permanent in duration **always** recognize a DTA for the excess tax basis of an equity investee over the amount for financial reporting purposes. As with all DTAs, in accordance with ASC 740-10-30-18, realization of the related DTA “depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law.” If realization of all or a portion of the DTA is not more likely than not, a valuation allowance is necessary.

## **8.10 Tax Consequences From Sales of Stock by Equity Method Investees [Deleted]**

## **8.11 Presentation of Tax Effects of Equity in Earnings of an Equity Method Investee**

The investor’s income tax provision equals the sum of current and deferred tax expense, including any tax consequences of the investor’s equity in earnings and temporary differences attributable to its investment in an equity method investee.

Because it is the investor’s tax provision, not the investee’s, the tax consequences of the investor’s equity in earnings and temporary differences attributable to its investment in the investee should be recognized in income tax expense and not be offset against the investor’s equity in earnings.

## **8.12 Noncontrolling Interests in Pass-Through Entities: Income Tax Financial Reporting Considerations**

ASC 810-10-45-18 through 45-21 require consolidating entities to report earnings attributed to noncontrolling interests as part of consolidated earnings and not as a separate component of income or expense. Thus, the income tax expense recognized by the consolidating entity will include the total income tax expense of the consolidated entity. When there is a noncontrolling interest in a consolidated entity, the amount of income tax expense that is consolidated will depend on whether the noncontrolling interest is a pass-through (i.e., a U.S. partnership) or taxable entity (e.g., a U.S. C corporation).

ASC 810 does not affect how entities determine income tax expense under ASC 740. Typically, no income tax expense is attributable to a pass-through entity; rather, such expense is attributable to its owners. Therefore, a consolidating entity with an interest in a pass-through entity should only recognize income taxes on its controlling interest in the pass-through entity’s pretax income. The income taxes on the pass-through entity’s pretax income attributed to the noncontrolling interest holders should not be included in the consolidated income tax expense.

**Example 8-9**

Entity X has a 90 percent controlling interest in Partnership Y (a limited liability corporation). Partnership Y is a pass-through entity and is not subject to income taxes in any jurisdiction in which it operates. Entity X's pretax income for 20X9 is \$100,000. Partnership Y has pretax income of \$50,000 for the same period. Entity X has a tax rate of 40 percent. For simplicity, this example assumes that there are no temporary differences.

Given the facts above, X would report the following in its consolidated income statement for 20X9:

Income before income tax expense (\$100,000 + \$50,000)	\$150,000
Income tax expense [(\$100,000 + (\$50,000 × 90%)) × 40%]	<u>(58,000)</u>
Consolidated net income	92,000
Less: net income attributable to noncontrolling interests (\$50,000 × 10%)	<u>(5,000)</u>
Net income attributable to controlling interest	<u>\$ 87,000</u>

In this example, ASC 810 does not affect how X determines income tax expense under ASC 740, since X only recognizes income tax expense for its controlling interest in the income of Y. However, ASC 810 does affect the ETR of X. Given the impact of ASC 810, X's ETR is 38.7 percent (\$58,000/150,000). Provided that X is a public entity and that the reconciling item is significant, X should disclose the tax effect of the amount of income from Y attributed to the noncontrolling interest in its numerical reconciliation from expected to actual income tax expense.

## 8.13 Accounting for the Tax Effects of Transactions With Noncontrolling Shareholders

A parent accounts for changes in its ownership interest in a subsidiary, when it maintains control, as equity transactions. The parent cannot recognize a gain or loss in consolidated net income or comprehensive income for such transactions and is not permitted to step up a portion of the subsidiary's net assets to fair value to the extent of any additional interests acquired (i.e., no additional acquisition method accounting). As part of the equity transaction accounting, the entity must also reallocate the subsidiary's AOCI between the parent and the noncontrolling interest.

The tax accounting consequences related to stock transactions associated with a subsidiary are dealt with in ASC 740-20-45-11. The direct tax effect of a change in ownership interest in a subsidiary when a parent maintains control is generally recorded in shareholders' equity. Some transactions with noncontrolling shareholders may create both a direct and an indirect tax effect. It is important to properly distinguish between the direct and indirect tax effects of a transaction, since their accounting may differ. For example, the indirect tax effect of a parent's change in its assumptions associated with undistributed earnings of a foreign subsidiary resulting from a sale of its ownership interest in that subsidiary is recorded as income tax expense rather than as an adjustment to shareholders' equity.

**Example 8-10**

Parent Entity A owns 80 percent of its foreign subsidiary, which operates in a zero-rate tax jurisdiction. The subsidiary has a net book value of \$100 million as of December 31, 20X9. Entity A's tax basis of its 80 percent investment is \$70 million. Assume that the carrying amounts of the interest of the parent (A) and noncontrolling interest holder (Entity B) in the subsidiary are \$80 million and \$20 million, respectively. The \$10 million difference between A's book basis and tax basis in the subsidiary is attributable to undistributed earnings of the foreign subsidiary. In accordance with ASC 740-30-25-17, A has not historically recorded a DTL for the taxable temporary difference associated with undistributed earnings of the foreign subsidiary because A has specific plans to reinvest such earnings in the subsidiary indefinitely and the reversal of the temporary difference is therefore indefinite.

On January 1, 20Y0, A sells 12.5 percent of its interest in the foreign subsidiary to a nonaffiliated entity, Entity C, for total proceeds of \$20 million. As summarized in the table below, this transaction (1) dilutes A's interest in the subsidiary to 70 percent and decreases its carrying amount by \$10 million ( $12.5\% \times \$80 \text{ million}$ ) to \$70 million, and (2) increases the total carrying amount of the noncontrolling interest holders (B and C) by \$10 million to \$30 million.

<b>Company</b>	<b>Original Carrying Amount</b>	<b>Original Ownership Interest</b>	<b>Carrying Amount 1/1/20Y0</b>	<b>Ownership Interest 1/1/20Y0</b>
A	\$ 80,000,000	80%	\$ 70,000,000	70%
B	20,000,000	20	20,000,000	20
C	_____	_____	10,000,000	10
Total	<u>\$100,000,000</u>	<u>100%</u>	<u>\$100,000,000</u>	<u>100%</u>

Below is A's journal entry on January 1, 20Y0, before consideration of income tax accounting:

Cash	20,000,000
Noncontrolling interest	10,000,000
APIC	10,000,000

Entity A's tax consequence from the tax gain on the sale of its investment in the subsidiary is \$4.5 million [ $\$20 \text{ million selling price} - (\$70 \text{ million tax basis} \times 12.5\% \text{ portion sold}) \times 40\% \text{ tax rate}$ ]. The amount comprises the following direct and indirect tax effects:

1. The direct tax effect of the sale is \$4 million. This amount is associated with the difference between the selling price and book basis of the interest sold by A (i.e., the gain on the sale) [ $\$20 \text{ million selling price} - (\$80 \text{ million book basis} \times 12.5\% \text{ portion sold})$ ]  $\times 40\%$  tax rate. The gain on the sale of A's interest is recorded in shareholders' equity; therefore, the direct tax effect is also recorded in shareholders' equity.
2. The indirect tax effect of the sale is \$500,000. This amount is associated with the preexisting taxable temporary difference (i.e., the undistributed earnings of the subsidiary) of the interest sold [ $(\$80 \text{ million book basis} - \$70 \text{ million tax basis}) \times 12.5\% \text{ portion sold}$ ]  $\times 40\%$  tax rate. The partial sale of the subsidiary results in a change in A's assertion regarding the indefinite reinvestment of the subsidiary's earnings associated with the interest sold by A. This is considered an indirect tax effect and recognized as income tax expense.

**Example 8-10 (continued)**

Below is A's journal entry on January 1, 20Y0, to account for the income tax effects of the sale of its interest in the foreign subsidiary:

Income tax expense	500,000
APIC	4,000,000
Current tax payable	4,500,000

As a result of the sale, A should reassess its intent and ability to indefinitely reinvest the earnings of the foreign subsidiary associated with its remaining 70 percent ownership interest. A DTL should be recognized if circumstances have changed and A concludes that the temporary difference is now expected to reverse in the foreseeable future. This reassessment and the recording of any DTL may occur in a period preceding the actual sale of its ownership interest, since a liability should be recorded when A's assertion regarding indefinite reinvestment changes.

## **8.13A Accounting for an Investment Tax Credit Received From an Investment in a Partnership Accounted for Under the Equity Method**

The investment tax credit guidance in ASC 740-10-25-46 specifies that an entity can use one of two methods to account for the receipt of an investment tax credit as an item of income in the financial statements: (1) the deferral method or (2) the flow-through method.

Under the deferral method, the investment tax credit would result in (1) a reduction to income taxes payable (or an increase in a DTA if the credit is carried forward to future years, subject to assessment for realization) and (2) either a reduction to the carrying value of the related asset or a deferred credit. The tax benefit of the investment tax credit is reflected in net income as a reduction to depreciation expense over the productive life of the related property.<sup>2</sup>

Under the flow-through method, the investment tax credit would result in (1) a reduction to income taxes payable for the year in which the credit arises (or an increase in a DTA if the credit is carried forward to future years, subject to assessment for realization) and (2) a reduction to income tax expense.

Accounting for investment tax credits was originally addressed in Opinion 2 (codified in ASC 740-10-25-46), which discusses direct investments in acquired depreciable property that generate investment tax credits. Since that guidance was introduced, however, the types of vehicles through which entities take advantage of investment tax credits have evolved. For example, entities often invest in partnerships whose operations include investments in assets that qualify for investment tax credits, which can then be "passed through" directly to the investors.

While ASC 740 addresses the accounting by an entity that directly owns an asset that generates an investment tax credit, it does not explicitly address the accounting by a reporting entity that is an investor in a flow-through entity that owns the asset that generates the credit that is then "passed through" to the investor.

<sup>2</sup> Note that there is an alternative view under which the benefit would be recorded in the income tax provision in accordance with paragraph 3 of Opinion 4.

A reporting entity must first consider whether it is required under ASC 810 (including the variable interest entity subsections of ASC 810-10) to consolidate the flow-through entity in which it has invested. If consolidation of the investee is not required, the reporting entity would most often account for the investment by using the equity method.

There are two acceptable approaches on how a reporting entity that accounts for its investment in a flow-through entity under the equity method should account for the tax benefits received in the form of investment tax credits. The approach an entity selects is an accounting policy election that should be applied consistently. (See [3.63A](#) for a discussion of the accounting for temporary differences related to investment tax credits.)

### ***Approach 1 — Account for Investment Tax Credits as an Income Tax Benefit***

Under this approach, the investor would account for the tax benefits received in the form of investment tax credits as an income tax benefit. This method is consistent with accounting for the tax benefits using the flow-through method. It is also consistent with ASC 323-740-55-8 (formerly Exhibit 94-1A of EITF Issue 94-1), which contains an example of the application of the equity method to an investment in a qualified affordable housing project that does not qualify for the proportional amortization method. In that example, the tax credits are recorded in the income tax provision in the year that they are received.

### ***Approach 2 — Apply a Model Similar to the Deferral Method***

This approach is premised on the guidance originally contained in paragraph 3 of Opinion 4 on an investment tax credit that was passed through to a lessee under an operating lease for leased property. That guidance indicated that the “lessee should account for the credit by whichever method is used for purchased property.” Paragraph 3 of Opinion 4 further provided an example in which the asset generating the investment tax credit was not carried on the lessee’s balance sheet; rather, the investment tax credit was passed through to the lessee in a manner similar to the way it would be passed through to an investor in a flow-through entity.<sup>3</sup> In the example, the entity was also allowed to use either the deferral method or the flow-through method, even in a situation in which the underlying asset that generated the credit was not actually reflected in the reporting entity’s financial statements.

Under this approach, the tax benefits from the investment tax credits would be deferred and amortized over the useful life of the related assets, resulting in a cost reduction that would be reflected as an adjustment in the equity method earnings (i.e., “above the line”). That is, the deferral method would yield an increase in the equity method earnings because less depreciation would flow through to the investor.<sup>4</sup>

<sup>3</sup> See also paragraph 11 of Opinion 2.

<sup>4</sup> Alternatively, under the deferral method, instead of reducing the cost basis of the qualifying asset or assets, an entity could recognize a deferred credit. In this scenario, the recovery of the deferred credit would result in a reduction to the income tax provision over the life of the qualifying asset or assets.

## Other Considerations Related to Foreign and Domestic Subsidiaries

### ASC 740-30

#### Determining Whether a Temporary Difference Is a Taxable Temporary Difference

**25-7** Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference shall be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the entity expects that it will ultimately use that means. For example, tax law may provide that:

- a. An entity may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the parent entity's tax basis for the stock of that subsidiary.
- b. An entity may execute a statutory merger whereby a subsidiary is merged into the parent entity, the noncontrolling shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business entity, and certain other requirements of the tax law are met. [FAS 109, paragraph 33]

**25-8** Some elections for tax purposes are available only if the parent owns a specified percentage of the subsidiary's stock. The parent sometimes may own less than that specified percentage, and the price per share to acquire a noncontrolling interest may significantly exceed the per-share equivalent of the amount reported as noncontrolling interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the noncontrolling interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the noncontrolling interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash. [FAS 109, paragraph 33]

#### Recognition of Deferred Tax Assets

**25-9** A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. [FAS 109, paragraph 34]

**25-10** For example, if an entity decides to sell a subsidiary that meets the requirements of paragraphs 205-20-45-1A through 45-1D for measurement and display as a discontinued operation and the parent entity's tax basis in the stock of the subsidiary (outside tax basis) exceeds the financial reporting amount of the investment in the subsidiary, the decision to sell the subsidiary makes it apparent that the deductible temporary difference will reverse in the foreseeable future. Assuming in this example that it is more likely than not that the deferred tax asset will be realized, [EITF 93-17, paragraph Issue] the tax benefit for the excess of outside tax basis over financial reporting basis shall be recognized when it is apparent that the temporary difference will reverse in the foreseeable future. The same criterion shall apply for the recognition of a deferred tax liability related to an excess of financial reporting basis over outside tax basis of an investment in a subsidiary that was previously not recognized under the provisions of paragraph 740-30-25-18. [EITF 93-17, paragraph Discussion]

**25-11** The need for a valuation allowance for the deferred tax asset referred to in paragraph 740-30-25-9 and other related deferred tax assets, such as a deferred tax asset for foreign tax credit carryforwards, shall be assessed.

**25-12** Paragraph 740-10-30-18 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences.

**25-13** Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past. [FAS 109, paragraph 34]

**ASC 740-30 (continued)**

**25-14** A tax benefit shall not be recognized, however, for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized under the requirements of paragraph 740-30-25-18. [FAS 109, paragraph 145]

**Ownership Changes in Investments**

**25-15** An investment in common stock of a subsidiary may change so that it is no longer a subsidiary because the parent entity sells a portion of the investment, the subsidiary sells additional stock, or other transactions affect the investment. If the remaining investment in common stock shall be accounted for by the equity method, the investor shall recognize income taxes on its share of current earnings of the investee entity in accordance with the provisions of Subtopic 740-10. If a parent entity did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 740-30-25-17 (and the entity in which the investment is held ceases to be a subsidiary), it shall accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent that any of those undistributed earnings (prior to the change in status) will be remitted. The change in the status of an investment would not by itself mean that remittance of these undistributed earnings shall be considered apparent. If a parent entity recognizes a deferred tax liability for the temporary difference arising from its equity in undistributed earnings of a subsidiary and subsequently reduces its investment in the subsidiary through a taxable sale or other transaction, the amount of the temporary difference and the related deferred tax liability will change. [APB 23, paragraph 13]

**25-16** An investment in common stock of an investee (other than a subsidiary or corporate joint venture) may change so that the investee becomes a subsidiary because the investor acquires additional common stock, the investee acquires or retires common stock, or other transactions affect the investment. A temporary difference for the investor's share of the undistributed earnings of the investee prior to the date it becomes a subsidiary shall continue to be treated as a temporary difference for which a deferred tax liability shall continue to be recognized to the extent that dividends from the subsidiary do not exceed the parent entity's share of the subsidiary's earnings subsequent to the date it became a subsidiary. [APB 23, paragraph 13]

## **8.14 Deferred Tax Consequences of an Investment in a More-Than-50-Percent-Owned Subsidiary**

How investors that hold more than 50 percent of the voting capital of a subsidiary<sup>5</sup> should recognize the deferred tax consequences for outside basis differences for their foreign and domestic subsidiaries under ASC 740-30-25 depends on whether the temporary difference is a potential DTL (an excess financial reporting basis over tax basis) or a potential DTA (an excess of tax basis over financial reporting basis) and, if a potential DTL, whether it relates to a domestic or foreign subsidiary.

### **Potential DTL: Domestic Subsidiary**

ASC 740-30-25-5(a) applies to investments in a more-than-50-percent-owned domestic subsidiary and assumes that the subsidiary would be consolidated under ASC 810 (see [8.02](#)). ASC 740-30-25-5(a) does not allow for the application of the indefinite reversal exception to the recognition of DTLs for undistributed earnings of a domestic subsidiary or corporate joint venture generated in fiscal years beginning on or after December 15, 1992. Therefore, under ASC 740-30-25-3, DTLs must be recognized "unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free" and the entity expects that it will ultimately use that means.

<sup>5</sup> See [3.02](#) for a discussion of the definition of "subsidiary."

## **Potential DTL: Foreign Subsidiary**

ASC 740-10-25-3(a) states that a DTL is not recognized for an "excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary" that meets the indefinite reversal criteria in ASC 740-30-25-17. See [3.04](#) for a discussion of inside and outside basis differences.

## **Potential DTA: Foreign and Domestic Subsidiary**

ASC 740-30-25-9 states:

A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture [foreign or domestic] that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future.

As used in ASC 740-30-25-9, the term "foreseeable future" refers to an entity's ability to reasonably anticipate the reversal of the outside basis difference. Further, we believe that in this context, "reverse" is intended to mean "be realized" (i.e., be taken as a deduction on the parent's income tax return). Since a deductible outside basis difference in a subsidiary generally results in a deduction on the parent's income tax return only upon sale or taxable liquidation of the subsidiary, under ASC 740-30-25-9, a DTA would rarely be recognized before the criteria in ASC 360-10-45-9 through 45-11 are met for classification of assets as held for sale. While future earnings of the subsidiary may reduce the deductible outside basis temporary difference, those future earnings do not result in a reversal of the temporary difference, as the term "reverse" is used in ASC 740-30-25-9. In other words, future earnings of the subsidiary do not result in a temporary difference deduction on the parent's income tax return. Therefore, anticipated future earnings of the subsidiary should not be relied upon to support a conclusion that "the temporary difference will reverse in the foreseeable future" and that a DTA can be recorded under ASC 740-30-25-9.

At the point at which the criteria in ASC 360-10-45-9 through 45-11 for a measurement date have been satisfied, the deferred tax consequences of the deductible outside basis difference should be recognized as a DTA. In accordance with ASC 740-10-30-18, realization of the related DTA "depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law." If it is not more likely than not that all or a portion of the DTA will be realized, a valuation allowance is necessary.

## **8.15 Tax-Free Liquidation or Merger of a Subsidiary**

In the assessment of whether the outside basis difference of an investment in a domestic subsidiary is a taxable difference in the United States, an 80 percent investment in the subsidiary alone is not sufficient for an entity to conclude that the outside basis difference is not a taxable temporary difference. While U.S. tax law provides a means by which an investment of 80 percent or more in a domestic subsidiary can be liquidated or merged into the parent in a tax-free manner, an entity must also **intend** to ultimately use that means. Satisfying the tax law requirements alone is not sufficient; the entity should also consider:

- Any regulatory approvals that may be required (e.g., in a rate-regulated entity in which a merger would be subject to regulatory approval and that approval is more than perfunctory).
- Whether the liquidation or merger is subject to approval by the noncontrolling interest holders.
- Whether it would be desirable for the entity to recover its investment in a tax-free manner. For example, if the entity's outside basis in the subsidiary is significantly higher than the subsidiary's inside basis, tax-free liquidation may be undesirable.

Some non-U.S. jurisdictions may stipulate similar rules for liquidation or merger of a subsidiary into a parent in a tax-free manner. A similar analysis should be performed on all subsidiaries for which the tax law provides a means by which a reported investment can be recovered in a tax-free manner and the parent intends to use that means.

In some circumstances, the parent may own less than the required percentage under the applicable tax law (i.e., more than 50 percent but less than 80 percent). In such cases, the parent may still be able to assert that it can recover its investment in a tax-free manner (and thus not treat the outside basis difference in the subsidiary as a taxable temporary difference) if it can do so without incurring significant cost. ASC 740-30-25-8 states, in part:

The parent sometimes may own less than that specified percentage, and the price per share to acquire a noncontrolling interest may significantly exceed the per-share equivalent of the amount reported as noncontrolling interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the noncontrolling interest is expected to occur at the point in time when settlement would not result in a **significant cost**. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the noncontrolling interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash. [Emphasis added]

In this context, one interpretation of significant cost could be that the costs (based on fair value) of acquiring the necessary interest in that subsidiary to recover it tax-free are significant. In performing this assessment, the parent can consider the cost that would be incurred at the end of the life of the subsidiary (i.e., once the subsidiary's assets have been converted to cash and all outstanding liabilities have been settled). Under the "end-of-life" scenario, the carrying value of the noncontrolling interest may be equivalent to fair value. If the cost of assuming the noncontrolling interest at the "end of the subsidiary's life" is practicable, a tax-free liquidation or merger can be assumed and the outside basis difference would not be treated as a taxable temporary difference (as long as the tax law provides a means for a tax-free liquidation or merger and the entity intends to use this means).

## **8.16 Exception to Deferred Taxes for an Investment in a More-Than-50-Percent-Owned Domestic Subsidiary [Deleted]**

## **8.17 Tax Consequences of Business Combinations Achieved in Stages: Other Tax Considerations**

A business combination achieved in stages occurs when an acquirer holds a noncontrolling investment (e.g., an equity method investment) in the acquired entity (the "original investment") before obtaining control of the acquired entity. When the acquirer obtains control of the acquired entity, it remeasures the original investment at fair value. The acquirer adds the fair value of the original investment to the total amount of consideration transferred in the business combination (along with the fair value of any noncontrolling interest still held by third parties) to determine the target's opening equity (which in turn drives the measurement of goodwill). The fair value remeasurement amount is recorded as a gain or loss and is reported in the statement of operations (e.g., separately and apart from the acquisition accounting). Any gains or losses previously recognized in OCI that are associated with the original investment are reclassified and included in the calculation of the gain or loss.

As discussed in [11.12](#), the remeasurement of the original investment at fair value will result in an increase or decrease in the financial reporting basis of the investment. Generally, the tax basis of the investment will not be affected and an outside basis difference will therefore be created. (For further guidance on outside basis differences, see [3.04](#).)

The remeasurement of the original investment at fair value is recorded as a gain or loss and is reported in the statement of operations (e.g., separately and apart from the acquisition accounting). The corresponding tax effect of the remeasurement should be recorded as a component of the income tax provision, unless an exception applies (e.g., under ASC 740-30-25-9, ASC 740-10-25-3, or ASC 740-30-25-7).

An acquirer should consider the following factors when accounting for the income tax consequences of a business combination achieved in stages:

### ***DTLs for Domestic Subsidiaries Acquired in Stages***

The acquirer may not be required to recognize a DTL for an outside basis difference once the acquirer obtains control of the acquiree. ASC 740-30-25-7 states that the acquirer should assess whether the outside basis difference of an investment in a domestic subsidiary is a taxable temporary difference. If the tax law provides a means by which the tax basis of the investment can be recovered in a tax-free transaction and the acquirer expects that it will ultimately use that means to recover its investment, a DTL should not be recognized for the outside basis difference. Therefore, under these circumstances, the acquiring entity should reverse any DTL previously recognized for the outside basis difference, including any DTL associated with the remeasurement of the original investment. This reversal of the DTL should be recognized in the acquirer's statement of operations in the same period that includes the business combination.

### ***DTLs for Foreign Subsidiaries Acquired in Stages***

Under ASC 740-30-25-16, an acquiring entity that acquires a foreign entity must continue to treat a temporary difference for its share of the undistributed earnings of the acquiree before the date it becomes a subsidiary as a taxable temporary difference. Therefore, in accordance with ASC 740-30-25-16, the acquiring entity should continue to recognize a DTL to the extent that the foreign subsidiary's dividends do not exceed the acquirer's share of the subsidiary's earnings after the date it becomes a subsidiary.

Questions have arisen about whether, in a step acquisition, a DTL resulting from a remeasurement of the original investment should also be retained in accordance with ASC 740-30-25-16. There are two acceptable approaches:

1. The DTL associated with the entire outside basis difference, including any DTL associated with the remeasurement of the original investment, should be retained.
2. Only the DTL associated with the undistributed earnings of the acquiree before control is obtained should be retained.

The approach an entity selects is an accounting policy election that, like all such elections, should be applied consistently.

## **8.18 State Tax Considerations in Connection With the Assessment of Outside Basis Differences Under ASC 740-30-25-7**

ASC 740-30-25-7 and 25-8 provide guidance on assessing whether the outside basis difference of an investment in a domestic subsidiary is a taxable difference. This assessment should be performed on a jurisdiction-by-jurisdiction basis. Accordingly, the outside basis difference of an investment in a domestic subsidiary that is not a taxable difference for federal purposes would also need to be assessed at the state level.

An entity should consider the following factors in applying the guidance in ASC 740-30-25-7 and 25-8 at the state level:

- Whether tax-free liquidation is permitted in the applicable state jurisdictions. See [8.15](#) for further discussion of tax-free liquidations.
- Whether the parent files a separate, combined, or consolidated return in the state jurisdiction and whether intra-entity transactions (e.g., dividends) are eliminated when subsidiaries are combined or consolidated in that state return.
- Whether a dividends-received deduction is available in the state jurisdiction or whether federal taxable income is used as the starting point for the state tax liability calculation and is unadjusted for dividends-received deductions taken on the federal return. A dividends-received deduction is a deduction on an income tax return for dividends paid from a subsidiary to a parent.

See [4.07](#) for a discussion of further considerations related to certain state matters, including optional future tax elections in the measurement of DTAs and DTLs.

#### **Example 8-11**

Subsidiary B, a 90 percent owned subsidiary of Entity A, only operates in one state (State C), which does not permit a tax-free liquidation in accordance with ASC 740-30-25-7. Entity A is taxable in State C. Subsidiary B is consolidated in Entity A's federal return. The only outside basis difference in Subsidiary B relates to \$1,000 of unremitted earnings, which Entity A expects to be remitted as dividends. For federal purposes, since Entity A holds more than 80 percent of Subsidiary B, Entity A can deduct 100 percent of the dividends it receives from Subsidiary B (i.e., the dividends-received deduction). State C does not adjust federal taxable income for the dividends-received deduction. In this example, the unremitted earnings of Subsidiary B to Entity A would not create a temporary difference on which Entity A should record a DTL.

#### **Example 8-12**

Assume the same facts as in Example 8-11 except that State C adjusts federal income for the dividends-received deduction. For federal purposes, Entity A can still deduct 100 percent of the dividends it receives from Subsidiary B; thus, no temporary difference is created for federal tax purposes. However, State C's adjustment of federal income for the dividends-received deduction would create a temporary difference for state income tax purposes on which Entity A should record a DTL because state tax law does not provide a means by which the reported amount of the investment can be recovered tax free.

## **8.19 Realization of a DTA Related to an Investment in a Subsidiary: Deferred Income Tax Exceptions Not a Source of Income**

In the assessment of DTAs for realizability, future reversal of an existing taxable temporary difference for which a DTL has not been recognized under the indefinite reversal criteria of ASC 740-30-25-17 should not be considered a source of taxable income. ASC 740-30-25-13 indicates that an entity should not consider *future* distributions of *future* earnings of a subsidiary or corporate joint venture in assessing the need for a valuation allowance unless a DTL has been recognized for *existing* undistributed earnings or earnings have been remitted in the past. Similarly, an entity should not consider *future* reversals of *existing* taxable temporary differences as a source of taxable income unless a DTL has been recognized on the related taxable temporary difference since the entity has, by not recording a DTL, asserted that remittance of the subsidiary's existing undistributed earnings will be postponed indefinitely. The example below illustrates this concept.

### Example 8-13

Assume that Entity X, a U.S. domestic parent entity, has a wholly owned foreign subsidiary, FS1. The amount for financial reporting and the tax basis of X's investment in FS1 are \$2,000 and \$1,000, respectively, on December 31, 20X1 (i.e., X has a taxable outside basis difference related to its investment in FS1). Further assume that X has an NOL DTA of \$1,000, with a 20-year carryforward period.<sup>6</sup>

Entity X has not recorded a DTL related to its investment in FS1 because X has asserted that the indefinite reinvestment criteria have been met for the \$1,000 taxable temporary difference, which is attributable to undistributed earnings. In addition, FS1 has not previously remitted earnings.

Ordinarily, an existing taxable temporary difference (e.g., from the undistributed earnings of FS1) is a potential source of taxable income for consideration in the assessment of the need for a valuation allowance. However, X has not previously accrued a DTL on the earnings of FS1, and FS1 has not remitted earnings in the past; therefore, X cannot consider the reversal of the outside basis taxable temporary difference associated with its investment in FS2 as a source of taxable income when determining whether it is more likely than not that the NOL DTA is realizable.

## 8.20 Recognition of a DTA Related to a Subsidiary Classified as a Discontinued Operation

An entity decides to sell a subsidiary that meets the requirements for measurement and display as a discontinued operation in ASC 205-20. The parent entity's tax basis in the stock of the subsidiary (outside tax basis) exceeds the financial reporting amount of the investment in the subsidiary, and the decision to sell the subsidiary makes it apparent that the deductible temporary difference will reverse in the foreseeable future.

ASC 740-30-25-9 states that an entity must recognize a DTA for the excess of the tax basis over financial reporting basis of an investment in a subsidiary "only if it is apparent that the temporary difference will reverse in the foreseeable future." However, ASC 360-10-40-5 states that a gain on the sale of a long-lived asset (or disposal group) must be recognized as of the sale date.

ASC 740-30-25-10 states that the "tax benefit for the excess of outside tax basis over financial reporting basis shall be recognized when it is apparent that the temporary difference will reverse in the foreseeable future." The criterion in ASC 740-30-25-9 (i.e., reversal of temporary difference in foreseeable future) would be met no later than when the "held-for-sale" criteria in ASC 360-10-45-9 are met. An entity should apply the guidance in ASC 740-20-45-2 and ASC 740-20-45-8 to determine whether the deferred tax benefit should be reported as part of discontinued operations or continuing operations. Typically, this tax benefit would be allocated to discontinued operations, but an approach in which the benefit is allocated to income from continuing operations may be acceptable. See the discussion in [7.10](#) regarding the reporting of tax effects of components that are classified as discontinued operations and the interaction of the intraperiod income tax accounting guidance.

The same criterion should apply to the recognition of a DTL related to an excess of financial reporting basis over outside tax basis of an investment in a subsidiary. In other words, the deferred tax consequences of temporary differences related to investments in foreign subsidiaries that were not previously recognized as a result of application of the exception in ASC 740-30-25-18(a) should be recognized when it becomes apparent that the temporary difference will reverse in the foreseeable future. In addition, the potential tax consequences of basis differences related to investments in domestic subsidiaries that were not previously recognized because (1) the tax law provides a means to recover the reported amount of the investment in a tax-free liquidation or statutory merger, and (2) the

<sup>6</sup> The carryforward period does not provide a different result; therefore, the conclusion reached in this example would be the same even if the carryforward period were indefinite.

entity had previously expected that it would ultimately use those means, should be accrued when it becomes apparent that the reversal of those basis differences will have a future tax consequence.

ASC 205-20 governs the pretax accounting for discontinued operations, and ASC 740 governs the tax accounting. Thus, an entity that expects a pretax gain on the discontinuance of part of its business would be precluded from recognizing that pretax gain until the gain is realized. However, if the entity cannot apply the provisions of ASC 740-30-25-7 and 25-8, it would be required to recognize (and expense) any previously unrecognized DTL when the criteria in ASC 360-10-45-9 are met, as described in the preceding paragraph.

## **8.21 Change in Investment From a Subsidiary to an Equity Method Investee**

If, in accordance with ASC 323, a portion of a subsidiary is disposed of and the equity method is used to account for the remaining investment in common stock, the investor should recognize income taxes on its share of the prospective current earnings of the investee entity.

ASC 740-30-25-15 states that "if a parent entity did not recognize income taxes on its equity in undistributed earnings of a subsidiary" because the temporary difference is related to an investment in a foreign subsidiary that is essentially permanent in duration, it should "accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent that any of those undistributed earnings (prior to the change in status) will be remitted." Further, this paragraph clarifies the term "apparent," as used in this context, stating that the "change in the status of an investment would not by itself mean that remittance of these undistributed earnings shall be considered apparent." If a parent entity recognized income taxes on its equity in undistributed earnings of a subsidiary, the amount of deferred income taxes of the parent attributable to undistributed earnings of the subsidiary should be considered in accounting for a disposition through a sale or another transaction that reduces the investment. Example 8-14 illustrates this concept.

### **Example 8-14**

Assume that Entity X had \$1,000 of unremitted earnings from its investment in a foreign subsidiary, FI, and that management has determined that all earnings were indefinitely reinvested and that the related temporary difference would not reverse in the foreseeable future. Therefore, no DTL has been recorded. Further assume that, at the beginning of 20X1, FI sold previously owned capital stock to an unrelated third-party investor such that X no longer controlled most of its voting common shares. However, because of its equity share of FI, X was required to use the equity method of accounting in accordance with ASC 323. During 20X1, X's equity in earnings of FI was \$2,000 and no dividends were paid or payable. In addition, X can no longer control the dividend policy of FI because it no longer controls most of the seats on the board of directors, and FI has announced a change in dividend policy beginning with 20X2 in which 20 percent of retained earnings, as of December 31, 20X2, will be paid to shareholders of record as of that date.

#### **Case 1**

During 20X1, Entity X would accrue as a current charge to income tax expense from continuing operations the tax effect of establishing (1) a DTL for the tax consequences of \$2,000 of taxable income attributable to its share of equity in earnings of FI during 20X1 and (2) a DTL for its portion of the 20 percent equity in retained earnings to be distributed in 20X2 in accordance with FI's new policy of remitting earnings in the future (calculated on the basis of the retained earnings balance at the end of 20X1).

### Example 8-14 (continued)

#### Case 2

Assume the same facts as in Case 1, except that FI's dividend policy regarding undistributed earnings did not change as a result of the change in ownership in 20X1 and that the new majority investor's policy is to indefinitely reinvest all earnings. Entity X would only accrue a DTL for the tax consequences of the \$2,000 related to its share in equity in earnings of FI. No additional accrual for the deferred tax consequences of remitting X's share of undistributed earnings is necessary because no facts have come to the attention of X that would lead it to conclude that previously undistributed earnings will be remitted currently or in the future.

#### Case 3

Assume the same facts as in Case 2, except that X's management concludes during 20X1 that it will dispose of its remaining investment in FI through a sale within the foreseeable future. During 20X1, X would accrue, as a current charge to income tax expense from continuing operations, the tax effect of establishing (1) a DTL for the tax consequences of \$2,000 of taxable income attributable to its share of equity in earnings of FI during 20X1 and (2) a DTL for 100 percent of the remaining outside basis difference, which is assumed to enter into the determination of taxable income (i.e., recovery of the recorded amount of the investment) in the future when the sale is consummated and the investment is realized.

The cases in Example 8-14 illustrate a change in the consolidation of a foreign subsidiary, but the concepts are also applicable to domestic subsidiaries. Also, see [8.17](#) for further discussion of the tax consequences of business combinations achieved in stages.

## Exceptions to Comprehensive Recognition of Deferred Income Taxes for Outside Basis Differences

### ASC 740-30

**25-17** The presumption in paragraph 740-30-25-3 that all undistributed earnings will be transferred to the parent entity may be overcome, and no income taxes shall be accrued by the parent entity, for entities and periods identified in the following paragraph if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent entity shall have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. These criteria required to overcome the presumption are sometimes referred to as the indefinite reversal criteria. Experience of the entities and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent entity's representation of indefinite postponement of remittances from a subsidiary. [APB 23, paragraph 12] The indefinite reversal criteria shall not be applied to the inside basis differences of foreign subsidiaries. [EITF 93-16, paragraph Discussion]

**25-18** As indicated in paragraph 740-10-25-3, a deferred tax liability shall not be recognized for either of the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

- a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration
- b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992. [FAS 109, paragraph 31]

**25-19** If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity, it shall accrue as an expense of the current period income taxes attributable to that remittance. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent entity shall adjust income tax expense of the current period. [APB 23, paragraph 12]

## 8.22 Evidence Needed to Support the Indefinite Reinvestment Assertion

ASC 740-30-25-3 states that it "shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent entity." ASC 740-30-25-17 states that this presumption "may be overcome, and no income taxes shall be accrued by the parent entity . . . if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely."

An entity's documented plan for reinvestment of foreign earnings would enable it to overcome the presumption that all undistributed earnings of a foreign subsidiary will be transferred to the parent entity. To support its assertion that the undistributed earnings of a subsidiary will be indefinitely reinvested, an entity should demonstrate that the foreign subsidiary has both the **intent and ability** to indefinitely reinvest undistributed earnings. Past experience with the entity, in and of itself, would not be sufficient for an entity to overcome the presumption in ASC 740-30-25-3. In documenting its written plan for reinvestment of foreign earnings, an entity should consider such factors as:

- Operating plans (for both the parent company and the subsidiary).
- Budgets and forecasts.
- Long-term and short-term financial requirements of the parent company and the subsidiary (i.e., working capital requirements and capital expenditures).
- Restrictions on distributing earnings (i.e., requirements of foreign governments, debt agreements, or operating agreements).
- History of dividends.
- Tax-planning strategies an entity intends to rely on to demonstrate the recoverability of DTAs.

This analysis is performed for each foreign subsidiary as of each balance sheet date. (See [8.01](#) for guidance on determining whether a specific investment of a consolidated parent company is a foreign or domestic subsidiary.) This analysis should be performed on a subsidiary-by-subsidiary basis. An entity could reach different conclusions for two subsidiaries within the same jurisdiction. (See [8.24](#) for considerations related to a change in management's intent regarding repatriation of earnings.)

Further, in a business combination, this analysis should be performed by the acquirer as of the acquisition date, regardless of any previous position taken by the acquiree or historical practice by the subsidiary. As a result of the analysis, market participants could reach different conclusions regarding the same acquiree.

## 8.23 DTL for a Portion of an Outside Basis Difference

ASC 740-30-25-18 states that a DTL is not required 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" unless "it becomes apparent that those temporary differences will reverse in the foreseeable future." In certain circumstances, an entity may require its foreign subsidiary or foreign corporate joint venture to remit only a portion of undistributed earnings.

An entity is permitted to recognize a DTL only for the portion of the undistributed earnings to be remitted in the future (remittances are not limited to dividends or distributions). ASC 740-30-25-18 is not an all-or-nothing requirement.

### Example 8-15

Entity A has one subsidiary, B, a wholly owned subsidiary in foreign jurisdiction X. Subsidiary B has \$500,000 in undistributed earnings, which represents the entire outside basis difference in B (there has been no fluctuation in the exchange rates). On the basis of available evidence, A has historically concluded that no part of this basis difference was expected to reverse in the foreseeable future and that, therefore, the indefinite reversal criteria in ASC 740-30-25-17 and 25-18 were met in accordance with management's intent and the associated facts and circumstances. Consequently, A has not historically recorded a DTL on its book-over-tax basis difference in its investment in B.

In the current year, B has net income of \$300,000 and declares a one-time dividend for the full \$300,000. Subsidiary B has no plans to declare or pay future dividends, and there are no other changes in facts or circumstances to suggest that the indefinite reversal assertion on the existing \$500,000 outside basis difference would be inappropriate. Further, the one-time circumstances that led to the distribution of the \$300,000 are not expected to reoccur. In this example, A could continue to assert the indefinite reinvestment of B's earnings in the future. Entity A should document its intent and ability to indefinitely reinvest the undistributed earnings; see [8.22](#) for further discussion.

### Example 8-16

Assume the same facts as in Example 8-15, except that the dividend was declared as a result of projected shortfalls in A's working capital requirements during the coming year. The ongoing short-term capital needs of A may suggest that A can no longer indefinitely reinvest the earnings of B. In this example, the indefinite reinvestment assertion may no longer be appropriate and, if not, A should record a DTL on its entire \$500,000 outside basis difference.

## 8.24 Ability to Overcome the Presumption in ASC 740-30-25-3 in the Future After a Change in Management's Plans for Reinvestment or Repatriation of Foreign Earnings

As discussed in [8.22](#), an entity's documented plan for reinvestment of foreign earnings would enable it to overcome the presumption that all undistributed earnings of a foreign subsidiary will be transferred to the parent. An entity's operating plans (both domestically and overseas) and past experience are examples of the types of evidence required to substantiate the parent entity's representation of indefinite postponement of remittances from a subsidiary. In some circumstances, an entity's reinvestment or repatriation plan may change because of different factors such as the parent's liquidity requirements or changes in tax ramifications of repatriation.

An entity may have asserted previously that it had a plan to indefinitely reinvest foreign earnings overseas to overcome the presumption described in ASC 740-30-25-3 that undistributed foreign earnings will be transferred to the parent entity. As a result of various factors, the same entity may later decide to repatriate some or all of its undistributed foreign earnings.

A change in management's intent regarding repatriation of earnings may taint management's future ability to assert that earnings are indefinitely reinvested. However, it depends on the reason(s) for the change. The following are a few questions an entity could consider in determining whether management's ability is tainted in this situation:

- Did management have sufficient evidence of a specific plan for reinvestment or repatriation of foreign earnings in the past?
- Is it clear that this change is a result of a temporary and identifiable event (e.g., a change in tax law available for a specified period)?
- Can management provide evidence that supports what has changed from its previous plans?
- Does management have a plan for reinvestment of future earnings?

Generally, if the conditions were met, management would be able to assert indefinite reinvestment of foreign earnings in the future.

However, if management's current actions indicate that its previous plan was not supported by actual business needs (e.g., stated foreign capital requirements were over what proved to be necessary), the change in intent may call into question management's ability to assert that future foreign earnings are indefinitely reinvested.

## **8.25 Whether a Change in Management's Plans for Reinvestment or Repatriation of Foreign Earnings Is a Recognized or Nonrecognized Subsequent Event**

As discussed in [8.24](#), in some circumstances, an entity's reinvestment or repatriation plan may change because of various factors such as the parent's liquidity requirements or changes in the tax ramifications of repatriation. ASC 740-30-25-19 indicates that the impact of the change in plans would be accounted for in the period in which management's plans change (e.g., when management no longer can assert that all or a portion of its foreign earnings is indefinitely reinvested). However, an entity may need to use judgment to identify the period in which management's decision to change its plans occurred if this decision occurs soon after the balance sheet date.

An entity should consider the nature and timing of the factors that influenced management's decision to change its plans when evaluating whether a change in management's plans for reinvestment or repatriation of foreign earnings is a recognized or nonrecognized subsequent event under ASC 855. Specifically, if identifiable events occurred after the balance sheet date that caused the facts or conditions that existed as of the balance sheet date to change significantly, and management changed its intent regarding indefinite reinvestment because of the new facts, the change in intent may be a nonrecognized subsequent event.

In contrast, if the change in intent after the balance sheet date is due to factors other than responding to the occurrence of an identifiable event, the facts or conditions that existed at the end of the period are unlikely to have changed significantly. Therefore, if prior-period financial statements have not been issued or are not yet available to be issued (as these terms are defined in the subsequent-event guidance in ASC 855-10-20), the entity would generally be required to record the effect of the change in management's plan in these financial statements (i.e., a recognized subsequent event).

### Example 8-17

Assume that a change in tax rates associated with repatriation of foreign earnings occurs in period 2 and that this event causes management to reconsider and change its plan in that period. The change in tax rates is an identifiable event that caused the facts or conditions that existed at the end of period 1 to change significantly. In this case, the effect of the change in plans, which is attributable specifically to the change in tax rate, should be recorded in period 2 (i.e., a nonrecognized subsequent event).

In contrast, an entity may change its repatriation plans because of operating factors or liquidity needs and, shortly after a reporting period, may not be able to assert that its foreign earnings are indefinitely reinvested. In this case, an entity must perform a careful analysis to determine whether the conditions causing the changes in management's plans existed at the end of the reporting period. The results of this analysis will affect whether the accounting effect of the change in plans should be recorded as a recognized or nonrecognized subsequent event under ASC 855.

## Presentation and Disclosure Considerations

### ASC 740-30

#### **Presentation**

**45-1** This guidance addresses presentation in the income statement of specific types of adjustments to income taxes. The specific types of adjustments addressed result from either the recognition or derecognition of deferred income taxes related to exceptions to comprehensive recognition of deferred income taxes arising from investments in subsidiaries and corporate joint ventures.

**45-2** Paragraph 740-30-25-18 identifies situations where deferred tax liabilities are not recorded for specific temporary differences. Paragraph 740-30-25-19 provides that 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. [APB 23, paragraph 12]

**45-3** If a parent entity did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 740-30-25-17 and the entity in which the investment is held ceases to be a subsidiary, paragraph 740-30-25-15 requires that it shall accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent that any of those undistributed earnings prior to the change in status will be remitted. [APB 23, paragraph 13]

#### **Disclosure**

**50-1** This guidance establishes disclosure requirements applicable to unrecognized deferred tax liabilities related to investments in subsidiaries and corporate joint ventures.

**ASC 740-30 (continued)**

**50-2** All of the following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures:

- a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
- b. The cumulative amount of each type of temporary difference
- c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable. [FAS 109, paragraph 44] While paragraph 740-30-25-14 prohibits recognition of a tax benefit for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized, favorable tax treatment would be reflected in measuring that unrecognized deferred tax liability for disclosure purposes. [FAS 109, paragraph 145]
- d. The amount of the deferred tax liability for temporary differences other than those in (c) (that is, undistributed domestic earnings) that is not recognized in accordance with the provisions of paragraph 740-30-25-18. [FAS 109, paragraph 44]

## 8.26 Disclosure of Outside Basis Differences

If an entity has two foreign subsidiaries operating in different tax jurisdictions and has a “taxable” outside basis difference (i.e., an outside basis difference for which, in the absence of the exception in ASC 740-30-25-1 through 25-6, the accrual of a DTL would be required) related to one subsidiary and a “deductible” outside basis difference related to the other, it is not acceptable for the entity to net the outside basis differences to meet the disclosure requirements of ASC 740-30-50-2. The disclosures required by ASC 740-30-50-2(c) for unrecognized DTLs related to foreign subsidiaries should include only subsidiaries with “taxable” outside basis differences.

# Chapter 9 — Interim Reporting

The core principle of ASC 740-270 is that the interim period is integral to the entire financial reporting year. Thus, this chapter describes the general process for allocating an entity's annual tax provision to its interim financial statements. A major part of that process is estimating the entity's AETR, which is determined and updated in each interim reporting period.

An entity faces various challenges when estimating its AETR. For example, when estimating this rate, an entity must also estimate its income by jurisdiction, impact of operating losses, changes to valuation allowances, and utilization of tax credits. These estimates are further complicated when a change in tax law or income tax rates occurs within a particular interim period. An entity must also consider taxable transactions outside of ordinary income when calculating discrete tax consequences (or benefits) and recognize them in the interim period in which they occur and in the appropriate components of the financial statements.

## Background and Scope

### ASC 740-270

**05-1** This Subtopic addresses the accounting and disclosure for income taxes in interim periods. The accounting requirements established in this Subtopic build upon the general requirements for accounting for income taxes established in Subtopic 740-10 as well as the intraperiod tax allocation process established in Subtopic 740-20.

**05-2** Subtopic 740-10 addresses the computation of total tax expense for an entity. Subtopic 740-20 addresses the process of allocating total income tax expense (or benefit) for a period to different components of comprehensive income and shareholders' equity.

**05-3** Because an interim period is a subset of a longer period, typically a year, incremental requirements for recognition and measurement are established by this Subtopic.

**ASC 740-270 (continued)****05-4** This Subtopic describes:

- a. The general computation of interim period income taxes (see paragraphs 740-270-30-1 through 30-9)
- b. The application of the general computation to specific situations (see paragraphs 740-270-30-22 through 30-28)
- c. The interim period income taxes requirements applicable to significant unusual or infrequently occurring items and discontinued operations (see Section 740-270-45)
- d. Special computations applicable to operations taxable in multiple jurisdictions (see paragraph 740-270-30-36)
- e. Guidelines for reflecting the effects of new tax legislation in interim period income tax provisions (see paragraphs 740-270-25-5 through 25-6)
- f. Disclosure requirements (see paragraph 740-270-50-1). [FIN 18, paragraph 2]

This Subtopic also provides Examples and illustrations in Section 740-270-55.

**Overall Guidance**

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Subtopic 740-10-15.

**Recognition****ASC 740-270**

**25-1** This guidance addresses the issue of how and when income tax expense (or benefit) is recognized in interim periods and distinguishes between elements that are recognized through the use of an estimated annual effective tax rate applied to measures of year-to-date operating results, referred to as ordinary income (or loss), and specific events that are discretely recognized as they occur.

**25-2** The tax (or benefit) related to ordinary income (or loss) shall be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items shall be individually computed and recognized when the items occur. [FIN 18, paragraph 6]

**25-3** If an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

**25-4** The tax benefit of an operating loss carryforward from prior years shall be included in the effective tax rate computation if the tax benefit is expected to be realized as a result of ordinary income in the current year. Otherwise, the tax benefit shall be recognized in the manner described in paragraph 740-270-45-4 in each interim period to the extent that income in the period and for the year to date is available to offset the operating loss carryforward or, in the case of a change in judgment about realizability of the related deferred tax asset in future years, the effect shall be recognized in the interim period in which the change occurs. [FIN 18, paragraph 20]

**25-5** The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be recorded after the effective dates prescribed in the statutes and reflected in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a deferred tax liability or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate.

**25-6** The tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year shall be recognized as of the enactment date of the change as tax expense (benefit) for the current year. See Example 6 (paragraph 740-270-55-44) for illustrations of accounting for changes caused by new tax legislation.

## **ASC 740-270 (continued)**

**25-7** The effect of a change in the beginning-of-the-year balance of a valuation allowance as a result of a change in judgment about the realizability of the related deferred tax asset in future years shall not be apportioned among interim periods through an adjustment of the effective tax rate but shall be recognized in the interim period in which the change occurs.

### **Recognition of the Tax Benefit of a Loss in Interim Periods**

**25-8** This guidance establishes requirements for considering whether the amount of income tax benefit recognized in an interim period shall be limited due to interim period losses.

**25-9** The tax effects of losses that arise in the early portion of a fiscal year shall be recognized only when the tax benefits are expected to be either:

- a. Realized during the year
- b. Recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Subtopic 740-10.

**25-10** An established seasonal pattern of loss in early interim periods offset by income in later interim periods shall constitute evidence that realization is more likely than not, unless other evidence indicates the established seasonal pattern will not prevail.

**25-11** The tax effects of losses incurred in early interim periods may be recognized in a later interim period of a fiscal year if their realization, although initially uncertain, later becomes more likely than not. When the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision shall be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized. [APB 28, paragraph 20]

**25-12** If an entity has a significant unusual or infrequently occurring loss or a loss from discontinued operations, the tax benefit of that loss shall be recognized when the tax benefit of the loss is expected to be either:

- a. Realized during the year
- b. Recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Subtopic 740-10.

Realization would appear to be more likely than not if future taxable income from (ordinary) income during the current year is expected based on an established seasonal pattern of loss in early interim periods offset by income in later interim periods. [FIN 18, paragraph 18]

## **Pending Content (Transition Guidance: ASC 718-10-65-4)**

**25-12** If an entity has a significant unusual or infrequently occurring loss or a loss from discontinued operations, the tax benefit of that loss shall be recognized in an interim period when the tax benefit of the loss is expected to be either:

- a. Realized during the year
- b. Recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Subtopic 740-10.

Realization would appear to be more likely than not if future taxable income from (ordinary) income during the current year is expected based on an established seasonal pattern of loss in early interim periods offset by income in later interim periods. [FIN 18, paragraph 18] The guidance in this paragraph also applies to a tax benefit resulting from an employee share-based payment award within the scope of Topic 718 on stock compensation when the deduction for the award for tax purposes is greater than the cumulative cost of the award recognized for financial reporting purposes. [ASU 2016-09, paragraph 19]

**25-13** See Example 3, Cases A and B (paragraphs 740-270-55-26 through 55-28) for example computations involving unusual or infrequently occurring losses.

**ASC 740-270 (continued)**

**25-14** If recognition of a deferred tax asset at the end of the fiscal year for all or a portion of the tax benefit of the loss depends on taxable income from the reversal of existing taxable temporary differences, see paragraphs 740-270-30-32 through 30-33 for guidance. If all or a part of the tax benefit is not realized and future realization is not more likely than not in the interim period of occurrence but becomes more likely than not in a subsequent interim period of the same fiscal year, the previously unrecognized tax benefit shall be reported that subsequent interim period in the same manner that it would have been reported if realization had been more likely than not in the interim period of occurrence, that is, as a tax benefit relating to continuing operations or discontinued operations. [FIN 18, paragraph 18] See Subtopic 740-20 for the requirements to allocate total income tax expense (or benefit).

**Revised Implementation Guidance and Illustrations**

- [Example 3: Accounting for Income Taxes Applicable to Unusual, Infrequently Occurring, or Extraordinary Items](#) [ASC 740-270-55-24].
- [Example 4: Accounting for Income Taxes Applicable to Income \(or Loss\) From Discontinued Operations at an Interim Date](#) [ASC 740-270-55-29].
- [Example 5: Accounting for Income Taxes Applicable to Ordinary Income if an Entity Is Subject to Tax in Multiple Jurisdictions](#) [ASC 740-270-55-37].
- [Example 6: Effect of New Tax Legislation](#) [ASC 740-270-55-44].

## 9.01 Estimating the AETR for Interim Reporting of Income Taxes

To calculate its estimated AETR, an entity must estimate its ordinary income and the related tax expense or benefit for the full fiscal year (total of expected current and deferred tax provisions).

An entity's annual ordinary income **excludes** the following:

- Significant unusual or infrequently occurring items.
- Items recognized net of tax:
  - Discontinued operations.
  - OCI items not recognized in the statement of operations.

Income tax effects for the above items that are excluded from ordinary income are discretely calculated and recognized in the period in which they occur. In general (except for the items above), if the effects of a future event can be reasonably estimated and the income (or loss) associated with the future event is included in pretax ordinary income, the tax effects of the event should be included in the AETR.

The AETR should also include anticipated investment tax credits (see ASC 740-270-30-14 and 30-15 for certain exclusions), FTCs, percentage depletion, capital gains rates, and other available tax-planning alternatives. The deferred tax expense (or benefit) should include the tax effect of any required valuation allowances (for current-year-originating DTAs) as well as the effect of any uncertain tax positions expected to be taken.

In certain situations, a negative AETR may be projected (e.g., nondeductible expenses exceed pretax loss). Often these estimates are sensitive to ordinary income and may be an indicator that reasonable estimates cannot be made (see [9.06](#) for further discussion).

Example 9-1 illustrates a typical computation of the AETR and interim tax provision, as determined under ASC 740.

### Example 9-1

Assume the following:

- The entity bases its AETR for the first quarter of 20X1 on estimated results expected for the full fiscal year ending December 31, 20X1.
- No DTAs or DTLs exist at the beginning of 20X1.
- Graduated tax rates are a significant factor in the calculation of the entity's DTAs.
- Enacted tax rates are as follows:

Taxable Income	Tax Rate
\$0 – \$50,000	15%
\$50,001 – \$75,000	25%
\$75,001 – \$100,000	34%*
Over \$100,000	34%**

\* In the case of an entity that has taxable income greater than \$100,000 for any taxable year, the amount of tax determined shall be increased by the lesser of (1) 5 percent of such excess above \$100,000 or (2) \$11,750.

\*\* Entities with taxable income greater than \$15 million are additionally required to increase their tax liability by the lesser of 3 percent of the excess above \$15 million or \$100,000.

- Available evidence supports a conclusion that no valuation allowance will be required at the end of 20X2.
- Actual and estimated pretax and taxable income for 20X1 year-to-date, fiscal year 20X1, and fiscal year 20X2 are as follows:

	Actual			Estimated		
	20X1 Q1	20X1	20X2	20X1	20X2	20X2
Pretax income	\$ 55,000	\$ 60,000	\$ 60,000			
Nondeductible expenses	10,000	15,000	15,000			
Deductible temporary difference: Restructuring accrual	10,000	25,000	(25,000)			
Taxable income	<u>\$ 75,000</u>	<u>\$100,000</u>	<u>\$ 50,000</u>			

**Example 9-1 (continued)****Solution****Estimated AETR — 20X1**

Pretax income	<u>\$ 60,000</u>
Estimated tax payable based on estimated 20X1 income of \$100,000:	
\$50,000 × 15% =	\$ 7,500
\$25,000 × 25% =	6,250
\$25,000 × 34% =	<u>8,500</u> 22,250
Deferred tax expense (benefit)	
\$25,000 × 15%*	<u>(3,750)</u>
Tax provision	<u>18,500</u>
Net income	<u>\$ 41,500</u>
ETR (\$18,500 ÷ \$60,000)	<u>30.8%</u>

- \* The applicable income tax rate used for interim period tax allocation in this example is determined in accordance with the guidance contained in ASC 740-10-10-3. Because the \$25,000 deductible temporary difference reverses in 20X2, the estimated applicable tax rate is 15 percent based on the tax rate that applies to the \$50,000 estimated taxable income in 20X2.

The entity's income statement for the first quarter of 20X1 is as follows:

<b>Income Statement (Select Accounts)</b>	<b>20X1 Q1</b>
Pretax income	<u>\$ 55,000</u>
Income tax expense:	
Current tax payable (\$16,940 + \$1,500)	18,440
Deferred tax benefit (\$10,000 ÷ \$25,000) × \$3,750	<u>(1,500)</u>
Total (\$55,000 × 30.8%)	<u>16,940</u>
Net income	<u>\$ 38,060</u>
ETR	<u>30.8%</u>

**Analysis**

- To determine the AETR, the entity must estimate the current and deferred tax consequences for the full year.
- If the entity expects a DTA at the end of the current year, it must assess available evidence to determine whether realization of that DTA at year-end will be more likely than not.
- Graduated rates may affect the estimated AETR.

## 9.02 Tax-Exempt Interest in the Calculation of the Estimated AETR

When computing the estimated AETR for interim financial reporting, it is acceptable for an entity to either include tax-exempt interest income in or exclude it from the computation. However, the method elected should be consistently applied. Because “the accounting practice . . . for tax-exempt interest income in interim periods appears to be uniform” (as described in paragraph 80 of Interpretation 18), the FASB did not explicitly provide guidance requiring a specific approach. Comments received from respondents suggest that the common practice at the time among financial institutions was to exclude tax-exempt interest income from the estimated tax rate calculation. If tax-exempt interest income is included in ordinary income, the resulting tax benefit (permanent difference) should also be included in the calculation of the estimated AETR.

## 9.03 Impact of Changes in an Indefinite Reinvestment Assertion for Interim-Period Tax Purposes

For interim income tax reporting purposes, the beginning-of-the-year outside basis difference that is expected to reverse in the foreseeable future is recorded as a discrete item in the period of the change in assertion. However, the amounts pertaining to the current year (e.g., current-year earnings) will be captured within the estimated AETR in accordance with ASC 740-270-35-6. For the same reasons discussed in [7.09](#), the adjustment for the beginning-of-the-year outside basis difference is (1) generally allocated to continuing operations and (2) calculated by using the exchange rate at the beginning of the year. Example 9-2 illustrates an entity's accounting for a change in indefinite reinvestment assertion for interim reporting tax purposes.

### Example 9-2

Entity X has a profitable foreign subsidiary, A; X has asserted that the undistributed earnings of A are indefinitely reinvested, meeting the indefinite reversal criteria in ASC 740-30-25-17. Therefore, X has not recorded a DTL in connection with the financial-reporting-over-tax basis difference for the investment in A (the outside basis difference). Further, A's functional currency is its local currency; accordingly, any resulting translation differences in consolidation by X are accounted for in OCI (and X does not recognize any deferred taxes related to the translation adjustments).

In a subsequent year, X changes its intent to indefinitely reinvest the prior earnings of A, requiring the recognition of a DTL for the related part of the outside basis difference. The resulting tax expense is recorded as an expense in the current period. The tax expense related to the outside basis difference is generally allocated to continuing operations by analogy to the out-of-period guidance in ASC 740-20-45-8 and because “backward tracing” is not permitted under ASC 740. However, the tax expense allocated to continuing operations should be based on a computation that assumes no current-year change in the foreign currency exchange rates (i.e., the tax effect of prior-period income is based on the exchange rate at the beginning of the year, and the tax effect of the current-period income is based on the exchange rate used in translating that income). In accordance with ASC 740-20-45-11(b), any difference between the preceding tax effect and the actual amount recognized would be recognized as the tax effect of the current-period currency translation adjustment.

## 9.04 Balance Sheet Effects of the Interim Provision for Income Taxes

In accordance with ASC 740-10, entities use a balance sheet approach to determine the annual provision for income taxes. However, for interim financial statements, ASC 740-270 requires entities to determine the year-to-date income tax expense or benefit by applying an estimated AETR to year-to-date ordinary income. Because of the inherent disconnect between the year-end balance sheet approach of ASC 740-10 and the interim income statement approach of ASC 740-270, questions have arisen about how to reflect the year-to-date expense or benefit on the balance sheet. That is, the year-to-date tax expense or benefit that an entity determines under ASC 740-270 will typically not reconcile to the balance sheet adjustments that would be required if the year-end balance sheet approach of ASC 740-10 were applied to the current and deferred tax accounts on an interim basis. ASC 740-270 neither addresses this disconnect nor provides guidance on how to record the balance sheet effects of recording the interim provision for income taxes.

An entity should generally adjust its income tax balance sheet accounts as of interim reporting periods in a manner that is representationally faithful to either the balance sheet approach of ASC 740-10 (with respect to the measurement of current and deferred taxes) or the income statement approach of ASC 740-270. For example, adjusting current and deferred taxes by developing a “split” AETR that consists of current and deferred components would appear to be representationally faithful to the income statement approach of ASC 740-270. Alternatively, calculating the actual deferred year-to-date tax provision and deriving the adjustment to current taxes (or calculating current taxes and deriving the adjustment to deferred taxes) would appear to be representationally faithful to the balance sheet approach of ASC 740-10 (at least with respect to one of the balance sheet components).

Other methods may also be acceptable depending on an entity's specific facts and circumstances, including materiality considerations. Further, in limited circumstances, an entity might conclude that the use of an estimated AETR is inappropriate (as described by ASC 740-270-25-3); in such instances, the entity would instead use the tax balance sheet to determine the year-to-date tax expense or benefit.

Because the method applied to adjust the income tax balance sheet accounts for interim reporting periods would not be disclosed in the annual financial statements, entities should consider disclosing the method applied in their interim financial statements.

**Example 9-3**

Company A is preparing interim financial statements and calculates an estimated AETR of 25 percent that, when applied to year-to-date ordinary income of \$100, results in an interim provision for income taxes of \$25.

To adjust its income tax balance sheet accounts for interim reporting purposes, A might apply one of the following methods:

1. *Split estimated AETR* — On a forecasted basis, A estimates an 80/20 split between the current and deferred portions of the annual provision for income taxes and applies this split to the interim provision to allocate the adjustment between current and deferred balance sheet accounts.
2. *Calculate current taxes* — Company A calculates its current taxes payable in accordance with tax law applied to year-to-date income and records a \$40 liability. On the basis of the required AETR provision of \$25, A adjusts the deferred taxes for the beginning of the year by \$15 (a debit entry to the balance sheet).
3. *Calculate deferred taxes* — Company A calculates its deferred taxes as of the interim balance sheet date and adjusts its deferred taxes for the beginning of the year by \$10 (a credit entry to the balance sheet). On the basis of the required AETR provision of \$25, A recognizes a current liability of \$15.

<b>Balance Sheet</b>			
<b>Debits (Credits)</b>	<b>Current Taxes</b>	<b>Deferred Taxes</b>	<b>Income Statement Provision</b>
1. Split AETR	20	5	25
2. Calculate current taxes	40	(15)	25
3. Calculate deferred taxes	15	10	25

Note that in most cases, none of the methods above produce the same balance sheet and related expense or benefit that would arise if the balance sheet approach of ASC 740-10 were applied.

## 9.05 Interim Implications of Intraperiod Tax Allocation for Discontinued Operations When There Is a Loss From Continuing Operations

ASC 740-270-25-2 states:

The tax (or benefit) related to ordinary income (or loss) shall be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items shall be **individually computed** and recognized when the items occur. [Emphasis added]

Discontinued operations are specifically excluded from the definition of ordinary income (or loss) and should therefore be excluded from the computation of the AETR. The tax effect of discontinued operations should be recognized in the period in which the pretax amounts are recognized. Such amounts should be consistent with the intraperiod tax allocation (i.e., the tax related to the discontinued operations is the incremental tax effect of those pretax amounts).

ASC 740-20-45-7 contains the following exception to the income tax accounting treatment of a loss from continuing operations:

The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations.

**The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations.** That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the

realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [Emphasis added]

There are three acceptable alternatives related to how an entity should record an interim tax provision containing discontinued operations (or other items recorded separately from continuing operations) in interim periods when there is a loss from continuing operations. Each alternative is illustrated in Example 9-4.

#### Example 9-4

Assume the following:

- Entity T has an NOL carryforward of \$1 million. The DTA of \$400,000 (at a 40 percent tax rate) is fully offset by a valuation allowance (i.e., realization is **not** more likely than not).
- Pretax income from continuing operations for fiscal year 20X2 is estimated to be a loss of \$400,000 realized evenly over each quarter.
- At the end of the first quarter, T sells a component of its operations, resulting in a pretax gain of \$300,000 and an annual estimated total pretax loss of \$100,000.
- There are no changes in T's assertion that realization of the DTA is not more likely than not; thus, T continues to record a valuation allowance against current-year losses, resulting in zero income tax expense or benefit for the current period.

Because of the exception in ASC 740-20-45-7, T must allocate a tax benefit to continuing operations as a result of the \$300,000 gain in discontinued operations and loss in continuing operations. The allocation of the tax benefit (to continuing operations) and tax expense (to net the gain on discontinued operations) is calculated as follows:

Gain from discontinued operations	\$ 300,000
Statutory tax rate	<u>40%</u>
Tax expense allocated to discontinued operations	<u>\$ 120,000</u>

On the basis of the above computation, the estimated AETR for continuing operations is 30 percent, calculated as follows:

Estimated annual tax benefit	\$ (120,000)	= 30%
Estimated annual pretax loss	\$ (400,000)	

**Example 9-4 (continued)**

The paragraphs below illustrate, given the above facts, the three acceptable alternatives on how an entity should record its tax provision in interim periods when there is a loss from continuing operations. As with other accounting policies, the method selected must be disclosed and should be applied consistently.

**Alternative 1**

Quarter	Continuing Operations			Discontinued Operations			Balance Sheet
	Income/(Loss)	AETR	Tax	Income/(Loss)	AETR	Tax	
First	\$(100,000)	30%	\$ 30,000	\$300,000	40%	\$(120,000)	\$ (90,000)
Second	(100,000)	30%	30,000				(60,000)
Third	(100,000)	30%	30,000				(30,000)
Fourth	<u>(100,000)</u>	30%	<u>30,000</u>				<u>—</u>
	<u><u>\$(400,000)</u></u>		<u><u>\$120,000</u></u>	<u><u>\$300,000</u></u>		<u><u>\$(120,000)</u></u>	<u><u>\$ —</u></u>

In this alternative, T would apply the concepts of the AETR during each period for continuing operations and would recognize discontinued operations as a discrete item in the period in which it occurs. However, ASC 740-20-45-7 requires an equal amount of continuing operations tax benefit and "other component" tax expense (i.e., financial statement component neutral). While the above approach complies with the requirements of an AETR for continuing operations and a discrete item for other components by year-end, the resulting effect does not maintain the financial statement component neutrality (i.e., equal amounts of tax expense and benefit that are not related to changes in the tax balance sheet accounts).

**Alternative 2**

Quarter	Continuing Operations			Discontinued Operations			Balance Sheet
	Income/(Loss)	AETR	Tax	Income/(Loss)	AETR	Tax	
First	\$(100,000)		\$120,000	\$300,000	40%	\$(120,000)	\$ —
Second	(100,000)						—
Third	(100,000)						—
Fourth	<u>(100,000)</u>		<u>\$120,000</u>	<u>\$300,000</u>		<u>\$(120,000)</u>	<u>—</u>
	<u><u>\$(400,000)</u></u>		<u><u>\$120,000</u></u>	<u><u>\$300,000</u></u>		<u><u>\$(120,000)</u></u>	<u><u>\$ —</u></u>

**Example 9-4 (continued)**

This alternative maintains the financial statement component neutrality of ASC 740-20-45-7. It also meets the requirement to recognize the tax effect of other components on a discrete basis that is consistent with what the intraperiod tax allocation amount will be for the full year. However, these requirements are only met if the entity does not comply with the requirement to use an AETR for continuing operations.

**Alternative 3**

Quarter	Continuing Operations			Discontinued Operations			Balance Sheet
	Income/(Loss)	AETR	Tax	Income/(Loss)	AETR	Tax	
First	\$(100,000)	30%	\$ 30,000	\$300,000		\$ (30,000)	\$ —
Second	(100,000)	30%	30,000			(30,000)	—
Third	(100,000)	30%	30,000			(30,000)	—
Fourth	<u>(100,000)</u>	30%	<u>30,000</u>	<u>_____</u>		<u>(30,000)</u>	<u>_____</u>
	<u><u>\$(400,000)</u></u>		<u><u>\$120,000</u></u>	<u><u>\$300,000</u></u>		<u><u>\$120,000)</u></u>	<u><u>\$ _____</u></u>

This alternative similarly maintains financial statement component neutrality as of each interim date as well as at year-end. Further, the tax benefit recognized in continuing operations is based on the use of an AETR. However, the tax related to discontinued operations has not been recognized entirely in the period in which the gain was recognized.

## 9.06 Calculating an Interim Tax Provision When a Portion of Ordinary Income Cannot Be Reliably Estimated

To calculate its AETR, an entity must estimate its ordinary income or loss and the related tax expense or benefit for the full fiscal year. Generally, an entity can reliably estimate ordinary income (or loss); however, there may be instances in which the entity is unable to estimate part of its ordinary income (or loss). In situations in which an entity is unable to estimate a portion of its ordinary income (or loss), the guidance in ASC 740-270-25-3 applies:

If an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

Accordingly, the pretax amount of ordinary income (or loss) that cannot be reliably estimated and the related tax effects should be excluded from the entity's estimate of its AETR *in all periods*, and the tax effects of the item that cannot be estimated should be recorded discretely in the interim period in which that item is reported.

Examples of such items may include (but are not limited to) impairment losses and foreign exchange gains or losses that would not already be excluded from the entity's estimate of its AETR (e.g., because they are significant unusual or infrequently occurring items).

For guidance on calculating an interim tax provision when the AETR is highly sensitive to changes in estimates of ordinary income or loss, see [9.06A](#).

## **9.06A Calculating an Interim Tax Provision When the AETR Is Highly Sensitive to Changes in Estimates of Ordinary Income or Loss**

If a company's AETR is highly sensitive to changes in estimates of total ordinary income (or loss), the AETR may not be considered reliable. If a reliable estimate of the AETR cannot be made, the best estimate of the AETR may be the actual effective tax rate for the year to date.

The AETR may be highly sensitive to changes in estimates of total ordinary income (or loss) when, for example, an entity is expecting marginal ordinary income (or loss) and relatively significant permanent differences or tax credits.

The determination of what constitutes a "reliable estimate" is a matter of professional judgment.

For guidance on calculating an interim tax provision when a portion of ordinary income cannot be reliably estimated, see [9.06](#).

## **9.07 Interim-Period Treatment of a Nonrecognized Subsequent Event With Respect to the Estimated AETR**

ASC 740-270-35-3 indicates that at the end of each successive interim period during the fiscal year, an entity should revise its estimated AETR, if necessary, to reflect its current best estimate.

Questions have arisen regarding whether an entity's current best estimate of its AETR should include events that occurred after the interim balance sheet date but before its financial statements are issued or are available to be issued (i.e., a nonrecognized subsequent event as contemplated in ASC 855).

Generally, a nonrecognized subsequent event should not be reflected in the AETR (but should be disclosed if significant). This approach is based on ASC 855-10-25-3, which states that nonrecognized subsequent events should not result in the adjustment of the financial statements.

We are aware of an alternative approach in practice under which an entity's current best estimate of its AETR is based on information available up to the date on which its financial statements are issued or are available to be issued, even though that might include information that did not exist or was not relevant until after the interim balance sheet date. Even under this approach, an entity would still be required to exclude items for which the tax effects must be recognized in the period in which they occur (e.g., changes in unrecognized tax benefits, changes in tax laws or rates, a change in tax status, an initial public offering, or a business combination). Entities should consult with their accounting advisers before applying this alternative approach.

## **9.08 Adjustments of Intraperiod Tax Allocation Made in a Prior Interim Period**

Assume that a tax effect is allocated to an item other than income from continuing operations during the first quarter of the current fiscal year. However, as a result of the occurrence of unanticipated events in the third quarter of the same fiscal year, the allocation of the tax effect to that item subsequently changes (e.g., the unanticipated events change the entity's assessment of the need for a valuation allowance for its DTAs). The change in tax effect should be reflected as an adjustment of the original allocation. The objective should be to properly reflect the intraperiod allocation of tax expense for the annual period. The intraperiod tax allocation should be adjusted at each interim date, if necessary, to achieve that goal.

This approach is consistent with the example in ASC 740-270-55-28, which illustrates the accounting in interim periods for income taxes applicable to unusual or infrequently occurring items. However, this conclusion does not apply to the interim-period effects of changes in tax law or rates. As discussed in

ASC 740-10-45-17, the effects of changes in tax law or rates on prior interim periods should be included in the current interim period as part of income from continuing operations.

#### Example 9-5

In the first and second quarters of 20X1, an entity generated tax benefits from unrealized losses on an investment in an equity security, which resulted in the recognition of a DTA. In accordance with ASC 740-20-45-11(b), the expense related to the unrealized losses was recorded net of tax through OCI. On the basis of the entity's expected future earnings, no valuation allowance on the DTA was deemed necessary. No further tax benefits were generated in the third and fourth quarters.

Beginning in the third quarter and through the end of the fiscal year, unanticipated events resulted in continued operating losses for the entity; by year-end, a full valuation allowance on the DTA was necessary. While the recording of a DTA was appropriate in the first and second quarters, a valuation allowance should be recognized through OCI in the fourth quarter. For the annual period, there is no impact on the intraperiod tax allocation because the need for a valuation allowance occurred in the same annual period in which the DTA was generated. If the valuation allowance was not required until the subsequent year, the change in the valuation allowance would be allocated to income from continuing operations, in accordance with ASC 740-20-45-4.

#### Example 9-6

An entity releases a valuation allowance in the first quarter against a DTA on the basis of an expected gain on sale of a discontinued operation (assume that the income from the sale is of the appropriate character for the entity to realize the DTA). Different approaches to recording the intraperiod allocation in the quarter may be appropriate as long as the objective to properly reflect the intraperiod allocation of tax expense for the annual period is met.

If management is unsure about whether it will sell the component in the current year, the entity may use one of the following two approaches to allocate the anticipated benefit from the release of the valuation allowance:

- *Approach 1* — Allocate the anticipated benefit to discontinued operations in the first quarter and, if the anticipated transaction does not occur by the end of the year, subsequently reclassify the benefit to income from continuing operations.
- *Approach 2* — Allocate the anticipated benefit to income from continuing operations in the first quarter and, if the anticipated transaction does occur by the end of the year, subsequently reclassify the benefit to income from discontinued operations in the quarter in which the component is sold.

However, if management expects to sell the component in the current year, the entity should follow Approach 1, and if management does not expect to sell the component in the current year, the entity should follow Approach 2.

See [7.05](#) for further guidance on accounting for changes in valuation allowances resulting from items other than continuing operations.

## 9.09 Changes in the Valuation Allowance in an Interim Period

If a change in the beginning-of-the-year valuation allowance is recognized as a result of a change in judgment about the realizability of the related DTA in **future years**, the effect should not be spread throughout the year but should be recognized in the interim period in which the change in judgment occurs. However, if the change in the valuation allowance is necessary as a result of a change in judgment about the realizability of the related DTA in the **current year** (e.g., as a consequence of earning income or incurring losses in the current year), the effect is spread over remaining interim periods in the year as an adjustment to the estimated AETR.

Examples 9-7 through 9-9 illustrate this concept.

### Example 9-7

Assume the following:

- At the beginning of fiscal year 20X1, Entity X has a DTA of \$10,000 that relates to \$25,000 of NOLs that all expire in 20X5. A full valuation allowance is recorded against the DTA because X believes, on the basis of the weight of available evidence, that it is more likely than not that the DTA will not be realized.
- Assume that X has no other DTAs or DTLs.
- Entity X's tax rate is 40 percent.
- Income before tax for the first quarter of 20X1 totals \$1,000.
- Income before tax for the second quarter of 20X1 totals \$1,000.
- At the beginning of the year, X estimates, on the basis of new evidence, that it will earn \$1,000 of income before tax in each of the quarters in 20X1.
- At the end of the second quarter, X estimates, on the basis of new evidence, that it will earn \$30,000 of taxable income in 20X2–20X4. Accordingly, X concludes that it is more likely than not that all of its DTAs will be realized.

The following table illustrates X's tax provision in each of the four quarters of 20X1:

	Quarter Ended 3/31/X1	Quarter Ended 6/30/X1	Quarter Ended 9/30/X1	Quarter Ended 12/31/X1	Year Ended 12/31/X1
Income before income taxes	\$ 1,000	\$ 1,000	\$ 1,000*	\$ 1,000*	\$ 4,000*
Income tax expense (benefit):**					
Reduction in gross DTAs as a result of application of NOLs to reduce current period's taxable income <sup>†</sup>	400	400	400	400	1,600
Reduction in valuation allowance as a result of reduction in gross DTAs <sup>‡</sup>	(400)	(400)	(400)	(400)	(1,600)
Reduction in valuation allowance as a result of changes in judgement over the future years <sup>§</sup>	—	(8,400)	—	—	(8,400)
Total income tax expense	—	(8,400)	—	—	(8,400)
Net income	\$ 1,000	\$ 9,400	\$ 1,000	\$ 1,000	\$ 12,400

\* Income for the third and fourth quarters are estimates as of the end of the second quarter.

\*\* The components of income tax expense (benefit) have been shown separately for illustrative purposes only.

<sup>†</sup> As income is earned, X's NOLs will be applied to reduce taxable income to zero. Accordingly, the application of NOLs to reduce taxable income will reduce X's gross DTAs.

<sup>‡</sup> The reduction of X's gross DTAs as a result of the application of NOLs to reduce taxable income will cause a corresponding decrease in the valuation allowance.

<sup>§</sup> At the end of the second quarter — after application of NOLs to reduce current-period income but before consideration of any further reduction in valuation allowance as a result of the realizability of DTAs in future years on the basis of new information — X has a \$9,200 valuation allowance (\$10,000 beginning balance less \$800 reduction in valuation allowance as a result of the application of NOLs to reduce first- and second-quarter income).

**Example 9-7 (continued)**

Because X estimated that it will earn income of \$1,000 in each quarter in the current year, \$8,400 (\$9,200 less \$800 of valuation allowance expected to be released in the third and fourth quarters on the basis of forecasted income) of the \$9,200 valuation allowance **relates to changes in judgment over realizability of the DTA in future years**. Therefore, \$8,400 of the valuation allowance should be reduced in the second quarter (in addition to the \$400 reduction in valuation allowance attributable to application of NOLs to the second-quarter income of \$1,000).

The effect of reducing the remaining \$800 of valuation allowance should be spread over the remaining interim periods in the current year because it relates to **estimates over income earned in interim periods in the current year**. This will cause X's ETR in the third and fourth quarters to be 0 percent if the estimates are accurate.

**Example 9-8**

Assume that during the first quarter of fiscal year 20X1, Entity A, operating in a tax jurisdiction with a 50 percent tax rate, generates a tax credit of \$3,000 that, under tax law, will expire at the end of 20X2. At the end of the first quarter of 20X1, available evidence about the future indicates that taxable income of \$1,000 and \$3,000 will be generated during 20X1 and 20X2, respectively. Therefore, a valuation allowance of \$1,000 [ $\$3,000 \text{ tax credit} - (\$4,000 \text{ combined forecasted taxable income of } 20X1 \text{ and } 20X2 \times 50\%)$ ] will be necessary at the end of 20X1. If it is assumed that the entity will generate \$9,000 of tax-exempt income during 20X1, estimated pretax accounting income for the full fiscal year is \$10,000 ( $\$1,000 + \$9,000$ ).

Because the valuation allowance relates to tax benefits generated during the current year, the tax consequences of both the \$500 ( $\$1,000 \text{ taxable income} \times 50\%$ ) currently payable and the \$2,000 ( $\$3,000 \text{ tax credit less } \$1,000 \text{ valuation allowance}$ ) net DTA expected to be recognized at the end of 20X1 are applied ratably to income generated during the interim periods of fiscal year 20X1.

Thus, if pretax accounting income is \$5,000 during the first quarter of 20X1, a benefit for income taxes of \$750 [ $(\$2,000 \text{ net tax benefit attributable to tax credit net of valuation allowance} - \$500 \text{ current tax payable}) \times \$5,000/\$10,000$ ] would be recognized and net income of \$5,750 would be reported for that interim period. If it is assumed that the estimates about the future do not change during the remainder of the year, the tax benefit of the remaining \$750 ( $\$1,500 - \$750$ ) of net DTAs would be recognized ratably over the pretax accounting income generated in the later interim periods of fiscal year 20X1.

**Example 9-9**

Assume that Entity B also operates in a tax jurisdiction with a 50 percent tax rate and is computing its ETR for fiscal year 20X2 at the end of its first quarter. At the end of the previous year, 20X1, B recorded a DTA of \$4,000 for a tax credit carryforward generated in that year that, according to tax law, expires in 20X3, and B reduced that DTA by a valuation allowance of \$1,000 on the basis of an estimate of taxable income of \$3,000 in 20X2 and \$3,000 in 20X3.

At the end of the first quarter of 20X2, assume that B's estimate of future taxable income expected in 20X3 is revised from \$3,000 to \$2,000, pretax accounting income and taxable income for 20X2 are expected to be the same, and no new tax credits are expected during the year. Because the additional valuation allowance of \$500 ( $\$1,000 \text{ reduction in estimated } 20X3 \text{ taxable income} \times 50\%$ ) relates to a change in judgment about the realizability of the related DTA in future years, the entire effect is recognized during the first quarter of 20X2. Thus, if B had pretax accounting income of \$2,000 in the first quarter of 20X2 and its AETR for the full fiscal year is 50 percent, it would record income tax expense of \$1,500 [ $(\$500 \text{ increase in valuation allowance attributable to change in judgment over } 20X3 \text{ estimated taxable income}) + (\$2,000 \text{ accounting income} \times 50\% \text{ tax rate})$ ] and net income of \$500 for the first quarter of 20X2.

**Example 9-9 (continued)**

Assume, instead, that at the end of the first quarter of 20X2, B's estimate of future taxable income expected in 20X2 is reduced from \$3,000 to \$2,500 and that B's estimate of future taxable income expected in 20X3 continues to be \$3,000. Accordingly, an additional \$250 of valuation allowance, over what was recorded at the end of 20X1, is expected to be needed at the end of 20X2. Assume that pretax accounting income for the first quarter of 20X2 totals \$2,000. As a result, for the first quarter of 20X2, B would record income tax expense of \$1,200. The \$1,200 is computed as follows:

Tax on estimated income (\$2,500 estimated income at 50% tax rate)	\$ 1,250
Increase in valuation allowance	<u>250</u>
Total tax expense estimated for the year	<u><u>\$ 1,500</u></u>
Estimated ETR (\$1,500 ÷ \$2,500)	<u><u>60%</u></u>
Income earned in the first quarter of 20X2	<u><u>\$ 2,000</u></u>
Income tax expense for the first quarter of 20X2	<u><u>\$ 1,200</u></u>

## 9.10 Changes in Tax Laws and Rates Occurring in Interim Periods

Under ASC 740, the effects of new legislation are recognized upon enactment, which in the U.S. federal jurisdiction is the date the president signs a tax bill into law. The tax effects of a change in tax laws or rates on taxes currently payable or refundable for the current year are reflected in the computation of the AETR after the effective dates prescribed in the statutes or after the new legislation becomes administratively effective, beginning no earlier than the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a DTL or DTA is recognized as a discrete item in the interim period that includes the enactment date and accordingly is not allocated among interim periods remaining in the fiscal year by an adjustment of the AETR. If the effective date of a change in tax law differs from the enactment date, affected DTAs or DTLs are remeasured in the interim period that includes enactment; however, the remeasurement should include only the effects of the change on items that are expected to reverse after the effective date. For example, if an entity has two temporary differences that may be affected by a tax law change and expects one to reverse before the effective date of the change and the other to reverse after the effective date, the one that reverses after the effective date would be remeasured for the change in tax law in the interim period of enactment.

Certain changes in tax laws are applied retroactively and do not involve a tax rate change. When provisions of a new tax law are effective retroactively, they can affect both the current-year measure of tax expense or benefit (either current or deferred) and the tax expense or benefit recognized in prior annual periods that ended after the effective date of the retroactive legislation. The effect (if any) on both the prior annual period and the current annual period is recognized in the interim period (and annual period) that includes the date of enactment. When retroactive legislation is enacted in an interim period before the fourth quarter of the annual accounting period, the effect on the current annual accounting period is generally recognized by updating the AETR for the effect of the retrospective legislation. That updated AETR is then applied to the year-to-date ordinary income through the end of the interim period that includes the enactment date. The cumulative amount of tax expense or benefit for the current year is then adjusted to this amount, which effectively "catches up" the prior interim periods for the change in law.

In certain circumstances, an entity might not use the AETR approach to account for its interim income tax provision (generally because the entity cannot make a reliable estimate; for more information, see [9.06](#)). In these situations, an entity would be required to determine the actual effect of retrospective legislation on its year-to-date activity. When retrospective legislation affects the computation of an interim tax expense or benefit, the impact on the entity's balance sheet should be consistent with its normal policy for adjusting the balance sheet accounts (current and deferred) on an interim basis.

As noted, some entities (depending on their particular fiscal year-end) also recognize the effects that the retroactive legislation has on the prior annual accounting period (periods that ended after the retrospective effective date). These effects might be reflected as changes to current tax accounts, deferred tax accounts, or both. Amounts pertaining to the prior annual accounting period must be recognized entirely in the period that includes the enactment date and should not be reflected in the current-period AETR described above.

Finally, an entity that has not yet issued its report for the interim or annual period that ended before enactment cannot consider the enactment in preparing those statements; however, the effect that the retroactive legislation will have on the period being reported should still be disclosed. To determine the amount to disclose in such circumstances, the entity generally must perform computations similar to those described above.

Example 9-10 illustrates the accounting for a change in tax rate retroactive to interim periods of the current year.

#### Example 9-10

Entity C, operating in a tax jurisdiction with a 35 percent tax rate, is computing its AETR for each quarter of 20X2. Entity C's estimated annual ordinary pretax income is \$8,000, which it earns in equal amounts during each quarter of fiscal year 20X2. At the end of the previous year, C recorded a DTA of \$350 for a \$1,000 liability on the financial statements that is deductible on the tax return when paid. As the payments are made, they reduce the liability throughout the year, as shown in the following table:

Item	January 1	March 31	June 30	September 30	December 31
Balance sheet liability	\$ (1,000)	\$ (950)	\$ (850)	\$ (800)	\$ (200)

Entity C has another temporary difference related to an accumulated hedging loss in the statement of OCI. The following table summarizes the gain (loss) activity during each quarter of 20X2:

Item	January 1	March 31	June 30	September 30	December 31
Accumulated hedging (loss) gain	\$ (300)	\$ (600)	\$ (400)	\$ (200)	\$ 100

**Example 9-10 (continued)**

The table below illustrates C's estimated AETR calculation for fiscal year 20X2 at the end of the first quarter. As discussed in [9.01](#), the changes in OCI are excluded from the AETR calculation.

**Estimated AETR Calculations**

Estimated annual ordinary income	\$ 8,000
Temporary difference	<u>(800)</u>
Estimated taxable income	7,200
Tax rate	<u>35%</u>
Current tax expense	2,520
Deferred tax expense	<u>280</u>
Estimated annual tax provision	<u>\$ 2,800</u>
Estimated AETR	35%

**Estimated Change in DTA**

	Gross	Tax Rate	DTA
1/1/20X2	\$ 1,000	35%	\$ 350
12/31/20X2	<u>200</u>	35%	<u>70</u>
Change	<u>\$ 800</u>		<u>\$ 280</u>

At the end of May, legislation was enacted that increased the tax rate for 20X2 and years thereafter to 40 percent. The effect of the change in the tax rate related to the DTA is recognized on the enactment date as a discrete item, and the effect of the change on taxes currently payable is recognized by adjusting the AETR in the interim period of the change.

On the enactment date, the balance sheet liability was \$900 and the cumulative loss in OCI was \$500. The following table illustrates the calculation of the amount to be recorded as a discrete income tax benefit for an increase in the DTA related to the balance sheet liability:

	Balance on January 1, 20X2	Before Enactment	Impact of Enactment	After Enactment	Expected Balances on December 31, 20X2
Liability	\$ 1,000	\$ (100)	\$ 900	\$ (700)	\$ 200
Tax rate	<u>35%</u>	<u>35%</u>	<u>5%</u>	<u>40%</u>	<u>40%</u>
DTA	<u>\$ 350</u>	<u>\$ (35)</u>	<u>\$ 45</u>	<u>\$ (280)</u>	<u>\$ 80</u>

The \$45 in the "Impact of Enactment" column represents the discrete adjustment that must be recognized upon enactment from the \$100 that was paid before enactment and that is currently payable (this amount is recognized by adjusting the AETR in the second quarter). The deferred tax expense for the revised AETR calculation is the combination of the change in the DTA before and after enactment, excluding the discrete adjustment (i.e., \$35 and \$280). This calculation is shown in the following table:

**Example 9-10 (continued)****Estimated AETR Calculations**

Estimated annual ordinary income	\$ 8,000
Temporary difference	(800)
Estimated taxable income	7,200
Tax rate	40%
Current tax expense	2,880
Deferred tax expense	315*
Estimated annual tax provision	\$ 3,195
Estimated AETR	39.9%

\* \$315 = \$35 (before enactment) + \$280 (after enactment).

Because of the enacted tax rate increase, a discrete adjustment also must be made for the cumulative \$500 loss in OCI for hedging activity.

	Balance on January 1, 20X2	Before Enactment	Impact of Enactment	After Enactment	Expected Balances on December 31, 20X2
Cumulative loss (gain)	\$ 300	\$ 200	\$ 500	\$ (600)	\$ (100)
Tax rate	35%	35%	5%	40%	40%
DTA (DTL)	\$ 105	\$ 70	\$ 25	\$ (240)	\$ (40)

While the changes in OCI for hedging activity are not a component of the AETR calculation, the amount to adjust the DTA for the tax rate increase (i.e., \$25) is a discrete item that is part of continuing operations and therefore affects the tax expense in the quarter of enactment.

The following table summarizes the quarterly income tax provision on the basis of the above calculations:

**Quarterly AETR Calculation**

	Q1	Q2	Q3	Q4
Pretax income (cumulative)	\$ 2,000	\$ 4,000	\$ 6,000	\$ 8,000
AETR	35.0%	39.9%	39.9%	39.9%
Tax (cumulative)	700	1,598	2,396	3,195
Discrete tax (cumulative)	—	(70)*	(70)	(70)
Total income tax (cumulative)	\$ 700	\$ 1,528	\$ 2,326	\$ 3,125
Previously recorded	\$ —	\$ 700	\$ 1,528	\$ 2,326
Tax expense for quarter	\$ 700	\$ 828	\$ 798	\$ 799
ETR	35.0%	41.4%	39.9%	39.9%

**Example 9-10 (continued)****Quarterly OCI Changes**

	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
OCI (pretax)	\$ (300)	\$ 200	\$ 200	\$ 300
Tax	105	(75)**	(80)	(120)
OCI (net)	<u>\$ (195)</u>	<u>\$ 125</u>	<u>\$ 120</u>	<u>\$ 180</u>

\* \$70 = \$45 (DTA) + \$25 (OCI).

\*\* \$75 = [(\$100 (before enactment) × 35%) + \$100 (after enactment) × 40%].

The effect of the change in tax rates should be (1) reported as a separate line item in income tax expense from continuing operations or (2) disclosed in the footnotes.

## 9.11 Interim Income Tax Accounting for Significant Unusual or Infrequently Occurring Items

ASC 740-270-25-2 states that the “tax (or benefit) related to **ordinary** income (or loss) shall be computed at an estimated [AETR] and the tax (or benefit) related to all other items shall be **individually computed** and recognized when the items occur” (emphasis added).

The ASC master glossary defines ordinary income (or loss) as follows:

Ordinary income (or loss) refers to income (or loss) from continuing operations before income taxes (or benefits) excluding significant unusual or infrequently occurring items. Discontinued operations and cumulative effects of changes in accounting principles are also excluded from this term. The term is not used in the income tax context of ordinary income versus capital gain. The meaning of unusual or infrequently occurring items is consistent with their use in the definitions of the terms unusual nature and infrequency of occurrence.<sup>[1]</sup>

An entity records the tax effects of items excluded from ordinary income in the period in which the items occur and excludes those tax effects from the calculation of the estimated AETR. Example 9-11 illustrates an interim tax provision that includes a significant unusual or infrequent item.

<sup>1</sup> Although use of the term “unusual or infrequently occurring items” is consistent with the accounting definition of extraordinary items in ASC 225, it relates to items that are not classified as a separate component of the financial statement, as prescribed in that Codification topic.

**Example 9-11**

Assume the following:

- The entity computes its AETR for each quarter of 20X1 on the basis of estimated results expected for the full fiscal year ending December 31, 20X1.
- The statutory tax rate in 20X1 is 50 percent.
- In the third quarter, a significant unusual or infrequent loss was realized in the amount of \$15,000 and only \$10,000 of the loss is deductible for tax purposes.

Quarter	Ordinary Income			Income Tax — Ordinary Income		
	Reporting Period	Year-to-Date	AETR	Year-to-Date	Previously Reported	Reporting Period
First	\$ 10,000	\$ 10,000	50%	\$ 5,000		\$ 5,000
Second	20,000	30,000	50%	15,000	\$ 5,000	10,000
Third	15,000	45,000	50%	22,500	15,000	7,500
Fourth	<u>35,000</u>	80,000	50%	40,000	22,500	<u>17,500</u>
Annual	<u><u>\$ 80,000</u></u>					<u><u>\$ 40,000</u></u>

Quarter	Significant Unusual or Infrequent Loss			Income Tax — Significant Unusual or Infrequent Loss		
	Reporting Period	Year-to-Date	Tax Rate	Year-to-Date	Previously Reported	Reporting Period
First						
Second						
Third	\$ (15,000)	\$ (15,000)	50%	\$ (5,000)*		\$ (5,000)
Fourth	<u>—</u>	(15,000)		(5,000)		<u>—</u>
Annual	<u><u>\$ (15,000)</u></u>					<u><u>\$ (5,000)</u></u>

\* The \$5,000 tax benefit relates to the tax effect of the \$10,000 deductible loss. The remaining \$5,000 is not tax-deductible as stated in the facts of this example.

Quarter	Total Income			Total Income Tax		
	Reporting Period	Year-to-Date		Year-to-Date	Previously Reported	Reporting Period
First	\$ 10,000	\$ 10,000		\$ 5,000		\$ 5,000
Second	20,000	30,000		15,000	\$ 5,000	10,000
Third	<u>—</u>	30,000		17,500	15,000	2,500
Fourth	<u>35,000</u>	65,000		35,000	17,500	<u>17,500</u>
Annual	<u><u>\$ 65,000</u></u>					<u><u>\$ 35,000</u></u>

The AETR estimate of 50 percent applied to ordinary income is not affected by the significant unusual or infrequent item. See ASC 740-270-55-24 through 55-36 for other examples.

## Measurement

### ASC 740-270

#### General Methodology and Use of Estimated Annual Effective Tax Rate

**30-1** This guidance establishes the methodology, including the use of an estimated annual effective tax rate, to determine income tax expense (or benefit) in interim financial information.

**30-2** In reporting interim financial information, income tax provisions shall be determined under the general requirements for accounting for income taxes set forth in Subtopic 740-10. [APB 28, paragraph 19]

**30-3** Income tax expense (or benefit) for an interim period is based on income taxes computed for ordinary income or loss and income taxes computed for items or events that are not part of ordinary income or loss.

**30-4** Paragraph 740-270-25-2 requires that the tax (or benefit) related to ordinary income (or loss) be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items be individually computed and recognized when the items occur.

#### Pending Content (Transition Guidance: ASC 718-10-65-4)

**30-4** Paragraph 740-270-25-2 requires that the tax (or benefit) related to ordinary income (or loss) be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items be individually computed and recognized when the items occur [FIN 18, paragraph 6] (for example, the tax effects resulting from an employee share-based payment award within the scope of Topic 718 when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes). [ASU 2016-09, paragraph 19]

**30-5** The estimated annual effective tax rate, described in paragraphs 740-270-30-6 through 30-8, shall be applied to the year-to-date ordinary income (or loss) at the end of each interim period to compute the year-to-date tax (or benefit) applicable to ordinary income (or loss). [FIN 18, paragraph 9]

**30-6** At the end of each interim period the entity shall make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. [APB 28, paragraph 19] In some cases, the estimated annual effective tax rate will be the statutory rate modified as may be appropriate in particular circumstances. In other cases, the rate will be the entity's estimate of the tax (or benefit) that will be provided for the fiscal year, stated as a percentage of its estimated ordinary income (or loss) for the fiscal year (see paragraphs 740-270-30-30 through 30-34 if an ordinary loss is anticipated for the fiscal year). [FIN 18, paragraph 8]

**30-7** The tax effect of a valuation allowance expected to be necessary for a deferred tax asset at the end of the year for originating deductible temporary differences and carryforwards during the year shall be included in the effective tax rate. [APB 28, paragraph 20]

**30-8** The estimated effective tax rate shall also reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this estimated effective tax rate, no effect shall be included for the tax related to significant unusual or infrequently occurring items that will be separately reported or for items that will be reported net of their related tax effect in reports for the interim period or for the fiscal year. The rate so determined shall be used in providing for income taxes on a current year-to-date basis. [APB 28, paragraph 19]

**ASC 740-270 (continued)****Pending Content (Transition Guidance: ASC 718-10-65-4)**

**30-8** The estimated effective tax rate also shall reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this estimated effective tax rate, no effect shall be included for the tax related to [APB 28, paragraph 19] an employee share-based payment award within the scope of Topic 718 when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes, [ASU 2016-09, paragraph 19] Significant unusual or infrequently occurring items that will be reported separately, or for items that will be reported net of their related tax effect in reports for the interim period or for the fiscal year. The rate so determined shall be used in providing for income taxes on a current year-to-date basis. [APB 28, paragraph 19]

**30-9** Examples 1 through 2 (see paragraphs 740-270-55-2 through 55-23) contain illustrations of the computation of estimated annual effective tax rates beginning in paragraphs 740-270-55-3; 740-270-55-12; and 740-270-55-19 through 55-20.

**Exclusion of Items from Estimated Annual Effective Tax Rate**

**30-10** This guidance identifies items that are always excluded from the determination of the estimated annual effective tax rate. This guidance also specifies the alternatives for including or excluding certain investment tax credits in the estimated annual effective tax rate.

***Items Always Excluded from Estimated Annual Effective Tax Rate***

**30-11** The effects of changes in judgment about beginning-of-year valuation allowances and effects of changes in tax laws or rates shall be excluded from the estimated annual effective tax rate calculation. [FIN 18, paragraph 16] See paragraph 740-270-25-5 for requirements related to when the estimated annual effective tax rate shall be adjusted to reflect changes in tax laws and rates that affect current year taxes payable or refundable.

**30-12** Taxes related to significant unusual or infrequently occurring items that will be separately reported or for items that will be reported net of their related tax effect also shall be excluded from the estimated annual effective tax rate calculation. [FIN 18, paragraph 16]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**30-12** Taxes related to an employee share-based payment award within the scope of Topic 718 when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes, [ASU 2016-09, paragraph 19] Significant unusual or infrequently occurring items that will be reported separately or items that will be reported net of their related tax effect shall be excluded from the estimated annual effective tax rate calculation. [FIN 18, paragraph 16]

**30-13** As these items are excluded from the estimated annual effective tax rate, Section 740-270-25 requires that the related tax effect be recognized in the interim period in which they occur. [FIN 18, paragraph 16] See Example 3 (paragraph 740-270-55-24) for illustrations of accounting for these items in the interim period which they occur.

## ASC 740-270 (continued)

### Certain Tax Credits

**30-14** Certain investment tax credits may be excluded from the estimated annual effective tax rate. If an entity includes allowable investment tax credits as part of its provision for income taxes over the productive life of acquired property and not entirely in the year the property is placed in service, amortization of deferred investment tax credits need not be taken into account in estimating the annual effective tax rate; however, if the investment tax credits are taken into account in the estimated annual effective tax rate, the amount taken into account shall be the amount of amortization that is anticipated to be included in income in the current year (see paragraphs 740-10-25-46 and 740-10-45-28).

**30-15** Further, paragraphs 840-30-30-14 and 840-30-35-34 through 35-35 require that investment tax credits related to leases that are accounted for as leveraged leases shall be deferred and accounted for as return on the net investment in the leveraged leases in the years in which the net investment is positive and explains that the use of the term years is not intended to preclude application of the accounting described to shorter periods. If an entity accounts for investment tax credits related to leveraged leases in accordance with those paragraphs for interim periods, those investment tax credits shall not be taken into account in estimating the annual effective tax rate. [FIN 18, paragraph 8]

### Pending Content (Transition Guidance: ASC 842-10-65-1)

**30-15** Further, paragraphs 842-50-30-1 and 842-50-35-3 through 35-4 require that investment tax credits related to leases that are accounted for as leveraged leases shall be deferred and accounted for as return on the net investment in the leveraged leases in the years in which the net investment is positive and explains that the use of the term years is not intended to preclude application of the accounting described to shorter periods. If an entity accounts for investment tax credits related to leveraged leases in accordance with those paragraphs for interim periods, those investment tax credits shall not be taken into account in estimating the annual effective tax rate. [FIN 18, paragraph 8]

### Ability to Make Estimates

**30-16** This guidance addresses the consequences of an entity's inability to reliably estimate some or all of the information which is ordinarily required to determine the annual effective tax rate in interim financial information.

**30-17** Paragraph 740-270-25-3 requires that if an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated be reported in the interim period in which the item is reported.

**30-18** Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on evaluations of possible future events and transactions and may be subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate. [FIN 18, paragraph 8]

**30-19** The effect of translating foreign currency financial statements may make it difficult to estimate an annual effective foreign currency tax rate in dollars. For example, in some cases depreciation is translated at historical exchange rates, whereas many transactions included in income are translated at current period average exchange rates. If depreciation is large in relation to earnings, a change in the estimated ordinary income that does not change the effective foreign currency tax rate can change the effective tax rate in the dollar financial statements. This result can occur with no change in exchange rates during the current year if there have been exchange rate changes in past years. If the entity is unable to estimate its annual effective tax rate in dollars or is otherwise unable to make a reliable estimate of its ordinary income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the tax (or benefit) applicable to ordinary income (or loss) in that jurisdiction shall be recognized in the interim period in which the ordinary income (or loss) is reported. [FIN 18, paragraph 85]

### Effect of Operating Losses

**30-20** This guidance addresses changes to the general methodology to determine income tax expense (or benefit) in interim financial information as set forth in paragraph 740-270-30-5 when an entity has experienced or expects to experience operating losses.

**ASC 740-270 (continued)**

**30-21** An entity may have experienced year-to-date ordinary income (or loss) at the end of any interim period. These year-to-date actual results of either ordinary income (or loss) may differ from the results expected by the entity for either ordinary income (or loss) for the full fiscal year. This guidance identifies the required methodology for recording interim period income taxes for each of the four possible relationships of year-to-date ordinary income (or loss) and expected full fiscal year ordinary income (or loss). See Examples 1 through 2 (paragraphs 740-270-55-2 through 55-23) for example computations in these different situations. This guidance also establishes income tax benefit limitations when ordinary losses exist. [FIN 18, paragraph 2]

***Year-to-Date Ordinary Income; Anticipated Ordinary Income for the Year***

**30-22** If an entity has ordinary income for the year to date at the end of an interim period and anticipates ordinary income for the fiscal year, the interim period tax shall be computed in accordance with paragraph 740-270-30-5. [FIN 18, paragraph 10]

**30-23** See Example 1, Cases A and B1 (paragraphs 740-270-55-4 through 55-6) for illustrations of the application of these requirements.

***Year-to-Date Ordinary Loss; Anticipated Ordinary Income for the Year***

**30-24** If an entity has an ordinary loss for the year to date at the end of an interim period and anticipates ordinary income for the fiscal year, the interim period tax benefit shall be computed in accordance with paragraph 740-270-30-5, except that the year-to-date tax benefit recognized shall be limited to the amount determined in accordance with paragraphs 740-270-30-30 through 30-33. [FIN 18, paragraph 11]

**30-25** See Example 1, Cases B2 and B3 (paragraphs 740-270-55-7 through 55-8) for illustrations of the application of these requirements.

***Year-to-Date Ordinary Income; Anticipated Ordinary Loss for the Year***

**30-26** If an entity has ordinary income for the year to date at the end of an interim period and anticipates an ordinary loss for the fiscal year, the interim period tax shall be computed in accordance with paragraph 740-270-30-5. The estimated tax benefit for the fiscal year, used to determine the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8, shall not exceed the tax benefit determined in accordance with paragraphs 740-270-30-30 through 30-33. [FIN 18, paragraph 12]

**30-27** See Example 2, Cases A2 and C2 (paragraphs 740-270-55-16 and 740-270-55-20) for illustrations of the application of these requirements.

***Year-to-Date Ordinary Loss; Anticipated Ordinary Loss for the Year***

**30-28** If an entity has an ordinary loss for the year to date at the end of an interim period and anticipates an ordinary loss for the fiscal year, the interim period tax benefit shall be computed in accordance with paragraph 740-270-30-5. The estimated tax benefit for the fiscal year, used to determine the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8, shall not exceed the tax benefit determined in accordance with paragraphs 740-270-30-30 through 30-33. In addition to that limitation in the effective rate computation, if the year-to-date ordinary loss exceeds the anticipated ordinary loss for the fiscal year, the tax benefit recognized for the year to date shall not exceed the tax benefit determined, based on the year-to-date ordinary loss, in accordance with paragraphs 740-270-30-30 through 30-33. [FIN 18, paragraph 13]

**30-29** See Example 2, Cases A1, B, and C1 (paragraphs 740-270-55-15, 740-270-55-17, and 740-270-55-19) for illustrations of the application of these requirements.

**Determining Income Tax Benefit Limitations**

**30-30** Paragraph 740-270-25-9 provides that a tax benefit shall be recognized for a loss that arises early in a fiscal year if the tax benefits are expected to be either of the following:

- a. Realized during the year
- b. Recognizable as a deferred tax asset at the end of the year in accordance with the requirements established in Subtopic 740-10. Paragraph 740-10-30-5(e) requires that a valuation allowance be recognized if it is more likely than not that the tax benefit of some portion or all of a deferred tax asset will not be realized.

## ASC 740-270 (continued)

**30-31** The limitations described in the preceding paragraph shall be applied in determining the estimated tax benefit of an ordinary loss for the fiscal year, used to determine the estimated annual effective tax rate and the year-to-date tax benefit of a loss. [FIN 18, paragraph 14]

**30-32** The reversal of existing taxable temporary differences may be a source of evidence in determining whether a tax benefit requires limitation. A deferred tax liability related to existing taxable temporary differences is a source of evidence for recognition of a tax benefit when all of the following conditions exist:

- a. An entity anticipates an ordinary loss for the fiscal year or has a year-to-date ordinary loss in excess of the anticipated ordinary loss for the fiscal year.
- b. The tax benefit of that loss is not expected to be realized during the year.
- c. Recognition of a deferred tax asset for that loss at the end of the fiscal year is expected to depend on taxable income from the reversal of existing taxable temporary differences (that is, a higher deferred tax asset valuation allowance would be necessary absent the existing taxable temporary differences). [FIN 18, paragraph 15]

The requirement to consider the reversal of existing taxable temporary differences is illustrated in Example 2, Case D (see paragraph 740-270-55-21).

**30-33** If the tax benefit relates to an estimated ordinary loss for the fiscal year, it shall be considered in determining the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8. If the tax benefit relates to a year-to-date ordinary loss, it shall be considered in computing the maximum tax benefit that shall be recognized for the year to date. [FIN 18, paragraph 15]

**30-34** See Example 2, Cases A1; B, C1; and C2 (paragraphs 740-270-55-15 ; 740-270-55-17; and 740-270-55-19 through 55-20) for illustrations of computations involving operating losses, and Example 1, Cases B2 and B3 (see paragraphs 740-270-55-7 through 55-8), and Example 2, Case A2 (see paragraph 740-270-55-16) for illustrations of special year-to-date limitation computations.

## Multiple Tax Jurisdictions

**30-35** This guidance addresses possible changes to the general interim period income tax expense methodology when an entity is subject to tax in multiple jurisdictions.

**30-36** If an entity that is subject to tax in multiple jurisdictions pays taxes based on identified income in one or more individual jurisdictions, interim period tax (or benefit) related to consolidated ordinary income (or loss) for the year to date shall be computed in accordance with the requirements of this Subtopic using one overall estimated annual effective tax rate with the following exceptions:

- a. If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with paragraphs 740-270-30-30 through 30-33, no tax benefit can be recognized, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). A separate estimated annual effective tax rate shall be computed for that jurisdiction and applied to ordinary income (or loss) in that jurisdiction in accordance with the methodology otherwise required by this Subtopic.
- b. If an entity is unable to estimate an annual effective tax rate in a foreign jurisdiction in dollars or is otherwise unable to make a reliable estimate of its ordinary income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). The tax (or benefit) related to ordinary income (or loss) in that jurisdiction shall be recognized in the interim period in which the ordinary income (or loss) is reported. The tax (or benefit) related to ordinary income (or loss) in a jurisdiction may not be limited to tax (or benefit) in that jurisdiction. It might also include tax (or benefit) in another jurisdiction that results from providing taxes on unremitted earnings, foreign tax credits, and so forth. [FIN 18, paragraph 22]

See Example 5, Cases A; B; and C (paragraphs 740-270-55-39 through 55-43) for illustrations of accounting for income taxes applicable to ordinary income if an entity is subject to tax in multiple jurisdictions.

**ASC 740-270 (continued)****Accounting for Income Taxes Applicable to the Cumulative Effect of a Change in Accounting Principle**

**30-37** Topic 250 establishes the accounting requirements related to recording the effect of a change in accounting principle. The guidance in this Subtopic addresses issues related to the measurement of the tax effect in interim periods associated with those changes.

**30-38** The tax (or benefit) applicable to the cumulative effect of the change on retained earnings at the beginning of the fiscal year shall be computed the same as for the annual financial statements. [FIN 18, paragraph 63]

**30-39** When an entity makes an accounting change in other than the first interim period of the entity's fiscal year, paragraph 250-10-45-14 requires that financial information for the prechange interim periods of the fiscal year shall be reported by retrospectively applying the newly adopted accounting principle to those prechange interim periods. The tax (or benefit) applicable to those prechange interim periods shall be recomputed. The revised tax (or benefit) shall reflect the year-to-date amounts and annual estimates originally used for the prechange interim periods, modified only for the effect of the change in accounting principle on those year-to-date and estimated annual amounts. [FIN 18, paragraph 64]

**Subsequent Measurement**

**35-1** This guidance addresses the accounting for interim period income tax expense (or benefit) in periods subsequent to an entity's first interim period within a fiscal year. See Section 740-270-30 for a description of and requirements related to the determination of the estimated annual effective tax rate.

**35-2** The estimated annual effective tax rate is described in paragraphs 740-270-30-6 through 30-8. As indicated in paragraph 740-270-30-18, estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on evaluations of possible future events and transactions and may be subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate. [FIN 18, paragraph 8]

**35-3** As indicated in paragraph 740-270-30-6, at the end of each successive interim period the entity shall make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. As indicated in paragraph 740-270-30-8, the rate so determined shall be used in providing for income taxes on a current year-to-date basis. [APB 28, paragraph 19] The rate shall be revised, if necessary, as of the end of each successive interim period during the fiscal year to the entity's best current estimate of its annual effective tax rate. [FIN 18, paragraph 8]

**35-4** As indicated in paragraph 740-270-30-5, the estimated annual effective tax rate shall be applied to the year-to-date ordinary income (or loss) at the end of each interim period to compute the year-to-date tax (or benefit) applicable to ordinary income (or loss). The interim period tax (or benefit) related to ordinary income (or loss) shall be the difference between the amount so computed and the amounts reported for previous interim periods of the fiscal year. [FIN 18, paragraph 9]

**35-5** One result of the year-to-date computation is that, if the tax benefit of an ordinary loss that occurs in the early portions of the fiscal year is not recognized because it is more likely than not that the tax benefit will not be realized, tax is not provided for subsequent ordinary income until the unrecognized tax benefit of the earlier ordinary loss is offset (see paragraphs 740-270-25-9 through 25-11). [FIN 18, paragraph 9] As indicated in paragraph 740-270-30-31, the limitations described in paragraph 740-270-25-9 shall be applied in determining the estimated tax benefit of an ordinary loss for the fiscal year, used to determine the estimated annual effective tax rate, and the year-to-date tax benefit of a loss. [FIN 18, paragraph 14] As indicated in paragraph 740-270-30-33, if the tax benefit relates to an estimated ordinary loss for the fiscal year, it shall be considered in determining the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8. If the tax benefit relates to a year-to-date ordinary loss, it shall be considered in computing the maximum tax benefit that shall be recognized for the year to date. [FIN 18, paragraph 15]

**35-6** A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior interim period within the same fiscal year is an integral part of an annual period and, consequently, shall be reflected as such under the requirements of this Subtopic. [FIN 48, paragraph 14] This requirement differs from the requirement in paragraph 740-10-25-15 applicable to a change in judgment that results in subsequent recognition, derecognition, or a change in measurement of a tax position taken in a prior annual period, which requires that the change (including any related interest and penalties) be recognized as a discrete item in the period in which the change occurs.

#### ASC 740-270 (continued)

**35-7** See Example 1, Case C (paragraph 740-270-55-9) for an illustration of how changes in estimates impact quarterly income tax computations.

#### Related Implementation Guidance and Illustrations

- [Example 1: Accounting for Income Taxes Applicable to Ordinary Income \(or Loss\) at an Interim Date If Ordinary Income Is Anticipated for the Fiscal Year](#) [ASC 740-270-55-2].
- [Example 2: Accounting for Income Taxes Applicable to Ordinary Income \(or Loss\) at an Interim Date If an Ordinary Loss Is Anticipated for the Fiscal Year](#) [ASC 740-270-55-11].

## 9.12 Recognition of the Tax Benefit of a Loss in an Interim Period

Under ASC 740-270-25-9, the “tax effects of losses that arise in the early portion of a fiscal year shall be recognized only when the tax benefits are expected to be . . . realized” either during the current year or “as a deferred tax asset at the end of the year.” ASC 740-270-25-10 indicates that an “established seasonal pattern of loss in early interim periods offset by income in later interim periods” is generally sufficient to support a conclusion that realization of the tax benefit from the early losses is more likely than not. In addition, in accordance with ASC 740-270-30-31, limitations on the recognition of a DTA are “applied in determining the estimated tax benefit of an ordinary loss for the fiscal year.” This benefit is “used to determine the estimated annual effective tax rate and the year-to-date tax benefit of a loss.” The term “ordinary loss” in this context excludes significant unusual or infrequently occurring items that will be separately reported or reported net of their related tax effects. The tax benefit of losses incurred in early interim periods would not be recognized in those interim periods if available evidence indicates that the income is not expected in later interim periods.

If the tax benefits of losses that are incurred in early interim periods of a fiscal year are not recognized in those interim periods, an entity should not provide income tax expense on income generated in later interim periods until the tax effects of the previous losses are offset. In accordance with ASC 740-270-30-7, the “tax effect of a valuation allowance expected to be necessary for a deferred tax asset” at the end of a fiscal year for deductible temporary differences and carryforwards that originate during the current fiscal year should be spread throughout the fiscal year by an adjustment to the AETR.

## 9.13 Intraperiod Tax Allocation in Interim Periods

ASC 740-20-45-3 indicates that an entity determines the tax benefit of an operating loss carryforward recognized in a subsequent year under ASC 740 in the same way that it determines the source of the income in that year and not in the same way that it determines the source of (1) the operating loss carryforward or (2) the “expected future income that will result in realization of a deferred tax asset” for the operating loss carryforward. This method of intraperiod tax allocation for annual periods also applies to reporting the tax benefit of an operating loss carryforward in interim periods.

## 9.14 Recognizing Interest Expense for Interim-Period Reporting When Interest Is Classified as Income Tax Expense

Entities that report on interim periods must apply the provision of ASC 740-270 that requires entities to use an AETR to recognize income taxes for interim reporting periods. (For more information on estimating AETR, see [9.01](#).) ASC 740-10-45-25 indicates that interest recognized for the underpayment of income taxes can be classified in the statement of operations as either income tax or interest expense, depending on the entity's accounting policy election.

An entity that has adopted an accounting policy to include interest expense for the underpayment of income taxes as a component of income taxes in accordance with ASC 740-270 should **not** recognize interest expense through the estimated AETR for interim reporting purposes. This is because the interest expense relates to prior-year UTBs and is not based on taxes for current-year income and expense amounts. This conclusion was confirmed with the SEC staff. The SEC staff also indicated that it encourages registrants to clarify the effects of the policy decision to record interest expense as a component of income taxes by disclosing the components of income tax expense.

Disclosing the components of the tax provision is likely to be useful to financial statement users because the application of ASC 740 to the accounting for tax positions may create unexpected results in an entity's tax rate. For example, in a period in which an entity sustains a loss, tax expense would generally be zero; however, an entity that records interest expense as a component of income taxes would show tax expense. Likewise, in the period an entity sustains a loss, it may record a tax benefit for the reversal of interest expense associated with a UTB that is subsequently recognized as a result of the expiration of the statute of limitations associated with the tax position. The following is an example of a more comprehensive disclosure:

Current tax expense (benefit)	\$ XXX
Tax expense (benefit) recognized for UTBs in the income statement	XXX
Interest expense, gross of related tax effects	XXX
Interest income, gross of related tax effects	XXX
Penalties, gross of related tax effects	XXX
Deferred tax expense (benefit)	XXX
Tax benefits charged or credited to APIC	<u>XXX</u>
<b>Total tax provision</b>	\$ XXX

ASC 740 does not provide guidance on the classification (i.e., current or deferred provision) of accrued interest expense, interest income, and penalties when these amounts are recorded in the income tax provision. Accordingly, entities may make an accounting policy election to record these amounts in either the current or deferred income tax provision and should disclose the election in the financial statements, if material.

Nonpublic entities are also encouraged to provide these disclosures. Entities should also consider separately disclosing other components of the tax provision, such as those that affect goodwill or APIC.

## 9.15 Computing an Interim Tax Provision for an Entity Subject to Tax in Multiple Jurisdictions

ASC 740-270-30-36 states that for entities subject to tax in multiple jurisdictions, the “interim period tax (or benefit) related to consolidated ordinary income (or loss) for the year to date shall be computed . . . using one overall estimated [AETR].” However, ASC 740-270-30-36(a) and (b) contain the following two exceptions to this general guidance, which can lead to the exclusion of a **jurisdiction** from the AETR:

- a. If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with paragraphs 740-270-30-30 through 30-33, no tax benefit can be recognized, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated [AETR] and interim period tax (or benefit). A separate estimated [AETR] shall be computed for that jurisdiction and applied to ordinary income (or loss) in that jurisdiction in accordance with the methodology otherwise required by this Subtopic.
- b. If an entity is unable to estimate an [AETR] in a foreign jurisdiction in dollars or is otherwise unable to make a reliable estimate of its ordinary income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated [AETR] and interim period tax (or benefit). The tax (or benefit) related to ordinary income (or loss) in that jurisdiction shall be recognized in the interim period in which the ordinary income (or loss) is reported. The tax (or benefit) related to ordinary income (or loss) in a jurisdiction may not be limited to tax (or benefit) in that jurisdiction. It might also include tax (or benefit) in another jurisdiction that results from providing taxes on unremitted earnings, foreign tax credits, and so forth.

An entity must use judgment in determining whether a tax benefit can be recognized. ASC 740-270-30-30 states that “a tax benefit shall be recognized for a loss that arises early in a fiscal year if the tax benefits are expected to be either” (1) “[r]ealized during the year” or (2) “[r]ecognizable as a deferred tax asset at the end of the year in accordance with the requirements established in Subtopic 740-10.” See ASC 740-270-30-32 and Example 2, Case D, in ASC 740-270-55-21 for guidance on situations in which the “reversal of existing taxable temporary differences may be a source of evidence in determining whether a tax benefit requires limitation.”

If an entity is able to recognize any benefit (even a relatively small one) attributable to the anticipated ordinary loss in a separate jurisdiction, the entity cannot exclude ordinary income (or loss) in that jurisdiction and the related tax expense from the overall computation of the estimated AETR. When recognizing a tax benefit for **any** of the anticipated ordinary loss for the fiscal year or the ordinary loss for the year to date, an entity must include the ordinary loss in the separate jurisdiction and the related tax in the computations of the estimated AETR and interim-period tax (or benefit). When determining whether any tax benefit can be recognized for an ordinary loss in a separate jurisdiction, an entity must consider local tax laws and whether a tax benefit can be recognized for the ordinary loss (e.g., whether the entity can use the losses in a consolidated tax return, can employ income/loss sharing or group relief with other entities in the same jurisdiction, can carry back current-year losses to offset prior-year income, or can recognize a benefit in a different jurisdiction attributable to the loss jurisdiction).

The examples below illustrate the guidance in ASC 740-270-30-36(a) with respect to an entity subject to tax in multiple jurisdictions, one of which anticipates an ordinary loss for the year. In Example 9-12, no amount of tax benefit can be recognized for the forecasted loss; in Example 9-13, however, a tax benefit can be recognized for a portion of the forecasted loss.

**Example 9-12**

Assume the following:

- An entity operates through separate corporate entities in three countries: A, B, and C.
- The entity has no unusual or infrequently occurring items during the fiscal year and anticipates no tax credits or events that do not have tax consequences.
- The full year's forecasted pretax income (loss) and anticipated tax expense (benefit) for the three countries are shown below.
- The entity can reliably estimate its ordinary income (loss) and tax (in dollars) in the three countries for the fiscal year.
- An ordinary loss is anticipated for the current year in Country C. Under ASC 740-270-30-30 through 30-33, no tax benefit can be recognized for this loss. Accordingly, in accordance with ASC 740-270-30-36(a), the corporate entity in Country C is excluded from the computation of the overall AETR.

Computation of the overall estimated AETR is as follows:

	A	B	C	Total	Combined — Excluding C
Forecasted income (loss) for the year	80,000	40,000	(20,000)	100,000	120,000
Anticipated tax expense (benefit) for the year	32,000	8,000	—	40,000	40,000
AETR					33%

Quarterly tax computations are as follows:

Reporting Period	Ordinary Income (Loss)						Tax Expense (Benefit)			
				Combined	Year to Date —	Less			Reporting Period	
	A	B	C	Total	Excluding C	Year to Date	Previously Reported			
First quarter	20,000	10,000	(15,000)	15,000	30,000	30,000	33%	10,000	10,000	
Second quarter	20,000	10,000	5,000	35,000	30,000	60,000	33%	20,000	10,000	
Third quarter	20,000	10,000	(10,000)	20,000	30,000	90,000	33%	30,000	20,000	
Fourth quarter	20,000	10,000	—	30,000	30,000	120,000	33%	40,000	30,000	
Fiscal year	80,000	40,000	(20,000)	100,000	120,000				40,000	

This example is consistent with "Case B: Ordinary Loss in a Jurisdiction; Realization of the Tax Benefit Not More Likely Than Not" in ASC 740-270-55-41.

### Example 9-13

Assume the same facts as in Example 1 except that the entity will be able to recognize a small tax benefit of \$1,000 related to the ordinary loss in Country C as a result of a carryback claim. Because the entity can recognize some benefit related to the current-year loss, the income (loss) in Country C should not be removed from the computation of the overall AETR.

Computation of the overall estimated AETR is as follows:

	A	B	C	Total
Forecasted income (loss) for the year	80,000	40,000	(20,000)	100,000
Anticipated tax expense (benefit) for the year	32,000	8,000	(1,000)	39,000
AETR				39%

Quarterly tax computations are as follows:

Reporting Period	Ordinary Income (Loss)				Tax Expense (Benefit)				
	A	B	C	Total	Year to Date	AETR	Year to Date	Less Previously Reported	Reporting Period
First quarter	20,000	10,000	(15,000)	15,000	15,000	39%	5,850		5,850
Second quarter	20,000	10,000	5,000	35,000	50,000	39%	19,500	5,850	13,650
Third quarter	20,000	10,000	(10,000)	20,000	70,000	39%	27,300	19,500	7,800
Fourth quarter	20,000	10,000	—	30,000	100,000	39%	39,000	27,300	11,700
Fiscal year	80,000	40,000	(20,000)	100,000					39,000

## 9.16 Impact of Zero-Tax-Rate Jurisdictions and Nontaxable Entities on an Entity's AETR

ASC 740 does not provide explicit guidance on how to adjust a parent entity's consolidated estimated AETR (if at all) when a portion of its business is conducted by entities that either are operating in a zero-tax-rate jurisdiction or are nontaxable.

ASC 740-270-30-36 states, in part:

If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with paragraphs 740-270-30-30 through 30-33, no tax benefit can be recognized, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit).

The exception in ASC 740-270-30-36 should not be extended to exclude nontaxable entities or entities that are operating in a zero-tax-rate jurisdiction from the overall computation of the AETR. We do not believe that the exception in ASC 740-270-30-36 (discussed in [9.15](#)) is applicable in such circumstances because this paragraph contains a cross-reference to the discussion on realizability of a benefit for current-year losses in ASC 740-270-30-30 through 30-33 and does not focus on nontaxable entities or entities operating in a zero-tax-rate jurisdiction for which no benefit would inherently be recorded. Accordingly, such entities should generally be reflected in the computation of an entity's AETR regardless of whether they have a profit or loss for the year.

**Example 9-14**

Entity P is a nontaxable flow-through entity that has a wholly owned subsidiary, S, a taxable C corporation that operates in a jurisdiction in which the tax rate is 40 percent. Estimated annual pretax income for P and S is \$900 and \$100, respectively. Estimated annual consolidated pretax income and tax expense are \$1,000 and \$40, respectively, resulting in an estimated AETR of 4 percent. Year-to-date pretax income of P and S is \$370 and \$30, respectively. The year-to-date interim tax expense is \$16 (\$400 year-to-date consolidated pretax income multiplied by 4 percent).

**Example 9-15**

Entity P operates in a jurisdiction in which the tax rate is 40 percent and has a wholly owned subsidiary, S, that operates in a jurisdiction in which the tax rate is 0 percent. Estimated annual pretax income (loss) for P and S is \$1,100 and (\$100), respectively. Estimated annual consolidated pretax income and tax expense are \$1,000 and \$440, respectively, resulting in an annual estimated AETR of 44 percent. Year-to-date pretax income (loss) for P and S is \$430 and (\$30), respectively. The year-to-date interim tax expense is \$176 (\$400 year-to-date consolidated pretax income multiplied by 44 percent).

## Presentation and Disclosure Considerations

### ASC 740-270

#### **Presentation**

**45-1** Subtopic 740-20 establishes requirements to allocate total income tax expense (or benefit) of an entity for a period to different components of comprehensive income and shareholders' equity. That process is referred to as intraperiod tax allocation. This Section addresses that required allocation of income tax expense (or benefit) in interim periods.

**45-2** Section 740-20-45 describes the method of applying tax allocation within a period. The tax allocation computation shall be made using the estimated fiscal year ordinary income together with unusual items, infrequently occurring items, and discontinued operations for the year-to-date period. [FIN 18, paragraph 16]

**45-3** Discontinued operations that will be presented net of related tax effects in the financial statements for the fiscal year shall be presented net of related tax effects in interim financial statements. Unusual or infrequently occurring items that will be separately disclosed in the financial statements for the fiscal year shall be separately disclosed as a component of pretax income from continuing operations, and the tax (or benefit) related to those items shall be included in the tax (or benefit) related to continuing operations. See paragraphs 740-270-25-12 through 25-14 for interim period recognition guidance when an entity has a significant unusual or infrequently occurring loss or a loss from discontinued operations. See paragraphs 740-270-45-7 through 45-8 for the application of interim period allocation requirements to recognized income tax expense (or benefit) and discontinued operations. [FIN 18, paragraph 17] See Example 7 (paragraph 740-270-55-52) for an illustration of the income statement display of these items.

**45-4** Paragraph 740-20-45-3 requires that the manner of reporting the tax benefit of an operating loss carryforward recognized in a subsequent year generally is determined by the source of the income in that year and not by the source of the operating loss carryforward or the source of expected future income that will result in realization of a deferred tax asset for the operating loss carryforward. The tax benefit is allocated first to reduce tax expense from continuing operations to zero with any excess allocated to the other source(s) of income that provides the means of realization, for example, discontinued operations, other comprehensive income, and so forth. That requirement also pertains to reporting the tax benefit of an operating loss carryforward in interim periods. [FIN 18, paragraph 20]

## ASC 740-270 (continued)

**45-5** Paragraph 740-270-25-11 establishes the requirement that when the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision shall be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized.

### ***Specific Requirements Applicable to Discontinued Operations***

**45-6** This guidance addresses specific requirements for the intraperiod allocation of income taxes in interim periods when there are discontinued operations.

**45-7** When an entity reports discontinued operations, the computations described in paragraphs 740-270-25-12 through 25-14, 740-270-30-11 through 30-13, and 740-270-45-2 through 45-3 shall be the basis for the tax (or benefit) related to the income (or loss) from operations of the discontinued operation before the date on which the criteria in paragraph 205-20-45-1E are met. [FIN 18, paragraph 19]

**45-8** Income (or loss) from operations of the discontinued operation, prior to the interim period in which the date on which the criteria in paragraph 205-20-45-1E are met occurs, will have been included in ordinary income (or loss) of prior periods and thus will have been included in the estimated annual effective tax rate and tax (or benefit) calculations described in Sections 740-270-30 and 740-270-35 applicable to ordinary income. The total tax (or benefit) provided in the prior interim periods shall not be recomputed but shall be divided into two components, applicable to the remaining ordinary income (or loss) and to the income (or loss) from operations of the discontinued operation as follows. A revised estimated annual effective tax rate and resulting tax (or benefit) shall be computed, in accordance with Sections 740-270-30 and 740-270-35 applicable to ordinary income, for the remaining ordinary income (or loss), on the basis of the estimates applicable to such operations used in the original calculations for each prior interim period. The tax (or benefit) related to the operations of the discontinued operation shall be the total of:

- a. The difference between the tax (or benefit) originally computed for ordinary income (or loss) and the recomputed amount for the remaining ordinary income (or loss)
- b. The tax computed in accordance with paragraphs 740-270-25-12 through 25-14; 740-270-30-11 through 30-13; and 740-270-45-2 through 45-3 for any unusual or infrequently occurring items of the discontinued operation. [FIN 18, paragraph 19]

See Example 4 (paragraph 740-270-55-29) for an illustration of accounting for income taxes applicable to income (or loss) from discontinued operations at an interim date.

### **Disclosure**

#### ***Variations in Customary Income Tax Expense Relationships***

**50-1** Application of the requirements for accounting for income taxes in interim periods may result in a significant variation in the customary relationship between income tax expense and pretax accounting income. The reasons for significant variations in the customary relationship between income tax expense and pretax accounting income shall be disclosed in the interim period financial statements if they are not otherwise apparent from the financial statements or from the nature of the entity's business. [FIN 18, paragraph 25]

# Chapter 10 — Share-Based Compensation

Under U.S. tax law, stock option awards can generally be categorized into two groups: (1) statutory options (ISOs) and ESPPs that are qualified under IRC Section 423 and (2) nonstatutory options (also known as NQSOs or NSOs).

Under ASC 718-740, only awards that ordinarily result in a tax deduction for the entity granting the awards result in a temporary difference for which tax effects must be accounted for in the entity's financial statements. If the awards do not result in a tax deduction for the entity, the cumulative amount of compensation cost recorded in the financial statements would be a permanent difference and those related costs would be an item or part of an item that reconciles the entity's statutory tax rate to its effective tax rate. For public entities, disclosure of this reconciliation is required by ASC 740-10-50-12.

The exercise of an ISO or a qualified ESPP **does not** result in a tax deduction for the employer unless an employee or former employee makes a disqualifying disposition. As a result, until or unless a disqualifying disposition is made, recognition of income tax benefits is not permitted when ISOs or ESPPs have been granted. See [10.04](#) for guidance on how to account for the tax effects when a disqualifying disposition of an award occurs.

The exercise of an NQSO **does** result in a tax deduction for the grantor that is equal to the intrinsic value of the option when exercised. As a result, income tax accounting is required when compensation cost is recorded in the financial statements for NQSOs that are granted.

Under ASC 718, the "cumulative amount of compensation cost recognized for [awards] that ordinarily would result in a future tax deduction [is] considered to be a deductible temporary difference in applying [ASC 740]." Accordingly, for such awards, DTAs (and related tax benefits) are recognized as the related compensation cost is recognized. Further, under ASC 718-740-05-4, "tax deductions [for equity-classified awards] may arise in different amounts and in different periods from compensation cost recognized in financial statements." This is because, for NQSO plans, the entity usually receives a deduction for the excess of the market price of its stock over the exercise price of the award on the exercise date (i.e., the intrinsic value) rather than the grant-date fair-value-based measure of the award.

As of the exercise date (or vesting date for nonvested share awards), entities should record the tax benefit of any excess tax deduction over compensation cost recognized in net income (i.e., the excess tax benefit) as an increase (credit) to paid-in capital. This is true as long as the excess tax benefit has been realized under ASC 718. Tax benefit deficiencies (i.e., when compensation cost recognized in the income statement is greater than the tax deduction) are recorded as a decrease (debit) to paid-in capital but only to the extent that previous excess tax benefits exist (often referred to as the "APIC pool"). In the absence of an APIC pool, tax benefit deficiencies must be recorded as a current-period income tax expense in the period of the tax deduction.

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. For public business entities, the ASU is effective for annual reporting periods beginning after December 15, 2016, including interim periods within those annual reporting periods. For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual reporting periods beginning after December 15, 2018. Early adoption will be permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance. See [ASU 2016-09 FAQs](#) for frequently asked questions (FAQs) related to implementation of ASU 2016-09.

## Background and Scope

### ASC 718-740

**05-1** Topic 740 addresses the majority of tax accounting issues and differences between the financial reporting (or book) basis and tax basis of assets and liabilities (basis differences).

**05-2** This Subtopic addresses the accounting for current and deferred income taxes that results from share-based payment arrangements, including employee stock ownership plans.

**05-3** This Subtopic specifically addresses the accounting requirements that apply to the following:

- a. The determination of the basis differences which result from tax deductions arising in different amounts and in different periods from compensation cost recognized in financial statements
- b. The recognition of tax benefits when tax deductions differ from recognized compensation cost
- c. The presentation required for income tax benefits from share-based payment arrangements.

**05-4** Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under tax law, allowable tax deductions may be measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally may not be tax deductible. Therefore, tax deductions may arise in different amounts and in different periods from compensation cost recognized in financial statements. Similarly, the amount of expense reported for an employee stock ownership plan during a period may differ from the amount of the related income tax deduction prescribed by income tax rules and regulations. [FAS 123(R), paragraph 58]

### Overall Guidance

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 718-10-15, with specific transaction qualifications noted below.

### Transactions

**15-2** The guidance in this Subtopic applies to share-based payment transactions with both employees and nonemployees.

## Recognition

### ASC 718-740

#### Determination of Temporary Differences

**25-1** This guidance addresses how temporary differences are recognized for share-based payment arrangement awards that are classified either as equity or as liabilities under the requirements of paragraphs 718-10-25-7 through 25-19. Incremental guidance is also provided for issues related to employee stock ownership plans.

**ASC 718-740 (continued)*****Instruments Classified as Equity***

**25-2** The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying the requirements of Subtopic 740-10. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

**25-3** Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future event can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award. [FAS 123(R), paragraph 59]

***Instruments Classified as Liabilities***

**25-4** The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. [FAS 123(R), paragraph 60]

***Employee Stock Ownership Plans***

**25-5** Paragraph 740-20-45-11(d) notes that an employee stock ownership plan and a stock option plan are analogous. Both are compensatory arrangements and both sometimes result in tax deductions for amounts that are not presently recognized as compensation expense in the financial statements under existing generally accepted accounting principles (GAAP). The tax benefits of both are reported as a credit to shareholders' equity. [FAS 109, paragraph 144] The following guidance is therefore incremental in that it addresses elements unique to an employee stock ownership plan. See Subtopic 718-40 for the non-income-tax accounting requirements and terminology applicable to employee stock ownership plans.

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**25-5** The following guidance addresses elements unique to an employee stock ownership plan. See Subtopic 718-40 for the non-income-tax accounting requirements and terminology applicable to employee stock ownership plans.

**25-6** For employers with leveraged employee stock ownership plans, the amount of employee stock ownership plan-related expense reported under the requirements of Subtopic 718-40 for a period may differ from the amount of the employee stock ownership plan-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result in either of the following situations:

- a. The fair value of shares committed to be released differs from the cost of those shares to the employee stock ownership plan.
- b. The timing of expense recognition is different for income tax and financial reporting purposes.

Such differences shall be reported in accordance with the requirements of Subtopic 740-10. Similar differences arise from employee stock options. Paragraph 740-20-45-11(d) requires that the tax effects of expenses for employee stock options recognized differently for financial reporting and tax purposes be recognized in the related component of shareholders' equity. [SOP 93-6, paragraph 49]

## ASC 718-740 (continued)

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**25-6** For employers with leveraged employee stock ownership plans, the amount of employee stock ownership plan-related expense reported under the requirements of Subtopic 718-40 for a period may differ from the amount of the employee stock ownership plan-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result in either of the following situations:

- a. The fair value of shares committed to be released differs from the cost of those shares to the employee stock ownership plan.
- b. The timing of expense recognition is different for income tax and financial reporting purposes.

Such differences shall be reported in accordance with the requirements of Subtopic 740-10. [SOP 93-6, paragraph 49]

**25-7** Employers with nonleveraged employee stock ownership plans may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference under the requirements of Subtopic 740-10. [SOP 93-6, paragraph 52]

**25-8** See Section 718-40-55 for several illustrations of the accounting for employee stock ownership plans, including the related income tax accounting.

### Tax Benefit Recognition of Excess Deductions Limited to Realized Amounts

**25-9** Actual tax deductions for share-based payment arrangements may be greater than compensation cost recognized for book purposes. Section 718-740-30 establishes a methodology for measuring the part of an entity's actual tax deduction that results in excess tax benefits and requires that such benefits be recorded as additional paid-in capital. The requirements for recognition of excess tax benefits are different from those for recognition of the benefit from the compensation cost amount recognized for book purposes.

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**25-9 Editor's Note:** Paragraph 718-740-25-9 will be superseded upon transition, together with its heading:

### Tax Benefit Recognition of Excess Deductions Limited to Realized Amounts

Paragraph superseded by Accounting Standards Update No. 2016-09.

**25-10** A share option exercise may result in a tax deduction before the actual realization of the related tax benefit because the entity, for example, has a net operating loss carryforward. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction would not be recognized until that deduction reduces taxes payable. [FAS 123(R), paragraph A94]

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**25-10** Paragraph superseded by Accounting Standards Update No. 2016-09.

## 10.01 Tax Effects of Share-Based Compensation

Not all grants of share-based payment awards will result in the recording of DTAs. Only awards that ordinarily would result in a tax deduction for the grantor (or subsidiary) give rise to a temporary difference whose tax effects must be accounted for. Otherwise, the cumulative amount of compensation cost recorded in the financial statements is a permanent difference and those related costs would be an item or a part of an item that reconciles the grantor's statutory tax rate to its ETR, as required by ASC 740-10-50-12.

Under U.S. tax law, stock option awards can generally be categorized into two groups:

- *Statutory options (ISOs and ESPPs that are qualified under IRC Sections 422 and 423)* — The exercise of an ISO or a qualified ESPP does not result in a tax deduction for the grantor unless the employee or former employee makes a disqualifying disposition. Thus, until or unless a disqualifying disposition is made, recognition of income tax benefits is not permitted when ISOs or ESPPs have been granted. See [10.02](#) for the definition of an ISO.
- *Nonstatutory options (also known as NQSOs or NSOs)* — The exercise of an NQSO results in a tax deduction for the grantor that is equal to the intrinsic value of the option when exercised. Therefore, a DTA is recognized for the cumulative compensation cost recorded in the financial statements for NQSOs that are granted. See [10.03](#) for the definition of an NQSO.

## 10.02 Incentive Stock Options

An ISO is a stock option that is subject to the rules of IRC Sections 421, 422, and 424. In general, an option is considered an ISO if:

- The option is granted within 10 years of adoption of the plan or, if earlier, the date on which the shareholders approve the plan.
- The maximum term of the option is 10 years from the grant date. For employees that own more than 10 percent of the total combined voting power of the employer or of its parent or subsidiary corporation, the maximum term is five years.
- The option price is not less than the fair market value of the stock at the time the option is granted. For employees that own more than 10 percent of the total combined voting power of the employer or of its parent or subsidiary corporation, the option price must not be less than 110 percent of the fair market value.
- The option is transferable only in the event of death.
- The employee is employed by the employer (or its parent or subsidiary) for the entire period up to three months before the exercise date of the option.

Generally, ISOs are not taxable to the employee (or former employee) for "regular" tax purposes until the stock acquired through exercise of the ISO has been disposed of. At that time, the employee will be subject to long-term CGT for the difference between the proceeds received upon disposal and the exercise price, as long as the employee has held the stock for the required periods. If the employee holds the stock for the required periods, the employer does not receive a tax deduction related to the ISO.

To receive the favorable tax treatment, the individual acquiring the stock upon exercising the option may not dispose of the stock within two years of the grant date or within one year of the exercise date. If these requirements are violated, a disqualifying disposition occurs and the option no longer qualifies for ISO treatment. If a disqualifying disposition occurs, the lesser of the excess of the fair market value of the stock on the exercise date over the strike price or the actual gain on sale is included in the employee's income as compensation in the year of disposition. The employer receives a tax deduction for the amount of income included by the individual.

The maximum amount of ISOs that may first become exercisable in a calendar year is \$100,000. Generally, any amounts in excess of \$100,000 should be treated as NQSOs. (See **10.03** for a discussion of NQSOs.) The \$100,000 is calculated on the basis of the fair market value of the underlying shares (not the grant-date fair-value-based measure of the options) when granted, not the fair market value on the vesting date.

Under the tax law, to exercise an ISO, an individual must recognize a "tax preference" item that is equal to the difference between the exercise price and the fair market value of the underlying shares on the exercise date. This tax preference item may cause the individual to owe AMT. Generally, the AMT may be avoided by selling the ISO shares in the same calendar year in which they were purchased (a disqualifying disposition; the tax consequences are noted above).

## **10.03 Nonqualified Stock Options**

An NQSO is an option that does not qualify as an ISO under IRC Sections 421–424. The taxation of NQSOs is generally governed by IRC Section 83. The terms of an NQSO can be more flexible than those of an ISO. For example, with an NQSO:

- The option price may be less than fair value.
- The option term may extend longer than 10 years (but generally is limited to 10 years by the plan).
- The option may be granted to nonemployees.
- Shareholder approval is not required for tax purposes (but may be required for other purposes).

An employee's exercise of an NQSO results in ordinary income for the employee. The amount of ordinary income is calculated as the difference between the option exercise price and the fair market value of the underlying shares on the exercise date. The recipient of the employee's services is entitled to a tax deduction equal to the ordinary income included in income by the employee at the same time the employee recognizes the income (provided that the stock is not subject to restrictions). The employer is required to include the income on the employee's W-2 and to withhold applicable income and payroll tax.

## **10.04 Change in Tax Status of an Award**

If an entity has non-tax-deductible awards (e.g., ISOs) that are expected to be subject to disqualifying dispositions, it should follow the guidance under ASC 718-740-25-3, which explains that an entity cannot record a tax benefit in the income statement until the disqualifying disposition of an award occurs. Therefore, no DTA and related tax benefit can be recognized in connection with such an award until a disqualifying disposition occurs.

When a disqualifying disposition occurs, a deduction is available to be taken in the employer's tax return. The benefit of any tax deduction resulting from the disqualifying disposition would be recorded as a reduction of current-period tax expense in the income statement.

**Example 10-1**

A company grants a fully vested ISO with a grant-date fair-value-based measure of \$100, which is recorded in the income statement as compensation cost. Since the award is an ISO, no corresponding DTA or related tax benefit is recorded because the award does not ordinarily result in a tax deduction for the company.

Assume that a disqualifying disposition occurs and results in the company's taking a deduction of \$120 in its tax return. If the company's applicable tax rate is 40 percent, the company would record a tax benefit of \$48 as a reduction of current income tax expense in the income statement ( $\$120 \text{ deduction} \times 40\% \text{ tax rate}$ ).

**Example 10-2**

Assume the same facts as in Example 10-1 except that the disqualifying disposition results in a deduction of only \$80. If the company's applicable tax rate is 40 percent, the company would record a tax benefit of \$32 in the income statement ( $\$80 \times 40\% \text{ tax rate}$ ).

## **10.05 “Recharge Payments” Made by Foreign Subsidiaries**

Generally, a U.S. parent company is not entitled to a share-based compensation tax deduction (in the United States) for awards granted to employees of a foreign subsidiary. Likewise, in most jurisdictions, a foreign subsidiary that does not bear the cost of the compensation will not be able to deduct the award in the foreign jurisdiction. Accordingly, some arrangements may specify that a foreign subsidiary will make a “recharge payment” to the U.S. parent company that is equal to the intrinsic value of the stock option upon its exercise so that the foreign subsidiary is entitled to take a local tax deduction equal to the amount of the recharge payment. Under such an arrangement, the U.S. parent company is not taxed on the payment made by the foreign subsidiary with respect to the parent company’s stock.

At its July 21, 2005, meeting, the FASB Statement 123(R) Resource Group agreed that in this case, the direct tax effects of share-based compensation awards should be accounted for under the ASC 718 income tax accounting model. Because the U.S. parent company does not receive a deduction on its U.S. tax return for awards granted to employees of the foreign subsidiary, the foreign subsidiary’s applicable tax rate is used to measure DTAs and excess tax benefits and tax benefit deficiencies recorded by the foreign subsidiary in accordance with ASC 718. Any indirect effects of the recharge payment are not accounted for under ASC 718. For example, any benefit that the recharge payment may have on the accounting for the outside basis difference under ASC 740-30 (if earnings of the foreign subsidiary are not indefinitely reinvested) will be recognized in the income statement at the time the deduction actually occurs for income tax reporting purposes.

Example 10.2A has been deleted.

## 10.06 Impact of Research and Development Cost-Sharing Arrangements

The discussion document for the FASB Statement 123(R) Resource Group's July 23, 2005, meeting states, in part:

Related companies that plan to share the cost of developing intangible property may choose to enter into what is called a cost-sharing agreement whereby one company bears certain expenses on behalf of another company and is reimbursed for those expenses. U.S. tax regulations specify the expenses that must be included in a pool of shared costs; such expenses include costs related to stock-based compensation awards granted in tax years beginning after August 26, 2003.

The tax regulations provide two methods for determining the amount and timing of share-based compensation that is to be included in the pool of shared costs: the "exercise method" and the "grant method." Under the exercise method, the timing and amount of the allocated expense is based on the intrinsic value that the award has on the exercise date. Companies that elect to follow the grant method use grant-date fair values that are determined based on the amount of U.S. GAAP compensation costs that are to be included in a pool of shared costs. Companies must include such costs in U.S. taxable income regardless of whether the options are ultimately exercised by the holder and result in an actual U.S. tax deduction.

### ***Before Adoption of ASU 2016-09***

Companies should consider the impact of cost-sharing arrangements when measuring, on the basis of the tax election they have made or plan to make, the initial DTA and future excess amount.

The following example, reprinted from the FASB Statement 123(R) Resource Group July 23, 2005, meeting discussion document, illustrates the tax accounting for cost-sharing payments:

Company A, which is located in the United States, enters into a cost-sharing arrangement with its subsidiary, Company B, which is located in Switzerland. Under the arrangement, the two companies share costs associated with the research and development of certain technology. Company B reimburses Company A for 30 percent of the research-and-development costs incurred by Company A. The U.S. tax rate is 40 percent. Cumulative book compensation for a fully vested option is \$100 for the year ending on December 31, 2006. The award is exercised during 2007, when the intrinsic value of the option is \$150.

The tax accounting-impact is as follows:

*Exercise method:* On December 31, 2006, Company A records \$28 as the deferred tax asset related to the option ( $\$100 \text{ [book compensation expense]} \times 70\% \text{ [percentage not subject to reimbursement]} \times 40\% \text{ [tax rate]}$ ). When, in 2007, the option is exercised, any net tax benefit that exceeds the deferred tax asset is an excess tax benefit and credited to APIC. The company is entitled to a U.S. deduction [while the meeting discussion document describes this as the deduction, the calculation is actually the tax benefit] (net of the inclusion) of \$42 ( $\$150 \text{ [intrinsic value when the option is exercised]} \times 70\% \text{ [percentage not reimbursed]} \times 40\%$ ). Accordingly, \$14 (\$42 – \$28) would be recorded in APIC.

*Grant method:* The cost-sharing impact is an increase of currently payable U.S. taxes each period; however, in contrast to the exercise method, the cost-sharing method should have no direct impact on the carrying amount of the U.S. deferred tax asset related to share-based compensation. If there was \$100 of stock-based compensation during 2006, the impact on the December 31, 2006, current tax provision would be \$12 ( $\$100 \text{ [book compensation expense]} \times 30\% \text{ [percentage reimbursed]} \times 40\%$ ). If the stock-based charge under [ASC 718] is considered a deductible temporary difference, a deferred tax asset also should be recorded in 2006 for the financial statement expense, in the amount of \$40 ( $\$100 \text{ [book compensation expense]} \times 40\%$ ). The net impact on the 2006 income statement is a tax benefit of \$28 (\$40 – \$12). At settlement, the excess tax deduction of \$20 ( $\$50 \times 40\%$ ) would be recorded in APIC.

### ***After the Adoption of ASU 2016-09***

Companies should consider the impact of cost-sharing arrangements when measuring, on the basis of the tax election they have made or plan to make, the initial and subsequent deferred tax effects.

The following example, reprinted from the FASB Statement 123(R) Resource Group July 23, 2005, meeting discussion document, illustrates the tax accounting for cost-sharing payments. Importantly,

the example was developed before the adoption of ASU 2016-09, ASC 718-740-35-2, as amended by ASU 2016-09, indicates that all excess tax benefits and deficiencies should be recorded in the income statement. Nevertheless, the example remains a helpful illustration of accounting for the income tax effects of cost-sharing arrangements:

Company A, which is located in the United States, enters into a cost-sharing arrangement with its subsidiary, Company B, which is located in Switzerland. Under the arrangement, the two companies share costs associated with the research and development of certain technology. Company B reimburses Company A for 30 percent of the research-and-development costs incurred by Company A. The U.S. tax rate is 40 percent. Cumulative book compensation for a fully vested option is \$100 for the year ending on December 31, 2006. The award is exercised during 2007, when the intrinsic value of the option is \$150.

The tax accounting-impact is as follows:

*Exercise method:* On December 31, 2006, Company A records \$28 as the deferred tax asset related to the option ( $\$100 \text{ [book compensation expense]} \times 70\% \text{ [percentage not subject to reimbursement]} \times 40\% \text{ [tax rate]}$ ). When, in 2007, the option is exercised, any net tax benefit that exceeds the deferred tax asset is an excess tax benefit and credited to APIC. The company is entitled to a U.S. deduction [while the meeting discussion document describes this as the deduction, the calculation is actually the tax benefit] (net of the inclusion) of \$42 ( $\$150 \text{ [intrinsic value when the option is exercised]} \times 70\% \text{ [percentage not reimbursed]} \times 40\%$ ). Accordingly, \$14 (\$42 – \$28) would be recorded in APIC.

*Grant method:* The cost-sharing impact is an increase of currently payable U.S. taxes each period; however, in contrast to the exercise method, the cost-sharing method should have no direct impact on the carrying amount of the U.S. deferred tax asset related to share-based compensation. If there was \$100 of stock-based compensation during 2006, the impact on the December 31, 2006, current tax provision would be \$12 ( $\$100 \text{ [book compensation expense]} \times 30\% \text{ [percentage reimbursed]} \times 40\%$ ). If the stock-based charge under [ASC 718] is considered a deductible temporary difference, a deferred tax asset also should be recorded in 2006 for the financial statement expense, in the amount of \$40 ( $\$100 \text{ [book compensation expense]} \times 40\%$ ). The net impact on the 2006 income statement is a tax benefit of \$28 (\$40 – \$12). At settlement, the excess tax deduction of \$20 ( $\$50 \times 40\%$ ) would be recorded in APIC.

Under each method described above, any excess tax benefits (\$14 under the exercise method example and \$20 under the grant method example) would be recorded as a credit to tax expense rather than to APIC.

## 10.07 The Effect of UTB Liabilities on Realization of Excess Tax Benefits

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

ASC 718-740-25-10 states the following:

A **share option** exercise may result in a tax deduction before the actual realization of the related tax benefit because the entity, for example, has a net operating loss **carryforward**. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction would not be recognized until that deduction reduces taxes payable. [Emphasis added]

Therefore, if an excess tax benefit is not “realized” in accordance with ASC 718, a credit is not recorded in APIC and is not available to offset future tax benefit deficiencies. See [10.19](#) for additional guidance on applying ASC 718-740-25-10.

The recognition of a liability for UTBs does not allow an unrealized excess tax benefit associated with share-based payment awards to become realized under ASC 718-740-25-10. UTBs recorded in connection with the application of ASC 740 represent an entity’s potential future obligation to the tax authority. The tax benefit related to the excess stock compensation deduction should not be recognized before the deduction reduces taxes that are actually payable. However, upon the disallowance of all or a portion of the tax position by the tax authority, taxes payable would increase, which may allow an entity to realize all or a portion of the excess tax benefit.

### Example 10-3

At the beginning of 20X8, an entity has (1) \$1,000 of off-balance-sheet excess tax benefit that has not been realized in accordance with ASC 718-740-25-10 and (2) a \$500 liability for a tax position that did not meet the more-likely-than-not recognition criterion. During the year, the tax authority disallows the entire uncertain tax position. As a result of the disallowance of the tax position, the entity reclasses the liability to current taxes payable. As long as the entity does not have an NOL carryforward or another tax credit carryforward to offset the increased tax liability, the entity would realize \$500 of the excess tax benefit by reducing taxes payable and increasing APIC.

## 10.08 Permanent Differences Related to an Exchange of Awards

The issuance of share-based awards can sometimes create permanent book-to-tax differences. One common example is an ISO award. (See [10.02](#) for more information about ISOs.) The entity will record compensation expense as the award is earned but will not receive a tax deduction upon the holder's exercise of the award (a deduction will only result if the holder subsequently disposes of the shares in a qualifying disposition). Since a deduction does not ordinarily result from an exercise, the award is not considered to give rise to a tax deduction; thus, no DTA can be recognized and the resulting book expense is considered a permanent book-to-tax difference.

A permanent difference also may result from a business combination. To incentivize a key employee of an acquiree, an acquirer may permit or require that employee to surrender fully vested shares for nonvested shares (restricted stock award). In this situation, the employee may make an election under Section 83(b) of the IRC. The original restricted stock award resulted in a tax liability for the employee and a tax deduction for the acquiree on the vesting date. Typically, the exchange is for equal value; therefore, the employee making the Section 83(b) election would not owe any additional tax on the exchange and would then pay more favorable CGT on any appreciation when the shares are sold. Similarly, the employer would not get a tax deduction for the new award, even though it would recognize book compensation cost over the award's vesting period.

For more information about a Section 83(b) election, see [10.15](#).

The entity (the acquirer) would account for the exchange if the employee makes the Section 83(b) election and would continue to account for the grant of the new unvested stock in accordance with ASC 718. Therefore, compensation cost would be measured on the basis of the fair-value-based measure of the new restricted stock award and would be recognized over the remaining vesting period. However, if the employee made the Section 83(b) election upon receipt of the nonvested shares and the predecessor company already received a deduction upon the vesting of the original award, the acquirer would not receive a future tax deduction. Therefore, the recognition of the compensation expense for book purposes would result in a permanent difference that would affect the entity's effective tax rate.

## 10.09 Accounting for Excess Tax Benefits Included in an NOL Carryforward Acquired in a Business Combination

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

Under ASC 718-740-25-10, the tax benefit for an excess deduction that would otherwise be credited to APIC is not recognized until the tax benefit is realized (i.e., the excess deduction reduces taxes payable). This postponed recognition of APIC might occur, for example, when the excess deduction becomes part of an NOL carryforward.

The prohibition in ASC 718-740-25-10 does not apply to excess tax benefits included in NOL carryforwards that are acquired in a business combination. At its July 21, 2005, meeting, the FASB Statement 123(R) Resource Group concluded that in instances in which a business combination results in a new basis of accounting for financial reporting, the acquired company's NOL carryforwards that resulted partly from the acquired company's excess tax benefits would lose their "character" or "taint" after the acquisition and should be recorded in accordance with ASC 805.

This conclusion would not apply, however, to a transaction in which the assets acquired and liabilities assumed are recorded at historical cost, as in a combination of entities under common control or a spin-off. In such a case, the unrealized excess tax benefits do not lose their "character" or "taint" and must be recognized only when realized in accordance with ASC 718-740-25-10.

## **10.10 Accounting for Income Taxes Related to Capitalized Share-Based Payment Compensation Cost**

### ***Before the Adoption of ASU 2016-09***

Under U.S. GAAP, compensation is capitalized for employees who spend time on production of inventory or construction of fixed assets. In accordance with ASC 718-740-25-2 (for instruments classified as equity) and ASC 718-740-25-4 (for instruments classified as liabilities), the "cumulative amount of compensation cost recognized for instruments . . . that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference." ASC 718-740-25-2 and ASC 718-740-25-4 also highlight that any deductible temporary differences should be based on the recognized compensation cost and that, for financial reporting purposes, capitalized compensation cost should be considered part of the tax basis of the related asset.

Upon realizing a tax deduction for awards for which the related compensation cost was capitalized, a company should apply the same income tax accounting method it used for awards whose compensation costs were expensed when determining (1) excess tax benefits and shortfalls, (2) corresponding net income and APIC presentation, and (3) the impact of tax benefit shortfalls on the amount of previous net excess tax benefits (known as the "APIC pool").

#### **Example 10-4**

In year 1, Company A grants nonqualified stock options to the employees involved in the construction of a fixed asset, resulting in the capitalization of \$1,500 of share-based compensation cost. Other key facts include the following:

- The asset is placed into service at the beginning of year 2 and has a 10-year life.
- Awards are fully vested on the grant date.
- Company A will receive a tax deduction for the intrinsic value of the option when it is exercised.
- Company A's tax rate is 40 percent, and the company has sufficient taxable income to realize the deduction.
- Employees exercise the options with an intrinsic value of \$4,000 at the end of year 3.

On the grant date, the share-based compensation cost related to the nonqualified stock options increases the carrying amount of A's fixed asset under construction by \$1,500. The offsetting entry is a credit to APIC.

#### **Journal Entry: Grant Date in Year 1**

Fixed asset	1,500
APIC	1,500

**Example 10-4 (continued)**

In year 2, A records \$150 of depreciation expense and has a \$1,350 remaining book basis in the portion of the equipment's carrying amount related to the share-based compensation cost. In accordance with ASC 718-740-25-2, A's corresponding tax basis is presumed to be \$1,500, which is not depreciated for tax-return purposes. As a result, A recognizes a \$60 DTA:  $[(\$1,500 \text{ tax basis} - \$1,350 \text{ book basis}) \times 40\% \text{ tax rate}]$ .

**Journal Entries: Year 2**

Depreciation expense (\$1,500/10)	150
Accumulated depreciation	150
DTA	60
Deferred tax expense	60

In year 3, A first records an additional \$150 of book depreciation expense and the corresponding DTA (in a manner similar to its year-2 accounting). As a result of the employees' exercise of the options, A receives a tax deduction of \$4,000. At this point, the tax basis of the options is zero and the book basis is \$1,200; therefore, A records a \$480 DTL ( $\$1,200 \times 40\%$ ). This DTL will be reduced as book depreciation continues to be recognized.

**Journal Entries: Year 3****Record Depreciation and DTA (Same as Year 2)**

Depreciation expense	150
Accumulated depreciation	150
DTA	60
Deferred tax expense	60

**Record Exercise of Options**

When accounting for the impact of exercising the options, the company must (1) record a reduction in income taxes payable of \$1,600 resulting from the employees' exercise of the options ( $\$4,000 \times 40\%$ ), (2) record a \$600 reduction in current tax expense based on the grant-date fair value ( $\$1,500 \times 40\%$ ), and (3) increase the APIC pool by \$1,000 for excess tax benefits associated with the excess \$2,500 deduction ( $\$2,500 \times 40\%$ ). In addition, the company adjusts the DTA to eliminate the \$120 accumulated through the end of year 2.

Income taxes payable	1,600
Current tax expense	600
APIC	1,000
Deferred tax expense	600
DTA (Y2 + Y3)	120
DTL (\$600 – total DTA)	480

In years 4 through 11, A would continue to record depreciation expense. In addition, the company would reduce the DTL and record a corresponding deduction in the deferred tax expense over the same period.

**Journal Entries: Years 4 Through 11**

Depreciation expense	150
Accumulated depreciation	150
DTL	60
Deferred tax expense	60

## **After the Adoption of ASU 2016-09**

Under U.S. GAAP, compensation is capitalized for employees who spend time on production of inventory or construction of fixed assets. In accordance with ASC 718-740-25-2 (for instruments classified as equity) and ASC 718-740-25-4 (for instruments classified as liabilities), the “cumulative amount of compensation cost recognized for instruments . . . that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference.” ASC 718-740-25-2 and ASC 718-740-25-4 also highlight that any deductible temporary differences should be based on the recognized compensation cost and that, for financial reporting purposes, capitalized compensation cost should be considered part of the tax basis of the related asset.

Upon generating a tax deduction for awards for which the related compensation cost was capitalized, a company should apply the same income tax accounting method it used for awards whose compensation costs were expensed when accounting for any excess tax benefits and shortfalls.

### **Example 10-4A**

In year 1, Company A grants nonqualified stock options to the employees involved in the construction of a fixed asset, resulting in the capitalization of \$1,500 of share-based compensation cost. Other key facts include the following:

- The asset is placed into service at the beginning of year 2 and has a 10-year life.
- Awards are fully vested on the grant date.
- Company A will receive a tax deduction for the intrinsic value of the option when it is exercised.
- Company A's tax rate is 40 percent.
- Employees exercise the options with an intrinsic value of \$4,000 at the end of year 3.

On the grant date, the share-based compensation cost related to the nonqualified stock options increases the carrying amount of A's fixed asset under construction by \$1,500. The offsetting entry is a credit to APIC.

#### **Journal Entry: Grant Date in Year 1**

Fixed asset	1,500
APIC	1,500

In year 2, A records \$150 of depreciation expense and has a \$1,350 remaining book basis in the portion of the equipment's carrying amount related to the share-based compensation cost. In accordance with ASC 718-740-25-2, A's corresponding tax basis is presumed to be \$1,500, which is not depreciated for tax-return purposes. As a result, A recognizes a \$60 DTA:  $[(\$1,500 \text{ tax basis} - \$1,350 \text{ book basis}) \times 40\% \text{ tax rate}]$ .

#### **Journal Entries: Year 2**

Depreciation expense (\$1,500/10)	150
Accumulated depreciation	150
DTA	60
Deferred tax expense	60

**Example 10-4A (continued)****Journal Entries: Year 3****Record Depreciation and DTA (Same as Year 2)**

Depreciation expense	150
Accumulated depreciation	150
DTA	60
Deferred tax expense	60

When accounting for the impact of exercising the options, the company must (1) record a reduction in income taxes payable of \$1,600 resulting from the employees' exercise of the options ( $\$4,000 \times 40\%$ ), (2) record a \$1,600 reduction in current tax expense resulting from the employees' exercise of the options ( $\$4,000 \times 40\%$ ).

Income taxes payable	1,600
Current tax expense	1,600
Deferred tax expense	600
DTA (Y2 + Y3)	120
DTL (\$600 – total DTA)	480

In years 4 through 11, A would continue to record depreciation expense. In addition, the company would reduce the DTL and record a corresponding deduction in the deferred tax expense over the same period.

**Journal Entries: Years 4 Through 11**

Depreciation expense	150
Accumulated depreciation	150
DTL	60
Deferred tax expense	60

**Measurement****ASC 718-740**

**30-1** The deferred tax benefit (or expense) that results from increases (or decreases) in the recognized share-based payment temporary difference, for example, an increase that results as additional service is rendered and the related cost is recognized or a decrease that results from forfeiture of an award, shall be recognized in the income statement. [FAS 123(R), paragraph 59]

**30-2** Subtopic 740-10 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between the deductible temporary difference computed pursuant to paragraphs 718-740-25-2 through 25-3 and the tax deduction that would result based on the current fair value of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under these requirements. [FAS 123(R), paragraph 61]

**ASC 718-740 (continued)****Subsequent Measurement**

**35-1** Section 718-740-30 addresses initial measurement issues related to share-based payment temporary differences. The requirements of that Section also apply to subsequent measurements of share-based payment temporary differences. The guidance in this Section is incremental to the guidance for initial measurement.

**Treatment of Tax Consequences When Actual Deductions Differ From Recognized Compensation Cost**

**35-2** This Section addresses the accounting required when actual tax deductions for compensation expense taken by an entity on its tax return for share-based payment arrangements differ in amounts and timing from those recorded in the financial statements. This Section establishes the methodology for identifying those amounts and specifies different treatment for excess tax deductions as compared to deficiencies in tax deductions.

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**35-2** This Section addresses the accounting required in a period when actual tax deductions for compensation expense taken by an entity on its tax return for share-based payment arrangements differ in amounts and timing from those recorded in the financial statements. The tax effect of the difference, if any, between the cumulative compensation cost of an award recognized for financial reporting purposes and the deduction for an award for tax purposes shall be recognized as income tax expense or benefit in the income statement. The tax effect shall be recognized in the period in which the tax deduction arises or, in the case of an expiration of an award, in the period in which the expiration occurs. The appropriate period depends on the type of award and the incremental guidance under the requirements of Subtopic 740-270 on income taxes — interim reporting. [ASU 2016-09, paragraph 14]

**Excess Tax Benefit**

**35-3** If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments is the excess tax benefit. If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised. [FAS 123(R), paragraph 62]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**35-3 Editor's Note:** Paragraph 718-740-35-3 will be superseded upon transition, together with its heading:

**Excess Tax Benefit**

Paragraph superseded by Accounting Standards Update No. 2016-09.

**35-4** See Examples 1, Case A (paragraph 718-20-55-10); 8 (paragraph 718-20-55-71); 15, Case A (paragraph 718-20-55-123); and Example 1 (paragraph 718-30-55-1), which provide illustrations of accounting for the income tax effects of various awards.

## ASC 718-740 (continued)

### **Tax Deficiency**

**35-5** The amount deductible for an award of equity instruments on the employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the related valuation allowance, if any, shall first be offset to the extent of any remaining additional paid-in capital from excess tax benefits arising from previous awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, and measured in accordance with a fair value based method of accounting. [FAS 123(R), paragraph 63]

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**35-5 Editor's Note:** Paragraph 718-740-35-5 will be superseded upon transition, together with its heading:

### **Tax Deficiency**

Paragraph superseded by Accounting Standards Update No. 2016-09.

**35-6** An entity may have continued to use a permitted intrinsic value method to measure and recognize share-based payment awards after 1994 when the first fair value based method of accounting and disclosure for share-based payment awards was effective. Use of an intrinsic value method before the adoption of a fair value based method for recognition purposes may have resulted in amounts actually recorded as additional paid-in capital from excess tax benefits being different from amounts that would have been recorded had such awards been recognized based on their fair values.

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**35-6** Paragraph superseded by Accounting Standards Update No. 2016-09.

**35-7** An entity that continued to use the intrinsic value method for measuring and recognizing awards permitted prior to the requirements of this Subtopic shall calculate the amount available for offset as the net amount of excess tax benefits that would have qualified as such had it instead adopted the fair value based method of accounting used in the entity's fair value disclosures for its intrinsic value based awards. In determining that amount, no distinction shall be made between excess tax benefits attributable to different types of equity awards, such as restricted shares or share options. An entity shall exclude from that amount excess tax benefits from share-based payment arrangements that are outside the scope of this Subtopic, excess tax benefits from employee stock ownership plans, and excess tax benefits that have not been realized pursuant to the requirements established in paragraph 718-740-25-10. See Examples 1, Case A (paragraph 718-20-55-10); 8 (paragraph 718-20-55-7); 15, Case A (paragraph 718-20-55-123); and Example 1 (paragraph 718-30-55-1), which provide illustrations of accounting for the income tax effects of various awards. [FAS 123(R), paragraph 63]

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**35-7** Paragraph superseded by Accounting Standards Update No. 2016-09.

**35-8** An alternative method for determining the amount available for offset by entities that had continued to use the intrinsic value method for measurement and recognition of awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, was available for a limited period of time when entities were required to change to the fair value based method of accounting for share-based payment transactions.

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**35-8** Paragraph superseded by Accounting Standards Update No. 2016-09.

**ASC 718-740 (continued)**

**35-9** Paragraph 718-740-45-4 addresses the accounting for any deficiency remaining after the offset to additional paid-in capital has exhausted any available excess tax benefits.

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**35-9** Paragraph superseded by Accounting Standards Update No. 2016-09.

## 10.11 Measuring DTAs in Reference to the Current Stock Price

ASC 718-740-30-2 prohibits an entity from considering the current price of the grantor's share when assessing whether (1) a valuation allowance should be provided on a DTA related to share-based compensation cost or (2) the gross amount of the DTA should be adjusted.

### **Valuation Allowance**

When an entity is evaluating the need for a valuation allowance, it should not consider the risk that the deduction will not be realized on the basis of current stock prices. Instead, the entity should apply the guidance in ASC 740-10-30-17 through 30-23. That is, whether the entity needs to record a valuation allowance depends on whether it is more likely than not that there is sufficient taxable income to realize the DTA.

Therefore, even if the award is deep out-of-the-money such that its exercise is unlikely or the award's intrinsic value on the exercise date is most likely less than its grant-date fair value, a valuation allowance should not be recorded unless or until it is more likely than not that future taxable income will not be sufficient to realize the related DTAs.

### **Gross Deferred Tax Asset**

The gross DTA is computed on the basis of gross temporary difference (i.e., the cumulative amount of share-based compensation cost recorded in the financial statements) and is not affected by the grantor's current share price. Gross DTAs should not be remeasured or written off because the stock price has declined so significantly that an award's exercise is unlikely to occur or that the intrinsic value on the exercise date will most likely be less than the cumulative compensation cost recorded in the financial statements.

However, for share-based payment awards classified as liabilities, the measurement of the gross DTAs does implicitly take into account the grantor's current stock price, since liability awards are remeasured at the end of each reporting period. The DTA resulting from compensation cost on liability awards would change as the fair-value-based measure of the award changes.

### Example 10-5

On January 1, 20X6, an entity grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of \$7. The awards vest at the end of the third year of service (cliff vesting), have an exercise price of \$23, and expire after the fifth year from the grant date. The entity’s applicable tax rate is 40 percent. On December 31, 20Y0, the entity’s share price is \$5. The entity has generated taxable income in the past and expects to continue to do so in the future.

In each reporting period, the entity would record compensation cost on the basis of the number of awards expected to vest, the grant-date fair-value-based measure of the award, and the amount of services rendered. Contemporaneously, a DTA would be recorded on the basis of the amount of compensation cost recorded and the entity’s applicable tax rate. On December 31, 20Y0, even though the likelihood that the employee will exercise the award is remote (i.e., the award is “deep out-of-the-money”) and the DTA therefore will not be realized, the entity would not be allowed to write off any part of the gross DTA or to provide a valuation allowance against the DTA until the award expires unexercised (January 1, 20Y1) (if there is sufficient future taxable income to realize that DTA). The entity would be able to record a valuation allowance against the DTA only when it is more likely than not that the entity will not generate sufficient taxable income to realize the DTA.

## 10.12 Basic Income Tax Effects of Share-Based Payment Awards

### ***Before the Adoption of ASU 2016-09***

ASC 718-740-25-2 explains that the “cumulative amount of compensation cost recognized for [awards] that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying [ASC 740].” Accordingly, for such awards, DTAs and related tax benefits are recognized as the related compensation cost is recognized. Further, under ASC 718-740-05-4, “tax deductions [for equity-classified awards] may arise in different amounts and in different periods from compensation cost recognized in financial statements.” An award’s excess tax benefits are recorded as an increase (credit) to paid-in capital (excess benefits arise when the ultimate tax deduction is greater than recorded book expense). Tax benefit deficiencies (which occur when the book expense is greater than the ultimate tax deduction) are recorded as a decrease (debit) to paid-in capital but only to the extent that previous excess tax benefits exist (often referred to as the “APIC pool”). In the absence of an APIC pool, tax benefit deficiencies must be recorded as an expense in the income statement in the period of the tax deduction. This discussion and the following example both assume that any excess tax benefit has been “realized,” as described in ASC 718-740-25-10.

### Example 10-6

A company grants to its employees 1,000 “at-the-money” nonqualified stock options, each of which has a grant-date fair-value-based measure of \$1. The awards vest at the end of the fourth year of service (cliff vesting). The company’s applicable tax rate is 40 percent. As the \$1,000 (1,000 awards × \$1 fair-value-based measure) of compensation cost is recognized over the service period, the company records a DTA in accordance with ASC 740; this DTA is equal to the book compensation cost multiplied by the corporation’s applicable tax rate. Assume no forfeitures.

If the tax deduction<sup>1</sup> on exercise is greater than the \$1,000 of compensation cost (e.g., \$1,200), the excess benefit is credited to equity.

If the tax deduction is less than the \$1,000 of compensation cost (e.g., \$800), the accounting for the deficiency (i.e., the amount of the DTA in excess of the actual tax benefit) will depend on the existence of an APIC pool. If a sufficient APIC pool exists, the shortfall is recorded as a reduction to paid-in capital. However, if the APIC pool is insufficient, the shortfall is recorded as an increase to current-period income tax expense.

<sup>1</sup> The tax deduction is computed as the difference between the company’s share price on the date of exercise and the exercise price stated in the award, multiplied by the number of options awarded.

**Example 10-6 (continued)****Journal Entry: Upon Exercise of Options (Assuming Sufficient APIC Pool Credits)**

Current taxes payable	320
Deferred tax expense	400
APIC	80
DTA	400
Current tax expense	400

If the APIC pool is insufficient, the shortfall is recognized as a current period tax expense in the period in which the award either results in a tax deduction on the tax return or expires unexercised. ASC 718-740-30-2 precludes recognition of that shortfall in earlier periods either through an adjustment to the deductible temporary difference (remains at \$1,000 in the example) or through a valuation allowance.

***After the Adoption of ASU 2016-09***

ASC 718-740-25-2 explains that the “cumulative amount of compensation cost recognized for [awards] that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying [ASC 740].” Accordingly, for such awards, DTAs and related tax benefits are recognized as the related compensation cost is recognized. Further, under ASC 718-740-05-4, “tax deductions [for equity-classified awards] may arise in different amounts and in different periods from compensation cost recognized in financial statements.” An award’s excess tax benefits and deficiencies are recorded in the income statement.

**Example 10-6A**

A company grants to its employees 1,000 “at-the-money” nonqualified stock options, each of which has a grant-date fair-value-based measure of \$1. The awards vest at the end of the fourth year of service (cliff vesting). The company’s applicable tax rate is 40 percent. As the \$1,000 (1,000 awards × \$1 fair-value-based measure) of compensation cost is recognized over the service period, the company records a DTA in accordance with ASC 740; this DTA is equal to the book compensation cost multiplied by the corporation’s applicable tax rate. Assume no forfeitures.

Upon exercise of the options, the fair value of the company’s stock is \$80, resulting in a deduction<sup>2</sup> of \$800 for income tax purposes.

**Journal Entry: Upon Exercise of Options**

Current taxes payable	320
Deferred tax expense	400
Current tax expense	320
DTA	400

To reverse DTA and record the tax benefit deficiency to the income statement.

**10.13 Tax Effects of Awards With Graded Vesting**

As discussed in ASC 718-10-35-8, an entity makes a policy decision about whether to recognize compensation cost for its share-based payment awards with only service conditions that have a graded vesting schedule on either (1) an accelerated basis (i.e., as though each separately vesting portion of the

<sup>2</sup> See [footnote 1](#).

award was, in substance, a separate award) or (2) a straight-line basis over the total requisite service period for the entire award. See [3.65](#) for additional information. There has been confusion about whether ASC 718-20-55-34 prohibits the use of the straight-line method to recognize the tax effects of stock-based compensation cost (i.e., whether the tax effects must be recognized on an accelerated basis even if compensation cost is recognized on a straight-line basis over the total requisite service period for the entire award). Informal discussions with the FASB staff have indicated that the method of recognizing the DTA should be consistent with the method of recognizing compensation cost. That is, if an entity elects to recognize compensation cost on a straight-line basis, the recognition of the DTA should also be recognized on a straight-line basis.

## **10.14 Recognizing Income Tax Effects on an Award-by-Award Basis**

At any given time, an entity may have awards outstanding that relate to different grants that have occurred at different points in time. Thus, an entity's DTA associated with share-based compensation will be composed of DTAs related to grants of awards with different exercise prices and different grant-date fair-value-based measures.

### ***Before the Adoption of ASU 2016-09***

An entity should determine whether the exercise of an award creates an excess tax benefit or tax benefit deficiency on an award-by-award basis. That is, the DTA that is "relieved" from the balance sheet when an award is exercised should be the amount that relates to that award only. Since the accounting is on an award-by-award basis, the entity should not consider the tax consequences related to other awards that have not yet been exercised in accounting for the income tax effects of awards that are exercised. Furthermore, when a portion of an award is exercised, only the portion of the DTA that relates to the portion of the award that was exercised should be relieved from the balance sheet.

Therefore, it is important for a company to keep track of the source of the different components of its DTA balance related to each share-based payment award.

#### **Example 10-7**

Assume the following:

- In 20X6, a company grants three separate awards of "at-the-money" fully vested employee share options, which are NQSOs.
- All of the awards expire on December 31, 20Y5.
- These awards are the company's only grants.
- The company's applicable tax rate is 40 percent.

The following table contains more specific information about the three awards:

<b>Number of Options</b>	<b>Grant Date</b>	<b>Exercise Price (per Option)</b>	<b>Grant-Date Fair-Value- Based Measure (per Option)</b>	<b>Compensation Cost Recorded</b>
100	February 1, 20X6	\$ 16	\$ 2	\$ 200
100	April 1, 20X6	13	3	300
100	May 1, 20X6	10	4	400

**Example 10-7 (continued)**

On June 1, 20X6, the company's deferred tax balance related to share-based compensation is \$360 [(\$200 + \$300 + \$400) × 40% tax rate]. On June 10, 20X6, 75 of the 100 options that were granted on April 1, 20X6, were exercised and the stock price of the company was \$20 per share. The deduction the company would claim on its tax return would be \$525 [(\$20 fair value on date of exercise – \$13 exercise price) × 75 options exercised]. This will create an excess tax benefit of \$120, computed as follows:

Deduction for tax purposes	\$ 525
Grant-date fair-value-based measure (\$3 × 75 options exercised)	<u>(225)</u>
Excess deduction	300
Applicable tax rate	<u>40%</u>
Excess tax benefit	<u>\$ 120</u>

The journal entries to record the income tax effect of the exercise of the stock option on June 10, 20X6, would be as follows:

**Journal Entries: Upon Exercise of Options**

Income taxes payable	210
Current tax expense	210
To adjust income taxes payable and current tax expense for the stock option deduction (\$525 × 40%).	
Deferred tax expense	90
DTA	90
To reverse the DTA (\$225 × 40%).	
Current tax expense	120
APIC	120
To record excess tax benefit in APIC (\$210 – \$90).	

Therefore, the company's DTA balance would be \$270 (\$360 – \$90) immediately after the exercise of the option for 75 shares.

**After the Adoption of ASU 2016-09**

An entity should determine whether the exercise of an award creates an excess tax benefit or tax benefit deficiency on an award-by-award basis. That is, the DTA that is "relieved" from the balance sheet when an award is exercised should be the amount that relates to that award only. Since the accounting is on an award-by-award basis, the entity should not consider the tax consequences related to other awards that have not yet been exercised in accounting for the income tax effects of awards that are exercised. Furthermore, when a portion of an award is exercised, only the portion of the DTA that relates to the portion of the award that was exercised should be relieved from the balance sheet.

Therefore, it is important for a company to keep track of the source of the different components of its DTA balance related to each share-based payment award.

### Example 10-7A

Assume the following:

- In 20X6, a company grants three separate awards of “at-the-money” fully vested employee share options, which are nonqualified stock options.
- All of the awards expire on December 31, 20Y5.
- These awards are the company’s only grants.
- The company’s applicable tax rate is 40 percent.

The following table contains more specific information about the three awards:

<b>Number of Options</b>	<b>Grant Date</b>	<b>Exercise Price (per Option)</b>	<b>Grant-Date Fair-Value- Based Measure (per Option)</b>	<b>Compensation Cost Recorded</b>
100	February 1, 20X6	\$ 16	\$ 2	\$ 200
100	April 1, 20X6	13	3	300
100	May 1, 20X6	10	4	400

On June 1, 20X6, the company’s deferred tax balance related to stock-based compensation is \$360 [(\$200 + \$300 + \$400) × 40% tax rate]. On June 10, 20X6, 75 of the 100 options that were granted on April 1, 20X6, were exercised and the stock price of the company was \$20 per share. The deduction the company would claim on its tax return would be \$525 [(\$20 fair value on date of exercise – \$13 exercise price) × 75 options exercised]. This will create an excess tax benefit of \$120, computed as follows:

Deduction for tax purposes	\$ 525
Grant-date fair-value-based measure (\$3 × 75 options exercised)	<u>(225)</u>
Excess deduction	300
Applicable tax rate	<u>40%</u>
Excess tax benefit	<u>\$ 120</u>

The journal entries to record the income tax effect of the exercise of the stock option on June 10, 20X6, would be as follows:

#### Journal Entries: Upon Exercise of Options

Income taxes payable	210
Current tax expense	210
To adjust income taxes payable and current tax expense for stock option deduction (\$525 × 40%) and to record excess tax benefit.	
Deferred tax expense	90
DTA	90
To reverse the DTA (\$225 × 40%).	

Therefore, the company’s DTA balance would be \$270 (\$360 – \$90) immediately after the exercise of the option for 75 shares.

## 10.15 Income Tax Effects of “Early Exercise” of Restricted Stock Awards

Under Section 83(b) of the IRC, an employee who receives nonvested stock may, within 30 days after the grant, choose to “early exercise” the award. “Early exercise” refers to an employee’s election to include in ordinary income the value of the stock as of the grant date, resulting in the employee’s deemed ownership, for tax purposes, of the shares received. Therefore, any subsequent appreciation realized by the employee upon sale of those shares is taxed at capital gains rates. When an employee chooses to early exercise the award, the employer (in the year of early exercise) receives a tax deduction for the value of the stock on the grant date.

When an employee elects to early exercise an award, a DTL should be recorded for the amount of the tax benefit based on the tax deduction that the employer will receive from the award. The DTL is reversed in proportion to the amount of book compensation that is being recognized over the subsequent requisite service period.

## 10.16 Measuring the Excess Tax Benefit Associated With Share-Based Compensation: Tax Credits and Other Items That Affect the ETR

### ***Before the Adoption of ASU 2016-09***

Entities may receive tax credits or deductions for qualifying expenditures, which often include employee share-based compensation costs (e.g., the research and experimentation credit and the domestic manufacturing deduction) that lower the entity’s ETR and can affect the determination of the “excess tax benefit” or “tax benefit deficiency” that must be accounted for under ASC 718-740-35-3 through 35-9. Accordingly, the excess tax benefit or deficiency of a share-based compensation deduction may differ from the amount computed on the basis of the applicable jurisdiction’s statutory tax rate multiplied by the excess or deficiency of the tax compensation deduction over an award’s corresponding compensation costs recognized for financial reporting purposes (e.g., “direct tax effects”).

Under U.S. GAAP, there are several acceptable approaches to determining the excess tax benefits or deficiencies that must be accounted for under ASC 718-740-35-3 through 35-9. One acceptable approach is to only consider the direct tax effects of the share-based compensation deduction. Under this approach, an entity would multiply its applicable income tax rate, as described in ASC 740-10-30-8, by the amount of cumulative share-based compensation cost and the deduction reported on a tax return to determine the amount of the DTA and the actual tax benefit, respectively. The income tax rate for each award should be computed on the basis of the rates applicable in each tax jurisdiction, as appropriate.

Under this approach, the indirect effects of the deduction are not considered. The actual tax benefit is computed by multiplying the tax deduction by the applicable income tax rate in effect in the period in which the award is settled, which, in the absence of a change in enacted tax rate or tax law, would generally equal the rate used when the associated DTA was recognized (e.g., the jurisdiction’s statutory tax rate).

A second acceptable approach would be to perform a full ASC 740 “with-and-without” computation. Under this approach, the entire incremental tax effect of the actual tax deduction would be compared with the entire incremental tax effect of the cumulative amount of compensation cost recognized for book purposes as if it were the actual tax deduction. The difference would be the amount of excess tax benefit or tax benefit deficiency.

A third acceptable alternative would be to compare the entire incremental tax effect of the actual tax deduction with the DTA recognized to determine the excess tax benefit or tax benefit deficiency.

Use of one of the approaches described above to measure the excess tax benefit or tax benefit deficiency constitutes an accounting policy that should be applied consistently to all awards and related tax effects. If an entity applied a different approach before adopting Statement 123(R) (as codified in ASC 718), it may, upon and as part of this adoption, elect to use one of the above approaches.

### ***After the Adoption of ASU 2016-09***

Entities may receive tax credits or deductions for qualifying expenditures, which often include employee share-based compensation costs (e.g., the research and experimentation credit and the domestic manufacturing deduction) that lower the entity's ETR and can affect the determination of the "excess tax benefit" or "tax benefit deficiency" that must be accounted for under ASC 718-740-35-2. Accordingly, the excess tax benefit or deficiency of a share-based compensation deduction may differ from the amount computed on the basis of the applicable jurisdiction's statutory tax rate multiplied by the excess or deficiency of the tax compensation deduction over an award's corresponding compensation costs recognized for financial reporting purposes (e.g., "direct tax effects").

Under U.S. GAAP, there are several acceptable approaches to determining the excess tax benefits or deficiencies that must be accounted for under ASC 718-740-35-2. One acceptable approach is to only consider the direct tax effects of the share-based compensation deduction. Under this approach, an entity would multiply its applicable income tax rate, as described in ASC 740-10-30-8, by the amount of cumulative share-based compensation cost and the deduction reported on a tax return to determine the amount of the DTA and the actual tax benefit, respectively. The income tax rate for each award should be computed on the basis of the rates applicable in each tax jurisdiction, as appropriate.

Under this approach, the indirect effects of the deduction are not considered. The actual tax benefit is computed by multiplying the tax deduction by the applicable income tax rate in effect in the period in which the award is settled, which, in the absence of a change in enacted tax rate or tax law, would generally equal the rate used when the associated DTA was recognized (e.g., the jurisdiction's statutory tax rate).

A second acceptable approach would be to perform a full ASC 740 "with-and-without" computation. Under this approach, the entire incremental tax effect of the actual tax deduction would be compared with the entire incremental tax effect of the cumulative amount of compensation cost recognized for book purposes as if it were the actual tax deduction. The difference would be the amount of excess tax benefit or tax benefit deficiency.

A third acceptable alternative would be to compare the entire incremental tax effect of the actual tax deduction with the DTA recognized to determine the excess tax benefit or tax benefit deficiency.

Use of one of the approaches described above to measure the excess tax benefit or tax benefit deficiency constitutes an accounting policy that should be applied consistently to all awards and related tax effects.

### **10.17 Change in Tax Rates**

When enacted changes in a tax rate occur, a DTA related to temporary differences arising from tax-deductible share-based payment awards should be adjusted in the period in which the change in the applicable tax rate is enacted into law. To determine the amount of the new DTA, an entity should multiply the new tax rate by the existing temporary difference for outstanding tax-deductible share-based payment awards measured as of the enactment date of the rate change. The difference between the new DTA and the existing DTA should be recorded as a deferred tax benefit or expense and allocated to income from continuing operations.

## 10.18 Amounts Included in the Excess Tax Benefits Available for Offset (“APIC Pool”)

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

To the extent that previous net excess tax benefits exist (often referred to as the “APIC pool”), tax benefit “deficiencies” or “shortfalls” (i.e., when the book expense is greater than the ultimate tax deduction) are recorded as a decrease to paid-in capital, bypassing the income statement.

Under Statement 123(R) (as codified in ASC 718), amounts included in a company’s APIC pool are determined in accordance with paragraph 81 of Statement 123(R). Further, upon adopting this standard, a company that uses the modified prospective or modified retrospective application method should include in its APIC pool any excess tax benefits from awards that would have been accounted for under the fair-value-based method (i.e., issued, modified, repurchased, or canceled after the effective date of Statement 123), regardless of whether the company has been applying the recognition provisions of Opinion 25 or Statement 123. (Entities that have adopted Statement 123(R) prospectively should refer to [10.28](#).) In computing its APIC pool after adopting Statement 123(R) (as codified in ASC 718), a company should be careful to (1) include all excess tax benefits of Statement 123 and Statement 123(R) (as codified in ASC 718) equity awards (e.g., nonvested shares, restricted shares, and stock options), (2) exclude excess tax benefits from awards that are outside of the scope of Statement 123(R) (as codified in ASC 718) (e.g., ESOPs), and (3) exclude excess tax benefits that have not been realized in accordance with ASC 740. (See ASC 718-740-25-10 for more information.)

Since the issuance of Statement 123, companies have been reporting the income tax effects (i.e., the excess tax benefits and tax benefit deficiencies) of their share-based payment awards for either recognition or pro forma disclosure purposes. Given that the amounts included in the APIC pool are an outgrowth of the reported tax effects, an entity should have been able to obtain the amounts that make up the APIC pool by referring back to prior Statement 123 disclosure calculations, prior tax filings, or both. However, for companies that previously may have been recognizing excess tax benefits before their realization, paragraph 81 of Statement 123(R) indicates such amounts should be reduced from their APIC pool.

On November 10, 2005, the FASB issued FSP FAS 123(R)-3, which allowed a company to elect to apply a simplified method, rather than the provisions of Statement 123(R), to compute its transition APIC pool upon adopting this Statement. Paragraph 81 of Statement 123(R) stated that “an entity shall include as available for offset only the net excess tax benefits that would have qualified . . . had the entity adopted Statement 123 for recognition purposes for all awards granted, modified, or settled in cash for fiscal years beginning after December 15, 1994.”

## 10.19 Realization of Excess Tax Benefits

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

ASC 718-740-25-10 states:

A share option exercise may result in a tax deduction before the actual **realization of the related tax benefit** because the entity, for example, has a net operating loss carryforward. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction **would not be recognized until that deduction reduces taxes payable.** [Emphasis added]

Therefore, if an excess tax benefit is not “realized” in accordance with ASC 718, a credit is not recorded in APIC and is not available to offset future tax benefit deficiencies. Questions about when an excess tax benefit is realized, and about what is meant by “until that deduction reduces taxes payable,” have arisen in practice.

At its September 13, 2005, meeting, the FASB Statement 123(R) Resource Group discussed this issue and identified two broad methods that would be acceptable for determining when excess tax benefits have been realized. As an accounting policy decision, entities should select a method to use upon adopting Statement 123(R) (as codified in ASC 718) and should apply the method consistently. The two broad methods identified can be described as follows.

### **Tax-Law-Ordering Approach**

Entities may choose to determine when an excess tax benefit has been realized on the basis of the ordering provisions of the tax law. Accordingly, an excess tax benefit is considered realized when it has been used for tax purposes (i.e., generally in the year in which it reduces taxable income). When an entity cannot determine ordering in accordance with the tax law, the entity may determine realization of excess tax benefits on a pro rata basis.

### **With-and-Without Approach**

In a manner consistent with the intraperiod allocation guidance in ASC 740-20-45, entities may choose a "with-and-without" approach to determine when an excess tax benefit has been realized.

Under this approach, an excess tax benefit is realized when the excess share-based compensation deduction provides the entity with an incremental benefit by reducing the current-year taxes payable that it otherwise would have had to pay in the absence of the share-based compensation deduction. For example, when an entity has NOL carryforwards that are sufficient to offset taxable income (before the effect of share-based compensation deductions is factored in), the excess tax benefit has not yet provided the entity with an incremental benefit (since, had the share-based compensation deduction not been taken in the tax return, the entity would have had enough loss carryforwards to reduce any income tax liability to zero). Accordingly, under a with-and-without approach, share-based compensation deductions are, effectively, always considered last to be realized.

#### **Example 10-8**

An entity generates taxable income of \$100 before factoring in the effect of the excess stock option deduction of \$20. The entity also has NOL carryforwards in the amount of \$10,000 (i.e., in excess of current-year taxable income before the stock option deduction) that are available to reduce taxable income. The excess stock deduction reduces the entity's current-year taxable income to \$80. Of the entity's NOL carryforwards, \$80 is used to reduce the remaining current-year taxable income to zero.

Under a tax-law-ordering approach, the excess tax benefit associated with the \$20 excess stock deduction would be considered "realized." This is because the stock option deduction has been reported in the tax return and reduces the entity's current-year taxable income that it otherwise would have had to pay tax on. Because the excess tax benefit is considered "realized" under this approach, the excess tax benefit would be recorded as a reduction of taxes payable, with a corresponding increase to APIC, and would be available to offset future tax benefit deficiencies.

Under a with-and-without approach, the excess tax benefit would not be considered "realized." This is because the entity would not have had to pay taxes even if the stock option deduction was not taken (because it has sufficient NOL carryforwards to reduce taxable income anyway). Therefore, under this approach, the benefit associated with the excess stock option deduction would not be recorded in APIC.

## 10.20 Tax Effects of Expiration of a Vested Award

### ***Before the Adoption of ASU 2016-09***

When a fully vested nonstatutory award has expired unexercised, the tax effects are accounted for as if the tax deduction taken is zero. Thus, the DTA recorded in the financial statements would be reduced to zero through a reduction of APIC to the extent that a sufficient APIC pool exists. The excess of the DTA over the APIC pool would be recorded as tax expense in the income statement. See ASC 718-20-55-23 for more information and an illustration.

#### **Example 10-9**

A company grants 1,000 “at-the-money” fully vested nonstatutory share options, each of which has a grant-date fair-value-based measure of \$4. The company’s applicable tax rate is 40 percent. Further assume that no valuation allowance has been established for the DTA and that the awards subsequently expire unexercised. On the expiration date, the company’s APIC pool is \$1,000. The company would record the following journal entries:

#### **Journal Entries: Upon Grant**

Compensation cost	4,000
APIC	4,000
To record compensation cost upon the grant of the award.	
DTA	1,600
Income tax expense	1,600
To record the tax effects upon the grant of the award.	

#### **Journal Entries: Upon Expiration**

Income tax expense	600
APIC	1,000
DTA	1,600
To reverse the tax effects of unexercised options.	

### ***After the Adoption of ASU 2016-09***

When a fully vested nonstatutory award has expired unexercised, the tax effects are accounted for as if the tax deduction taken is zero. Thus, the DTA recorded in the financial statements would be reduced to zero through a charge to income tax expense. See ASC 718-20-55-23.

**Example 10-9A**

A company grants 1,000 “at-the-money” fully vested nonstatutory share options, each of which has a grant-date fair-value-based measure of \$4. The company’s applicable tax rate is 40 percent. Further assume that no valuation allowance has been established for the DTA and that the awards subsequently expire unexercised. The company would record the following journal entries:

**Journal Entries: Upon Grant**

Compensation cost	4,000	
APIC		4,000
To record compensation cost upon the grant of the award.		
DTA	1,600	
Income tax expense		1,600

To record the tax effects upon the grant of the award.

**Journal Entries: Upon Expiration**

Income tax expense	1,600	
DTA		1,600
To reverse the tax effects of unexercised options.		

## 10.21 Combining Employee and Nonemployee APIC Pools

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

The excess tax benefits (APIC pools) created by exercises of share-based payment awards granted to employees can be combined with APIC pools created by exercises of share-based payment awards granted to nonemployees. The APIC pools created by exercises of nonemployee awards can be used to offset tax benefit deficiencies arising from exercises of awards granted to employees and vice versa.

## 10.22 Effect of Acquisitions, Sales, Spin-Offs, and Investments in Equity Method Investees on the APIC Pool — Parent-Company Awards

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

It is acceptable to include in the APIC pool, at the consolidated-entity level, the excess tax benefits from awards granted by the parent company to employees of all companies that are included in the consolidated financial statements. Accordingly, questions have arisen about the impact of acquisitions and sales of businesses, spin-off transactions, and investments in equity method investees on the calculation of a company’s APIC pool. The following paragraphs discuss the effect of each of these transactions on the determination of the APIC pool:

### ***Business Combinations***

*Acquisition method* — When a business combination is accounted for under the acquisition method, the acquired entity becomes a new reporting entity with a zero APIC pool as of the acquisition date. The acquired entity’s excess tax benefits recognized before the acquisition are not available to offset future tax benefit shortfalls at the parent level (or the target level, if the parent’s basis is pushed down).

*Pooling-of-interests method* — Before the issuance of FASB Statement 141, an entity that used the pooling-of-interests method to account for a business combination added the APIC pool of both entities

in determining the combined entity's APIC pool. Accordingly, in determining the historical amounts to be included in a company's APIC pool upon adoption of Statement 123(R) (as codified in ASC 718), an entity should consider the impact of historical pooling transactions in assessing the amount of excess tax benefits available to offset future tax benefit shortfalls. (Note that the pooling-of-interests method still applies to combinations of businesses under common control.)

### **Sales of Subsidiaries**

When a subsidiary is sold, any existing excess tax benefit related to awards granted in the parent company's equity should continue to be included in the consolidated APIC pool.

### **Spin-Offs**

One acceptable view is that the APIC pool created before the spin-off "follows the employee." For example, assume that a subsidiary is spun off by the parent company. Excess tax benefits resulting from awards in the parent's equity, exercised by the spinnee's (i.e., subsidiary's) employees before the spin-off, may be allocated to the spinnee as of the date of the spin-off. Under this approach, excess tax benefits created by exercises made by employees who are not spinnee employees should not be allocated to the spinnee as of the date of the spin-off.

An alternative view is that excess tax benefits (APIC pool) created before the spin-off follow the entity that issued the equity awards. That is, none of the APIC pool created before the spin-off by awards that are based on parent-company (spinnor) equity awards is allocated to the spinnee. Accordingly, the spinnee's APIC pool, as of the date of the spin-off, would be zero if all awards were based on the stock of the parent.

### **Equity Method Investees**

Excess tax benefits of an equity method investee (both those created by exercises of an equity method investee's equity awards and those created by exercises of the investor's equity awards granted to employees of the equity method investee) should not be included in the consolidated APIC pool.

## **10.23 Computing the APIC Pool in Interim Financial Statements**

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

Under ASC 718-740-35-5, the write-off of a DTA, net of the related valuation allowance, is first offset to APIC to the extent that the entity has a sufficient "APIC pool." (See [10.18](#) for a discussion of the APIC pool calculation.) The remaining balance, if any, of the write-off of a DTA related to a tax deficiency is recognized in the income statement.

Tax benefit deficiencies that are recognized in the income statement (because of a lack of sufficient APIC pool credits) can only be subsequently reversed if sufficient excess benefits are generated within the same fiscal year. This issue was discussed by the FASB Statement 123(R) Resource Group at its July 21, 2005, meeting. Resource Group members agreed that an acceptable approach would be to consider the APIC pool adjustment as an annual calculation (versus a daily, weekly, or quarterly adjustment). Under this approach, a "tax benefit deficiency" (and the related charge against income) occurring in one quarter can be offset and reversed in a subsequent quarter (within the same fiscal year) if, in that subsequent quarter, a realized excess tax benefit arises that is large enough to absorb the previous deficiency.

For interim reporting purposes, if a tax benefit deficiency occurs in an interim period before the interim period in which the excess tax benefit is realized, the income tax expense recorded for the previous deficiency would be reversed as income tax benefit in the subsequent interim period in which the

excess occurred (provided that realization of such an excess deduction is also expected within the year). The entire impact of tax benefit excesses and deficiencies should be accounted for in the respective interim period in which they occur. (That is, they should be treated as discrete items.) See [10.24](#) for guidance on whether an entity should anticipate future transactions when estimating an AETR for interim reporting purposes.

#### Example 10-10

Assume that a company's APIC pool balance is zero as of January 1, 20X6, the beginning of the fiscal year and the date of adoption of Statement 123(R) (as codified in ASC 718). On January 15, 20X6, a stock option is exercised and results in a tax benefit deficiency of \$80, but on January 20, 20X6, a stock option is exercised and results in an excess tax benefit of \$100. If it is assumed that these were the only stock option exercises during the year, it would be acceptable for the company to increase its APIC pool by \$20 during that year (rather than to record income tax expense of \$80 and to increase APIC pool by \$100).

#### Example 10-11

Assume the same facts as in Example 10-10, except that the second exercise of stock options occurs on April 20, 20X6, instead of on January 20, 20X6. In the quarter ended March 31, 20X6, the company would record an income tax expense in the amount of \$80 for the tax benefit deficiency. In the quarter ended June 30, 20X6, it would be acceptable for the company to record an income tax benefit of \$80 (reversing the prior deficiency recognized in the income statement) and a \$20 increase to paid-in capital. Only the \$20 would be available to offset future deficiencies.

## 10.24 Interim Financial Statements — Anticipating the Tax Effects of Share-Based Payment Awards

### ***Before the Adoption of ASU 2016-09***

An entity should not estimate the income tax effects of anticipated share-based payment transactions (e.g., employee exercises of stock options) when calculating, for interim reporting purposes, the ETR expected to be applicable for the full fiscal year. The effects of expected future excesses and deficiencies should not be anticipated since the exercise and share prices on the exercise date are outside the entity's control. The tax effects of the expected compensation expense should be included in the AETR.

#### Example 10-12

If, in the first quarter, an exercise of stock options results in a tax benefit deficiency, but it is anticipated that in the second quarter a large excess tax benefit will result, an entity should still record an income tax expense related to the tax benefit deficiency in the first quarter. In the second quarter, if an excess tax benefit does result, then the income tax expense recorded in the first quarter resulting from the deficiency can be reversed as income tax benefit. See also [10.23](#) for a discussion of the computation of the APIC pool on an annual basis.

#### Example 10-13

If share-based payment awards are expected to expire unexercised in the second quarter because they are "deep out-of-the-money," an entity should not consider the anticipated income tax expense as a result of the write-off of the related DTAs when estimating the AETR to compute the tax provision for the first quarter. Instead, the income tax expense related to the write-off of the DTA upon expiration of an award should be recorded in the period the awards expire unexercised (if the APIC pool is insufficient to offset the deficiency). The effect of the deficiency on the income statement should be recorded in the period in which it occurs and should not be spread over future interim periods.

## **After the Adoption of ASU 2016-09**

For interim reporting purposes, ASC 740-270-30-4, ASC 740-270-30-8, and ASC 740-270-30-12 require entities to account for excess tax benefits and tax deficiencies as discrete items in the period in which they occur (i.e., entities should exclude them from the AETR). Therefore, the effects of expected future excesses and deficiencies should not be anticipated. The tax effects of the expected compensation expense should be included in the AETR.

### **Example 10-13A**

If, in the first quarter, an exercise of stock options results in a tax benefit deficiency, but it is anticipated that in the second quarter a large excess tax benefit will result, an entity should still record an income tax expense related to the tax benefit deficiency in the first quarter. In the second quarter, if an excess tax benefit does result, then the income tax expense recorded in the first quarter resulting from the deficiency can be reversed as income tax benefit.

### **Example 10-13B**

If share-based payment awards are expected to expire unexercised in the second quarter because they are "deep out of the money," an entity should not consider the anticipated income tax expense as a result of the write-off of the related DTAs when estimating the AETR to compute the tax provision for the first quarter. Instead, the income tax expense related to the write-off of the DTA upon expiration of an award should be recorded in the period the awards expire unexercised.

## **10.25 Recording Tax Benefits of Awards Granted Before the Adoption of Statement 123(R)**

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

An entity may use the modified prospective application (MPA) method to adopt Statement 123(R) (as codified in ASC 718). In such situations, the grant date and exercise date of an award may "straddle" the adoption date. That is, the grant date occurs before the adoption of Statement 123(R) (as codified in ASC 718), all or a portion of the award is vested before adoption, and the award is exercised after the adoption of Statement 123(R) (as codified in ASC 718).

Under the MPA method, awards that were granted before the adoption of Statement 123(R) (as codified in ASC 718) would have been accounted for under Opinion 25. Such accounting may not have resulted in the recognition of compensation cost in the financial statements. Accordingly, a DTA and tax benefit would not have been recognized over the vesting period before the adoption of Statement 123(R) (as codified in ASC 718) to the extent that compensation cost was not recognized under Opinion 25.

When the MPA method was used to adopt Statement 123(R) (as codified in ASC 718), the recognition of the tax benefit resulting from the exercise of options will depend on whether the award was fully or partially vested at adoption.

If the award was fully vested, the entire tax benefit should be recorded as a credit to APIC. If the award was partially vested and there is an excess tax benefit, a portion of the reduction in taxes payable is offset by the reversal of the DTA that was recorded after adoption of Statement 123(R) (as codified in ASC 718). The remainder is recorded as a credit to APIC; however, this credit does not increase the APIC pool.

If the award was partially vested at adoption and there is a tax benefit deficiency, the portion of the award that was vested before and after adoption should be analyzed separately. On the basis of the proportion of compensation cost recognized after adoption of Statement 123(R) (as codified in ASC 718) (compared with the total fair-value-based measure of the award), an entity records a portion of the tax benefit deficiency in APIC to the extent that the APIC pool is sufficient; the remainder is recorded as income tax expense in accordance with ASC 718-740-45-4. The portion of the reduction in taxes payable that is associated with compensation cost reflected in the pro forma disclosures for periods before adoption should be recorded as a credit to APIC. However, the entire tax benefit deficiency reduces the APIC pool.

For a discussion of the amounts available to offset future tax deficiencies and related examples, see [10.26](#).

## **10.26 Effect on the APIC Pool When the Full Corresponding DTA Does Not Exist Upon Exercise**

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

As described in [10.25](#), for awards granted before and exercised after the effective date of Statement 123(R) (as codified in ASC 718), the amount of the excess tax benefit credited to APIC that is available to offset future tax deficiencies depends on whether the entity has elected to use the simplified method of calculating its APIC pool described in FSP FAS 123(R)-3, and, if so, whether the award is fully vested or partially vested as of the adoption of Statement 123(R) (as codified in ASC 718).

### ***If the Simplified Method Is Not Elected***

In determining the excess tax benefits available to offset future write-offs of DTAs (APIC pool), an entity that has not elected the simplified method should use only the realized tax benefit of the excess of (1) the tax deduction over (2) the cumulative compensation cost for financial reporting purposes, including amounts reflected in the pro forma disclosures. This would be the same amount as if the company had elected to use the modified retrospective method of adoption and had restated prior periods (i.e., the APIC pool calculated as if Statement 123 had been applied since its required effective date).

Therefore, if the deduction claimed in the tax return was greater than compensation cost for financial reporting purposes, only a portion of the tax benefit recorded as a credit to APIC may offset tax benefit deficiencies that arise in the future. If the deduction claimed in the tax return was less than compensation cost for financial reporting purposes, no amounts from that exercise would be available to offset future tax benefit deficiencies; instead, the entity's APIC pool would be reduced by the deficiency.

This will result in some amounts being recorded in APIC that, although they relate to a reduction of taxes payable due to the exercise of share-based payment awards, will never be used to offset future tax benefit deficiencies.

## If the Simplified Method Is Elected

If the simplified method under FSP FAS 123(R)-3 is elected, the increase in the APIC pool depends on whether the award was fully vested or partially vested upon adoption of Statement 123(R) (as codified in ASC 718). For an award that was fully vested upon adoption, paragraph 6 of FSP FAS 123(R)-3 explains that the entire amount recorded as a credit to equity increases the APIC pool. For an award that was partially vested upon adoption, paragraph 7 of FSP FAS 123(R)-3 explains that the increase in the APIC pool is computed in the same way as if the simplified method had not been elected, as described above. That is, the tax effect of the excess of (1) the tax deduction over (2) cumulative compensation cost for financial reporting purposes, including amounts reflected in the pro forma disclosures, increases the APIC pool, and the tax effect of any deficiencies reduces the APIC pool.

### Example 10-14

#### Fully Vested Award at Adoption

On March 31, 20X5, a company grants 1,000 “at-the-money” fully vested employee share options, which are NQSOs, each of the options has a grant-date fair-value-based measure of \$4. The options are classified as equity awards. The company’s applicable tax rate is 40 percent. On March 31, 20X5, the company was still accounting for its share-based payment awards in accordance with Opinion 25 and therefore recorded no compensation cost in its financial statements.

The company uses the MPA method to adopt Statement 123(R) (as codified in ASC 718) on January 1, 20X6. On September 30, 20X6, all of the stock options are exercised. In the period of exercise, the deduction taken on the company’s tax return is \$5,000 (the intrinsic value of the award on the exercise date).

The journal entries on the exercise date to record the income tax effects of the exercise would appear as follows:

#### Journal Entries

Income taxes payable	2,000
Current tax expense	2,000
To adjust income taxes payable and current tax expense for the stock option deduction (\$5,000 × 40%).	
Current tax expense	2,000
APIC	2,000
To record entire tax benefit in APIC.	

If the simplified method was not elected, of the \$2,000 credited to APIC, only \$400 [(\$5,000 tax deduction – \$4,000 compensation cost recognized for Statement 123 pro forma disclosure purposes) × 40% tax rate] can be used to offset future tax benefit deficiencies (i.e., the company’s APIC pool is increased by only \$400).

If the simplified method was not elected and the deduction taken in the company’s tax return was, instead, only \$3,000 (i.e., an amount less than the compensation cost reflected in the pro forma disclosures), the company’s Statement 123(R) (as codified in ASC 718) APIC pool would be reduced by \$400 [(\$3,000 – \$4,000) × 40%], but only to the extent that it does not reduce the APIC pool to below zero.

If the simplified method was elected, the entire \$2,000 credited to APIC increases the company’s APIC pool. If the simplified method was elected and the tax deduction was \$3,000, the resulting \$1,200 reduction in income taxes payable credited to APIC would increase the company’s APIC pool.

**Example 10-15****Partially Vested Award With Excess Tax Benefit**

A company grants stock options to an employee on April 1, 20X5. The options have a grant-date fair-value-based measure of \$4,000, cliff-vest on March 31, 20X6, and are classified as equity awards. The company uses the MPA method to adopt Statement 123(R) (as codified in ASC 718) on January 1, 20X6. Therefore, the stock options are 75 percent vested upon adoption. Accordingly, after adoption, the company records \$1,000 of compensation cost and \$400 of deferred tax benefit in 20X6 (if a 40 percent tax rate is assumed).

The exercise of the award gives the company a tax deduction of \$5,000, resulting in a tax benefit of \$2,000. The company records the following journal entries on the exercise date to reflect the income tax effects of the exercise:

**Journal Entries**

Income taxes payable	2,000
Current tax expense	2,000
To adjust income taxes payable and current tax expense for the stock option deduction (\$5,000 × 40%).	
Deferred tax expense	400
DTA	400
To reverse the DTA.	
Current tax expense	1,600
APIC	1,600
To record excess tax benefit in APIC.	

Only \$400 (\$2,000 tax benefit less \$1,600 total DTA (sum of accrual plus pro forma DTA)) increases the company's APIC pool (regardless of whether the simplified method was elected or not since the award was partially vested at adoption).

**Example 10-16****Partially Vested Award With Tax Benefit Deficiency**

Assume the same facts as in Example 10-15, except that the tax deduction resulting from exercise of the award is \$3,000 compared with a grant-date fair-value-based measure of \$4,000 (i.e., a tax benefit of \$1,200 compared with a total deferred tax benefit of \$1,600).

The company would record the following journal entries on the exercise date to reflect the income tax effects of the exercise:

**Journal Entries**

Income taxes payable	1,200
Current tax expense	1,200
To adjust income taxes payable and current tax expense for the stock option deduction (\$3,000 × 40%).	
Deferred tax expense	400
DTA	400
To reverse the DTA.	

**Example 10-16 (continued)**

Current tax expense	900
APIC	900
To record the effect of the partially vested shares. (The total benefit of \$1,200 is reduced for the 75 percent of shares that were vested before adoption ( $\$900 = \$3,000 \times 40\% \text{ tax rate} \times 75\%$ ).)	
The shortfall is \$100, which is recorded as income tax expense ( $\$400 \text{ initial DTA} - \$300 (\$3,000 \times 25\% \times 40\% \text{ tax rate})$ ) or ( $(\$400 \text{ deferred tax expense} + \$900 \text{ current tax expense}) - \$1,200 \text{ credit to current tax expense}$ ).	

## 10.27 Valuation Allowances on Excess Tax Benefits Established Before the Adoption of Statement 123(R)

Under Opinion 25 or Statement 123, an entity may have recognized a DTA for NOL carryforwards attributed to excess tax deductions from share-based compensation. Paragraph 81 of Statement 123(R) explains that entities should discontinue such a practice prospectively; rather, they should recognize the excess tax benefit and a corresponding credit to APIC only when the tax benefit is “realized” in accordance with ASC 718-740-25-10.

At its September 13, 2005, meeting, the FASB Statement 123(R) Resource Group agreed that the accounting for reversals of the valuation allowance after adoption of Statement 123(R) (as codified in ASC 718) depends on how the valuation allowance was originally established.

If an entity established the valuation allowance in the same year in which it recognized the DTA associated with the excess tax benefit, the valuation allowance would have originally been recognized through equity (i.e., no net excess tax benefit was recognized in equity). Therefore, when the entity is required to reverse its valuation allowance under ASC 740 after adopting Statement 123(R) (as codified in ASC 718), it should not reverse the portion of the valuation allowance recorded against the DTA until the excess tax benefit is realized. Alternatively, an entity may choose to derecognize both the DTA and corresponding valuation allowance as of adoption of Statement 123(R) (as codified in ASC 718).

However, if the valuation allowance was originally established in a year after the year in which the DTA was recorded, the valuation allowance would have been recorded as income tax expense. Therefore, when the entity is required to reverse its valuation allowance under ASC 740 after adopting Statement 123(R) (as codified in ASC 718), the reversal of the valuation allowance is recorded as a reduction in income tax expense.

## 10.28 Application of the Prospective Application Method to Nonpublic Entities' APIC Pool

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

Nonpublic companies that adopted Statement 123(R) (as codified in ASC 718) prospectively should determine the amount of previous net excess tax benefits (known as the “APIC pool”) available to offset future tax benefit deficiencies as of the date of adoption in accordance with paragraph 83 of Statement 123(R). Nonpublic entities that used the minimum-value method of measuring equity share options and similar instruments for either recognition or pro forma disclosure purposes under Statement 123 must adopt Statement 123(R) (as codified in ASC 718) by using a prospective application method. Accordingly, tax benefit deficiencies are offset against excesses generated by the awards accounted for under the same accounting standard.

Therefore, only excesses generated by awards granted, modified, or repurchased after adoption of Statement 123(R) (as codified in ASC 718) are available to offset future deficiencies related to Statement 123(R) (as codified in ASC 718) awards. In other words, regarding Statement 123(R) (as codified in ASC 718) awards, such nonpublic entities begin with a zero APIC pool upon adopting Statement 123(R) (as codified in ASC 718). However, deficiencies, if any, related to awards not accounted for under Statement 123(R) (as codified in ASC 718) may still be offset by excesses created by awards accounted for under the same standard.

Further, because an entity's APIC pool calculation "starts over" upon prospective adoption, the simplified method in FSP FAS 123(R)-3 (see paragraph 9 of FSP FAS 123(R)-3) is not relevant to nonpublic entities that adopt Statement 123(R) (as codified in ASC 718) prospectively.

## **10.29 Calculating the APIC Pool When a Company Becomes Public After Adopting Statement 123**

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

Paragraph 83 of Statement 123(R) requires companies that are nonpublic entities as of the Statement 123(R) (as codified in ASC 718) adoption date, and that used the minimum-value method to value options or similar awards for either disclosure or recognition purposes under Statement 123, to adopt the provisions of Statement 123(R) (as codified in ASC 718) prospectively. Accordingly, these entities will continue to account for awards granted before adoption of Statement 123(R) (as codified in ASC 718) in accordance with their previous accounting policy (i.e., under either Opinion 25 or Statement 123). Also, companies that became public companies after adopting Statement 123, but before adopting Statement 123(R) (as codified in ASC 718), must continue to use their prior policies to account for awards granted before they became public if the minimum-value method was previously used for disclosure or recognition purposes under Statement 123.

As discussed in [10.28](#), companies that use the prospective method to adopt Statement 123(R) (as codified in ASC 718) begin with a zero APIC pool for awards accounted for under Statement 123(R) (as codified in ASC 718). However, deficiencies, if any, related to awards not accounted for under Statement 123(R) (as codified in ASC 718) may still be offset by excesses created by awards accounted for under the same standard.

However, it is acceptable for a company that is a public entity when it adopts Statement 123(R) (as codified in ASC 718), but that became a public entity after adopting Statement 123, to use a different approach, as described below.

According to paragraphs 74 and 76 of Statement 123(R), companies that are considered public entities as of the effective date of Statement 123(R) (as codified in ASC 718) should use either the modified prospective or modified retrospective application method to adopt the Statement. Such entities must apply either the long-form method described in paragraph 81 of Statement 123(R) or the shortcut method described in FSP FAS 123(R)-3 to compute their APIC pool.

Paragraph 81 of Statement 123(R) states, in part, that "an entity shall include as available for offset only the net excess tax benefits that would have qualified as such had the entity adopted Statement 123 for recognition purposes for all awards granted, modified, or settled in cash for fiscal years beginning after December 15, 1994." FSP FAS 123(R)-3 explains that entities that use the modified prospective or modified retrospective method to adopt Statement 123(R) (as codified in ASC 718) may make a one-time election to adopt the transition method described in the FSP, which requires consideration of all amounts that apply to periods after the adoption of Statement 123.

Therefore, under the long-form method for computing the APIC pool available to offset future deficiencies of Statement 123(R) (as codified in ASC 718) awards, entities may include excess tax benefits of all Statement 123 awards, including awards granted before they became public entities; excess tax benefits of awards granted while entities were nonpublic should be computed by using the “minimum value” of the awards included in their Statement 123 pro forma disclosures. Under the shortcut method, minimum-value amounts must be used to compute the Statement 123(R) (as codified in ASC 718) APIC pool.

Deficiencies of awards accounted for under Opinion 25 (e.g., those granted before the entity became public but exercised after its adoption of Statement 123(R) (as codified in ASC 718) would be recorded in equity to the extent that the entity has a sufficient Opinion 25 APIC pool. The exercise of such an award would also increase or decrease the entity's Statement 123(R) (as codified in ASC 718) APIC pool depending on how the tax deduction compares with the minimum value of that award.

These conclusions were based on discussions with the FASB staff.

#### **Example 10-17**

Company A, which has a calendar fiscal year, became a public entity on January 1, 20X5. Company A was required to adopt Statement 123(R) (as codified in ASC 718) on January 1, 20X6, and, for recognition purposes, applied the provisions of Opinion 25 before adoption. For pro forma disclosures under Statement 123, A used the “minimum value” method to value awards granted before January 1, 20X5. After that date, awards were valued at fair-value-based measure for Statement 123 pro forma disclosures.

On January 1, 20X2, A granted options to an employee to purchase 100 shares of its common stock. The exercise price of the options is equal to the market price of A's stock on the grant date. Company A computed the “minimum value” of the award to be \$1 on the grant date. The options vested on December 31, 20X3, and the employee exercised the option in November 20X4 when the market price of A's common stock exceeded the option's exercise price by \$10. Because A was applying the provisions of Opinion 25, the entire tax benefit of \$4 (a 40 percent tax rate is assumed) would be recognized in APIC (and would increase the company's Opinion 25 APIC pool by \$4). However, for Statement 123 pro forma purposes, the exercise generates an excess tax benefit of \$3.60 (i.e., the tax benefit related to the tax deduction in excess of the minimum value calculated on the grant date).

If A elects to calculate the beginning balance of its APIC pool by using the long-form method described in paragraph 81 of Statement 123(R), the excess benefit of \$3.60 computed under Statement 123 would be available to offset future deficiencies that result from exercises of awards granted after A became public (including those that are exercised after Statement 123(R) (as codified in ASC 718) has been adopted). In addition, if A elects to use the shortcut method under FSP FAS 123(R)-3 to calculate its APIC pool, the same \$3.60 (based on application of the formula provided in the FSP) will be available to offset future tax deficiencies.

In contrast, if A was instead a nonpublic entity when it adopted Statement 123(R) (as codified in ASC 718), it would have been required to follow the prospective method of adoption described in paragraph 83 of Statement 123(R). Accordingly, the company would have had a Statement 123(R) (as codified in ASC 718) APIC pool of zero as of its adoption of Statement 123(R) (as codified in ASC 718), as described in [10.28](#).

#### **Example 10-18**

Assume the same facts as in Example 10-17. However, assume that on January 1, 20X1, the company also granted to an employee fully vested NQSOs with an intrinsic value of \$10. The options were fixed awards under Opinion 25. A DTA of \$4 was recorded on the balance sheet. Further assume that these stock options had a minimum value of \$11 for Statement 123 pro forma disclosure purposes.

In fiscal year 20X6, the employee's exercise of these options results in a tax deduction of \$8, or tax benefit of \$3.20. Accordingly, this generates an “Opinion 25 deficiency,” for which \$0.80 of the corresponding DTA needs to be written off to equity if there are sufficient Opinion 25 APIC pool credits; otherwise, the deficiency would be recorded as an increase to income tax expense. This exercise would also reduce the company's APIC pool that is available to offset deficiencies of Statement 123(R) (as codified in ASC 718) awards by \$1.20  $[(\$11 - \$8) \times 40\%]$ .

## Presentation Considerations

### ASC 718-740

#### Treatment of Tax Consequences When Actual Deductions Differ From Recognized Compensation Cost

**45-1** This Section addresses the presentation required when actual tax deductions for compensation expense taken by an entity on its tax return for share-based payment arrangements differ in amounts and timing from those recorded in the financial statements.

#### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-1 Editor's Note:** Paragraph 718-740-45-1 will be superseded upon transition, together with its heading:

#### Treatment of Tax Consequences When Actual Deductions Differ From Recognized Compensation Cost

Paragraph superseded by Accounting Standards Update No. 2016-09.

#### Excess Tax Benefit

**45-2** An excess tax benefit determined pursuant to paragraph 718-740-35-3 shall be recognized as additional paid-in capital, except that an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes. [FAS 123(R), paragraph 62]

#### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-2 Editor's Note:** Paragraph 718-740-45-2 will be superseded upon transition, together with its heading:

#### Excess Tax Benefit

Paragraph superseded by Accounting Standards Update No. 2016-09.

**45-3** See paragraphs 230-10-45-14(e), 230-10-45-17(c), and 230-10-45-25(f) for requirements to treat excess tax benefits which have been recorded as additional paid-in capital as a financing activity on the statement of cash flows.

#### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-3** Paragraph superseded by Accounting Standards Update No. 2016-09.

#### Tax Deficiency

**45-4** Paragraphs 718-740-35-5 through 35-8 contain measurement guidance on how much, if any, of the write-off of a deferred tax asset from a tax deficiency shall be offset against additional paid-in capital. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement. [FAS 123(R), paragraph 63]

#### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-4 Editor's Note:** Paragraph 718-740-45-4 will be superseded upon transition, together with its heading:

#### Tax Deficiency

Paragraph superseded by Accounting Standards Update No. 2016-09.

**ASC 718-740 (continued)****Employee Stock Ownership Plans**

**45-5** If the cost of shares committed to be released in an employee stock ownership plan is greater than their fair value, and in accordance with the requirements of paragraph 740-20-45-11(d), the employer shall credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders' equity. [SOP 93-6, paragraph 50]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**45-5** The tax effect of the difference, if any, between the cost of shares committed to be released and the fair value of the shares shall be recognized as income tax expense or benefit in the income statement. [ASU 2016-09, paragraph 15]

**45-6** Conversely, if the cost of shares committed to be released is less than their fair value, the employer shall charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders' equity to the extent of previous credits to shareholders' equity related to cost exceeding fair value of the employee stock ownership plan shares committed to be released in previous periods. [SOP 93-6, paragraph 50]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**45-6** Paragraph superseded by Accounting Standards Update No. 2016-09.

**45-7** Furthermore, the tax benefit of tax-deductible dividends on allocated employee stock ownership plan shares shall be recorded as a reduction of income tax expense allocated to continuing operations. Under the requirements of paragraph 740-20-45-11(e), the tax benefit of tax-deductible dividends on unallocated employee stock ownership plan shares that are charged to retained earnings shall be credited to shareholders' equity. However, because dividends on unallocated shares would not be charged to retained earnings under the requirements of paragraph 718-40-25-16, the tax benefit of tax-deductible dividends on unallocated employee stock ownership plan shares would not be credited to shareholders' equity. [SOP 93-6, paragraph 51]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**45-7** The tax benefit of tax-deductible dividends on allocated and unallocated employee stock ownership plan shares shall be recognized in the income statement. [SOP 93-6, paragraph 51]

**Tax Benefits of Dividends on Share-Based Payment Awards to Employees**

**45-8** A realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for any of the following equity classified awards shall be recognized as an increase to additional paid-in capital:

- a. Nonvested equity shares
- b. Nonvested equity share units
- c. Outstanding equity share options.

## ASC 718-740 (continued)

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-8** An income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for any of the following equity classified awards [EITF 06-11, paragraph 4] shall be recognized as income tax expense or benefit in the income statement: [ASU 2016-09, paragraph 15]

- a. Nonvested equity shares
- b. Nonvested equity share units
- c. Outstanding equity share options. [EITF 06-11, paragraph 4]

**45-9** The amount recognized in additional paid-in capital for the realized income tax benefit from dividends on the awards identified in the preceding paragraph shall be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards (as described in Section 718-740-35 and this Section). [EITF 06-11, paragraph 4]

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-9** Paragraph superseded by Accounting Standards Update No. 2016-09.

**45-10** Dividends or dividend equivalents paid to employees for the awards identified in paragraph 718-740-45-8 may result in a tax deduction prior to the actual realization of the related tax benefit because the employer, for example, has a net operating loss carryforward. Paragraph 718-740-25-10 requires the income tax benefit of those dividends not be recognized until the deduction reduces income taxes payable. Unrealized income tax benefits from dividends on equity-classified employee share-based payment awards shall be excluded from the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards. [EITF 06-11, paragraph 5]

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-10** Paragraph superseded by Accounting Standards Update No. 2016-09.

**45-11** Paragraph 718-10-55-45 requires dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests be charged to retained earnings. If the related award is not expected to vest, that paragraph requires the dividends or dividend equivalents to be recognized as compensation costs. Dividends and dividend equivalents shall be reclassified between retained earnings and compensation cost in a subsequent period if the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates).

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-11** Paragraph superseded by Accounting Standards Update No. 2016-09.

**ASC 718-740 (continued)**

**45-12** Adjustments to additional paid-in capital for reclassifications of the tax benefits from dividends on the awards discussed in the preceding paragraph in subsequent periods increase or decrease the entity's pool of excess tax benefits available to absorb tax deficiencies by a corresponding amount. Additionally, the tax benefits from dividends that are reclassified from additional paid-in capital to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit) if an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) shall be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification. [EITF 06-11, paragraph 6]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**45-12** Paragraph superseded by Accounting Standards Update No. 2016-09.

### **10.30 Balance Sheet Classification of DTAs Related to Nonqualified Stock Options**

An NQSO is an option that does not qualify for treatment as an ISO under the provisions of IRC Sections 421 through 424. As discussed in [10.03](#), NQSOs give employers more flexibility than ISOs.

#### ***Before the Adoption of ASU 2015-17***

The classification of the DTA associated with an NQSO on the balance sheet as a current or noncurrent asset will depend on whether the share-based payment award is classified as an equity award or a liability award. In accordance with ASC 740-10-45-4, if an NQSO is considered a liability award, an entity must classify the related DTA as either current or noncurrent on the basis of the financial accounting classification of the related liability for which the temporary difference exists. For example, if the NQSO is classified as a noncurrent liability, the related DTA should also be classified as noncurrent.

There are two alternatives for classifying the DTA related to an equity award. ASC 740-10-45-9 states that if a DTA "is not related to an asset or liability for financial reporting, [the DTA] shall be classified according to the expected reversal date of the temporary difference." Therefore, a DTA related to an equity award may be classified in accordance with its expected reversal or utilization date. The expected reversal or utilization date should be consistent with the expected term used to determine the fair-value-based measure of the award.

Another acceptable alternative is to classify the DTA associated with an equity award as a noncurrent asset. The classification of noncurrent is supported by analogy to the guidance on debt in ASC 470-10-45-14, which indicates that a short-term obligation should be excluded from current liabilities if the obligation is expected to be refinanced by issuance of an equity security. Consequently, since the equity awards will not require the use of current assets, noncurrent classification of the DTA is acceptable.

#### ***After the Adoption of ASU 2015-17***

In accordance with ASC 740-10-45-4, an entity must classify the DTA as noncurrent on the balance sheet.

## 10.31 ESOP: Income Tax Accounting Example

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

ASC 718-740-45-5 and 45-6 state:

If the cost of shares committed to be released in an employee stock ownership plan is greater than their fair value, and in accordance with the requirements of paragraph 740-20-45-11(d), the employer shall credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders' equity. Conversely, if the cost of shares committed to be released is less than their fair value, the employer shall charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders' equity to the extent of previous credits to shareholders' equity related to cost exceeding fair value of the employee stock ownership plan shares committed to be released in previous periods.

Some may contend that when the fair value of the shares released in an ESOP is greater than the cost of the shares committed to be released and sufficient previous credits to shareholders' equity related to the cost of shares having exceeded their fair value do not exist, the accounting treatment described in ASC 718-740-45-5 and 45-6 unfairly penalizes the income statement by limiting the tax benefit to the effective tax rate times the actual deduction (as opposed to the effective tax rate times the amount of total compensation cost recorded for financial reporting purposes).

Consider the following example that presents the journal entries in accordance with ASC 718-40 for a leveraged ESOP (for simplicity, the journal entries for the ESOP loan are not included):

Assume the following:

- Cost of shares committed to be released — \$40
- Fair value of shares when committed to be released — \$50
- Tax rate — 40 percent

No previous amounts related to the tax effects of the release of ESOP shares have been credited to APIC. Assume that the employer receives an income tax deduction equal to the cost of the shares when they are committed to be released and that the employer records compensation expense for financial reporting purposes equal to the fair value of the shares when they are committed to be released.

### Journal Entries

Unearned ESOP shares		40
Shareholders' equity		40
[Setup ESOP shares]		
Compensation expense		50
Unearned ESOP shares		40
APIC		10
[ESOP shares committed to be released]		
Income taxes payable		16
Income tax expense		16
[Record the tax effect of the shares committed to be released]		

Some suggest that the credit to income tax expense should be \$20, which equals the effective tax rate times the entire amount of compensation cost recorded for financial reporting purposes. Under this approach, the incremental \$4 credit to income tax expense would be offset by a debit to APIC.

In the circumstances described in the example above, the sponsor must strictly adhere to the guidance in ASC 718-740-45-5 and 45-6 and not debit APIC for the tax effect of the amount by which the book expense exceeds the deductible expense.

### **10.32 Tax Benefit of ESOP Dividends**

Assume that an ESOP has a loan from Company S, its sponsor (employer loan), and holds unallocated shares of S's common stock. Company S has a loan from a third party to finance its loan to the ESOP (indirect loan).

Under ASC 718-40-25-9, S would not recognize its loan to the ESOP and related interest income in the financial statements. In addition, in accordance with 718-40-25-16, S would not record dividends on unallocated shares as dividends for financial reporting purposes (i.e., not recorded in retained earnings). However, S receives a tax deduction for dividends paid on its unallocated shares of common stock held by the ESOP.

#### ***Before the Adoption of ASU 2016-09***

The tax benefit of tax deductible dividends on unallocated shares paid to the ESOP that are not recorded in retained earnings should be recorded as a reduction of income tax expense allocated to continuing operations. ASC 718-740-45-7 states, in part:

Under the requirements of paragraph 740-20-45-11(e), the tax benefit of tax-deductible dividends on unallocated employee stock ownership plan shares that are charged to retained earnings shall be credited to shareholders' equity. However, because dividends on unallocated shares would not be charged to retained earnings under the requirements of paragraph ASC 718-40-25-16, the tax benefit of tax-deductible dividends on unallocated employee stock ownership plan shares would not be credited to shareholders' equity.

Note that this guidance does not specify how an entity should account for the tax benefit of dividends on unallocated shares, other than to clearly state that ASC 740-20-45-11(e) does not apply. Dividends paid on unallocated shares may, depending on the terms of the ESOP, be used for employee compensation or debt service. The tax benefit of dividends paid on unallocated shares, used for either employee compensation or interest expense recognized in continuing operations, should be allocated to the continuing operations tax provision.

In the absence of direct guidance to the contrary, the tax benefit of dividends on unallocated shares used to reduce debt principal should also be allocated to the continuing operations tax provision. This approach is consistent with the "liability method" concepts inherent in ASC 740, as well as the guidance in ASC 718-740-45-7 on the tax benefit of tax-deductible dividends on allocated ESOP shares.

#### ***After the Adoption of ASU 2016-09***

The tax benefit of tax deductible dividends on unallocated shares paid to the ESOP that are not recorded in retained earnings should be recorded in the income statement. ASC 718-740-45-7 states, "The tax benefit of tax-deductible dividends on allocated and unallocated employee stock ownership plan shares shall be recognized in the income statement."

## Earnings per Share Considerations

### 10.33 Inclusion of “Out-of-the-Money” Share-Based Payment Awards With a Dilutive Effect Under the Treasury Stock Method Because of Tax Benefit Deficiencies

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

When determining whether to include share-based payment awards in the computation of diluted EPS under the treasury stock method, an entity must first determine whether the award is “in-the-money.” ASC 260-10-45-25 states, in part:

Options and warrants will have a dilutive effect under the treasury stock method **only when** the average market price of the common stock during the period exceeds the exercise price of the options or warrants (they are in the money). [Emphasis added]

That is, the treasury stock method is only intended to capture awards that a holder economically would exercise on the basis of a comparison of the stated exercise price of the award with the average market price of the entity’s common stock for the reporting period. If an award is in-the-money, only then would an entity use the treasury stock method to determine the number of incremental shares to include in the denominator of the computation of diluted EPS for the reporting period. Therefore, out-of-the-money awards are not included in the treasury stock calculation regardless of whether the tax benefit deficiency causes the award to have a dilutive effect when the treasury stock method is applied.

#### Example 10-19

This example demonstrates how a hypothetical tax benefit deficiency that will be created upon the assumed exercise of a share-based payment award could cause an out-of-the-money award to have a dilutive effect on diluted EPS when the treasury stock method is applied. However, as stated above, application of the treasury stock method would not be required for this award, since the award is out-of-the-money.

Assume the following:

- On January 1, 20X1, an entity granted 1,000 employee share options.
- The entity has no other outstanding share-based payment awards.
- The options have an exercise price of \$21 and a grant-date fair-value-based measure of \$10, and cliff-vest after four years of service.
- The average market price of the entity’s common stock for the year ended December 31, 20X4, was \$20 per share.
- The entity’s applicable tax rate is 40 percent.
- The entity has \$5,000 of excess tax benefits in its APIC pool.
- For simplicity, the effect of forfeitures has been ignored.

**Example 10-19 (continued)**

The number of incremental shares that would have been included (but that are excluded because the award is out-of-the-money) in the denominator of the computation of diluted EPS (for the year ended December 31, 20X4) under the treasury stock method is calculated as follows:

Shares to be issued upon exercise of employee share options outstanding as of December 31, 20X4	1,000
Proceeds:	
Exercise price (1,000 options × \$21 per option)	\$ 21,000
Average unrecognized compensation cost:	
{[unrecognized compensation cost at beginning of year (\$2,500) + unrecognized compensation cost at end of year (\$0)] ÷ 2}	1,250
Excess tax benefit (tax benefit deficiency) {[(\$20 average market price – \$21 exercise price) – \$10 grant-date fair value] × 1,000 options × 40% tax rate}	<u>(4,400)</u>
Total hypothetical proceeds	\$ 17,850
Average market price	\$ 20
Number of shares reacquired (\$17,850 hypothetical proceeds ÷ \$20 average market price)	892.50
Incremental number of shares that would be issued but excluded from diluted EPS (1,000 shares issued upon exercise – 892.5 shares reacquired)	107.50

### 10.34 Tax Benefit Component of Assumed Proceeds

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

ASC 260-10-45-29 indicates that excess tax benefits, and sometimes tax benefit deficiencies, of share-based payment awards are included in the computation of assumed proceeds under the treasury stock method. ASC 260-10-45-29 states, in part:

The excess tax benefit is the amount resulting from a tax deduction for compensation in excess of compensation expense recognized for financial reporting purposes. . . . Paragraph 718-740-35-5 states that the amount deductible on an employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. If the deferred tax asset related to that resulting difference would be deducted from additional paid-in capital (or its equivalent) pursuant to that paragraph assuming exercise of the options, that amount shall be treated as a reduction of assumed proceeds.

Therefore, there are two aspects of the tax benefit component of assumed proceeds under the treasury stock method — hypothetical excess tax benefits and tax benefit deficiencies.

#### ***Hypothetical Excess Tax Benefits***

An entity determines the amount of hypothetical excess tax benefits for all outstanding "in-the-money" awards on the basis of the intrinsic value of the award as of the reporting date for an unvested share award, by comparing the average market price of the entity's common stock for the reporting period (i.e., the hypothetical tax deduction of the award if vesting of the award is assumed) with its grant-date fair-value-based measure. For an award whose intrinsic value is greater than its grant-date fair-value-based measure (i.e., a hypothetical excess tax benefit), the entity includes the tax effect of that difference as an additive item in the tax benefit component of assumed proceeds.

## Hypothetical Tax Benefit Deficiencies

In contrast, for an award whose intrinsic value is less than its grant-date fair-value-based measure (i.e., a hypothetical tax benefit deficiency), the entity **potentially** includes the tax effect of that difference as a subtractive item in the tax benefit component of assumed proceeds. As indicated in ASC 260-10-45-29, hypothetical tax benefit deficiencies are subtractive items in the tax benefit component of assumed proceeds **only** to the extent that they are deducted from APIC. When determining the outstanding in-the-money awards that would be deducted from APIC, assuming exercise of the awards, an entity must first determine whether its APIC pool available for recognition purposes is sufficient to offset the hypothetical tax benefit deficiencies. If the APIC pool available for recognition purposes **is sufficient** to offset the hypothetical tax benefit deficiencies, the tax effect of the hypothetical tax benefit deficiencies is included as a subtractive item in the tax benefit component of assumed proceeds.

If the APIC pool available for recognition purposes is **not sufficient** to offset the hypothetical tax benefit deficiencies, an entity must begin to construct a hypothetical APIC pool. Depending on the sufficiency of the hypothetical APIC pool, some or all of the tax effects of the hypothetical tax benefit deficiencies are included as a subtractive item in the tax benefit component of assumed proceeds. The hypothetical APIC pool is developed by combining the APIC pool available for recognition purposes with the hypothetical excess tax benefits and hypothetical tax benefit deficiencies if exercise of all in-the-money awards is assumed.

To construct the hypothetical APIC pool, an entity needs to set an accounting policy for ordering the hypothetical excess tax benefits and hypothetical tax benefit deficiencies. That is, an entity may conclude that all hypothetical excess tax benefits are (1) included first, (2) included last, or (3) scheduled on the basis of some reasonable and rational approach when the hypothetical APIC pool is calculated. In addition to scheduling, an entity must consider the same realization concepts that apply to the APIC pool for recognition purposes. (See [10.35](#) for a more detailed discussion of the realization of hypothetical excess tax benefits in the construction of an entity's hypothetical APIC pool.)

## 10.35 Realization of Excess Tax Benefits in the Calculation of the Tax Benefit Component of Assumed Proceeds

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

An entity expects that its unexercised share-based payment awards will create an excess tax benefit upon assumed exercise for EPS purposes. In the first two quarters of the fiscal year, the entity has incurred **taxable losses**, but it expects to generate **taxable income** for the last two quarters and for the fiscal year.

When determining whether an excess tax benefit that will be created upon the assumed exercise of a share-based payment award (i.e., the hypothetical excess tax benefit) is included in the tax benefit component of assumed proceeds in accordance with the treasury stock method, an entity must apply the realizability concept in ASC 718-740-25-10. (See [10.19](#) for a more detailed discussion of the realizability concept in ASC 718-740-25-10.) When assessing the realizability of the excess tax benefit, an entity must choose an accounting policy for determining whether the excess tax benefit will be realized as of each interim and annual reporting period. If the excess tax benefit is considered realized, it is included as an additive item in the tax benefit component of assumed proceeds under the treasury stock method in the computation of the entity's diluted EPS.

Neither the EPS guidance in ASC 260 nor the share-based compensation guidance in ASC 718 provides guidance on assessing the realizability of the excess tax benefit that is created upon the assumed

exercise of the award for EPS purposes. In the absence of further guidance, we believe there are at least four acceptable approaches to applying the realizability concept to the hypothetical excess tax benefits:

1. *Quarterly-period assessment* — An entity may perform an assessment each quarter (i.e., a strict reporting-period approach) to determine whether it could realize the excess tax benefits if all of its outstanding share-based payment awards were exercised at the end of the period.
2. *Annual-period assessment* — An entity may determine the realizability of the excess tax benefits on the basis of the annual reporting period. ASC 740-270-25-8 through 25-11 list provisions to help an entity assess whether the excess tax benefits are realizable.
3. *Scheduling* — An entity may schedule all of its outstanding share-based payment awards to determine whether the hypothetical excess tax benefit computed as of the current reporting period would be realized in the period in which the awards become exercisable.
4. *More likely than not* — Because ASC 260-10-45-29 is unclear regarding the tax benefit component of assumed proceeds, an entity may assess whether it is more likely than not (i.e., a likelihood of more than 50 percent) that some or all of the excess tax benefits computed in the current reporting period will ever be realized. ASC 740-10-30-18 lists provisions to help an entity assess whether the excess tax benefits are realizable.

As always, an entity's accounting policies must be applied consistently and must be disclosed if they are material to the financial statements, in accordance with the disclosure guidance in ASC 235-10-50.

### **10.36 Estimating Expected Disqualifying Dispositions in the Calculation of the Tax Benefit Component of Assumed Proceeds**

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

ISOs do not result in a tax deduction for an entity unless an employee makes a disqualifying disposition. (See [10.02](#) for a more detailed discussion of ISOs.) If an entity has determined that employees have a history of making disqualifying dispositions, the entity cannot then estimate expected disqualifying dispositions in calculating the tax benefit component of assumed proceeds under the treasury stock method.

The EPS guidance in ASC 260-10-45-29 states that assumed proceeds include:

The amount of excess tax benefits, if any, that would be credited to additional paid-in capital **assuming exercise** of the options. . . Paragraph 718-740-35-5 states that the amount deductible on an employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. If the deferred tax asset related to that resulting difference would be deducted from additional paid-in capital (or its equivalent) pursuant to that paragraph **assuming exercise** of the options, that amount shall be treated as a reduction of assumed proceeds. [Emphasis added]

Because the tax benefit component of assumed proceeds is based on an assumed exercise of the options and the tax benefit associated with a disqualified ISO does not occur upon exercise but at some later date when the employee takes an action that disqualifies the option, no amount for ISOs is included as a tax benefit component of assumed proceeds under the treasury stock method.

Further, ASC 718-740-25-3 states that an employee's disqualifying disposition of stock under existing U.S. tax law can "give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction," and that the "tax effects of such an event shall be recognized only when it occurs." Thus, although ASC 718-740-25-3 does not address the EPS implications of such a situation, it does indicate that the tax benefit associated with a disqualifying event must not be recorded until it occurs. By analogy, the expected effect of disqualifying dispositions that will occur in the future should not be

estimated when an entity calculates the tax benefit component of assumed proceeds under the treasury stock method, because such dispositions have not yet occurred.

### **10.37 Earnings-per-Share Treatment of the Tax Benefits of Dividends on Unallocated Stock**

The EPS treatment of the tax benefits of dividends on unallocated stock held by an ESOP depends on whether the ESOP is accounted for under SOP 76-3 (grandfathered shares) or SOP 93-6 (codified in ASC 718-40).<sup>3</sup>

Issue 92-3 specified how an entity should account for the tax benefits of dividends on unallocated stock held by an ESOP that is applying the guidance in SOP 76-3. The EITF reached a consensus that tax benefits related to dividends paid on unallocated common stock held by an ESOP that are charged to retained earnings should not be an adjustment to net income in the computation of EPS.

Under ASC 718-40-25-16, dividends paid on unallocated ESOP shares are not treated as dividends for accounting purposes and therefore do not affect the if-converted EPS computations. Furthermore, ASC 718-740-45-7 requires that an entity record the related tax benefits as a reduction of income tax expense allocated to continuing operations.

### **Statement of Cash Flows**

#### **10.38 Presentation in the Statement of Cash Flows of the Income Tax Effects of Share-Based Payment Awards**

ASC 230-10-45-14(e) currently states that entities must present, in the statement of cash flows, the impact of the tax benefit of any realized excess tax deduction. This “excess tax benefit” is separate and apart from taxes paid and is reported as a component of cash inflows from financing activities. The excess tax benefit should be determined on a gross basis (i.e., as the sum of excess tax benefits on an award-by-award basis only, not netted with tax deficiencies). Actual taxes paid (an operating cash outflow) are increased by the same amount, resulting in an operating cash flows total that shows taxes that an entity would have paid had it not been for the excess tax benefit.



#### **Connecting the Dots**

In March 2016, the FASB issued ASU 2016-09 on share-based payments as part of its simplification initiative (i.e., the Board’s effort to reduce the cost and complexity of current U.S. GAAP while maintaining or enhancing the usefulness of the related financial statement information). Under ASU 2016-09, excess tax benefits would no longer represent financing activities since they would be recognized in the income statement; therefore, excess tax benefits would not be separate cash flows and would be classified in the same manner as other cash flows related to income taxes. Accordingly, ASU 2016-09 eliminates the requirement to reclassify excess tax benefits from operating activities to financing activities.

For public business entities, the new guidance in ASU 2016-09 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. The guidance related to the recognition of excess tax benefits in the statement of cash flows can be applied either prospectively or retrospectively. Early adoption is permitted.

<sup>3</sup> In November 1993, the AICPA issued SOP 93-6, which supersedes SOP 76-3 and nullifies Issue 92-3, except that employers may continue this accounting for shares acquired before January 1, 1993. Because this literature has been superseded, it is not included in the Codification. However, the accounting for grandfathered shares acquired before January 1, 1993, is still applicable.

**Example 10-20****Before the Adoption of ASU 2016-09**

On January 1, 20X1, Entity A grants 1,000 “at-the-money” nonqualified employee share options, each with a grant-date fair-value-based measure of \$10 and an exercise price of \$30. Assume that A’s applicable tax rate is 40 percent. As a result, A will record a \$4,000 tax benefit ( $[1,000 \text{ options} \times \$10 \text{ grant-date fair-value-based measure}] \times 40 \text{ percent tax rate}$ ) and a related deferred tax asset, for financial reporting purposes, over the requisite service period of the options.

On December 31, 20X4, the employee exercises all 1,000 options. On the date of exercise, A’s common stock has a fair value of \$42 per share. Under current U.S. income tax law, A will receive an income tax deduction on the basis of the difference between the fair value of the stock on the exercise date and the amount the employee pays to exercise the options ( $\$12,000 = [\$.42 \text{ fair value of A's common stock} - \$30 \text{ exercise price}] \times 1,000 \text{ options}$ ). As a result of the increase in A’s share price, A realizes a tax benefit of \$4,800 ( $\$12,000 \text{ income tax deduction} \times 40 \text{ percent tax rate}$ ) for income tax purposes. The \$4,800 tax benefit exceeds the tax benefit recognized for financial reporting purposes by \$800 (which is recorded directly to equity) and represents the excess tax benefit.

Further assume that in the year of exercise, A has taxable income of \$21,000 (before the impact of the \$12,000 stock compensation deduction is taken into account) or \$9,000 of taxable income after the stock compensation deduction. Entity A pays tax of \$3,600 ( $\$9,000 \text{ taxable income} \times 40 \text{ percent tax rate}$ ). Under ASC 230, the \$3,600 of taxes paid is reflected as an operating cash outflow. However, in the absence of the excess tax benefit, A would have paid an additional \$800 of taxes ( $[\$12,000 \text{ income tax deduction} - \$10,000 \text{ compensation cost}] \times 40 \text{ percent tax rate}$ ). The amount of taxes A would have paid in the absence of an excess tax benefit (\$800) should be shown as an additional cash outflow from operations and a corresponding cash inflow from financing activities.

**Example 10-20A****After the Adoption of ASU 2016-09**

Assume the same facts as in Example 10-20. Under ASU 2016-09, the \$800 excess tax benefit would no longer represent a financing activity since it would be recognized in the income statement. Therefore, the excess tax benefit no longer would be reported as a separate cash flow and would be classified as an operating activity in the same manner as other cash flows related to income taxes. Thus, the reclassification of the \$800 from operating activities to financing activities required under current GAAP (which grossed up cash outflows from operating activities and cash inflows from financing activities) is no longer required.

### **10.39 Tax Benefit Deficiencies of Share-Based Payment Awards**

Before the adoption of ASU 2016-09, the amount presented as financing cash inflows related to excess tax benefits should be determined on a gross basis (i.e., the sum of excess tax benefits on an award-by-award basis only). Tax benefit deficiencies realized in the same period do not reduce the amount of cash inflows from financing activities in the statement of cash flows for that period. Paragraph B228 of the Basis for Conclusions of Statement 123(R) states:

The Board considered whether the cash flow statement should report an increase in operating cash flows and a decrease in financing cash flows in a reporting period in which there is a charge to paid-in capital as a result of the write-off of a deferred tax asset related to an award that did not result in deductible compensation cost. The Board decided not to require that presentation because it believes that the operating and financing sections of the cash flow statement should reflect **only the effects of awards that generated tax savings from excess tax benefits**. [Emphasis added]

Therefore, for the same period, the amount presented as a financing cash inflow and an operating cash outflow for realized excess tax benefits will differ from the increase in APIC as a result of the realization of excess tax benefits because the increase in APIC is recorded net of tax benefit deficiencies realized in the period.

### Example 10-21

Assume that, in the same period, 100 stock options are exercised that result in the realization of a \$100 excess tax benefit and another 100 stock options are exercised that result in the realization of a \$20 tax benefit deficiency. In the statement of cash flows, the financing cash inflow and the operating cash outflow related to excess tax benefits would be \$100. However, the increase in APIC for the same period would be \$80.

## ASU 2016-09 FAQs

As noted in the introduction to this chapter, on March 30, 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. Since its issuance, a number of questions have arisen about the ASU's implementation. The questions and answers below discuss many income-tax-related aspects of the new guidance that may be of interest to stakeholders.

For more information about ASU 2016-09, see Deloitte's [April 21, 2016](#), and [June 20, 2016](#), *Heads Up* newsletters.

**1. If an entity has historical excess tax benefits that were not previously recognized because the related tax deduction had not reduced current taxes payable ("previously unrecognized excess tax benefits"), what amount is recorded upon adoption of ASU 2016-09? Is the amount recorded through retained earnings or APIC?**

ASU 2016-09 states that previously unrecognized excess tax benefits should be recognized on a modified retrospective basis. Entities should therefore record a DTA for previously unrecognized excess tax benefits outstanding as of the beginning of the annual period of adoption, with an offsetting adjustment to retained earnings.

**2. Does an entity have to reclassify its prior-year APIC pool from APIC to retained earnings upon adoption of ASU 2016-09?**

No. An entity's prior-year APIC pool is not affected because those excess benefits have already been recognized in the financial statements, and the recognition of excess tax benefits and tax deficiencies in the income statement is prospective only in the fiscal year of adoption. As a result, there is no reclassification between APIC and retained earnings in the fiscal years before adoption. The modified retrospective transition guidance only applies to previously *unrecognized* excess tax benefits outstanding upon adoption of ASU 2016-09 with a cumulative-effect adjustment to retained earnings.

**3. Does ASU 2016-09 affect how entities evaluate whether a valuation allowance is necessary?**

No. ASU 2016-09 does not change the general guidance on how entities evaluate whether a valuation allowance is required (i.e., an entity must still evaluate all available positive and negative evidence). Entities will, however, need to consider the impact, if any, that the balance sheet recognition of previously unrecognized excess tax benefits and anticipated excess tax benefits may have on their ability to realize a benefit for their overall portfolio of DTAs.

**4. Does an entity need to consider a valuation allowance in transition when setting up a DTA for previously unrecognized excess tax benefits?**

Yes. DTAs recognized as a result of the transition guidance in ASU 2016-09 should be assessed for realizability in accordance with ASC 740. A valuation allowance for DTAs recorded as a result of this transition guidance is recognized through a cumulative-effect adjustment to retained earnings.

**5. If an entity adopts ASU 2016-09 in an interim period other than its first fiscal quarter and records or releases a valuation allowance in an interim period before adoption, how does the adoption affect the entity's valuation allowance analysis?**

While the adoption of ASU 2016-09 does not directly affect an entity's valuation allowance assessment, the entity will need to assess any DTA recognized upon adoption related to previously unrecognized excess tax benefits for realizability as of the beginning of the fiscal year. To the extent that an entity adopts ASU 2016-09 in an interim period other than its first fiscal quarter, the entity will also need to update its valuation allowance assessment in each of the interim periods since the effective date of the adoption (since the effective date of adoption is the beginning of the fiscal year). Accordingly, the amount of the valuation allowance recorded or released in the current year interim periods before adoption could change.

**6. Does the ASU change the requirement to recognize a DTA for a future tax deduction that is equal to the cumulative amount of compensation cost recognized in the financial statements for equity-classified awards?**

No. A DTA must still be recognized for the cumulative amount of compensation cost recognized in the financial statements to the extent that such compensation is related to instruments classified as equity that ordinarily would result in a future tax deduction.

**7. If an entity recognizes a tax deficiency for share-based payment awards after adoption of ASU 2016-09, will it have to record the corresponding charge to the income statement?**

Yes. Upon adopting ASU 2016-09, entities will be required to recognize the income tax effects of share-based payment awards in the income statement when the awards vest or are settled (i.e., APIC pools will be eliminated). The shortfall will be recognized as a current-period tax expense in the income statement in the period in which the award either results in a tax deduction on the tax return or expires unexercised. See ASC 718-740-35-2.

**8. Should an entity forecast excess tax benefits (or tax deficiencies) for share-based payment awards (e.g., options or restricted stock) in its ASC 740-270 AETR?**

No. For interim reporting purposes, ASC 740-270-30-4 requires entities to account for excess tax benefits and tax deficiencies as discrete items in the period in which they occur (i.e., entities should exclude them from the AETR).

**9. How does an entity determine the amount of the discrete item related to excess tax benefits or tax deficiencies?**

Historically, for intraperiod allocation considerations, the following three approaches have been generally accepted for the calculation of the tax effects of excess tax benefits and tax deficiencies:

- *Direct effect* — Difference between (1) the actual tax deduction multiplied by the applicable tax rate (i.e., excludes indirect effects) and (2) the DTA recognized.
- *Full ASC 740 “with-and-without”* — Difference between (1) the entire incremental tax effect (i.e., includes indirect effects) of the actual tax deduction and (2) the entire incremental tax effect of the cumulative amount of compensation costs recognized for book purposes as if it were the actual tax deduction.
- *Entire incremental effect* — Difference between (1) the entire incremental tax effect (i.e., includes indirect effects) of the actual deduction and (2) the DTA recognized.

These approaches would continue to be appropriate for determining the amount of excess tax benefits or tax deficiencies to be recognized in the financial statements after the effective date of the adoption. For more information about the three approaches, see [10.16](#).

**10. May an entity change its accounting policy and approach (see FAQ 9 above) for determining the discrete amount related to excess tax benefits and tax deficiencies upon the adoption of ASU 2016-09?**

Yes. Given the lack of definitive guidance on this topic in ASU 2016-09, upon adoption entities may choose a new policy and approach for determining the amount related to excess tax benefits and tax deficiencies. Entities should consistently apply that approach after adoption.

**11. With the elimination of the APIC pool under the ASU, does an entity need to continue tracking its excess tax benefits and tax deficiencies?**

While an entity will no longer need to separately track excess tax benefits and tax deficiencies for APIC pool purposes, it will still need to calculate them for determining the discrete amount in calculating its interim tax provision.

**12. Does an entity still need to track its DTAs related to share-based payment compensation cost?**

Yes. ASC 718-740-25-2 continues to apply. It states:

The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying the requirements of Subtopic 740-10. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

In addition, under ASC 718-10-50-2A, an entity is required to disclose the total recognized tax benefit related to compensation cost for share-based payment arrangements.

**13. How are UTB liabilities treated if the UTBs can be offset by previously unrecognized excess tax benefits recognized as a DTA upon adoption of ASU 2016-09?**

There is no adjustment for UTBs upon the adoption of the ASU. However, an entity must apply ASC 740-10-45-10A and 45-10B and present a UTB as a reduction of a DTA for an NOL carryforward, a similar tax loss, or a tax credit carryforward to the extent that such tax attributes are available to settle the UTB as of the reporting date. Further, such UTBs should be considered part of the assessment of the realizability of the associated DTAs recognized upon adoption.

**14. Does the inclusion of excess tax benefits and tax deficiencies in the income statement affect the EPS calculation?**

Yes. The ASU's guidance on recording excess tax benefits and tax deficiencies in the income statement has a corresponding effect on the computation of basic and diluted EPS. In a manner similar to the transition associated with excess tax benefits and tax deficiencies, an entity would prospectively recognize the resulting change to EPS.

An entity that uses the treasury stock method to compute diluted EPS currently estimates (on the basis of current prices) the excess tax benefits and tax deficiencies to be recognized in APIC in determining the assumed proceeds available to repurchase shares. After adoption of the ASU, the entity would

exclude excess tax benefits and tax deficiencies from the calculation of assumed proceeds since it recognizes such amounts in the income statement. Therefore, if the entity uses the treasury stock method, the ASU will affect the denominator of diluted EPS. For periods in which excess tax benefits exceed tax deficiencies, the ASU will have an increased dilutive effect on the denominator because there will be fewer hypothetical shares to be purchased with fewer assumed proceeds.

In addition, the ASU affects the numerator of both basic and diluted EPS because net income will change as a result of the recognition of excess tax benefits and tax deficiencies in the income statement. For periods in which excess tax benefits exceed tax deficiencies, the ASU will positively affect the numerator.

The ASU's effect on the numerator in basic and diluted EPS calculations and the denominator in diluted EPS may significantly affect an entity's EPS (as well as net income).

# Chapter 11 — Business Combinations

This chapter focuses on the application of income tax considerations related to business combinations consummated after Statement 141(R) became effective (with the exception of 11.22, which covers guidance on deferred taxes related to goodwill that was recognized in transactions that occurred before the effective date of FASB Statement 141(R)).

ASC 805 requires that an entity record, generally through income tax expense, adjustments made after the measurement period (and adjustments during the measurement period that relate to facts and circumstances that did not exist as of the acquisition date) to (1) valuation allowances for acquired DTAs and (2) acquired tax uncertainties.

## Background and Scope

### ASC 805-740

**05-1** This Subtopic provides incremental guidance on accounting for income taxes related to business combinations and to acquisitions by not-for-profit entities. This Subtopic requires recognition of deferred tax liabilities and deferred tax assets (and related valuation allowances, if necessary) for the deferred tax consequences of differences between the tax bases and the recognized values of assets acquired and liabilities assumed in a business combination or in an acquisition by a not-for-profit entity. [FAS 109, paragraph 259]

**05-2** The recognition and measurement requirements related to accounting for income taxes in this Subtopic are exceptions to the recognition and measurement principles that are otherwise required for business combinations and acquisitions by not-for-profit entities, as established in Sections 805-20-25 and 805-20-30.

### Overall Guidance

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 805-10-15.

## Recognition

### ASC 805-740

**25-1** This Section provides general guidance on the recognition of deferred tax assets and liabilities in connection with a business combination. It also addresses certain business-combination-specific matters relating to goodwill, replacement awards, and the allocation of consolidated tax expense after an acquisition.

**25-2** An acquirer shall recognize a deferred tax asset or deferred tax liability arising from the assets acquired and liabilities assumed in a business combination [FAS 141(R), paragraph 26] and shall account for the potential tax effects of temporary differences, carryforwards, and any income tax uncertainties of an acquiree that exist at the acquisition date, or that arise as a result of the acquisition, in accordance with the guidance in Subtopic 740-10 together with the incremental guidance provided in this Subtopic. [FAS 141(R), paragraph 27]

**ASC 805-740 (continued)**

**25-3** As of the acquisition date, a deferred tax liability or asset shall be recognized for an acquired entity's taxable or deductible temporary differences or operating loss or tax credit carryforwards except for differences relating to the portion of goodwill for which amortization is not deductible for tax purposes, leveraged leases, and the specific acquired temporary differences identified in paragraph 740-10-25-3(a). Taxable or deductible temporary differences arise from differences between the tax bases and the recognized values of assets acquired and liabilities assumed in a business combination. Example 1 (see paragraph 805-740-55-2) illustrates this guidance. An acquirer shall assess the need for a valuation allowance as of the acquisition date for an acquired entity's deferred tax asset in accordance with Subtopic 740-10.

**25-4** Guidance on tax-related matters related to the portion of goodwill for which amortization is not deductible for tax purposes is in paragraphs 805-740-25-8 through 25-9; guidance on accounting for the acquisition of leveraged leases in a business combination is in paragraph 840-30-30-15; and guidance on the specific acquired temporary differences identified in paragraph 740-10-25-3(a) is referred to in that paragraph. [FAS 109, paragraph 30]

**Pending Content (Transition Guidance: ASC 842-10-65-1)**

**25-4** Guidance on tax-related matters related to the portion of goodwill for which amortization is not deductible for tax purposes is in paragraphs 805-740-25-8 through 25-9; guidance on accounting for the acquisition of leveraged leases in a business combination is in Subtopic 842-50; and guidance on the specific acquired temporary differences identified in paragraph 740-10-25-3(a) is referred to in that paragraph. [FAS 109, paragraph 30]

**25-5** The tax bases used in the calculation of deferred tax assets and liabilities as well as amounts due to or receivable from taxing authorities related to prior tax positions at the date of a business combination shall be calculated in accordance with Subtopic 740-10. [FIN 48, paragraph 12A]

**25-6** In a taxable business combination, the consideration paid is assigned to the assets acquired and liabilities assumed for financial reporting and tax purposes. However, the amounts recognized for particular assets and liabilities may differ for financial reporting and tax purposes. As required by paragraph 805-740-25-3, deferred tax liabilities and assets are recognized for the deferred tax consequences of those temporary differences. For example, a portion of the amount of goodwill for financial reporting may be allocated to some other asset for tax purposes, and amortization of that other asset may be deductible for tax purposes. If a valuation allowance is recognized for that deferred tax asset at the acquisition date, recognized benefits for those tax deductions after the acquisition date shall be applied in accordance with paragraph 805-740-45-2. [FAS 109, paragraph 261]

**25-7** See Examples 1 through 3 (paragraphs 805-740-55-2 through 55-8) for illustrations of the recognition of deferred tax assets and related valuation allowances at the date of a nontaxable business combination.

**Goodwill**

**25-8** Guidance on the financial accounting for goodwill is provided in Subtopic 350-20. For tax purposes, amortization of goodwill is deductible in some tax jurisdictions. In those tax jurisdictions, the reported amount of goodwill and the tax basis of goodwill are each separated into two components as of the acquisition date for purposes of deferred tax calculations. The first component of each equals the lesser of goodwill for financial reporting or tax-deductible goodwill. The second component of each equals the remainder of each, that is, the remainder, if any, of goodwill for financial reporting or the remainder, if any, of tax-deductible goodwill.

## ASC 805-740 (continued)

**25-9** Any difference that arises between the book and tax basis of that first component of goodwill in future years is a temporary difference for which a deferred tax liability or asset is recognized based on the requirements of Subtopic 740-10. If that second component is an excess of tax-deductible goodwill over the reported amount of goodwill, the tax benefit for that excess is a temporary difference for which a deferred tax asset is recognized based on the requirements of that Subtopic (see Example 4 [paragraph 805-740-55-9]). However, if that second component is an excess of goodwill for financial reporting over the tax-deductible amount of goodwill, no deferred taxes are recognized either at the acquisition date or in future years. [FAS 109, paragraph 262]

### Replacement Awards Classified as Equity

**25-10** Paragraph 805-30-30-9 identifies the types of awards that are referred to as replacement awards in the Business Combinations Topic. For a replacement award classified as equity that ordinarily would result in postcombination tax deductions under current tax law, an acquirer shall recognize 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 and therefore included in consideration transferred in the business combination. [FAS 141(R), paragraph A97]

**25-11** For a replacement award classified as equity that ordinarily would not result in tax deductions under current tax law, an acquirer shall recognize no deferred tax asset for the portion of the fair-value-based measure attributed to precombination service and thus included in consideration transferred in the business combination. A future event, such as an employee's disqualifying disposition of shares under a tax law, may give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. [FAS 141(R), paragraph A99]

### Allocation of Consolidated Tax Expense to the Acquired Entity After an Acquisition

**25-12** Paragraph 740-10-30-27 provides general guidance on the allocation of consolidated tax expense to the separate financial statements of members of a consolidated group. Under certain conditions, paragraph 805-50-25-3 permits an acquired entity to retain its preacquisition historical basis in separately issued financial statements after an acquisition.

**25-13** If there is a continuation of the historical basis for financial reporting at the same time as there is a tax basis step-up, any one of the following three methods is acceptable for allocating the consolidated tax provision, with appropriate disclosure:

- a. Modify the intra-entity tax allocation agreement so that taxes are allocated to the acquired entity on the preacquisition tax basis
- b. Credit the tax benefit from the tax basis step-up to the acquired entity's additional paid-in capital when realized
- c. Credit the tax benefit to income of the acquired entity as a permanent difference when realized. [EITF 86-9, paragraph Issue]

**25-14** Paragraph 740-10-50-17 specifies the disclosure requirements for separately issued financial statements of an entity that is a member of a group that files a consolidated tax return.

### Related Implementation Guidance and Illustrations

- [Example 1: Nontaxable Business Combination](#) [ASC 805-740-55-2].
- [Example 2: Valuation Allowance at Acquisition Date Subsequently Reduced](#) [ASC 805-740-55-4].
- [Example 3: Acquirer's Taxable Temporary Differences Eliminate Need for Acquiree Valuation Allowance](#) [ASC 805-740-55-7].
- [Example 4: Tax Deductible Goodwill Exceeds Financial Reporting Goodwill](#) [ASC 805-740-55-9].

## 11.01 Tax Consequences of Business Combinations

ASC 805-740 requires recognition of a DTL or DTA as of the acquisition date for the taxable and deductible temporary differences between (1) the financial reporting values of assets acquired and liabilities assumed and (2) the tax bases of those assets and liabilities.

Recognition of DTAs and DTLs for the tax consequences of temporary differences and carryforwards acquired in a business combination, as required under ASC 805, applies to both taxable and nontaxable business combinations. Generally, the difference between a taxable business combination and a nontaxable business combination is that the assets acquired and liabilities assumed in a taxable business combination are typically recorded at fair value for both income tax and financial reporting purposes; however, in a nontaxable business combination, the predecessor's tax bases are carried forward for assets acquired and liabilities assumed. In both taxable and nontaxable business combinations, the amounts assigned to the individual assets acquired and liabilities assumed for financial statement purposes are often different from the amounts assigned or carried forward for tax purposes. A DTL or DTA is recognized for each of these temporary differences (except the portion of financial reporting goodwill for which amortization is not deductible for tax purposes; leveraged leases; and other acquired temporary differences with deferred tax exceptions) in accordance with the recognition and measurement criteria of ASC 740.

Other factors an entity should consider when applying ASC 740 to the accounting for business combinations include, but are not limited to, the following:

- Tax benefits arising from the excess of tax-deductible goodwill over goodwill for financial reporting purposes must be recognized as of the acquisition date as a DTA. Conversely, ASC 805-740-25-9 prohibits the recognition of a DTL for financial reporting goodwill in excess of the amount that is amortizable for tax.
- A net DTA is recognized in a business combination if it is more likely than not that the tax benefits for deductible temporary differences and carryforwards will be realized.
- If separate tax returns are expected to be filed in future years (e.g., when a domestic entity acquires a foreign entity), only the available evidence of the acquired entity should be considered in the determination of whether it is more likely than not that the acquired tax benefits will be realized.
- The amounts recorded in the historical financial records for assets and liabilities of the acquired entity are not carried forward to the acquiring entity. Assets and liabilities of the acquired entity are recorded after the business combination by applying the ASC 805 recognition and measurement guidance (generally at fair value) (e.g., financial reporting goodwill, deferred taxes).
- Discounting of the income tax consequences of temporary differences and carryforwards to their present values is prohibited.

## **11.01A Determining Whether Income Tax Elections, Tax Planning, or Subsequent Business Integration Steps Should Be Included in the Application of the Acquisition Method of Accounting to a Business Combination**

ASC 805-20-25-3 states, in part:

[T]o qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions.

ASC 805-20-25-6 further states:

**At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.**

Under ASC 805-20-25-6, DTAs and DTLs recognized in a business combination should reflect the tax attributes of the acquired entity as well as the structure of the combined entity as it exists on the acquisition date. Accordingly, the tax effects of income tax elections, tax planning, and subsequent business integration steps that occur postclosing are generally accounted for separately and apart from the business combination (i.e., on "day 2"). However, some income tax elections, tax planning, and subsequent business integration steps may be so integral to the business combination transaction that they should be included in the application of the acquisition method of accounting to the business combination.

While ASC 805-10-25-20 through 25-22 provide general guidance an entity should consider when determining whether a transaction is part of the business combination, there is no direct guidance addressing whether the tax effects of income tax elections, tax planning, and subsequent business integration steps that occur postclosing are so integral to the business combination transaction that they should be included in the acquisition accounting.

Accordingly, an entity must apply significant judgment on the basis of its facts and circumstances and should consider the following questions, which are neither mutually exclusive nor individually conclusive, when determining whether to include income tax elections, tax planning, or other subsequent business integration steps that occur postclosing in its application of the acquisition method of accounting to the business combination.

- Was the income tax election, tax planning, or subsequent business integration step a factor in the negotiations of the business combination (e.g., were any adjustments to the purchase price considered during negotiations with the previous owners in contemplation of, or as consideration for, any of the income tax elections, tax planning, or subsequent business integration steps), or was the income tax election, tax planning, or subsequent business integration step identified postclosing?
- Was the effective date of the income tax election, tax planning, or subsequent business integration step concurrent with or retroactive to the acquisition date, or will it only become effective postclosing?
- Was the income tax election, tax planning, or subsequent business integration step primarily within the control of the acquirer or seller, or were there uncertainties or regulatory hurdles related to the income tax election, tax planning, or business integration step as of the closing?

- Would the income tax election, tax planning, or subsequent business integration step be expected of every market participant, or would it be based on the acquirer's specific facts and circumstances?
- Were the tax benefits of the income tax election, tax planning, or subsequent business integration step obtained without interaction with the government, or was the acquirer required to (1) make a separate payment directly to the governmental taxing authority or (2) forego tax attributes to obtain the tax benefits?

## **11.02 Recognition of an Acquiring Entity's Tax Benefits Not Considered in Acquisition Accounting**

In some tax jurisdictions, tax law permits the use of deductible temporary differences or carryforwards of an acquiring entity to reduce future taxable income if consolidated tax returns are filed after the acquisition. Assume that as a result of a business combination, it becomes more likely than not that an acquiring entity's preacquisition tax benefits will be realized. ASC 805-740-30-3 requires that changes in assumptions about the realizability of an **acquirer's** valuation allowance, as a result of the business combination, be recorded separately from the business combination accounting. If, as of the acquisition date, realization of the acquiring entity's tax benefits becomes more likely than not, reductions in the acquiring entity's valuation allowance should be recognized as an income tax benefit (or credited directly to contributed capital — see ASC 740-10-45-20 and related guidance in [Chapter 7, "Intraperiod Tax Allocation"](#)). Similarly, any subsequent changes to the acquiring entity's valuation allowance will not be recorded as part of acquisition accounting (i.e., no adjustments to goodwill).

See [11.03](#) for guidance on recognition of an acquiring entity's tax benefits after the acquisition date.

### **11.02A Considering Whether Acquired Deferred Tax Liabilities Support the Realization of Acquired or Acquirer Deferred Tax Assets**

In accordance with the guidance in ASC 740-10 and ASC 805-740, an acquirer recognizes DTAs (commonly referred to as acquired DTAs) and DTLs (commonly referred to as acquired DTLs) associated with the assets acquired and the liabilities assumed in a business combination. The acquirer also assesses whether a valuation allowance is required against some or all of the acquired DTAs.

In addition, as stated in ASC 805-740-30-3, the “tax law in some tax jurisdictions may permit the future use of either of the combining entities' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other entity after the business combination.” Therefore, if the combined entity expects to file a consolidated return, an acquirer may conclude that a valuation allowance is no longer required against some or all of its own existing DTAs as a result of the business combination.

Under ASC 805, a valuation allowance established against acquired DTAs is recorded as part of acquisition accounting (i.e., establishing the valuation allowance would generally result in an increase to goodwill). By contrast, under ASC 805-740-30-3, a change in the acquirer's valuation allowance as a result of the business combination is recognized as a component of income tax expense (i.e., it is accounted for separately from the business combination).

ASC 740-10-30-18 indicates that the future reversal of existing taxable temporary differences is one of four possible sources of taxable income that may be available to an entity for realizing a tax benefit for deductible temporary differences and carryforwards under the tax law. In some cases, acquired DTLs may represent a source of taxable income that supports the realizability of some or all of the benefit of either (1) the acquired DTAs or (2) the acquirer's DTAs but is not sufficient to support both. In this

circumstance, the guidance in ASC 805 and ASC 740 is not clear about whether the acquired DTLs should be first considered a source of taxable income in the evaluation of realizability of the acquired DTAs or the acquirer's existing DTAs.

There are two acceptable methods on how the source of taxable income from the future reversal of acquired DTLs should be allocated in the evaluation of the realizability of the acquired DTAs and the acquirer's existing DTAs. The method an acquirer selects is an accounting policy decision that should be applied consistently. The acquirer should also provide appropriate disclosures, including information about benefits or expenses recognized for changes in its valuation allowance made in accordance with ASC 805-740-50-1.

### ***Method 1 — Assess Acquired DTAs First***

The acquirer first considers the acquired DTLs to be a source of taxable income for realization of the acquired DTAs. ASC 805-20-30-1 states that the "acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values." Allocating the source of taxable income from the acquiree's DTLs first to the realization of the acquiree's DTAs is consistent with this principle. Any net residual source of taxable income from the acquiree's DTLs remaining after the acquiree's DTAs are taken into account would be considered a potential source of taxable income for the realization of the benefit of the acquirer's existing DTAs. Any change in the acquirer's valuation allowance is recognized in income tax expense.

### ***Method 2 — Assess on the Basis of Tax Law Ordering***

Allocation of the source of taxable income from the acquiree's DTLs is based on the tax law in the given jurisdiction. To determine whether the acquiree's DTAs or the acquirer's DTAs will be used to reduce taxable income that results from the reversal of the DTLs, the acquirer schedules the reversal of all temporary differences of both the acquirer and the acquiree on the basis of the applicable tax law. If such scheduling does not result in a determination, the acquirer should develop a systematic, rational, and consistent method for scheduling the reversal of the temporary differences. Under this method, a net DTL could be recorded through purchase accounting, and the entity could simultaneously recognize an income tax benefit for the release of the acquirer's valuation allowance. The net DTL that is reflected in the acquisition accounting will commonly result in an increase of an asset (generally goodwill).

Under this method, it is assumed that the fair value measurement principle is not applied to DTAs and DTLs and that scheduling of the combined group's DTLs and DTAs is a normal part of that valuation analysis by an acquirer. It is also assumed that immediately after the business combination, the valuation allowance determination is performed by using the combined group's postacquisition positive and negative evidence (i.e., not solely the acquiree's positive and negative evidence).

#### **Example 11-1A**

This example illustrates the application of each method in a valuation allowance assessment.

Assume the following:

- AC purchased TC in a nontaxable transaction.
- AC will file a consolidated tax return that will include TC.
- Before the acquisition, AC has a \$1,000 NOL DTA with a \$1,000 valuation allowance.
- After the application of acquisition accounting, TC has a \$600 NOL DTA and a \$600 DTL.
- Other than the \$600 DTL, there are no other sources of taxable income for realizing the benefit of the consolidated group's DTAs.

**Example 11-1A (continued)**

- In accordance with tax law, the oldest available NOLs must be utilized first. There are no other limitations on the use of attributes.
- The following table shows the years when the NOL carryforwards will expire:

	<b>Total</b>	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>X4</b>
AC	1,000	400	600		
TC	600			300	300

- The following table shows the years when the DTL will reverse:

	<b>Total</b>	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>X4</b>
TC	(600)	(150)	(150)	(150)	(150)

**Application of Method 1**

TC records a DTA of \$600 and a DTL of \$600 as part of the acquisition accounting. There is no impact on AC's deferred tax balances. AC's final consolidated financial statements will reflect a \$1,600 DTA, a \$600 DTL, and a \$1,000 valuation allowance.

**Application of Method 2**

Per tax law, AC's older NOL DTAs must be used first; however, a portion of AC's NOL DTAs will expire in X1 and X2 before the full reversal of the DTL. The \$300 of taxable income that will result from reversal of the acquired DTL in X1 and X2 will be allocated as a source of income to support the realizability of AC's NOL DTA. The \$300 of taxable income that will result from reversal of the acquired DTL in X3 and X4 will be allocated as a source of income to support the realizability of TC's NOL DTA.

The purchase price allocation for TC will therefore include a \$600 DTA, a \$600 DTL, and a \$300 valuation allowance as part of the acquisition accounting. AC will reverse \$300 of valuation allowance and record a corresponding income tax benefit of \$300. AC's final consolidated financial statements will reflect a \$1,600 DTA, a \$600 DTL, and a \$1,000 valuation allowance.

## 11.03 Recognition of an Acquiring Entity's Tax Benefits After the Acquisition Date

Assume that available evidence (see ASC 740-10-30-18) supports a conclusion that a valuation allowance for the acquiring entity will not be reduced as a result of a business combination. In a period after the business combination, a change in circumstance causes a change in judgment about realization of the acquiring entity's available DTAs.

ASC 805-740-35-3 requires that changes in assumptions about the realizability of an **acquirer's** valuation allowance as a result of a business combination be recorded separately from the business combination accounting. Accordingly, all changes to an acquirer's valuation allowances as the result of a business combination, whether as of the acquisition date or subsequently, should be recognized in income tax expense (or credited directly to contributed capital (see ASC 740-10-45-20)).

## 11.04 Accounting for Uncertainty in Income Taxes in Business Combinations

The recognition and measurement guidance in ASC 740 is applicable to a business combination accounted for in accordance with ASC 805. ASC 805-740-25-5 states, "The tax bases used in the calculation of deferred tax assets and liabilities as well as amounts due to or receivable from taxing authorities related to prior tax positions at the date of a business combination shall be calculated in accordance with Subtopic 740-10." In addition, the effect of subsequent changes to acquired uncertain tax positions established in the business combination should be recorded in accordance with the presentation and classification guidance in ASC 740 unless that change relates to new information about facts and circumstances that existed as of the acquisition date and occurs within the measurement period (as described in ASC 805-10-25-13 through 25-19). ASC 805-740-45-4(a) states that if the change occurs in the measurement period and relates to "new information about facts and circumstances that existed as of the acquisition date," it is reflected with a "corresponding adjustment to goodwill." However, if goodwill is reduced to zero, the remaining portion will be reflected as a bargain purchase gain.

See [11.37](#) for further guidance on changes in uncertain tax positions acquired in a business combination.

## 11.05 Deferred Taxes Associated With Acquired Intangible Assets

Deferred taxes are not recognized for differences between goodwill for financial statement purposes and nondeductible goodwill for tax purposes. However, deferred income taxes are always recognized for differences between the carrying amounts and tax bases of all acquired identifiable intangible assets (e.g., customer lists, trademarks, and core deposit intangibles of financial institutions), regardless of whether they are indefinite-lived or finite-lived. The FASB concluded that goodwill is a residual asset that is uniquely different from other types of long-term intangible assets that may not be deductible in certain tax jurisdictions. Therefore, the exception to recording deferred taxes on nondeductible goodwill is not carried over to indefinite-lived intangible assets.

## 11.06 Recording Deferred Taxes in a Business Combination on "Inside" and "Outside" Basis Differences

A basis difference arises when there is a difference between the financial reporting amount of an asset or liability and its tax basis, as determined by reference to the relevant tax laws in each tax jurisdiction. There are two categories of basis differences: "inside" basis differences and "outside" basis differences. (For more information about inside and outside basis differences, see [3.04](#).)

The following paragraphs describe the accounting for inside and outside basis differences that arise in a business combination:

### ***Inside Basis Difference***

An inside basis difference is a temporary difference between the carrying amount, for financial reporting purposes, of individual assets and liabilities and their tax bases that will give rise to a tax deduction or taxable income when the related asset is recovered or liability is settled. Deferred taxes are always recorded on taxable and deductible temporary differences unless one of the exceptions in ASC 740-10-25-3 applies.

## Outside Basis Difference

An outside basis difference is the difference between the carrying amount of an entity's investment (e.g., an investment in a consolidated subsidiary) for financial reporting purposes and the underlying tax basis in that investment (e.g., the tax basis in the subsidiary's stock).

Deferred taxes are always recorded for taxable and deductible temporary differences unless a specific exception applies. The exception that may apply under ASC 740 depends on whether the outside basis difference results in a DTL or a DTA. DTLs are recorded on all outside basis differences that are taxable temporary differences unless one of the exceptions in ASC 740-10-25-3 is applicable. ASC 740-30-25-9 states that no DTAs should be recorded on the excess of tax over financial reporting basis in subsidiaries and corporate joint ventures unless it is apparent that the temporary difference will reverse in the foreseeable future (e.g., generally within the next 12 months).

### Example 11-1

#### Inside Basis Difference

Assume the following:

- Acquiring Company (AC) purchases Target Company's (TC's) stock for \$1,000 in cash in a nontaxable business combination.
- TC has two subsidiaries (S1 and S2), each acquired in a taxable stock acquisition.
- S1's and S2's assets consist only of buildings, which have fair values of \$750 and \$250, respectively.
- All of the entities are domestic corporations with respect to AC.
- The tax rate is 40 percent.
- TC's only assets are its shares of S1 and S2, as illustrated in the following table:

<b>Identifiable Assets</b>	<b>TC's Stock</b>	<b>S1</b>	<b>S2</b>
Fair value	\$ 1,000	\$ 750	\$ 250
TC's tax basis in S1's and S2's stock	N/A	600	200
S1's and S2's tax bases in their underlying identifiable assets (assume no tax goodwill)	N/A	300	100

The entries recording the accounting for the initial acquisition are as follows:

To record AC's investment in TC:

<b>AC</b>	
Investment in TC	1,000
Cash	1,000

To record TC's investment in S1 and S2:

<b>TC</b>	
Investment in S1	750
Investment in S2	250
Equity	1,000

### Example 11-1 (continued)

To record deferred taxes on the temporary differences inside S1 and S2:

#### S1

Assets	750
Goodwill	180*
DTL	180**
Equity	750

\* No DTL is recorded for the amount of goodwill for financial reporting in excess of the tax basis of goodwill.

\*\*  $(750 - 300) \times 40\%$ .

#### S2

Assets	250
Goodwill	60*
DTL	60***
Equity	250

\* No DTL is recorded for the amount of goodwill for financial reporting in excess of the tax basis of goodwill.

\*\*\*  $(250 - 100) \times 40\%$ .

Note that while pushdown accounting is not required by ASC 805, entries have been recorded (i.e., pushed down) to the subsidiaries' books because, in accordance with ASC 740-10-30-5, "[d]eferred taxes shall be determined separately for each tax-paying component . . . in each tax jurisdiction." See [4.20](#) for further discussion.

### Example 11-2

#### Outside Basis Difference

Assume the same facts as in Example 11-1. AC must determine whether there is a basis difference in its investment in TC and TC's subsidiaries and whether that difference (if any) is a taxable temporary difference. The initial outside basis differences are as follows:

	TC's Stock	S1's Stock	S2's Stock
Initial book basis	\$ 1,000	\$ 750	\$ 250
Tax basis	1,000	600	200
Difference	—	150	50
DTL (if recognized)	—	60	20

As illustrated in the chart above, there is no difference between AC's book and tax basis in its investment in TC for AC to assess as of the acquisition date. AC does, however, have differences to assess with respect to TC's investment in S1 and S2. The following are two potential conclusions that AC could reach in assessing the outside basis difference:

- AC could determine that it would liquidate S1 and S2 into TC to eliminate the outside basis differences in a tax-free manner. Accordingly, in applying the provisions of ASC 740-30-25-7, AC could conclude that the outside basis differences in S1's and S2's stock are not temporary differences. See [8.15](#) for further discussion of a tax-free liquidation or merger of a subsidiary.
- AC could determine that to dispose of S1 and S2, AC would choose to have TC sell their stock rather than sell their assets to maximize after-tax proceeds. Accordingly, the outside basis differences in S1's and S2's stock would both be taxable temporary differences and the DTLs would be recorded in the business combination accounting.

## 11.07 Accounting for the Settlement of a Preexisting Relationship

If a business combination effectively results in the settlement of a preexisting relationship between an acquirer and an acquiree, the acquirer would recognize a gain or loss. ASC 805-10-55-21 indicates how such a gain or loss should be measured:

- a. For a preexisting noncontractual relationship, such as a lawsuit, fair value
- b. For a preexisting contractual relationship, the lesser of the following:
  1. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. An unfavorable contract is a contract that is unfavorable in terms of current market terms. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
  2. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount in (b)(1), the difference is included as part of the business combination accounting.

Note that if a preexisting contract is otherwise cancelable without penalty, no settlement gain or loss would be recognized. The acquirer's recognition of an asset or liability related to the relationship before the business combination will affect the calculation of the settlement (see Example 11-4 below).

When a business combination results in the settlement of a noncontractual relationship, such as a lawsuit or threatened litigation, the gain or loss should be recognized and measured at fair value. This settlement gain or loss may differ from any amount previously recorded under the contingency guidance in ASC 450.

Examples 11-3 and 11-4 have been adapted from ASC 805-10-55-30 through 55-32 to illustrate the tax effects of a preexisting relationship between parties to a business combination.

### Example 11-3

AC acquires TC in a **taxable** business combination. The acquisition includes a supply contract under which AC purchases electronic components from TC at fixed rates over a five-year period. Currently, the fixed rates are higher than the rates at which AC could purchase similar electronic components from another supplier. The supply contract allows AC to terminate the contract before the end of the initial five-year term only by paying a \$6 million penalty. With three years remaining under the supply contract, AC pays \$50 million to acquire TC. This amount is the fair value of TC and is based on what other market participants would be willing to pay for the entity (inclusive of the above market contract).

The total fair value of TC includes \$8 million related to the fair value of the supply contract with AC. 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 (e.g., selling effort, customer relationships) and a \$5 million component for pricing that is unfavorable to AC because it exceeds the price of current market transactions for similar items. TC has no other identifiable assets or liabilities that are related to the supply contract, and AC has not recognized any assets or liabilities in connection with the supply contract before the business combination. The remaining fair value of \$42 million relates to machine equipment. The tax rate is 40 percent. Assume a **taxable** transaction in a jurisdiction that allows for tax-deductible goodwill.

AC will record the following entries on the acquisition date:

Machine equipment	42,000,000
Goodwill	3,000,000
Loss on unfavorable supply contract	5,000,000
Cash	50,000,000

### Example 11-3 (continued)

In applying ASC 805-10-55-21(b), AC recognizes a loss of \$5 million (the lesser of the \$6 million stated settlement amount in the supply contract or 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.

DTA	2,000,000
Income tax expense	2,000,000

The \$5 million loss on the supply contract is recognized as an expense in the statement of operations for financial reporting purposes (e.g., separately and apart from the acquisition accounting). Typically, the supply contract will not be viewed as a separate transaction for tax purposes and will be included in tax-deductible goodwill, resulting in a temporary difference. This will give rise to a DTA and a tax provision credit as a result of tax affecting the \$5 million loss recognized in the statement of operations. The resulting DTA would be reversed when the goodwill is deducted on the tax return (as long as there are no realization concerns).

Note that if this transaction was structured as a **nontaxable** business combination (i.e., AC acquires the stock of TC), the basis difference that arises related to the \$5 million loss would not give rise to a DTA as discussed in the preceding paragraph (i.e., because it would now relate to an excess tax over financial reporting basis in a subsidiary and be subject to the exception in ASC 740-30-25-9).

### Example 11-4

Assume the same facts as in Example 11-3 (e.g., a **taxable** business combination and tax-deductible goodwill), except that AC had recorded a \$6 million liability and a \$2.4 million DTA related to the supply contract with TC before the business combination.

AC will record the following entries on the acquisition date:

Machine equipment	42,000,000
Goodwill	3,000,000
Liability — unfavorable supply contract	6,000,000
Cash	50,000,000
Gain	1,000,000
Income tax expense	2,400,000
DTA	2,400,000

In applying ASC 805-10-55-21(b), AC recognizes a \$1 million settlement gain on the contract (the \$5 million measured loss on the contract less the \$6 million loss previously recognized), along with the corresponding tax effects, separately from the business combination. The \$3 million at-market component of the contract is part of goodwill.

DTA	2,000,000
Income tax expense	2,000,000

Because the transaction is structured as a taxable business combination, the tax impact on the total \$5 million loss related to the supply contract is treated the same as in Example 11-3 (i.e., the supply contract will not be viewed as a separate transaction for tax purposes and will be included in tax-deductible goodwill, resulting in a temporary difference and corresponding DTA and tax provision credit).

## 11.08 Reacquired Rights

In a business combination, the acquirer may reacquire a right that it previously granted to the acquiree (e.g., a license or franchise). ASC 805-20-30-20 stipulates that reacquired rights are intangible assets that the acquirer must recognize apart from goodwill.

An acquirer measures the value of the reacquired right in a business combination in accordance with the fair value measurement guidance in ASC 820, with one exception: the value of the intangible asset is limited to its remaining contractual term (i.e., the contractual term that remains until the next renewal date), regardless of whether market participants would assume renewal or extension of the existing terms of the arrangement. Because renewals are not taken into consideration in the determination of the fair value, the reacquired right's tax basis and its financial reporting basis as of the acquisition date will generally differ and a DTA should be recognized for the difference between the assigned value for financial reporting and tax purposes.

Subsequently, for financial reporting purposes, an entity must amortize the intangible assets related to reacquired rights on the basis of their remaining contractual terms. (See Example 11-5.)

An acquiring entity must also determine whether the terms of the contract give rise to a reacquired right that is favorable or unfavorable in relation to similar market transactions for similar rights. If the terms of the contract do give rise to such a reacquired right, the acquirer recognizes a settlement gain or loss. ASC 805-10-55-21(b) provides guidance on calculating the settlement gain or loss, stating that it should be recorded as the lesser of:

1. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. . . .
2. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. [See Example 11-6 below.]

An acquirer may subsequently sell a reacquired right to a third party. The carrying amount of the recognized intangible asset (i.e., reacquired right) would then be included in the gain or loss on sale.

### Example 11-5

Company B sells products in Europe under a license agreement with Company A. Company A acquires B for \$100 million in a taxable business combination. As of the acquisition date, the license agreement has a remaining contractual term of three years and can be renewed at the end of the current term and indefinitely every five years thereafter. Assume that the pricing of the license agreement is at-market and that the agreement does not have explicit settlement provisions. The tax rate is 40 percent. Company A has calculated the following values for the license agreement:

- *\$7.5 million* — Value of the license for the remaining three-year contractual term.
- *\$20 million* — Fair value of the license agreement, calculated in accordance with the principles of ASC 820, which takes into account future renewals by market participants.
- *\$60 million* — Other tangible assets.

### Example 11-5 (continued)

The following illustrates the book and tax bases of the assets:

	<b>Book Basis</b>	<b>New Tax Basis</b>
Other tangible assets	\$ 60,000,000	\$ 60,000,000
License agreement	7,500,000	20,000,000
Goodwill	<u>32,500,000*</u>	<u>20,000,000</u>
	<u>\$100,000,000</u>	<u>\$100,000,000</u>

\* Before the impact of deferred taxes is considered.

Company A will record the following entry on the acquisition date:

Other tangible assets	60,000,000
License agreement	7,500,000
Goodwill	27,500,000**
DTA	5,000,000
Cash	100,000,000

\*\* (\$32,500,000 – \$5,000,000).

In this example, A would recognize an intangible asset for \$7.5 million and would amortize this amount over the remaining three-year contractual term for financial reporting purposes. Company A recognizes a DTA related to the license agreement's tax-over-book basis of \$5 million  $[(\$20 \text{ million} - \$7.5 \text{ million}) \times 40\%]$ . In accordance with ASC 805-740-25-3 and 25-9, no DTL is recorded for the book-over-tax-basis goodwill of \$7.5 million ( $\$27.5 \text{ million} - \$20 \text{ million}$ ).

### Example 11-6

Assume the same facts as in Example 11-5, except that under the terms of the license agreement, B pays a license fee that is below-market in relation to that of its competitors with similar licensing agreements. In addition, A now calculates the value of the license, for the remaining three-year contractual term, to be \$10 million. (Note that this amount is greater than the \$7.5 million value calculated in Example 11-5 for an at-market contract, because the expense related to the license is less than the market rate.)

Company A would record an intangible asset of \$7.5 million for the reacquired license (the at-market value for similar agreements) and would recognize a \$2.5 million settlement loss in the income statement. In effect, the settlement loss represents additional consideration A would be required to give B to terminate the existing agreement, which was unfavorable to A.

The following illustrates the book and tax bases of the assets:

	<b>Book Basis</b>	<b>New Tax Basis</b>
Other tangible assets	\$60,000,000	\$ 60,000,000
License agreement	7,500,000	20,000,000
Goodwill	<u>32,500,000*</u>	<u>20,000,000</u>
	<u>\$</u>	<u>\$</u>
	<u>100,000,000</u>	<u>100,000,000</u>

\* Before the loss on the unfavorable license agreement and the impact of deferred taxes are considered.

**Example 11-6 (continued)**

Company A will record the following entry on the acquisition date:

Other tangible assets	60,000,000
License agreement	7,500,000
Goodwill	30,000,000*
Loss on unfavorable license agreement	2,500,000
Cash	100,000,000

\* Before the impact of deferred taxes is considered.

DTA	5,000,000
Goodwill	4,000,000
Income tax expense	1,000,000

Company A recognizes a DTA related to the license agreement's tax-over-book basis of \$5 million  $[(\$20 \text{ million} - \$7.5 \text{ million}) \times 40\%]$ , of which \$4 million is a DTA recorded in the acquisition accounting (as a reduction to goodwill). The remaining component of the DTA of \$1 million is associated with the \$2.5 million financial reporting loss that was recognized in the statement of operations by the acquirer (i.e., separate and apart from acquisition accounting). Therefore, in evaluating the DTA for realizability after the acquisition date, an entity should remember that the character of the DTA originated in part from a finite-lived intangible asset and in part from an expense recorded in the statement of operations.

In addition, ASC 805-740-25-3 and 25-9 prohibit the recognition of a DTL for the book-over-tax-basis goodwill.

## 11.09 Income Tax Accounting for Transaction Costs in a Business Combination

Acquisition-related costs incurred by the acquirer (e.g., deal fees for attorneys, accountants, investment bankers, and valuation experts) must be expensed as incurred for financial reporting purposes unless they are subject to other U.S. GAAP (e.g., costs related to the issuance of debt or equity securities) in accordance with ASC 805-10. An acquirer should account for the tax effects associated with transaction costs in accordance with the nature of the costs incurred.

### Acquisition-Related Costs

Acquisition costs expensed as incurred for financial reporting purposes may or may not be deductible for tax purposes. A temporary difference results if acquisition-related costs are deductible for tax purposes and if that deduction is taken in a period other than the period in which the costs are expensed for financial reporting purposes. Because acquisition-related costs are not considered part of the acquisition and are expensed as incurred for financial reporting purposes, the related deferred taxes (if any) will be recorded as a component of income tax expense (i.e., outside of the business combination). See [11.10](#) for further discussion and examples of the deferred tax accounting for acquisition-related costs.

### Debt Issue Costs

Debt issue costs are excluded from business combination accounting. Generally, entities should capitalize and amortize debt issuance costs by using the effective interest method over the term of the related debt (unless the Fair Value Option subsections of ASC 825-10 apply). Deferred taxes should be recorded if there is a difference between the book and tax approaches to recognizing debt issue costs and the difference gives rise to a taxable or a deductible temporary difference.

## ***Costs of Registering and Issuing Equity Securities***

Costs of registering and issuing equity securities are excluded from the consideration transferred in a business combination and are not part of business combination accounting. For example, when equity securities are issued to consummate a business combination, the related out-of-pocket registration and issuance costs are generally treated as a reduction in APIC in accordance with SAB Topic 5.A. If the registration costs have not been paid by the acquisition date, the costs should be accrued as a liability, with a corresponding reduction in APIC. For U.S. tax purposes, the costs of registering and issuing equity securities are generally neither deductible nor amortizable. Accordingly, there should be no temporary differences associated with the costs of registering and issuing equity securities.

### **11.10 Income Tax Accounting for Acquisition-Related Costs Incurred in a Period Before Consummation of a Business Combination**

In accordance with ASC 805-10, acquisition-related costs incurred by the acquirer in connection with a business combination (e.g., deal fees for attorneys, accountants, investment bankers, and valuation experts) must be expensed as incurred for financial reporting purposes unless they are subject to other U.S. GAAP (e.g., costs related to the issuance of debt or equity securities).

When acquisition-related costs are incurred, it may not be clear whether they will ultimately be deductible for income tax reporting purposes. For example, certain acquisition-related costs may have to be capitalized for income tax reporting purposes when incurred and become immediately deductible if the business combination is not consummated. If the business combination is consummated, the capitalized costs may be added (1) to the basis of the assets acquired in a taxable asset acquisition or (2) to the basis in the stock of the acquired entity in a nontaxable stock acquisition.

When acquisition-related costs are incurred in a period before a business combination is consummated and those costs are capitalized for tax purposes, a book/tax basis difference results. The acquirer will need to assess whether that basis difference represents a deductible temporary difference for which a DTA should be recorded. In making this determination, the acquirer may use either of the following two approaches.<sup>1</sup>

#### ***Approach 1***

If the costs that were capitalized for tax purposes will become deductible in the event the business combination does not occur, a deductible temporary difference exists, and a DTA should be recorded when the expense is recognized for financial reporting purposes. If the business combination is ultimately consummated, the acquirer would need to reassess the DTA to determine whether recognition continues to be appropriate. For example, if the business combination occurs and is a taxable asset acquisition, the capitalized costs would be added to the basis of the net assets acquired, and a DTA would generally result. Alternatively, if the business combination is consummated and is a nontaxable stock acquisition, the capitalized costs would be added to the basis of the stock acquired, and an outside basis deductible temporary difference would typically be created. However, the entity would need to evaluate whether an exception to recognition of the outside basis DTA is applicable (i.e., the entity would need to evaluate ASC 740-30-25-9). If recognition is no longer appropriate, the DTA should be reversed to the income statement.

<sup>1</sup> The approach an entity selects is an accounting policy election that, like all such elections, should be applied consistently.

## **Approach 2**

The acquirer can record a DTA if, on the basis of (1) the probability that the business combination will be consummated and (2) the expected tax structure of the business combination, the acquisition-related expenses would result in a future tax deduction. Approach 2 requires the acquirer, in determining whether to record all or a portion of the DTA for the acquisition expenses, to make assumptions about how the transaction would be structured from a tax perspective and about the probability that the business combination would be consummated. As a result of this approach, the entity would conform its financial reporting to its “expectation” as of each reporting date (i.e., the DTA may be recognized and subsequently derecognized if expectations change from one reporting period to the next).

### ***Transaction Costs Incurred by the Target***

Like acquisition-related costs incurred by the acquirer, precombination transaction costs incurred by the target are generally expensed as incurred for financial reporting purposes. It may not be clear at the time the costs are incurred whether they will ultimately be deductible for income tax reporting purposes. In some jurisdictions, capitalized transaction costs incurred by the target may result in a tax deduction (1) if the business combination is not consummated or (2) if the business combination is consummated and is treated as a taxable asset sale. However, if the business combination is consummated in the form of a nontaxable stock sale, the target’s capitalized transaction costs may not be deductible or amortizable.

When the target incurs precombination transaction costs and those costs are capitalized for tax purposes, the target will also need to assess whether that temporary difference is a deductible temporary difference for which a DTA should be recorded. We believe that the target may use either of the aforementioned approaches available to the acquirer to account for the expected tax consequences of the precombination transaction costs.<sup>2</sup>

### **11.11 Income Tax Accounting for Acquisition-Related Costs Incurred in a Business Combination**

Acquisition-related costs incurred by the acquirer (e.g., deal fees for attorneys, accountants, investment bankers, and valuation experts) must be expensed as incurred for financial reporting purposes unless they are subject to other U.S. GAAP (e.g., costs related to the issuance of debt or equity securities) in accordance with ASC 805-10.

Acquisition-related costs expensed as incurred for financial reporting purposes may or may not be deductible for tax purposes. A temporary difference results if acquisition-related costs are deductible for tax purposes and if that deduction is taken in a period other than when the costs are expensed for financial reporting purposes. Because acquisition-related costs are not considered part of the acquisition and are expensed as incurred for financial reporting purposes, the related deferred taxes (if any) will be recorded as a component of income tax expense (i.e., outside of the business combination).

See [11.10](#) for guidance on income tax accounting for acquisition-related costs incurred in a period before the consummation of the business combination.

<sup>2</sup> The approach an entity selects is an accounting policy election that should be applied consistently.

### Example 11-7

#### Taxable Business Combination

AC acquires TC in a **taxable** business combination for \$1,000 and incurs \$200 of costs related to the acquisition. The identifiable assets have a fair value of \$700. For financial reporting purposes, AC expenses the \$200 acquisition-related costs. For financial reporting purposes, AC expenses the \$200 acquisition-related costs. For income tax reporting purposes, AC adds the \$200 acquisition-related costs to the total amount that is allocated to assets, resulting in tax-deductible goodwill of \$500. Assume that the tax rate is 40 percent.

AC would record the following entries on the acquisition date:

Assets	700	
Goodwill	300	
Cash		1,000
Acquisition expense	200	
Cash		200
DTA		80*
Income tax expense		80

\*  $\$200 \text{ (acquisition-related costs that are capitalized as amortizable goodwill for tax purpose)} \times 40\%$ .

The tax impact of the acquisition costs is reflected in the income statement because the excess amount of tax-deductible goodwill over financial reporting goodwill relates solely to the acquisition costs that are expensed for financial reporting purposes. As a result, neither (1) the acquisition-date comparison of tax-deductible goodwill to financial reporting goodwill nor (2) the iterative calculation described in ASC 805-740-25-8 and 25-9 and [11.20](#) is required.

### Example 11-8

#### Nontaxable Business Combination

AC acquires TC in a **nontaxable** business combination for \$1,000 and incurs \$200 of costs related to the acquisition. The identifiable assets have a fair value of \$700 and a tax basis of \$250. For financial reporting purposes, AC expenses the \$200 of acquisition-related costs. For tax purposes, AC adds the \$200 of acquisition-related costs to the basis of TC's stock. Assume a 40 percent tax rate.

AC would record the following entries on the acquisition date:

Assets	700	
Goodwill	480	
DTL		180*
Cash		1,000
Acquisition expense	200	
Cash		200

\*  $(\$700 \text{ fair value} - \$250 \text{ tax basis}) \times 40\%$ .

Unlike the acquisition expenses in the taxable business combination in Example 11-7, the acquisition expenses may not be tax-affected in a nontaxable business combination. The acquisition-related costs are included in the outside tax basis of AC's investment in TC. Therefore, the DTA would have to be assessed in accordance with ASC 740-30-25-9. As long as it is not apparent that the temporary difference will reverse in the foreseeable future, no DTA is recorded.

## 11.12 Tax Consequences of Business Combinations Achieved in Stages: Remeasurement of the Original Investment

A business combination is achieved in stages when an acquirer holds a noncontrolling interest in an investment (e.g., an equity method investment) in the acquired entity (the “original investment”) before obtaining control of the acquired entity. When the acquirer obtains control of the acquired entity, it remeasures the original investment at fair value. The acquirer adds the fair value of the original investment to the total amount of consideration transferred in the business combination (along with the fair value of any noncontrolling interest still held by third parties) to determine the target’s opening equity (which in turn affects the measurement of goodwill). The gain or loss resulting from the fair value remeasurement is reported in the statement of operations (separately and apart from the acquisition accounting). Any gains or losses previously recognized in other comprehensive income that are associated with the original investment are reclassified and included in the calculation of the gain or loss.

For the acquirer, the remeasurement of the original investment in a business combination achieved in stages at fair value will result in an increase or a decrease in the financial reporting basis of the investment. Generally, the tax basis of the investment will not be affected, and an outside basis difference will therefore be created. (For further guidance on outside basis differences, see [3.04](#).)

The gain or loss resulting from the remeasurement of the original investment at fair value is reported in the statement of operations (separately and apart from the acquisition accounting). The corresponding tax effect of the remeasurement should be recorded as a component of the income tax provision unless an exception applies (e.g., ASC 740-30-25-9, ASC 740-10-25-3, or ASC 740-30-25-7). See Example 11-10 below.

See [8.17](#) for additional factors an entity should consider when accounting for income tax consequences of business combinations achieved in stages.

### Example 11-9

In year 1, Acquisition Company (AC) purchased 20 percent of Target Company (TC), a domestic investee, for \$100. In year 2, AC has a \$200 book basis and \$100 tax basis in its equity method investment and has recorded a DTL of \$40 on the outside basis difference. Assume that the tax rate is 40 percent.

AC’s entries are as follows:

#### **Year 1**

Investment in TC	100
Cash	100

#### **Year 2**

Investment in TC	100
Deferred tax expense	40
DTL	40
Equity earnings	100

In a nontaxable business combination, AC purchases the remaining 80 percent of TC for \$2,000. The fair value of all the identifiable assets is \$2,000, and their tax basis is \$500.

AC remeasures its 20 percent investment in TC as \$500 (for simplicity, any control premium is ignored) and recognizes \$300 of gain.

**Example 11-9 (continued)**

AC records the following entries for the remeasurement of its original investment in TC:

Investment in TC	300
Deferred tax expense	120
Gain on remeasurement — original investment	300
DTL	120*

\* Tax effects of the increase in the outside-basis difference ( $\$300 \times 40\%$ ).

AC records a DTL on the remeasurement gain because it determines that the outside basis difference is a taxable temporary difference (i.e., the exception in ASC 740-30-25-7 does not apply).

AC records the following entries for the acquisition and resulting deferred taxes:

**AC**

Investment in TC	2,000
Cash	2,000

**TC (to reflect “push-down” of the entries to TC’s books)**

Identifiable assets	2,000
Goodwill	1,100
DTL	600
Equity	2,500

A DTL of \$600 is recorded on the inside basis difference, since the book basis of the assets acquired is greater than the tax basis ( $\$2,000 - \$500$ ). No DTL is recorded on the book-greater-than-tax basis ( $\$1,100 - \$0$ ) in goodwill, in accordance with ASC 805-740-25-9.

If, at any time after the acquisition, AC (1) reassesses the outside basis difference in its investment in TC and concludes that the tax law provides a means by which the reported amount of its investment can be recovered tax-free, and (2) expects that it will ultimately use that means, the DTL on the outside basis difference would be reversed as an adjustment to income tax expense.

**Example 11-10**

Assume the same facts as in Example 11-9, except that in applying ASC 740-30-25-7, AC determines that its outside basis difference in TC is not a taxable temporary difference and, therefore, records no deferred taxes.

AC records the following entries for the remeasurement of its original investment in TC:

Investment in TC	300
DTL	40
Gain on remeasurement — original investment	300
Deferred tax benefit	40

### Example 11-10 (continued)

Because AC determines that its outside basis difference in TC is not a taxable temporary difference under ASC 740-30-25-7, AC reverses the previously recorded DTL for the outside basis difference ( $(\$200 \text{ book basis} - \$100 \text{ tax basis}) \times 40\% \text{ tax rate}$ ) and records no DTL for the outside basis difference created from the remeasurement gain.

AC records the following entries for the acquisition and resulting deferred taxes:

#### **AC**

Investment in TC	2,000
Cash	2,000

#### **TC (to reflect “push-down” of the entries to TC’s books)**

Identifiable assets	2,000
Goodwill	1,100
DTL	600
Equity	2,500

A DTL of \$600 ( $(\$2,000 - \$500) \times 40\%$ ) is still recorded on the inside basis difference of the assets acquired, since the exception in ASC 740-30-25-7 is only related to the outside basis differences.

As discussed in [11.13, if TC were a foreign entity](#), AC would be required to continue recording a DTL for the taxable temporary difference related to its share of the undistributed earnings of the acquiree before the date it became a subsidiary to the extent that dividends from the subsidiary do not exceed the acquirer's share of the subsidiary's earnings after the date it became a subsidiary. Therefore, the reversal of the DTL and the related deferred tax benefit of \$40 shown in the first entry above would not be applicable.

**If TC were a partnership for U.S. tax purposes**, the exception in ASC 740-30-25-7 would generally not apply because an investor in a flow-through entity typically cannot recover its investment in a tax-free manner. Rather, the outside basis difference would reverse through normal operations and would therefore be a taxable temporary difference. In addition, deferred taxes would not be recorded on the underlying assets inside TC since TC is a nontaxable entity.

## **11.13 Tax Consequences of Business Combinations Achieved in Stages: Other Tax Considerations**

A business combination achieved in stages occurs when an acquirer holds a noncontrolling investment (e.g., an equity method investment) in the acquired entity (the “original investment”) before obtaining control of the acquired entity. When the acquirer obtains control of the acquired entity, it remeasures the original investment at fair value. The acquirer adds the fair value of the original investment to the total amount of consideration transferred in the business combination (along with the fair value of any noncontrolling interest still held by third parties) to determine the target's opening equity (which in turn affects the measurement of goodwill). The fair value remeasurement amount is recorded as a gain or loss and is reported in the statement of operations (separately and apart from the acquisition accounting). Any gains or losses previously recognized in OCI that are associated with the original investment are reclassified and included in the calculation of the gain or loss.

As discussed in [11.12](#), the remeasurement of the original investment at fair value will result in an increase or a decrease in the financial reporting basis of the investment. Generally, the tax basis of the investment will not be affected and an outside basis difference will therefore be created. (For further guidance on outside basis differences, see [3.04](#) and [11.06](#).)

The remeasurement of the original investment at fair value is recorded as a gain or loss and is reported in the statement of operations (separately and apart from the acquisition accounting). The corresponding tax effect of the remeasurement should be recorded as a component of the income tax provision, unless an exception applies (e.g., under ASC 740-30-25-9, ASC 740-10-25-3, or ASC 740-30-25-7).

An acquirer should consider other factors when accounting for the income tax consequences of a business combination achieved in stages.

### ***DTLs for Domestic Subsidiaries Acquired in Stages***

The acquirer may not be required to recognize a DTL for an outside basis difference once the acquirer obtains control of the acquiree. ASC 740-30-25-7 states that the acquirer should assess whether the outside basis difference of an investment in a domestic subsidiary is a taxable temporary difference. If the tax law provides a means by which the tax basis of the investment can be recovered in a tax-free transaction and the acquirer expects that it will ultimately use that means to recover its investment, a DTL should not be recognized for the outside basis difference. Therefore, under these circumstances, the acquiring entity should reverse any DTL previously recognized for the outside basis difference, including any DTL associated with the remeasurement of the original investment. This reversal of the DTL should be recognized in the acquirer's statement of operations in the same period that includes the business combination.

### ***DTLs for Foreign Subsidiaries Acquired in Stages***

Under ASC 740-30-25-16, an acquiring entity that acquires a foreign entity must continue to treat a temporary difference for its share of the undistributed earnings of the acquiree before the date it becomes a subsidiary as a taxable temporary difference. Therefore, in accordance with ASC 740-30-25-16, the acquiring entity should continue to recognize a DTL to the extent that the foreign subsidiary's dividends do not exceed the acquirer's share of the subsidiary's earnings after the date it becomes a subsidiary.

Questions have arisen about whether, in a step acquisition, a DTL resulting from a remeasurement of the original investment should also be retained in accordance with ASC 740-30-25-16. There are two acceptable approaches:

1. The DTL associated with the entire outside basis difference, including any DTL associated with the remeasurement of the original investment, should be retained.
2. Only the DTL associated with the undistributed earnings of the acquiree before control is obtained should be retained.

The approach an entity selects is an accounting policy election that, like all such elections, should be applied consistently.

## 11.14 Accounting for Income Taxes in a Business Combination That Resulted in a Bargain Purchase

A bargain purchase occurs when the net of the fair value of the identifiable assets acquired and liabilities assumed exceeds the sum of:

1. The acquisition-date fair value of the consideration transferred, including the fair value of the acquirer's previously held interest (if any) in the acquiree (i.e., a business combination achieved in stages).
2. The fair value of any noncontrolling interest in the acquiree.

The acquirer recognizes the excess (i.e., the bargain purchase element) as a gain on the acquisition date.

When an entity has been acquired, the acquirer calculates the gain on the bargain purchase after the deferred taxes on the inside basis differences (see [11.06](#) for more information about inside and outside basis differences) are recorded on the acquired entity's assets and liabilities. This recognized gain increases the acquirer's investment in the acquired entity and causes a corresponding increase in the acquired entity's equity for financial reporting purposes. However, for tax purposes, the bargain purchase gain is generally not included in the tax basis of the investment in the acquiree. Therefore, a difference arises between the investment in the acquiree for financial reporting purposes and the investment in the acquiree for tax purposes. If deferred taxes are recorded on the outside basis difference caused by the bargain purchase gain, the tax effects would be recorded outside of the business combination as a component of income tax expense.

### Example 11-11

#### Taxable Business Combination — Bargain Purchase

AC pays \$800 to acquire TC in a taxable business combination. The fair value of the identifiable assets is \$1,000. AC recognizes a \$120 gain on the bargain purchase. Assume a 40 percent tax rate.

For the inside basis difference, a DTL of \$80 is recorded on the difference between the book basis (\$1,000) and tax basis (\$800) of the acquired assets.

The entries for the acquisition, gain on the bargain purchase, and resulting deferred taxes are as follows:

#### TC's entry:

Assets	1,000
DTL	80
Equity	920*

\* \$800 consideration plus \$120 gain on bargain purchase.

#### AC's entry:

Investment in TC	920
Cash	800
Gain on bargain purchase	120

Regarding the outside basis difference, the carrying amount of AC's investment in TC for financial reporting purposes will increase by \$120 and there will be a corresponding increase in TC's equity as a result of the recognition of the \$120 gain.

**Example 11-11 (continued)**

The following table illustrates AC's investment in TC:

	<b>Book Basis</b>	<b>New Tax Basis</b>
TC stock	\$ 800	\$ 800
Gain on bargain purchase	<u>120</u>	<u>—</u>
Total	<u>\$ 920</u>	<u>\$ 800</u>

In accordance with ASC 740-30-25-7, AC could determine that the outside basis difference in TC's stock is not a taxable temporary difference because (1) the tax law provides a means by which the reported amount of that investment can be recovered tax-free and (2) AC expects it will ultimately use that means. See [8.15](#) for further discussion of tax-free liquidation or merger of a subsidiary.

**Example 11-12****Nontaxable Business Combination — No Bargain Purchase Gain Recognized as a Result of the DTL**

AC pays \$800 to acquire the stock of TC in a nontaxable business combination. The fair value of the identifiable assets is \$1,000. Assume that the tax bases of the identifiable assets are \$400 and that the tax rate is 40 percent.

The following are TC's and AC's entries recording the acquisition and resulting deferred taxes:

**TC's entry:**

Assets	1,000
Goodwill	40
DTL	240
Equity	800

**AC's entry:**

Investment in TC	800
Cash	800

The gain on the bargain purchase is calculated after deferred taxes are recorded. AC does not recognize a gain on the bargain purchase because the fair value of the identifiable assets acquired and liabilities assumed (net amount of \$760) does not exceed the consideration transferred. There is no bargain purchase after the DTL is recorded for the difference between the book basis of \$1,000 and tax basis of \$400 for the assets acquired.

**Example 11-13****Nontaxable Business Combination — Bargain Purchase**

Assume the same facts as in Example 11-12 except that the tax bases of the identifiable assets are \$700 rather than \$400.

A DTL of \$120 is recorded for the difference between the book basis of \$1,000 and tax basis of \$700 for the assets acquired. The entries recording the acquisition gain on the bargain purchase and resulting deferred taxes are as follows:

**TC's entry:**

Assets	1,000
DTL	120
Equity	880

**AC's entry:**

Investment in TC	880
Cash	800
Gain on bargain purchase	80

These entries show that AC recognizes an \$80 gain on the bargain purchase. As a result of AC's recognition of an \$80 gain, AC's investment in TC will increase by \$80, with a corresponding increase in TC's equity. Thus, an outside basis difference will arise between the book basis of \$880 and tax basis of \$800 for TC's stock. AC determines that the outside basis difference in TC's stock is a taxable temporary difference and records a DTL.

**AC's entry:**

Deferred tax expense	32
DTL	32

The DTL represents an \$80 basis difference at a tax rate of 40 percent. Goodwill is not affected because the outside basis difference is related to the bargain purchase gain recognized and therefore is unrelated to the business combination accounting.

## 11.15 Accounting for the Tax Effects of Contingent Environmental Liabilities Assumed in a Business Combination

There are unique tax considerations related to situations in which an acquirer purchases the assets of an entity that has preexisting contingent environmental liabilities. Presumably, the acquirer has factored the costs of any known remediation requirements into the amount that it would pay for the property when determining the property's fair value in a business combination.

For financial reporting purposes, the asset requiring environmental remediation is recorded at fair value, full remediation is assumed, and a liability is recorded to recognize the estimated costs of remediation. However, for tax purposes, the asset is recorded at its unremediated value. Therefore, the acquirer will record a DTL for the taxable temporary difference between the amount recorded for financial reporting purposes and the tax basis of the asset.

Furthermore, Treasury Regulation Section 1.338-5(b)(2)(iii) gives the following example illustrating when to adjust the tax basis for the contingent environmental liability:

T, an accrual basis taxpayer, is a chemical manufacturer. In Year 1, T is obligated to remediate environmental contamination at the site of one of its plants. Assume that all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy but economic performance has not occurred with respect to the liability within the meaning of section 461(h). P acquires all of the stock of T in Year 1 and makes a section 338 election for T. Assume that, if a corporation unrelated to T had actually purchased T's assets and assumed T's obligation to remediate the contamination, the corporation would not satisfy the economic performance requirements until Year 5. . . . The incurrence of the liability in Year 5 under the economic performance rules is an increase in the amount of liabilities properly taken into account in the basis and results in the redetermination of AGUB [adjusted grossed-up basis].

Therefore, in a taxable business combination, the settlement of a contingent environmental liability will generally increase tax-deductible goodwill. Therefore, as described in [11.29](#), the acquirer should assume that the contingent environmental liability will be settled at its acquisition-date fair value and should include this amount in the calculation of tax-deductible goodwill when performing the acquisition-date comparison with financial reporting goodwill. If the amount of the hypothetical tax-deductible goodwill (i.e., tax-deductible goodwill that includes the amount associated with the contingency) exceeds the amount of financial reporting goodwill, a DTA should be recorded. However, if the financial reporting goodwill continues to exceed the hypothetical tax-deductible goodwill, no DTL is recorded for the excess (because of the exception in ASC 805-740-25-9). See [11.20](#) for further discussion of the acquisition-date comparison of financial reporting goodwill with tax-deductible goodwill.

#### Example 11-14

AC acquires the stock of TC for \$45 million in a taxable business combination on June 30, 20X9 (e.g., a stock acquisition with a taxable election under Section 338 of the IRC). As part of the acquisition, AC recognizes a contingent environmental liability with a fair value of \$1 million in connection with contaminated land. For financial reporting purposes, the land is recognized at its fair value (full remediation is assumed) of \$5 million; however, for tax purposes, the land is recognized at only \$4 million (i.e., the tax basis is based on unremediated fair value). The remaining assets of TC have a fair value of \$37 million with an equal tax basis. AC's applicable tax rate is 40 percent.

Goodwill for both financial reporting and tax purposes is calculated below:

	<b>Book Basis</b>	<b>Tax Basis</b>
Land	\$ 5,000,000	\$ 4,000,000
All other assets	37,000,000	37,000,000
Contingent environmental liability	(1,000,000)	—
Consideration transferred	<u>(45,000,000)</u>	<u>(45,000,000)</u>
Goodwill	<u>\$ 4,000,000*</u>	<u>\$ 4,000,000</u>

\* Before the impact of deferred taxes is considered.

AC will recognize a DTL of \$400,000 for the taxable temporary difference between the tax basis of the land and the amount recorded for financial reporting purposes ( $[\$5,000,000 - \$4,000,000] \times 40\%$ ).

For tax purposes, AC has determined that once the contingent environmental liability is settled, it will be added to tax-deductible goodwill. Therefore, AC includes the acquisition-date fair value of the contingent environmental liability in tax-deductible goodwill when comparing acquisition-date tax-deductible goodwill with financial reporting goodwill.

**Example 11-14 (continued)**

Tax-deductible goodwill is compared with financial reporting goodwill as follows:

Tax-deductible goodwill	\$ 4,000,000
Acquisition-date fair value of the contingent environmental liability	<u>1,000,000</u>
Hypothetical tax-deductible goodwill	\$ 5,000,000
Financial reporting goodwill (\$4,000,000 + \$400,000)	<u>4,400,000</u>
Excess of hypothetical tax-deductible goodwill over financial reporting goodwill	<u>\$ 600,000</u>

Because hypothetical tax-deductible goodwill exceeds financial reporting goodwill, AC records a DTA by using the following iterative calculation, as further described in [11.20](#):

$$\text{DTA} = (0.40/[1 - 0.40]) \times \$600,000$$

$$\text{DTA} = \$400,000$$

The following entries are recorded on June 30, 20X9:

**AC:**

Investment in TC	45,000,000
Cash	45,000,000

**TC (to reflect “push-down” of the entries to TC’s books):**

All other identifiable assets	37,000,000
Land	5,000,000
DTA	400,000
Goodwill	4,000,000*
Contingent environmental liability	1,000,000
DTL	400,000**
Equity	45,000,000

\* ([\\$4,000,000 + \$400,000 DTL] – \$400,000 DTA).

\*\* DTL recognized for the taxable temporary difference in the land acquired ([\\$5,000,000 – \\$4,000,000] × 40%).

## 11.16 Research and Development Assets Acquired in a Business Combination

Under ASC 350-30-35-17A, acquired R&D assets will be separately recognized and measured at their acquisition-date fair values. ASC 350-30-35-17A states that an R&D asset acquired in a business combination must be considered an indefinite-lived intangible asset until completion or abandonment of the associated R&D efforts. Once the R&D efforts are complete or abandoned, an entity should apply the guidance in ASC 350 to determine the useful life of the R&D assets and should amortize these assets accordingly in the financial statements. If the project is abandoned, the asset would be written off if it has no alternative use.

In accordance with ASC 740, deferred taxes should be recorded for temporary differences related to acquired R&D assets as of the business combination's acquisition date. As with all acquired assets and assumed liabilities, an entity must compare the amount recorded for an R&D intangible asset with its tax basis to determine whether a temporary difference exists. If the tax basis of the R&D intangible asset is zero, as it will be in a typical nontaxable business combination, a DTL will be recorded for that basis difference. (See [4.27](#) for guidance on using these DTLs to evaluate DTAs for realization.)

## **11.17 Obtaining Tax Basis Step-Up of Acquired Net Assets Through Payment to a Tax Authority**

In some tax jurisdictions, an acquirer may pay the taxing authority to obtain a step-up in the tax basis of the net assets of the acquired business. In accordance with ASC 740-10-25-53, a payment to a taxing authority to obtain a step-up in tax basis is generally accounted for as a separate transaction between the acquirer and the tax authority (i.e., outside of the business combination) and recognized in continuing operations as income tax expense.

See ASC 740-10-55-202 for an example of such a transaction.

## **11.18 Income Tax Accounting for Assets Acquired in a Business Combination That Were Subject to an Intra-Entity Sale**

As discussed in [3.16](#), when an intra-entity sale of inventory or other assets occurs at a profit between affiliated entities that are included in consolidated financial statements but not in a consolidated tax return, the purchasing entity's tax basis of that asset exceeds the reported amount in the consolidated financial statements. This occurs because, for financial reporting purposes, the effects of gains or losses on transactions between entities included in the consolidated financial statements are eliminated in consolidation. ASC 740-10-25-3(e) requires that income taxes paid on intra-entity profits on assets remaining within the group be accounted for under ASC 810-10 and prohibits recognition of a DTA for the difference between the tax basis of the assets in the buyers' tax jurisdiction and their cost as reported in the consolidated financial statements. Specifically, ASC 810-10-45-8 states, "If income taxes have been paid on intra-entity profits on assets remaining within the consolidated group, those taxes shall be deferred or the intra-entity profits to be eliminated in consolidation shall be appropriately reduced."

However, ASC 805-740-25-3 requires that, in a business combination, a DTA be recognized when the tax basis of an acquiree's asset exceeds the reported amount of the asset in the financial statements.

A DTA or DTL should be recognized for the difference between the acquisition-date fair value assigned to the asset and the buyer's actual tax basis (i.e., the tax basis after the intra-entity sale). When the inventory is sold to a party outside the consolidated group or depreciation of the fixed asset occurs, the DTA or DTL should be reversed. The intra-entity sales of inventory or other assets after the business combination should be accounted for under the normal guidance in ASC 740-10-25-3(e).

## **11.19 Tax Considerations Related to Leveraged Leases Acquired in a Business Combination**

ASC 840-10-25-43(c) defines a leveraged lease as having all of the following characteristics:

1. It meets the criteria . . . for a direct financing lease.
2. It involves at least three parties . . .
3. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor . . .
4. The lessor's net investment . . . declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination.

As indicated in ASC 840-30, the initial recognition of a leveraged lease is based on projected after-tax cash flows. However, in a business combination, an acquired entity's individual assets and liabilities are generally assigned fair values before taxes are considered.

In accordance with ASC 840-30-30-15, the acquiring entity should record an acquired leveraged lease on the basis of the remaining future cash flows while giving appropriate recognition to the estimated future tax effects of those cash flows. Therefore, the fair value assigned to an acquired leveraged lease is determined on an after-tax basis (e.g., net of tax) and deferred taxes should not be established for temporary differences related to acquired leveraged leases as of the acquisition date.

See ASC 840-30-55-50 for an example of the accounting for a leveraged lease acquired in a business combination.

## **11.19A Income Tax Benefits From Amortization of Intangible Assets in Fair Value Measurements**

When using an income approach on a post-tax basis to measure the fair value of an intangible asset, an entity should include **all** incremental cash flows. These would include positive cash flows resulting from future income tax deductions for the asset's amortization expense (commonly referred to as tax amortization benefits or TABs) that a market participant would expect to receive. A market participant would expect to receive the TABs if the jurisdiction in which the transaction is consummated allows for a deduction for amortization expense of intangible assets. An entity must use judgment in determining which jurisdiction should be considered from a market-participant perspective.

At the 2006 AICPA Conference on Current SEC and PCAOB Developments, Cheryl Tjon-Hing, a valuation specialist in the SEC's Office of the Chief Accountant, discussed how an entity should treat TABs in measuring an asset's fair value. She stated, in part:

Tax amortization benefits (TAB) represents, as its name implies, the cash flow generated to an owner of an asset as a result of being able to write-off the full fair value of that asset for tax purposes — generally, this benefit may impact a fair value conclusion, derived using an income approach, by as much as 20% to 30%. Now, it seems logical that the fair value of an asset should not change just because of the way a transaction is structured.

**So TABs should be taken into account, in determining asset fair values, no matter what the tax**

**attributes of a transaction are.** But for those requiring more specific guidance, FAS 109, paragraph A129 [footnote omitted] implicitly states that TABs should be factored into an asset's fair value. To the extent that a portion of the step-up value is not deductible for tax purposes, that is what deferred tax liabilities are for. In fact, preparers of fair value measurements should be aware that if a TAB is not factored into the fair value of an asset, there may be a mismatch if any associated deferred tax liability is recorded, for accounting purposes, in an acquisition transaction. Now, despite the aforementioned accounting guidance, we often see that TABs are excluded from asset fair values measured for business combinations effected through a purchase of shares — usually, this is because preparers argue that any step-up in fair value over tax value is not deductible for tax purposes. [Emphasis added]

One of the AICPA's practice aids, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*, includes a discussion of TABs and is a valuable resource for understanding and applying valuation techniques for intangible assets. However, entities should use caution when referring to this practice aid because it has not yet been updated to reflect certain changes in fair value guidance resulting from the issuance of FASB Statement 157. Entities should only use this practice aid when it does not conflict with ASC 820 or other authoritative GAAP, since it has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA or the FASB and thus is not authoritative guidance.

## 11.20 Deferred Taxes Associated With Goodwill

ASC 805-740-25-3 indicates that recognition of deferred taxes on differences between the financial reporting and the tax basis of goodwill depends on whether goodwill is deductible under the tax law. For financial reporting purposes, deferred taxes should not be recognized for goodwill book and tax differences in tax jurisdictions where deductions are not allowed for the amortization or impairment of the goodwill. In tax jurisdictions where amortization of goodwill is tax-deductible, goodwill for financial reporting purposes and tax-deductible goodwill must be separated as of the acquisition date into two components, in accordance with ASC 805-740-25-8 and 25-9.

The first component of goodwill ("component 1 goodwill") equals the lesser of (1) goodwill for financial reporting purposes or (2) tax-deductible goodwill. Any difference that arises between the book and tax basis of component 1 goodwill in future periods is a temporary difference for which a DTA or DTL is recognized.

The second component of goodwill ("component 2 goodwill") equals (1) total goodwill (the greater of financial reporting goodwill or tax-deductible goodwill) less (2) the calculated amount of component 1 goodwill. Since tax basis in goodwill that can only be deducted upon cessation or sale of the acquired business is not deductible goodwill, it is possible to have two component 2 goodwill amounts for which there is no deferred tax accounting (i.e., one for financial reporting basis and one for tax basis). If component 2 goodwill is an excess of tax-deductible goodwill over financial reporting goodwill, an entity must recognize the excess as of the acquisition date as a DTA in accordance with ASC 740. The entity should use an iterative calculation to determine this DTA because goodwill and the DTA are established simultaneously as of the acquisition date. ASC 805-740-55-9 through 55-13 provide the "simultaneous equations method" for this purpose. Using this method, an entity simultaneously determines the amount of goodwill to record for financial reporting purposes and the amount of the DTA. Example 11-15 illustrates the application of the simultaneous equations method.

Previously under the requirements of Statement 141, if component 2 goodwill was an excess of tax-deductible goodwill over financial reporting goodwill, an entity was required to recognize the tax basis for the excess when deducted in the tax return filed. When realized, the excess tax benefit acquired in those transactions was applied first to reduce goodwill related to the acquisition to zero, then to reduce other noncurrent intangible assets related to the acquisition to zero, and lastly to reduce income tax expense. This requirement will continue to apply to goodwill recognized in business combinations before the effective date of Statement 141(R). See [11.22](#) for further guidance.

However, in accordance with ASC 805-740-25-9, if component 2 goodwill is an excess of financial reporting goodwill over tax-deductible goodwill, no DTL should be recorded.

Furthermore, in certain business combinations, the acquired entity may have tax-deductible goodwill from a prior acquisition for which it received carry-over tax basis. The acquired tax-deductible goodwill should be included in the acquisition date allocation between component 1 goodwill and component 2 goodwill.

**Example 11-15**

Assume the following:

- Acquisition date of January 1, 20X9.
- Financial reporting goodwill of \$800, before initial tax adjustments.
- Tax goodwill of \$1,000.
- Annual tax amortization of \$500 per year.
- No other temporary differences.
- Tax rate of 40 percent.
- Income before taxes in year 1 is \$10,000, in year 2 is \$11,000, and in year 3 is \$12,000.

**On Acquisition Date:**

1. Preliminary calculation of goodwill components:

	<b>Book</b>	<b>Tax</b>
Component 1 goodwill	\$ 800	\$ 800
Component 2 goodwill	<u>      </u>	<u>200</u>
Total goodwill	<u>\$ 800</u>	<u>\$ 1,000</u>

2. Calculation of the DTA:

- $DTA = (0.40/[1 - 0.40]) \times \$200$ .
- $DTA = \$133$ .

3. Entry to record the DTA:

DTA	133
Goodwill	133

(Note: "Final" financial reporting goodwill is \$667.)

**Accounting in Years 1–3:**

1. Calculation of taxes payable:

	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>
Book income (pretax)	\$ 10,000	\$ 11,000	\$ 12,000
Tax amortization	<u>500</u>	<u>500</u>	<u>—</u>
Taxable income	<u>\$ 9,500</u>	<u>\$ 10,500</u>	<u>\$ 12,000</u>
Taxes payable (40%)	<u>\$ 3,800</u>	<u>\$ 4,200</u>	<u>\$ 4,800</u>

**Example 11-15 (continued)**

## 2. Calculation of deferred taxes:

Goodwill is not amortized for financial reporting purposes. Each year, a DTL must be calculated and recognized for the difference between component 1 financial reporting goodwill and component 1 tax goodwill. This DTL will reverse when the company impairs, sells, or disposes of the related assets.

	<b>January 1, 20X9</b>	<b>End of Year 1</b>	<b>End of Year 2</b>	<b>End of Year 3</b>
Financial reporting basis — goodwill	\$ 667	\$ 667	\$ 667	\$ 667
Tax basis — component 1 goodwill	667	334	—	—
Tax basis — component 2 goodwill	333	166	—	—
Total tax basis in goodwill	1,000	500	—	—
Temporary difference — component 1 goodwill	—	333	667	667
Temporary difference — component 2 goodwill	333	167	—	—
DTL — component 1 goodwill	—	133	267	267
DTA — component 2 goodwill	\$ 133	\$ 67*	\$ —	\$ —
Deferred income tax expense		\$ 200	\$ 200	\$ —
Current income tax benefit		\$ (200)	\$ (200)	

\* Although the deferred tax allocation seemingly creates a DTL for component 1 goodwill and a DTA for component 2 goodwill, both components should be viewed as a net DTL in the assessment of the need for a valuation allowance (i.e., no valuation allowance would be needed on the DTA of \$67).

## 3. Realization of the tax benefit:

A tax benefit will be realized for the tax deduction associated with goodwill.

**Entries for Years 1 and 2:**

Income tax expense	200
DTL	133
DTA	67*

\* Represents deferred taxes associated with the component 2 goodwill temporary difference amortized over two years ( $[\$333 \div 2] \times 40\%$ ).

## 4. Profit and loss snapshot:

	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>
Book income (pretax)	\$ 10,000	\$ 11,000	\$ 12,000
Tax amortization			
Current	3,800	4,200	4,800
Deferred	200	200	—
Total income tax expense	4,000	4,400	4,800
Net income	\$ 6,000	\$ 6,600	\$ 7,200

## 11.21 Allocation of Tax Amortization of Goodwill

As discussed in [11.20](#), in jurisdictions in which goodwill is deductible under the tax law, goodwill for financial reporting purposes and tax-deductible goodwill should be separated as of the acquisition date into two components in accordance with ASC 805-740-25-8 and 25-9. The first component of goodwill ("component 1 goodwill") equals the lesser of (1) goodwill for financial reporting purposes or (2) tax-deductible goodwill. The second component of goodwill ("component 2 goodwill") equals (1) total goodwill (the greater of financial reporting goodwill or tax-deductible goodwill) less (2) the calculated amount of component 1 goodwill.

When tax-deductible goodwill exceeds goodwill for financial reporting purposes, entities have alternatives for allocating tax amortization between component 1 goodwill and component 2 goodwill. However, these alternatives will have the same net effect on the consolidated financial statements.

The following two approaches are acceptable for allocating tax amortization between component 1 goodwill and component 2 goodwill:

- *Approach 1* — Allocate the tax amortization first to any amount of tax-deductible goodwill greater than goodwill for financial reporting purposes (i.e., allocate first to component 2 goodwill). Under this approach, the entity will first reduce any DTA recognized in the acquisition accounting before recognizing a DTL.
- *Approach 2* — Allocate the tax amortization on a pro rata basis between component 1 goodwill and component 2 goodwill. Under this approach, the entity will reduce the DTA recognized in the acquisition accounting for the tax amortization allocated to component 2 goodwill and at the same time recognize a DTL for the tax amortization allocated to component 1 goodwill.

Example 11-16 demonstrates the two approaches and their similar effects on the financial statements.

### Example 11-16

Assume that Entity X acquires Entity Y in a taxable business combination. The acquisition results in goodwill for financial reporting purposes of \$1 million and tax-deductible goodwill of \$1.6 million. Entity X's tax rate is 40 percent. Because tax-deductible goodwill exceeds goodwill for financial reporting purposes, X recognizes a DTA of \$400,000 as part of the business combination accounting (see [11.20](#) for guidance on calculating this amount), with an offset to goodwill for financial reporting purposes (i.e., final goodwill for financial reporting purposes is \$600,000 on the acquisition date). Assume for tax purposes that the tax-deductible goodwill is amortized over 10 years and that X has not recognized any goodwill impairments. In this example, component 1 goodwill would be \$600,000 (i.e., the lesser of goodwill for financial reporting purposes and tax-deductible goodwill) and component 2 goodwill would be \$1 million (i.e., the difference between total tax-deductible goodwill of \$1.6 million and component 1 goodwill of \$600,000).

**Example 11-16 (continued)**

The following entries would be recorded to recognize the first year of tax amortization:

- *Approach 1* — The tax amortization of \$160,000 (\$1,600,000/10 years) would be allocated to the component 2 goodwill. Therefore, component 2 goodwill would be reduced to \$840,000 (\$1,000,000 – \$160,000) and the DTA recognized as of the acquisition date would be reduced by \$64,000 (\$160,000 × 40%).

Income taxes payable	64,000
Income tax expense	64,000

To record the income tax benefit of the tax amortization.

Income tax expense	64,000
DTA	64,000

To allocate the tax amortization between component 1 and component 2 goodwill under Approach 1.

- *Approach 2* — The tax amortization of \$160,000 (\$1,600,000/10 years) would be allocated on a pro rata basis between the component 1 goodwill and the component 2 goodwill. Component 2 goodwill would be reduced to \$900,000 [\$1,000,000 – (\$1,000,000/\$1,600,000 × \$160,000)] and the DTA associated with component 2 goodwill would be reduced by \$40,000 [(\$1,000,000/\$1,600,000 × \$160,000) × 40%]. Component 1 goodwill would be reduced to \$540,000 [\$600,000 – (\$600,000/\$1,600,000 × \$160,000)], which would create a DTL of \$24,000 [(\$600,000/\$1,600,000 × \$160,000) × 40%] for the taxable temporary difference between goodwill for financial reporting purposes and tax-deductible goodwill.

Income taxes payable	64,000
Income tax expense	64,000

To record the income tax benefit of the tax amortization.

Income tax expense	64,000
DTL	24,000
DTA	40,000

To allocate the tax amortization between component 1 and component 2 goodwill under Approach 1.

While amortization of the goodwill is reflected in both approaches, Approach 2 seemingly creates a DTL with the allocation. However, the goodwill remains one asset for financial reporting purposes and, correspondingly, the related deferred taxes should be considered on a net basis in the assessment of the need for a valuation allowance (i.e., the ending DTA in year 1 would be \$336,000).

## 11.22 Deferred Taxes Associated With Goodwill in Pre-Statement 141(R) Acquisitions

FASB Statement 141(R) (codified in ASC 805) amended paragraph 262 of FASB Statement 109 to require that the tax benefit associated with component 2 tax-deductible goodwill (an excess of tax-deductible goodwill over financial reporting goodwill) be recognized as of the acquisition date. Before the amendments made by Statement 141(R), the tax benefit associated with component 2 tax-deductible goodwill was recognized only when realized on the tax return. This tax benefit was applied first to reduce goodwill related to the acquisition to zero, then to reduce other noncurrent intangible assets related to the acquisition to zero, and lastly to reduce income tax expense.

After the effective date of Statement 141(R) (codified in ASC 805), the tax benefit associated with component 2 tax-deductible goodwill should continue to be recognized for business combinations previously accounted for in accordance with FASB Statement 141 (i.e., business combinations consummated in periods before the effective date of Statement 141(R)).

An entity would still need to apply the guidance in paragraphs 262 and 263 of Statement 109 (before the Statement 141(R)/ASC 805 amendments) to any component 2 tax-deductible goodwill from business combinations accounted for under Statement 141. That is, for business combinations consummated before the effective date of ASC 805 (Statement 141(R)), goodwill would continue to be adjusted as the tax benefit associated with component 2 goodwill is realized on the tax return. Paragraph 262 of Statement 109, before being amended by Statement 141(R), stated:

Amortization of goodwill is deductible for tax purposes in some tax jurisdictions. In those tax jurisdictions, the reported amount of goodwill and the tax basis of goodwill are each separated into two components as of the combination date for purposes of deferred tax calculations. The first component of each equals the lesser of (a) goodwill for financial reporting or (b) tax-deductible goodwill. The second component of each equals the remainder of each, that is, (1) the remainder, if any, of goodwill for financial reporting or (2) the remainder, if any, of tax-deductible goodwill. Any difference that arises between the book and tax basis of that first component of goodwill in future years is a temporary difference for which a deferred tax liability or asset is recognized based on the requirements of this Statement. No deferred taxes are recognized for the second component of goodwill. If that second component is an excess of tax-deductible goodwill over the reported amount of goodwill, the tax benefit for that excess is recognized when realized on the tax return, and that tax benefit is applied first to reduce to zero the goodwill related to that acquisition, second to reduce to zero other noncurrent intangible assets related to that acquisition, and third to reduce income tax expense.

Paragraph 263 of Statement 109, before being amended by Statement 141(R), included an example that illustrated the accounting for the tax consequences of goodwill when amortization of goodwill is deductible for tax purposes. That example has been adapted to illustrate the accounting that still applies (even after the effective date of Statement 141(R)) to tax benefits associated with component 2 tax-deductible goodwill.

### Example 11-17

Assume the following:

- As of the acquisition date (i.e., January 1, 20X8), the financial reporting amount and tax basis amount of goodwill are \$600 and \$800, respectively.
- For tax purposes, amortization of goodwill will result in tax deductions of \$400 in each of years 1 and 2. Those deductions result in current tax benefits in years 20X8 and 20X9.
- For simplicity, the consequences of other temporary differences are ignored for years 20X8–2X11.
- The entity has a calendar year-end and will adopt Statement 141(R) on January 1, 20X9.
- Income before income taxes is \$1,000 in each of years 20X8–2X11.
- The tax rate is 40 percent for all years.

Income taxes payable for years 20X8–2X11 are:

	<b>20X8</b>	<b>20X9</b>	<b>2X10</b>	<b>2X11</b>
Income before amortization of goodwill	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000
Tax amortization of goodwill	400	400	—	—
Taxable income	600	600	1,000	1,000
Income tax payable	<u>\$ 240</u>	<u>\$ 240</u>	<u>\$ 400</u>	<u>\$ 400</u>

**Example 11-17 (continued)**

As of the combination date, goodwill is separated into two components as follows:

	<b>Reported Amount</b>	<b>Tax Basis</b>
First component	\$ 600	\$ 600
Second component	—	200
Total goodwill	<u>\$ 600</u>	<u>\$ 800</u>

A DTL is recognized for the tax amortization of goodwill for years 20X8 and 20X9 for the excess of the financial reporting amount over the tax basis of the first component of goodwill. Although there is no difference between the book and tax basis of component 1 goodwill as of the business combination date (both \$600), a difference does arise as of the reporting date. This difference results from (1) the reduction of book goodwill by the realized benefits on component 2 goodwill (the calculation is explained below) and (2) the tax amortization of the component 1 tax-deductible goodwill. When the second component of goodwill is realized on the tax return for years 20X8 and 20X9, the tax benefit is allocated to reduce financial reporting goodwill.

The second component of goodwill is deductible at \$100 per year in years 20X8 and 20X9. Those tax deductions provide \$40 (\$100 at 40 percent) of tax benefits that are realized in years 20X8 and 20X9. The realized benefits reduce the first component of goodwill and produce a deferred tax benefit by reducing the taxable temporary difference related to that component of goodwill. Thus, the total tax benefit (TTB) allocated to reduce the first component of goodwill in years 20X8 and 20X9 is the sum of (1) the \$40 realized tax benefit allocated to reduce goodwill and (2) the deferred tax benefit from reducing the DTL related to goodwill. The TTB is determined as follows:

TTB = realized tax benefit plus (tax rate times TTB)

$$\text{TTB} = \$40 + (0.40 \times \text{TTB})$$

$$\text{TTB} = \$67$$

Goodwill for financial reporting purposes for years 20X8–2X11 is:

	<b>20X8</b>	<b>20X9</b>	<b>2X10</b>	<b>2X11</b>
Balance at beginning of year	\$ 600	\$ 533	\$ 466	\$ 466
TTB allocated to reduce goodwill	67	67	—	—
Balance at end of year	<u>\$ 533</u>	<u>\$ 466</u>	<u>\$ 466</u>	<u>\$ 466</u>

The DTL for the first component of goodwill and the related amount of deferred tax expense (benefit) for years 20X8–2X11 are:

	<b>20X8</b>	<b>20X9</b>	<b>2X10</b>	<b>2X11</b>
Reported goodwill at end of year	\$ 533	\$ 466	\$ 466	\$ 466
Tax basis of goodwill (first component)	300	—	—	—
Taxable temporary difference	<u>\$ 233</u>	<u>\$ 466</u>	<u>\$ 466</u>	<u>\$ 466</u>
DTL:				
At end of year (40 percent)	93	186	186	186
At beginning of year	—	93	186	186
Deferred tax expense for the year	<u>\$ 93</u>	<u>\$ 93</u>	<u>\$ —</u>	<u>\$ —</u>

**Example 11-17 (continued)**

Income for financial reporting for years 20X8–2X11 is:

	<b>20X8</b>	<b>20X9</b>	<b>2X10</b>	<b>2X11</b>
Income before income tax	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000
Income tax expense:				
Current	240	240	400	400
Deferred	93	93	—	—
Benefit applied to reduce goodwill	67	67	—	—
Income tax expense	400	400	400	400
Net income	<u>\$ 600</u>	<u>\$ 600</u>	<u>\$ 600</u>	<u>\$ 600</u>

## 11.23 Tax Benefits of Tax-Deductible Share-Based Payment Awards Exchanged in a Business Combination

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. This section includes guidance for before and after the adoption of the new guidance. See [Chapter 10, "Share-Based Compensation,"](#) for guidance on adopting ASU 2016-09.

The appropriate income tax accounting for tax-deductible share-based payment awards exchanged in a business combination depends on the timing of the exchange relative to the acquisition date.

### ***Before the Adoption of ASU 2016-09***

#### Income Tax Accounting as of the Acquisition Date

For share-based payment awards that (1) are exchanged in a business combination and (2) ordinarily result in a tax deduction under current tax law (e.g., nonqualified share options), an acquirer should record a DTA as of the acquisition date for the tax benefit of the fair-value-based measure<sup>3</sup> of the acquirer's replacement award included in the consideration transferred.

#### Income Tax Accounting After the Acquisition Date

For the portion of the fair-value-based measure of the acquirer's replacement award that is attributed to postcombination service and therefore included in postcombination compensation cost, a DTA is recorded over the remaining service period (i.e., as the postcombination compensation cost is recorded) for the tax benefit of the postcombination compensation cost.

In accordance with ASC 718, the DTA for awards classified as equity is not subsequently adjusted to reflect changes in the entity's share price. In contrast, for awards classified as a liability, the DTA is remeasured, along with the compensation cost, in every reporting period until settlement.

<sup>3</sup> This guidance uses the term fair-value-based measure; however, ASC 718 also permits the use of calculated value or intrinsic value in specified circumstances. This guidance would also apply in situations in which calculated value or intrinsic value is permitted.

## Income Tax Accounting Upon Exercise of the Share-Based Payment Awards

ASC 805-740-45-5 and 45-6 state that any difference between (1) the tax benefit received from exercising the share-based payment awards and (2) the previously recorded DTA balance related to the fair-value-based measure attributed to both precombination service (included in consideration transferred) and postcombination service (included in postcombination compensation cost) should be recognized in accordance with ASC 718-740-45-2 and 45-3. That is, any excess of the tax benefit of the tax deduction over the DTA (i.e., excess tax benefits) should be recorded as an increase (credit) to paid-in capital. In contrast, any shortfalls of the tax benefit of the tax deduction in comparison to the DTA (i.e., tax benefit deficiencies) are recorded as a decrease (debit) to paid-in capital but only to the extent that previous excess tax benefits exist (often referred to as the "APIC pool"). In the absence of an APIC pool, tax benefit deficiencies **must be** recorded as an expense in the income statement in the period of the tax deduction.

The following examples, adapted from ASC 805-30-55, illustrate the income tax accounting for tax benefits received from tax-deductible share-based payment awards that are exchanged in a business combination after the effective date of FASB Statement 141(R).

### Example 11-18

The par value of the common stock issued and cash received for the option's exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and therefore adopted Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are awards that would typically result in a tax deduction (e.g., nonqualified share options).
- Company A's applicable tax rate is 40 percent.
- Company A has an APIC pool.

Company A issues replacement awards of \$110 (fair-value-based measure) on the acquisition date in exchange for Company B's awards of \$100 (fair-value-based measure) on the acquisition date. The exercise price of the replacement awards issued by A is \$15. No postcombination services are required for the replacement awards, and B's employees had rendered all of the required service for the acquiree awards as of the acquisition date.

The amount attributable to precombination service is the fair-value-based measure of B's awards (\$100) on the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to postcombination service is \$10, which is the difference between the total value of the replacement awards (\$110) and the portion attributable to precombination service (\$100). Because no postcombination service is required for the replacement awards, A immediately recognizes \$10 as compensation cost in its postcombination financial statements. See the following journal entries.

#### **Journal Entries: June 30, 20X1**

Goodwill	100
Compensation cost	10
APIC	110

To record the portions of the fair-value-based measure of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).

**Example 11-18 (continued)**

DTA	44
Goodwill	40
Income tax provision	4

To record the associated income tax effects of the fair-value-based measure of the portions of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).

On September 30, 20X1, all replacement awards issued by A are exercised when the market price of A's shares is \$150. Given the exercise of the replacement awards, A will realize a tax deduction of \$135 (\$150 market price of A's shares less the \$15 exercise price). The tax benefit of the tax deduction is \$54 ( $\$135 \times 40\%$  tax rate). Therefore, an excess tax benefit of \$10 (tax benefit of the tax deduction of \$54 less the previously recorded DTA of \$44) is recorded to APIC. See the following journal entry.

**Journal Entry: September 30, 20X1**

Taxes payable	54
Deferred tax expense	44
DTA	44
Current tax expense	44
APIC	10

To record the income tax effects of the award upon exercise.

**Example 11-19**

The par value of the common stock issued and cash received for the option's exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and therefore adopted FASB Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are awards that would typically result in a tax deduction (e.g., nonqualified options).
- Company A's applicable tax rate is 40 percent.

Company A exchanges replacement awards that require one year of postcombination service for share-based payment awards of Company B for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is \$100 on the acquisition date. The exercise price of the replacement awards is \$15. When originally granted, B's awards had a requisite service period of four years. As of the acquisition date, B's employees holding unexercised awards had rendered a total of seven years of service since the grant date. Even though B's employees had already rendered the requisite service for the original awards, A attributes a portion of the replacement award to postcombination compensation cost in accordance with ASC 805-30-30-12 because the replacement awards require one year of postcombination service. The total service period is five years — the requisite service period for the original acquiree award completed before the acquisition date (four years) plus the requisite service period for the replacement award (one year).

**Example 11-19 (continued)**

The portion attributable to precombination service equals the fair-value-based measure of the acquiree award (\$100) multiplied by the ratio of the precombination service period (four years) to the total service period (five years). Thus, \$80 ( $\$100 \times [4 \text{ years}/5 \text{ years}]$ ) is attributed to the precombination service period and therefore is included in the consideration transferred in the business combination. The remaining \$20 is attributed to the postcombination service period and therefore is recognized as compensation cost in A's postcombination financial statements, in accordance with ASC 718. See the following journal entries.

**Journal Entries: June 30, 20X1**

Goodwill	80	
APIC		80
DTA		32
Goodwill		32

To record the portion of the fair-value-based measure of the replacement award attributable to precombination service (i.e., consideration transferred) and the associated income tax effects.

**Journal Entries: December 31, 20X1**

Compensation cost	10	
APIC		10
DTA		4
Income tax provision		4

To record the compensation cost and the associated income tax effects for the six-month period from the date of the acquisition until December 31, 20X1.

On June 30, 20X2, all replacement awards issued by A vest and are exercised when the market price of A's shares is \$150. Given the exercise of the replacement awards, A will realize a tax deduction of \$135 (\$150 market price of A's shares less the \$15 exercise price). The tax benefit of the tax deduction is \$54 ( $\$135 \times 40\%$  tax rate). Therefore, an excess tax benefit of \$14 (tax benefit of the tax deduction of \$54 less the previously recorded DTA of \$40 ( $\$32 + \$4 + \$4$ ))) is recorded to APIC. See the following journal entries.

**Journal Entries: June 30, 20X2**

Compensation cost	10	
APIC		10
DTA		4
Income tax provision		4

To record the compensation cost and the associated income tax effects for the six-month period ended June 30, 20X2.

**Example 11-19 (continued)****Journal Entries: June 30, 20X2**

Taxes payable	54
Deferred tax expense	44
Current tax expense	40
DTA	40
APIC	14

To record the income tax effects of the award upon exercise.

### ***After the Adoption of ASU 2016-09***

#### **Income Tax Accounting as of the Acquisition Date**

For share-based payment awards that (1) are exchanged in a business combination and (2) ordinarily result in a tax deduction under current tax law (e.g., nonqualified share options), an acquirer should record a DTA as of the acquisition date for the tax benefit of the fair-value-based measure<sup>4</sup> of the acquirer's replacement award included in the consideration transferred.

#### **Income Tax Accounting After the Acquisition Date**

For the portion of the fair-value-based measure of the acquirer's replacement award that is attributed to postcombination service and therefore included in postcombination compensation cost, a DTA is recorded over the remaining service period (i.e., as the postcombination compensation cost is recorded) for the tax benefit of the postcombination compensation cost.

In accordance with ASC 718, the DTA for awards classified as equity is not subsequently adjusted to reflect changes in the entity's share price. In contrast, for awards classified as a liability, the DTA is remeasured, along with the compensation cost, in every reporting period until settlement.

#### **Income Tax Accounting Upon Exercise of the Share-Based Payment Awards**

ASC 805-740-45-5 states that "the deduction reported on a tax return for a replacement award classified as equity may be different from the fair-value-based measure of the award. The tax effect of that difference shall be recognized as income tax expense or benefit in the income statement of the acquirer."

The following examples, adapted from ASC 805-30-55, illustrate the income tax accounting for tax benefits received from tax-deductible share-based payment awards that are exchanged in a business combination after the effective date of FASB Statement No. 141(R).

<sup>4</sup> See [footnote 3](#).

**Example 11-19A**

The par value of the common stock issued and cash received for the option's exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and therefore adopted Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are awards that would typically result in a tax deduction (e.g., nonqualified share options).
- Company A's applicable tax rate is 40 percent.

Company A issues replacement awards of \$110 (fair-value-based measure) on the acquisition date in exchange for Company B's awards of \$100 (fair-value-based measure) on the acquisition date. The exercise price of the replacement awards issued by A is \$15. No postcombination services are required for the replacement awards, and B's employees had rendered all of the required service for the acquiree awards as of the acquisition date.

The amount attributable to precombination service is the fair-value-based measure of B's awards (\$100) on the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to postcombination service is \$10, which is the difference between the total value of the replacement awards (\$110) and the portion attributable to precombination service (\$100). Because no postcombination service is required for the replacement awards, A immediately recognizes \$10 as compensation cost in its postcombination financial statements. See the following journal entries.

**Journal Entries: June 30, 20X1**

Goodwill	100
Compensation cost	10
APIC	110

To record the portions of the fair-value-based measure of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).

**Journal Entries: June 30, 20X1**

DTA	44
Goodwill	40
Income tax provision	4

To record the associated income tax effects of the fair-value-based measure of the portions of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).

**Example 11-19A (continued)**

On September 30, 20X1, all replacement awards issued by A are exercised when the market price of A's shares is \$150. Given the exercise of the replacement awards, A will realize a tax deduction of \$135 (\$150 market price of A's shares less the \$15 exercise price). The tax benefit of the tax deduction is \$54 (\$135 × 40% tax rate). Therefore, an excess tax benefit of \$10 (tax benefit of the tax deduction of \$54 less the previously recorded DTA of \$44) is recorded to current income tax expense. See the following journal entry.

**Journal Entry: September 30, 20X1**

Taxes payable	54
Deferred tax expense	44
Current tax expense	54
DTA	44
To record the income tax effects of the award upon exercise.	

**Example 11-19B**

The par value of the common stock issued and cash received for the option's exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and therefore adopted FASB Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are awards that would typically result in a tax deduction (e.g., nonqualified options).
- Company A's applicable tax rate is 40 percent.

Company A exchanges replacement awards that require one year of postcombination service for share-based payment awards of Company B for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is \$100 on the acquisition date. The exercise price of the replacement awards is \$15. When originally granted, B's awards had a requisite service period of four years. As of the acquisition date, B's employees holding unexercised awards had rendered a total of seven years of service since the grant date. Even though B's employees had already rendered the requisite service for the original awards, A attributes a portion of the replacement award to postcombination compensation cost in accordance with ASC 805-30-30-12 because the replacement awards require one year of postcombination service. The total service period is five years — the requisite service period for the original acquiree award completed before the acquisition date (four years) plus the requisite service period for the replacement award (one year).

**Example 11-19B (continued)**

The portion attributable to precombination service equals the fair-value-based measure of the acquiree award (\$100) multiplied by the ratio of the precombination service period (four years) to the total service period (five years). Thus, \$80 ( $\$100 \times [4 \text{ years}/5 \text{ years}]$ ) is attributed to the precombination service period and therefore is included in the consideration transferred in the business combination. The remaining \$20 is attributed to the postcombination service period and therefore is recognized as compensation cost in A's postcombination financial statements, in accordance with ASC 718. See the following journal entries.

**Journal Entries: December 31, 20X1**

Compensation cost	10	
APIC		10
DTA	4	
Income tax provision		4

To record the compensation cost and the associated income tax effects for the six-month period from the date of the acquisition until December 31, 20X1.

**Journal Entries: June 30, 20X1**

Goodwill	80	
APIC		80
DTA	32	
Goodwill		32

To record the portion of the fair-value-based measure of the replacement award attributable to precombination services (i.e., consideration transferred) and the associated income tax effects.

On June 30, 20X2, all replacement awards issued by A vest and are exercised when the market price of A's shares is \$150. Given the exercise of the replacement awards, A will realize a tax deduction of \$135 (\$150 market price of A's shares less the \$15 exercise price). The tax benefit of the tax deduction is \$54 ( $\$135 \times 40\%$  tax rate). Therefore, an excess tax benefit of \$14 (tax benefit of the tax deduction of \$54 less the previously recorded DTA of \$40 ( $\$32 + \$4 + \$4$ ))) is recorded to current income tax expense. See the following journal entries.

**Journal Entries: June 30, 20X2**

Compensation cost	10	
APIC		10
DTA	4	
Income tax provision		4

To record the compensation cost and the associated income tax effects for the six-month period ended June 30, 20X2.

**Journal Entries: June 30, 20X2**

Taxes payable	54	
Deferred tax expense		40
Current tax expense		54
DTA		40

To record the income tax effects of the award upon exercise.

## 11.23A Settlement of Share-Based Payment Awards Held by the Acquiree's Employees

In a business combination, the acquiring company often issues replacement share-based payment awards to the acquiree's employees. See [11.23](#) for additional information on the accounting implications of such replacement awards. In other situations, however, the acquiring company may choose to cash-settle the awards instead. If the awards are unvested at the time of the business combination, the acquiring company's discretionary decision to cash-settle the awards will typically result in its recognition of an accounting cost for the unvested portion in the postacquisition period (see ASC 805-30-55-23 and 55-24). However, since the tax deduction may be included in the acquiree's final tax return, an entity may have questions about when and how to account for the corresponding tax benefit in the acquirer's financial statements.

Consider the following example: On December 1, 20X1, Company A entered into an agreement to acquire Company B, in which A offered to purchase all issued and outstanding shares of B. Under the terms of the purchase agreement, A is required to cash-settle all outstanding employee awards held by B's employees. Company A agreed to pay each holder of the awards, through B's payroll system, a cash payment due on settlement no later than five business days after the closing of the purchase agreement. As a result, vesting will be accelerated for all of B's unvested employee awards that A will cash-settle. During negotiations of the purchase agreement, A agreed to the cash-settlement provision because it wanted to (1) compensate B's employees and (2) establish postacquisition compensation arrangements that would be consistent with A's existing compensation arrangements. Because no postcombination services are required by holders of B's awards that will be cash-settled, and because the decision to accelerate the awards was made at A's discretion, the accelerated unrecognized compensation cost of B's awards would be accounted for as if A had decided to accelerate the vesting of B's awards immediately after the purchase-agreement closing. Therefore, A will allocate the fair value of these awards to postcombination compensation cost because all the awards that were outstanding and cash-settled were unvested before the close of the acquisition. Company B will file a short-period income tax return for the period of January 1, 20X1, through December 1, 20X1, because it was purchased by A. Under the agreement, on December 6, 20X1, B cash-settled all awards outstanding. The settlement of B's awards is tax-deductible in B's short-period tax return for the period ended December 1, 20X1, because B cash-settled the awards within two-and-a-half months of the end of B's taxable period ending December 1, 20X1. The income tax deduction for the cash-settled awards reduces taxable income and creates an NOL carryforward in B's income tax return for the short period ended December 1, 20X1. This NOL carryforward is available to reduce A's postcombination taxable income. Because the cash settlement of B's awards is deductible for tax purposes in B's precombination consolidated tax return and payment did not occur until December 6, 20X1, A's tax-basis acquisition accounting balance sheet would reflect not only the NOL but also an employee compensation liability as of the close of the acquisition on December 1, 20X1. Company A is accounting for the compensation cost associated with the cash-settled awards attributable to postcombination services as a transaction that is separate from the business combination. As a result, A will have postcombination compensation cost for which the related tax deduction will be claimed on B's precombination tax return.

Each of the following alternatives is acceptable in accounting for the tax consequences (deduction claimed by B) of the postcombination compensation expense that is recognized separately and apart from the business combination:

- *Alternative 1 — Recognize all tax consequences in purchase accounting* — Recognizing the tax consequences of the postcombination compensation cost in purchase accounting is consistent with B's deduction of the compensation cost on its income tax return for the precombination short period. Company A's acquisition tax-basis balance sheet reflects the tax consequences related to the deduction claimed by B. As a result, the acquisition balance sheet includes a DTA related to the NOL carryforward created by the deduction claimed on B's tax return. In addition, the acquisition balance sheet will also include a DTL representing the taxable temporary difference related to A's assumed obligation to settle B's awards, which is included in A's tax return but is not recognized for book purposes until after the combination.
- *Alternative 2 — Recognize tax consequences separately from purchase accounting* — Under this alternative, because ASC 805 requires entities to recognize the compensation cost in the postcombination financial statements, it is assumed that the tax effects of the postcombination compensation cost also arise separately from the business combination in A's postcombination financial statements. Accordingly, there is no DTA or DTL established in B's acquisition balance sheet. Rather it is assumed that A receives a tax deduction that creates a DTA (to the extent that such deduction increased an NOL carryforward) or reduction in taxes payable (to the extent that such deduction reduced taxes payable) separately from the business combination, which results in a tax benefit for A in the postcombination financial statements.

Although the balance sheet presentation of each alternative would differ, the same amount of goodwill and tax effects would be reflected in the postcombination income statement.

## **11.24 Tax Benefits Received From the Disqualifying Disposition of Incentive Stock Options Exchanged in a Business Combination**

The guidance in this section is applicable only before an entity adopts ASU 2016-09.

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. See [Chapter 10, "Share-Based Compensation,"](#) for guidance on adopting ASU 2016-09.

Under ASC 805-740, an acquirer **should not** record a DTA as of the acquisition date for the tax benefits of the fair-value-based measure<sup>5</sup> of the acquirer's replacement share-based payment award included in the consideration transferred that ordinarily does not result in a tax deduction (e.g., ISOs). However, an acquirer may receive a tax deduction from these awards as a result of events that occur after the acquisition date (e.g., a disqualifying disposition). While ASC 805-740-25-11 states that the "tax effects of such an event shall be recognized only when it occurs," it does not address how such effects are recognized in the financial statements.

The following are two currently acceptable approaches to accounting for these share-based payment awards exchanged in a business combination that do not ordinarily result in a tax deduction.

<sup>5</sup> See [footnote 2](#).

## **Approach 1**

The tax benefit of any tax deduction up to the sum of (1) the amount of the acquisition-date fair-value-based measure of the replacement share-based payment award included in the consideration transferred and (2) the postcombination compensation cost recognized for the replacement share-based payment award, should be included in the income tax provision (i.e., the sum of (1) and (2) should equal the fair-value-based measure of the replacement share-based payment award as of the acquisition date). Any tax benefit of the tax deduction that is greater than this sum would be recognized as APIC. This view is consistent with ASC 718-740-25-9, which states that only the “excess tax benefit” should be recognized as an adjustment to APIC. In addition, the results of this approach are similar to the results when an entity accounts for the excess tax benefits received from share-based payment awards that ordinarily result in a tax deduction (i.e., nonqualified awards), as described in [11.23](#).

## **Approach 2**

The tax benefit of any tax deduction up to the postcombination compensation cost recognized for the replacement share-based payment award should be included in the income tax provision. Any tax benefit of the tax deduction greater than this amount would be recognized as APIC.

The examples below, adapted from ASC 805-30-55, illustrate the income tax accounting for tax benefits received from ISOs that are exchanged in a business combination after the effective date of FASB Statement 141(R).

### **Example 11-20**

#### **Approach 1**

The par value of the common stock issued and cash received for the option’s exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and adopted FASB Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are ISOs that do not normally result in a tax deduction.
- Company A’s applicable tax rate is 40 percent.

Company A exchanges replacement awards that require one year of postcombination service for share-based payment awards of B for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is \$100 on the acquisition date. The exercise price of the replacement awards is \$15. When originally granted, B’s awards had a requisite service period of four years. As of the acquisition date, B’s employees holding unexercised awards had rendered a total of seven years of service since the grant date. Even though B’s employees had already rendered all the requisite service for the original awards, A attributes a portion of the replacement award to postcombination compensation cost in accordance with ASC 805-30-30-12 because the replacement awards require one year of postcombination service. The total service period is five years — the requisite service period for the original acquiree award completed before the acquisition date (four years) plus the requisite service period for the replacement award (one year).

**Example 11-20 (continued)**

The portion attributable to precombination service equals the fair-value-based measure of the acquiree award (\$100) multiplied by the ratio of the precombination service period (four years) to the total service period (five years). Thus, \$80 ( $\$100 \times [4 \text{ years}/5 \text{ years}]$ ) is attributed to the precombination service period and therefore is included in the consideration transferred in the business combination. The remaining \$20 is attributed to the postcombination service period and therefore is recognized as compensation cost in A's postcombination financial statements, in accordance with ASC 718. See the following journal entries:

**Journal Entry: June 30, 20X1**

Goodwill	80
APIC	80

To record the portion of the fair-value-based measure of the replacement awards attributable to precombination service (i.e., consideration transferred). No DTA is recorded, since the ISOs exchanged normally do not result in a tax deduction.

**Journal Entry: December 31, 20X1**

Compensation cost	10
APIC	10

To record the compensation cost for the six-month period from the acquisition date until December 31, 20X9. No DTA is recorded, since the ISOs exchanged normally do not result in a tax deduction.

On June 30, 20X2, all replacement awards issued by A are exercised and the underlying shares are sold before the minimum holding period required by the IRS, thus resulting in a disqualifying disposition. On June 30, 20X2, the market price of A's shares is \$150. Given the disqualifying disposition of the replacement awards, A will realize a tax deduction of \$135 (\$150 market price of A's shares less the \$15 exercise price). The tax benefit of the tax deduction is \$54 ( $\$135 \times 40\% \text{ tax rate}$ ). See the following journal entries:

**Journal Entry: June 30, 20X2**

Compensation cost	10
APIC	10

To record the compensation cost for the six-month period ended June 30, 20X2.

**Journal Entry: June 30, 20X2**

Taxes payable	54
Income tax provision	40
APIC	14

To record the income tax effects of the award upon disqualifying disposition.

The amount included in the income tax provision is computed as the tax effect of the sum of (1) the amount of the acquisition-date fair-value-based measure of the replacement share-based payment awards included in the consideration transferred (\$80) and (2) the postcombination compensation cost recognized for the replacement share-based payment awards (\$20), or  $[(\$80 + \$20) \times 40\% \text{ tax rate}] = \$40$ . The amount recognized in APIC is computed as the tax benefit of the tax deduction greater than this sum or  $[(\$135 - \$100) \times 40\% \text{ tax rate}] = \$14$ .

**Example 11-21****Approach 2**

The par value of the common stock issued and cash received for the option's exercise price are not considered in this example.

Assume the same facts and circumstances as in Approach 1 in Example 11-20. Under Approach 2, the June 30 and December 31, 20X1, journal entries will be the same as those under Approach 1.

As in Approach 1 in Example 11-20, on June 30, 20X2, all replacement awards issued by A are exercised and the underlying shares are sold before the minimum holding period required by the IRS, thus resulting in a disqualifying disposition. On June 30, 20X2, the market price of A's shares is \$150. Given the disqualifying disposition of the replacement awards, A will realize a tax deduction of \$135 (\$150 market price of A's shares less the \$15 exercise price). The tax benefit of the tax deduction is \$54 ( $\$135 \times 40\%$  tax rate). See the following journal entries:

**Journal Entry: December 31, 20X2**

Compensation cost	10
APIC	10

To record the compensation cost for the six-month period ended June 30, 20X2.

**Journal Entry: June 30, 20X2**

Taxes payable	54
Income tax provision	8
APIC	46

To record the income tax effects of the award upon disqualifying disposition.

The amount included in the income tax provision is computed as the tax effect of the postcombination compensation cost recognized for the replacement share-based payment award (\$20), or  $(\$20 \times 40\% \text{ tax rate}) = \$8$ . The amount recognized in APIC is computed as the tax benefit of the tax deduction greater than the tax effect of the postcombination compensation cost, or  $[(\$135 - \$20) \times 40\% \text{ tax rate}] = \$46$ .

## 11.25 Revisions to Accounting for a Business Combination After the Measurement Period

ASC 805-10-25-15 states:

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure any of the following as of the acquisition date in accordance with the requirements of this Topic:

- a. The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree (see Subtopic 805-20)
- b. The consideration transferred for the acquiree (or the other amount used in measuring goodwill in accordance with paragraphs 805-30-30-1 through 30-3)
- c. In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer (see paragraph 805-30-30-1(a)(3))
- d. The resulting goodwill recognized in accordance with paragraph 805-30-30-1 or the gain on a bargain purchase recognized in accordance with paragraph 805-30-25-2.

In addition, ASC 805-10-25-14 states, in part:

The measurement period ends as soon as the acquirer 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. However, the measurement period shall not exceed one year from the acquisition date.

Under certain circumstances, an entity may revise the accounting for a business combination after the measurement period has ended. ASC 805-10-25-19 states, "After the measurement period ends, the acquirer shall revise the accounting for a business combination **only** to correct an error in accordance with Topic 250" (emphasis added). An entity needs to use judgment in determining when an identified adjustment should be considered a correction of an error or is the result of events occurring after the acquisition date and thus warranting prospective treatment in a manner consistent with a change in estimate.

ASC 250-10-20 defines an error in previously issued financial statements (an "error") as follows:

An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of [GAAP], or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

In determining whether the change is a correction of an error, an entity should use judgment to determine whether the information was or should have been "reasonably knowable" or "readily accessible" from the company's books and records in a prior reporting period and whether the application of information at that time would have resulted in different reporting.

#### Example 11-22

Entity A acquired Entity B on September 30, 20X1, in a nontaxable business combination accounted for under ASC 805. Entity A obtained an independent appraisal for several of the intangible assets acquired in the combination, and the appraisal was not complete by the time A issued its financial statements for the year ended December 31, 20X1. Entity A included the provisional fair value for the intangible assets and the related DTLs in its annual financial statements. In June 20X2, A received the independent appraisal of the intangible assets, which increased the fair value of the assets recorded as provisional amounts. In its interim financial statements for the quarter ended June 30, 20X2, A will retrospectively adjust its intangible-asset balances to account for this updated information (pertaining to the facts and circumstances that existed as of the acquisition date) received during the measurement period. The measurement period is now considered closed, since A is not waiting for any additional information regarding the provisional amounts.

In January 20X3 (i.e., the measurement period has lapsed), A discovered that although the financial statements had been adjusted for the change in fair value of its acquired intangible assets, the related DTL had not been adjusted accordingly. This would be considered an error in the accounting for the business combination, which will be evaluated in accordance with ASC 250. Any adjustments made to correct the DTL would then be made to correct the original business combination accounting (i.e., would not be considered a measurement-period adjustment) and are not subject to the provisions related to changes in deferred taxes or other tax attributes outside of the measurement period.

## Measurement

### ASC 805-740

**30-1** An acquirer shall measure a deferred tax asset or deferred tax liability arising from the assets acquired and liabilities assumed in a business combination in accordance with Subtopic 740-10. [FAS 141(R), paragraph 26] Discounting deferred tax assets or liabilities is prohibited for temporary differences (except for leveraged leases, see Subtopic 840-30) related to business combinations as it is for other temporary differences. [FAS 109, paragraph 130]

#### Pending Content (Transition Guidance: ASC 842-10-65-1)

**30-1** An acquirer shall measure a deferred tax asset or deferred tax liability arising from the assets acquired and liabilities assumed in a business combination in accordance with Subtopic 740-10. [FAS 141(R), paragraph 26] Discounting deferred tax assets or liabilities is prohibited for temporary differences (except for leveraged leases, see Subtopic 842-50) related to business combinations as it is for other temporary differences. [FAS 109, paragraph 130]

**30-2** See Example 1 (paragraph 805-740-55-2) for an illustration of the measurement of deferred tax assets and a related valuation allowance at the date of a nontaxable business combination.

**30-3** The tax law in some tax jurisdictions may permit the future use of either of the combining entities' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other entity after the business combination. If the combined entity expects to file a consolidated tax return, an acquirer may determine that as a result of the business combination its valuation for its deferred tax assets should be changed. For example, the acquirer may be able to utilize the benefit of its tax operating loss carryforwards against the future taxable profit of the acquiree. In such cases, the acquirer reduces its valuation allowance based on the weight of available evidence. However, that reduction does not enter into the accounting for the business combination but is recognized as an income tax benefit (or credited directly to contributed capital [see paragraph 740-10-45-20]). [FAS 109, paragraph 266]

### Subsequent Measurement

**35-1** An acquirer may have a valuation allowance for its own deferred tax assets at the time of a business combination. The guidance in this Section addresses measurement of that valuation allowance and the potential need to distinguish the separate parts of the acquirer and the acquired entity in the measurement of valuation allowances together with expected future results of operations. Guidance on the subsequent measurement of deferred tax assets or liabilities arising from the assets acquired and liabilities assumed in a business combination, and any income tax uncertainties of an acquiree that exist at the acquisition date, or that arise as a result of the acquisition, is provided in Subtopic 740-10.

**35-2** Changes in the acquirer's valuation allowance, if any, that result from the business combination shall reflect any provisions in the tax law that restrict the future use of either of the combining entities' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other entity after the business combination.

**35-3** Any changes in the acquirer's valuation allowance shall be accounted for in accordance with paragraph 805-740-30-3. For example, the tax law may limit the use of the acquired entity's deductible temporary differences and carryforwards to subsequent taxable income of the acquired entity included in a consolidated tax return for the combined entity. In that circumstance, or if the acquired entity will file a separate tax return, the need for a valuation allowance for some portion or all of the acquired entity's deferred tax assets for deductible temporary differences and carryforwards is assessed based on the acquired entity's separate past and expected future results of operations. [FAS 109, paragraph 264]

## 11.26 Initial Measurement of the Income Tax Consequences of Contingent Consideration in a Business Combination

For financial reporting purposes, the acquirer is required to recognize contingent consideration as part of the consideration transferred in the business combination. The obligation is recorded at its acquisition-date fair value and classified as a liability or as equity depending on the nature of the consideration.

- Contingent consideration classified as equity is not remeasured. Generally, any deferred tax consequences resulting from the resolution of the contingency are charged or credited directly to equity.
- Contingent consideration classified as a liability is remeasured at fair value on each reporting date. All post-measurement-period adjustments are recorded through earnings.
- If the contingent consideration is considered a hedging instrument under ASC 815, the changes in fair value are initially recognized in OCI (see ASC 805-30-35-1).

For tax purposes, the acquirer is generally precluded from recognizing contingent consideration as part of the consideration transferred until the contingency has become fixed and determinable with reasonable accuracy, or in some jurisdictions, until it has been settled. This could result in a difference in the total consideration recognized for financial reporting and tax purposes on the acquisition date.

To determine whether a DTA or DTL should be recognized on the acquisition date, the acquirer should determine the expected tax consequences that would result if the contingent consideration was settled at its initial reported amount in the financial statements. In other words, the acquirer should determine the tax consequences as if the contingent consideration was settled at the amount reported in the financial statements as of the acquisition date. The tax consequences will, in part, depend on how the business combination is structured for tax purposes (i.e., taxable or nontaxable business combination).

### **Taxable Business Combination**

In a taxable business combination, the settlement of contingent consideration will generally increase the tax basis of goodwill. The acquirer should assume that the contingency will be settled at its acquisition-date fair value and should include this amount in the calculation of tax-deductible goodwill when performing the acquisition-date comparison of tax-deductible goodwill with financial reporting goodwill. If the amount of the hypothetical tax-deductible goodwill (i.e., tax-deductible goodwill that includes the amount associated with the contingent consideration) exceeds the amount of financial reporting goodwill, a DTA should be recorded. However, if the financial reporting goodwill continues to exceed the hypothetical tax-deductible goodwill, no DTL is recorded for the excess (because of the exception in ASC 805-740-25-9). See [11.20](#) for further discussion of the acquisition-date comparison of financial reporting goodwill with tax-deductible goodwill.

### **Nontaxable Business Combination**

In a nontaxable business combination, the settlement of contingent consideration will generally increase the tax basis in the stock of the acquired company (i.e., it increases the outside tax basis). If the hypothetical tax basis in the shares (i.e., tax basis that includes the amount associated with the contingent consideration) exceeds the financial reporting basis of the shares acquired, the acquirer should consider the provisions of ASC 740-30-25-9 regarding the possible limitations on recognizing a DTA. However, if the financial reporting basis of the shares acquired exceeds the hypothetical tax basis, the acquirer should consider the provisions of ASC 740-10-25-3(a) and ASC 740-30-25-7 regarding the possible exceptions to recognizing a DTL. See [11.06](#) for further discussion of recognizing DTAs and DTLs related to outside basis differences.

See [11.27](#) for a discussion of the subsequent measurement of the income tax consequences of contingent consideration in a business acquisition.

## **11.27 Subsequent Measurement of the Income Tax Consequences of Contingent Consideration in a Business Combination**

After an acquisition, an acquirer should determine the tax consequences resulting from a change in the fair value of contingent consideration and recognize the deferred tax consequences of such changes as a component of income tax expense (i.e., outside of the business combination), unless the change qualifies as a measurement-period adjustment under ASC 805-10-25-13.

See [11.26](#) for guidance on the initial measurement of the income tax consequences of contingent consideration in a business combination.

### **Taxable Business Combination**

In a taxable business combination, a subsequent increase or decrease in the fair value of the contingent consideration will result in an adjustment to the tax bases of the acquired assets. A DTA or DTL would be recorded through the tax provision for the expected tax consequences.

If the revised fair value **exceeds** the amount originally recorded as a liability, a DTA will be recorded in connection with expected additional tax-deductible goodwill. For financial reporting purposes, this additional tax-deductible goodwill is treated as unrelated to the acquisition (i.e., it is attributed to the expense recognized); therefore, the DTA results in recognition of a tax provision benefit to continuing operations rather than a reduction in financial reporting goodwill.

If the contingent consideration is adjusted to an amount that is **less than** the liability originally recorded on the books, a gain is recognized for financial reporting purposes. This gain is eliminated from taxable income (e.g., by a Schedule M adjustment for U.S. federal tax). This adjustment to pretax book income is treated, in substance, as an accelerated deduction of component 1 amortizable goodwill (see [11.20](#) for a discussion of goodwill components). In this case, a DTL is recognized and the related income tax expense is recorded (see Example 11-23).

### **Nontaxable Business Combination**

In a nontaxable business combination, an increase or a decrease in the fair value of the contingent consideration for financial reporting purposes would result in an adjustment to the original hypothetical tax basis of the acquired company's stock. In many cases, an exception to recording deferred taxes on outside basis differences will apply (e.g., see ASC 740-10-25-3(a) and ASC 740-30-25-7 and 25-8 for DTLs and ASC 740-30-25-9 for DTAs). See Example 11-24.

**Example 11-23****Taxable Business Combination**

AC acquires the stock of TC for \$45 million and a contingent payment (classified as a liability) with a fair value of \$5 million in a **taxable** business combination on June 30, 20X9 (e.g., a stock acquisition with a taxable election under Section 338 of the IRC). The identifiable assets have a fair value of \$45 million and an initial tax basis of \$45 million. AC's applicable tax rate is 40 percent.

The following entries are recorded on June 30, 20X9:

**AC:**

Investment in TC	50,000,000
Cash	45,000,000
Contingent consideration liability	5,000,000

**TC (to reflect "push-down" of the entries to TC's books):**

Identifiable assets	45,000,000
Goodwill	5,000,000
Equity	50,000,000

AC determines that the expected tax consequences of settling the \$5 million contingent consideration liability would be to increase the tax basis of its identifiable assets and goodwill to equal the book amounts. Therefore, no deferred taxes are recorded on the acquisition date because AC identifies no difference when performing the acquisition-date comparison of hypothetical tax-deductible goodwill with financial reporting goodwill.

**September 30, 20X9**

On September 30, 20X9, subsequent facts and circumstances indicate that the contingent consideration has a fair value of \$3 million.

**AC:**

Contingent consideration liability	2,000,000
Gain on remeasurement — contingent	2,000,000
Deferred tax expense	800,000
DTL	800,000

The \$2 million decrease would reduce the hypothetical tax-deductible component 1 goodwill by \$2 million. Accordingly, an \$800,000 DTL is recognized ( $\$2 \text{ million} \times 40\%$ ), with an offsetting entry to deferred tax expense.

**Example 11-23 (continued)****December 31, 20X9**

On December 31, 20X9, AC settles the contingent consideration for \$11 million (fair value).

**AC:**

Expense on remeasurement — contingent consideration	8,000,000
Contingent consideration liability	3,000,000
Cash	11,000,000
DTA	2,400,000
DTL	800,000
Deferred tax expense	3,200,000

The \$8 million increase gives rise to an equal amount of tax-deductible goodwill that corresponds to the \$8 million pretax book expense. Accordingly, a \$2.4 million DTA is recognized along with a decrease of the \$800,000 DTL that was recognized on September 30, 20X9. The offsetting entry is to recognize deferred tax expense of \$3.2 million.

**Example 11-24****Nontaxable Business Combination**

AC acquires the stock of TC for \$45 million and a contingent payment (classified as a liability) with a fair value of \$5 million in a **nontaxable** business combination on June 30, 20X9. The identifiable assets have a fair value of \$45 million and a carryover tax basis of \$45 million. AC's applicable tax rate is 40 percent.

The following entries are recorded on June 30, 20X9:

**AC:**

Investment in TC	50,000,000
Cash	45,000,000
Contingent consideration liability	5,000,000

**TC (to reflect “push-down” of the entries to TC’s books):**

Identifiable assets	45,000,000
Goodwill	5,000,000
Equity	50,000,000

AC determines that the expected tax consequences of settling the \$5 million contingent liability would be to increase the tax basis of its investment in TC. As demonstrated below, after considering the future tax consequences of settling the contingent consideration liability, there is no difference between the book basis and the hypothetical tax basis of its investment in TC, so no deferred taxes are recorded on the acquisition date.

Tax basis of AC's investment in TC	\$ 45,000,000
Contingent consideration	<u>5,000,000</u>
Hypothetical tax basis	50,000,000
AC's investment in TC for financial reporting	<u>50,000,000</u>
Difference	<u>\$ _____</u>

**Example 11-24 (continued)**

However, if, after the contingent liability is considered, the hypothetical tax basis had exceeded the book basis, AC would have needed to consider ASC 740-30-25-9 before recognizing a DTA on the outside basis difference. If, after the contingent consideration liability is considered, the hypothetical tax basis had still been less than the book basis, AC would have needed to consider ASC 740-10-25-3(a) and ASC 740-30-25-7 before recognizing a DTL on the outside basis difference.

**September 30, 20X9**

On September 30, 20X9, subsequent facts and circumstances indicate that the contingent consideration has a fair value of \$3 million.

**AC:**

Contingent consideration liability	2,000,000
Gain on remeasurement — contingent consideration	2,000,000

Because the future settlement of the contingent consideration will affect the outside tax basis of the shares, AC considers ASC 740-10-25-3(a) and ASC 740-30-25-7 and concludes that no associated DTL should be recorded. Therefore, there is book income without a corresponding tax expense, resulting in an impact to the ETR.

**December 31, 20X9**

On December 31, 20X9, AC settles the contingent consideration for \$11 million (fair value).

**AC:**

Expense on remeasurement — contingent consideration	8,000,000
Contingent consideration liability	3,000,000
Cash	11,000,000

Because the settlement of the contingent consideration affects the outside tax basis of the shares, AC considers ASC 740-30-25-9 and concludes that no associated DTA should be recorded. Therefore, there is book expense without a corresponding tax benefit, resulting in an impact to the ETR.

## 11.28 Applicable Tax Rates: Business Combination Accounting

ASC 740-10-30-5 states that “[d]eferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction.” In addition, under ASC 740-10-30-8, an acquired entity’s deferred taxes should be measured by “using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.”

If, in periods after the business combination, the combined entity expects to file a consolidated tax return, the enacted tax rates for the combined entity should be used in measuring the deferred taxes of the acquirer and the acquiree. The effect of tax law or rate changes that occur after the acquisition date should be reflected in income from continuing operations in the period in which the change in tax law or rate occurs (e.g., not as part of the business combination).

## **Tax Holidays**

Deferred taxes are not recognized for the expected taxable or deductible amounts of temporary differences that relate to assets or liabilities that are expected to be recovered or settled during a tax holiday. Paragraph 183 in the Basis for Conclusions of Statement 109 states:

The Board considered whether a deferred tax asset ever should be recognized for the expected future reduction in taxes payable during a tax holiday. In most jurisdictions that have tax holidays, the tax holiday is "generally available" to any enterprise (within a class of enterprises) that chooses to avail itself of the holiday. The Board views that sort of exemption from taxation for a class of enterprises as creating a nontaxable status (somewhat analogous to S-corporation status under U.S. federal tax law) for which a deferred tax asset should not be recognized.

Therefore, deferred taxes are recognized for the expected taxable or deductible amounts of temporary differences that are expected to reverse outside of the tax holiday. In some situations, a temporary difference associated with a particular asset or liability may reverse during both the tax holiday and periods in which the entity is taxed at the enacted rates. Accordingly, it may be necessary to use scheduling to determine the appropriate deferred taxes to record in connection with the business combination.

## **State Tax Footprint**

The acquirer's state tax footprint for an entity can change because of a business combination. For example, an acquirer that is operating in Nevada with no deferred state taxes but substantial temporary differences acquires a target company in California. As a result of this acquisition, the acquirer is now required to file a combined California tax return with the target company. Therefore, the acquirer must record deferred taxes for California state tax when no state taxes were previously recognized. When calculating the impact of this change on the state tax footprint, an entity must account for the income tax effects of its assets and liabilities before the combination separately from those that were acquired as part of the business combination.

Any change in the measurement of existing deferred tax items of the acquirer as a result of this acquisition are recorded "outside" of the acquisition accounting as a component of income tax expense. The initial recognition of deferred tax items of the target company by the acquirer is accounted for as part of the business combination. (Note that the target company's deferred taxes are measured in accordance with ASC 740, since this is one of the exceptions to the fair value measurement principles in ASC 805.)

### **11.29 Initial Measurement of the Tax Effects of Contingencies Assumed in a Business Combination**

Under ASC 805-20-25-19, a contingency should be recognized at its acquisition-date fair value if the acquisition-date fair value can be determined during the measurement period.

ASC 805-20-35-3 does not prescribe a specific method for measuring and accounting for contingencies after the acquisition date for financial reporting purposes; rather, it states that the acquirer should "develop a systematic and rational basis for subsequently measuring and accounting for . . . contingencies depending on their nature." A contingency could result in a temporary difference on the acquisition date.

For tax purposes, the acquirer is generally precluded from recognizing a contingency until the contingency has become fixed and determinable with reasonable accuracy, or in some jurisdictions, until it has been settled. This could result in a basis difference between the assets and liabilities recognized for financial reporting and tax purposes on the acquisition date.

When assessing whether a DTA or DTL should be recognized on the acquisition date, the acquirer should determine the expected tax consequences that would result if the contingency was settled at its initial reported amount in the financial statements. In other words, the acquirer should determine the tax consequences as if the contingency was settled at the amount reported in the financial statements as of the acquisition date. The tax consequences will, in part, depend on how the business combination is structured for tax purposes (i.e., taxable or nontaxable business combination).

### **Taxable Business Combination**

In a taxable business combination, the settlement of a contingency will generally affect the tax basis of goodwill. Therefore, the acquirer should assume that the contingency will be settled at its acquisition-date fair value and should include this amount in the calculation of tax-deductible goodwill when performing the acquisition-date comparison of tax-deductible goodwill with financial reporting goodwill. If the amount of the hypothetical tax-deductible goodwill (i.e., tax-deductible goodwill that includes the amount associated with the contingency) exceeds the amount of financial reporting goodwill, a DTA should be recorded. However, if the financial reporting goodwill continues to exceed the hypothetical tax-deductible goodwill, no DTL is recorded for the excess (because of the exception in ASC 805-740-25-9). See [11.20](#) for further discussion of the acquisition-date comparison of financial reporting goodwill with tax-deductible goodwill.

### **Nontaxable Business Combination**

In a nontaxable business combination, the settlement of a contingency may result in a tax deduction or taxable income (e.g., a legal dispute between an acquired entity and a third party is settled, resulting in a payment from the third party to the acquired entity). If the settlement of the contingency will result in either a tax deduction or taxable income, deferred taxes should be recorded as part of the acquisition accounting.

See [11.30](#) for a discussion of the subsequent measurement of the tax effects of contingencies assumed in a business combination.

## **11.30 Subsequent Measurement of the Tax Effects of Contingencies Assumed in a Business Combination**

After the acquisition, the acquirer should account for the tax consequences resulting from a change in the fair value of an acquired contingency and recognize the deferred tax consequences of such change as a component of income tax expense (i.e., outside of the business combination), unless the change qualifies as a measurement-period adjustment under ASC 805-10-25-13.

See [11.29](#) for guidance on the initial measurement of the tax effects of contingencies assumed in a business combination.

### **Taxable Business Combination**

In a taxable business combination, a subsequent increase or decrease in the fair value of the contingency will result in an adjustment to the tax bases of the acquired assets. A DTA or DTL would be recorded through the tax provision for the expected tax consequences.

If the revised fair value exceeds the amount recorded as a liability, a DTA will be recorded in connection with expected additional tax-deductible goodwill. For financial reporting purposes, the additional tax-deductible goodwill is treated as unrelated to the acquisition for book purposes (i.e., it is attributed to the expense recognized); therefore, a DTA results in the recording of a benefit to the continuing operation's income tax provision rather than a reduction in financial reporting goodwill.

If the contingency is settled for an amount less than the liability recorded on the books, there is a favorable adjustment to pretax book income. This pretax book income is eliminated from taxable income (e.g., by a Schedule M adjustment for U.S. federal tax). This adjustment to pretax book income is treated, in substance, as an accelerated deduction of component 1 amortizable goodwill (see [11.20](#) for a discussion of goodwill components). In this case, a DTL is recognized and the related income tax expense is recorded (see Example 11-25).

### **Nontaxable Business Combination**

In a nontaxable business combination, if it was determined that the settlement of the contingency would result in either a tax deduction or taxable income, a subsequent change in the fair value of the contingency would result in a corresponding change to the previously recorded DTA or DTL. Any change recorded to either the DTA or DTL would be recognized as a component of income tax expense (i.e., outside of the business combination). See Example 11-25.

#### **Example 11-25**

##### **Taxable Business Combination**

AC acquires the stock of TC for \$45 million in a **taxable** business combination on June 30, 20X9 (e.g., a stock acquisition with a taxable election under Section 338 of the IRC). In connection with the acquisition, AC recognizes a contingent liability at a fair value of \$650,000. AC's applicable tax rate is 40 percent.

The goodwill for financial reporting purposes is \$4 million (including the fair value of the contingent liability). Tax-deductible goodwill is \$3.5 million, excluding the fair value of the contingent liability.

For tax purposes, AC has determined that once the contingency is settled, it will be added to tax-deductible goodwill. Therefore, AC includes the acquisition-date fair value of the contingent liability in tax-deductible goodwill when comparing acquisition-date tax-deductible goodwill with financial reporting goodwill.

Tax-deductible goodwill is compared with financial reporting goodwill as follows:

Tax-deductible goodwill	\$ 3,500,000
Acquisition-date fair value of the contingent liability	<u>650,000</u>
Hypothetical tax-deductible goodwill	4,150,000
Financial reporting goodwill	<u>4,000,000</u>
Excess of hypothetical tax-deductible goodwill over financial reporting goodwill	\$ <u>150,000</u>

Because hypothetical tax-deductible goodwill exceeds financial reporting goodwill, AC records a DTA by using the following iterative calculation, as described in [11.20](#):

$$\text{DTA} = (0.40/[1 - 0.40]) \times \$150,000$$

$$\text{DTA} = \$100,000$$

**Example 11-25 (continued)**

The following entries are recorded on June 30, 20X9:

**AC:**

Investment in TC	45,000,000
Cash	45,000,000

**TC (to reflect “push-down” of the entries to TC’s books):**

Identifiable assets	41,650,000
DTA	100,000
Goodwill (\$4,000,000 – \$100,000)	3,900,000
Contingent liability	650,000
Equity	45,000,000

**September 30, 20X9**

On September 30, 20X9, AC remeasures the contingent liability and determines its fair value to be \$300,000, a decrease of \$350,000 (\$650,000 – \$300,000). AC has determined that the adjustment to the contingent liability will decrease tax-deductible goodwill if settled at its adjusted financial reporting basis. Therefore, AC reduces the DTA recorded on the acquisition date and records a DTL. The acquisition-date comparison of financial reporting goodwill with tax-deductible goodwill should not be reperformed after the acquisition date.

The following entry is recorded on September 30, 20X9 (for simplicity, the effects of tax-deductible goodwill amortization are excluded from this example):

**TC (to reflect “push-down” of the entries to TC’s books):**

Contingent liability	350,000
Deferred tax expense	140,000*
Gain on remeasurement — contingent liability	350,000
DTA	100,000
DTL	40,000

\*  $\$350,000 \times 40\%.$

**December 31, 20X9**

On December 31, 20X9, AC settles the contingent liability for \$1,000,000. The \$700,000 increase in the obligation gives rise to an operating expense for financial reporting purposes and a deferred tax benefit of \$280,000 ( $\$700,000 \times 40\%$  tax rate). At settlement, AC adjusts its tax-deductible goodwill for the \$1,000,000 settlement amount. Deferred taxes are adjusted accordingly.

The following entry is recorded on December 31, 20X9 (for simplicity, the effects of tax-deductible goodwill amortization are excluded from this example):

**TC (to reflect “push-down” of the entries to TC’s books):**

Contingent liability	300,000
Expense on remeasurement — contingent liability	700,000
DTA	240,000
DTL	40,000
Cash	1,000,000
Deferred tax benefit	280,000

**Example 11-26****Nontaxable Business Combinations**

AC acquires the stock of TC for \$45 million in a **nontaxable** business combination on June 30, 20X9. In connection with the acquisition, AC recognizes a contingent liability at a fair value of \$650,000. The tax basis of the contingent liability is zero. For this example, assume that there are no differences between the carryover tax basis and book basis of the identifiable assets acquired. AC has determined that it will receive a tax deduction when the contingency is settled. AC's applicable tax rate is 40 percent.

Because AC has determined that the contingent liability has a tax basis of zero and will result in a tax deduction when settled, a temporary difference exists.

The following entries are recorded on June 30, 20X9:

**AC:**

Investment in TC	45,000,000
Cash	45,000,000

**TC (to reflect “push-down” of the entries to TC’s books):**

Identifiable assets	41,650,000
DTA	260,000
Goodwill (\$4,000,000 – \$260,000)	3,740,000
Contingent liability	650,000
Equity	45,000,000

**September 30, 20X9**

On September 30, 20X9, AC remeasures the contingent liability and determines its fair value to be \$300,000, a decrease of \$350,000 (\$650,000 – \$300,000). AC has determined that the adjustment to the contingent liability will decrease the tax deduction allowed at settlement.

The following entry is recorded on September 30, 20X9:

**TC (to reflect “push-down” of the entries to TC’s books):**

Contingent liability	350,000
Deferred tax expense	140,000*
Gain on remeasurement — contingent liability	350,000
DTA	140,000

\*  $\$350,000 \times 40\%.$

**Example 11-26 (continued)****December 31, 20X9**

On December 31, 20X9, AC settles the contingent liability for \$1,000,000. The \$700,000 increase in the obligation gives rise to an operating expense for financial reporting purposes. AC is entitled to a tax deduction at settlement.

The following entry is recorded on December 31, 20X9:

**TC (to reflect “push-down” of the entries to TC’s books):**

Contingent liability	300,000
Expense on remeasurement — contingent liability	700,000
Deferred tax expense	120,000
Income taxes payable	400,000
Cash	1,000,000
DTA	120,000
Current tax benefit	400,000

### **11.31 Impact of Indefinite-Lived Intangible Assets on Accounting for Income Taxes [Deleted]**

### **11.32 Goodwill Impairment Test — Tax Considerations**

ASC 350-20 requires that goodwill be tested for impairment either annually or between annual tests if certain events or circumstances occur.

The current guidance in ASC 350 includes a goodwill impairment test that consists of two steps. Under that guidance, an entity may perform the two-step goodwill impairment test if it (1) qualitatively determines the fair value of the reporting unit is more likely than not less than the carrying amount or (2) chooses not to perform the qualitative assessment outlined in ASC 350-20-35-3 through 35-3G.

ASC 350-20-35-4 through 35-17 outline the two steps as follows on the basis of the fair value determined for each reporting unit:

- Step 1:
  - Quantitatively determine whether the fair value of the reporting unit is less than its carrying amount, including goodwill. If so, proceed to step 2.
  - If the fair value of the reporting unit is not less, further testing of goodwill for impairment is not performed.
  - If the carrying amount of the reporting unit is zero or negative, proceed to step 2 if, on the basis of qualitative considerations, it is more likely than not that a goodwill impairment exists.
- Step 2:
  - Determine the implied fair value of the goodwill of the reporting unit by assigning the fair value of the reporting unit used in step 1 to all the assets and liabilities of that reporting unit (including any recognized and unrecognized intangible assets) as if the reporting unit had been acquired in a business combination.
  - Compare the implied fair value of goodwill with the carrying amount of goodwill to determine whether goodwill is impaired.

In January 2017, the FASB issued ASU 2017-04, which eliminates step 2 from the goodwill impairment test (i.e., the measurement of the amount of impairment loss when the carrying amount of a reporting unit is greater than its fair value). Instead, when an entity performs a quantitative goodwill impairment test, it compares the fair value of a reporting unit with the reporting unit's carrying amount (i.e., performs what was previously step 1 of the two-step goodwill impairment test) to determine whether the reporting unit is impaired and, if so, the amount of impairment loss.

Further, in accordance with ASU 2017-04, "if a reporting unit has tax deductible goodwill, recognizing a goodwill impairment loss may cause a change in deferred taxes that results in the carrying amount of the reporting unit immediately exceeding its fair value upon recognition of the loss. In those circumstances, the entity shall calculate the impairment loss and associated deferred tax effect in a manner similar to that used in a business combination in accordance with the guidance in paragraphs 805-740-55-9 through 55-13. The total loss recognized shall not exceed the total amount of goodwill allocated to the reporting unit."

### ***Reporting Unit Bought or Sold in a Taxable or Nontaxable Business Combination***

ASC 350-20-35-25 states that an entity's assumption about whether a reporting unit would be bought or sold in a taxable or nontaxable business combination in its step 1 analysis of the goodwill impairment test<sup>6</sup> is a matter of judgment and will depend on facts and circumstances.

ASC 350-20-35-26 provides the following considerations to help entities make this determination:

- a. Whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value
- b. The feasibility of the assumed structure
- c. Whether the assumed structure results in the highest and best use and would provide maximum value to the seller for the reporting unit, including consideration of related tax implications.

In addition, under ASC 350-20-35-27, an entity must also consider the following factors (not all-inclusive) when assessing whether it is appropriate to assume a nontaxable transaction:

- a. Whether the reporting unit could be sold in a nontaxable transaction
- b. 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.

The guidance above applies to periods both before and after an entity adopts the guidance in ASU 2017-04.

### ***Assigning Deferred Taxes and Related Valuation Allowances to a Reporting Unit***

When determining a reporting unit's carrying value in step 1 of the goodwill impairment test,<sup>7</sup> an entity should assign deferred taxes and any related valuation allowances to its reporting units.

ASC 350-20-35-7 states that the deferred taxes and any related valuation allowances related to the assets and liabilities of the reporting unit should be included in the carrying value of the reporting unit. This is true regardless of whether the entity assumes, in its determination of the fair value of the reporting unit, that the reporting unit would be bought or sold in a taxable or nontaxable business combination. In determining whether to assign DTAs associated with net operating loss and tax credit

<sup>6</sup> Upon the adoption of ASU 2017-04, when an entity performs a quantitative goodwill impairment test (i.e., performs what was previously step 1 of the two-step goodwill impairment test), it compares the fair value of a reporting unit with the reporting unit's carrying amount to determine whether the reporting unit is impaired and, if so, the amount of impairment loss.

<sup>7</sup> See footnote 6.

carryforwards to a reporting unit, an entity should consider the following guidance from ASC 350-20-35-39 and 35-40:

**35-39** For the purpose of testing goodwill for impairment, acquired assets and assumed liabilities shall be assigned to a reporting unit as of the acquisition date if both of the following criteria are met:

- a. The asset will be employed in or the liability relates to the operations of a reporting unit.
- b. The asset or liability will be considered in determining the fair value of the reporting unit.

Assets or liabilities that an entity considers part of its corporate assets or liabilities shall also be assigned to a reporting unit if both of the preceding criteria are met. Examples of corporate items that may meet those criteria and therefore would be assigned to a reporting unit are environmental liabilities that relate to an existing operating facility of the reporting unit and a pension obligation that would be included in the determination of the fair value of the reporting unit. This provision applies to assets acquired and liabilities assumed in a business combination and to those acquired or assumed individually or with a group of other assets.

**35-40** Some assets or liabilities may be employed in or relate to the operations of multiple reporting units. The methodology used to determine the amount of those assets or liabilities to assign to a reporting unit shall be reasonable and supportable and shall be applied in a consistent manner. For example, assets and liabilities not directly related to a specific reporting unit, but from which the reporting unit benefits, could be assigned according to the benefit received by the different reporting units (or based on the relative fair values of the different reporting units). In the case of pension items, for example, a pro rata assignment based on payroll expense might be used. A reasonable allocation method may be very general. For use in making those assignments, the basis for and method of determining the fair value of the acquiree and other related factors (such as the underlying reasons for the acquisition and management's expectations related to dilution, synergies, and other financial measurements) shall be documented at the acquisition date.

If an entity has recorded a valuation allowance at the consolidated level and files a consolidated return, it should allocate the valuation allowance on the basis of the DTAs and deferred tax liabilities assigned to each reporting unit.

The guidance above applies to periods both before and after an entity adopts the guidance in ASU 2017-04.

### **Tax Bases When Determining Implied Fair Value of a Reporting Unit's Goodwill**

When determining the implied fair value of a reporting unit's goodwill in step 2 of the goodwill impairment test, ASC 350-20-35-20 states that an entity should use the tax bases of a reporting unit's assets and liabilities implicit in the assumed tax structure (i.e., taxable or nontaxable) in performing step 1 of the goodwill impairment test. If the entity assumed a nontaxable transaction, it should use its existing tax bases. If the entity assumed a taxable transaction, new tax bases are established on the basis of the fair value (i.e., fair value according to applicable tax law) of the reporting unit's assets and liabilities.

This guidance is applicable only before an entity adopts ASU 2017-04.

### 11.33 Determining the Deferred Tax Effects of a Goodwill Impairment

In January 2017, the FASB issued ASU 2017-04, which simplifies the accounting for goodwill impairments by eliminating step 2 from the goodwill impairment test.

Upon the adoption of ASU 2017-04, as stated in the new guidance, “[i]f a reporting unit has tax deductible goodwill, recognizing a goodwill impairment loss may cause a change in deferred taxes that results in the carrying amount of the reporting unit immediately exceeding its fair value upon recognition of the loss. In those circumstances, the entity shall calculate the impairment loss and associated deferred tax effect in a manner similar to that used in a business combination in accordance with the guidance in paragraphs 805-740-55-9 through 55-13. The total loss recognized shall not exceed the total amount of goodwill allocated to the reporting unit.”

This section applies to periods both before and after an entity adopts the guidance in ASU 2017-04.

The initial accounting for an acquisition of a business is affected by whether the transaction is structured as a taxable or nontaxable transaction and whether the acquisition results in tax-deductible and nondeductible goodwill. (See [11.01](#) and [11.20](#) for further discussion of the initial accounting in a business combination.) ASC 350-20-35-41 states that, for financial reporting purposes, “goodwill acquired in a business combination shall be assigned to one or more reporting units as of the acquisition date.”

ASC 350-20-35-1<sup>8</sup> states that “goodwill shall be tested for impairment at a level of reporting referred to as a **reporting unit**” (emphasis added). Under U.S. GAAP, a reporting unit is defined as “an operating segment or one level below an operating segment.”

However, ASC 740-10-30-5 states that “[d]eferred taxes shall be determined separately for each tax-paying component . . . in each tax jurisdiction.”

A reporting unit’s goodwill balance subject to impairment testing may comprise both tax-deductible and nondeductible goodwill. One common method used to allocate the goodwill impairment among the legal entities comprising the reporting unit is pro rata allocation. Under this approach, an entity proportionately allocates the impairment to tax-deductible and nondeductible goodwill on the basis of the proportion of each in the reporting unit. Other approaches may also be acceptable; however, the approach an entity selects is an accounting policy election that, like all such elections, should be applied consistently.

The example below demonstrates the application of the pro rata allocation approach. Note that this approach involves consolidated financial statements. When one or more of the legal entities within a reporting unit prepare separate-company financial statements, the allocations may differ between the separate and consolidated financial statements. Entities are encouraged to consult with their income tax accounting advisers when determining an appropriate approach.

<sup>8</sup> ASU 2017-04 amends ASC 350-20-35-1 to state that “goodwill shall be tested **at least annually** for impairment at a level of reporting referred to as a reporting unit” (emphasis added). While ASC 350-20-35-1 is amended, as described above, the requirement under ASC 350-20-35-28 to test goodwill at least annually did not change.

**Example 11-27**

Entity X has one reporting unit, R, that consists of two legal entities, Y and Z. Entities Y and Z operate in different tax jurisdictions and have tax rates of 30 percent and 40 percent, respectively. Entity X's annual goodwill impairment test coincides with its December 31 fiscal year-end. Assume the following with respect to R:

**Legal Entity Y**

	<b>Component 1 Goodwill</b>	<b>Component 2 Goodwill</b>	<b>Tax Basis</b>	<b>Total Book Basis</b>
January 1, 20X9	\$ 1,000,000	\$ 500,000	\$ 1,000,000	\$ 1,500,000
Tax amortization	—	—	100,000	—
December 31, 20X9, before impairment	<u>\$ 1,000,000</u>	<u>\$ 500,000</u>	<u>\$ 900,000</u>	<u>\$ 1,500,000</u>

**Legal Entity Z**

	<b>Component 1 Goodwill</b>	<b>Component 2 Goodwill</b>	<b>Tax Basis</b>	<b>Total Book Basis</b>
January 1, 20X9	\$ 4,000,000	\$ 500,000	\$ 4,000,000	\$ 4,500,000
Tax amortization	—	—	400,000	—
December 31, 20X9, before impairment	<u>\$ 4,000,000</u>	<u>\$ 500,000</u>	<u>\$ 3,600,000</u>	<u>\$ 4,500,000</u>

On December 31, 20X9, before its annual goodwill impairment test:

- Unit R has total goodwill of \$6 million (\$1.5 million + \$4.5 million) for financial reporting purposes.
- Unit R has remaining tax-deductible goodwill of \$4.5 million (\$0.9 million + \$3.6 million).
- Entity Y has a DTL of \$30,000 [(\$1,000,000 – \$900,000) × 30%] related to the taxable temporary difference of its component 1 goodwill.
- Entity Z has a DTL of \$160,000 [(\$4,000,000 – \$3,600,000) × 40%] related to the taxable temporary difference of its component 1 goodwill.

In accordance with ASC 805-740-25-9, neither legal entity has recognized deferred taxes for component 2 goodwill because component 2 goodwill comprises an excess of goodwill for financial reporting purposes over tax-deductible goodwill.

Entity X performs its annual goodwill impairment test on December 31, 20X9, and concludes that a goodwill impairment of \$2 million exists for R. In accordance with its accounting policy election, for tax purposes, X allocates the \$2 million impairment proportionately between Y and Z on the basis of the carrying amount of goodwill. Thus, \$500,000 [(\$1,500,000/\$6,000,000) × \$2,000,000] of the impairment is allocated to Y and \$1,500,000 [(\$4,500,000/\$6,000,000) × \$2,000,000] of the impairment is allocated to Z. Entities Y and Z then allocate their portions of the impairment proportionately between component 1 and component 2 goodwill on the basis of the relative carrying amount of each component, as shown below.

**Example 11-27 (continued)****Legal Entity Y**

	<b>Component 1 Goodwill</b>	<b>Component 2 Goodwill</b>	<b>Tax Basis</b>	<b>Book Basis</b>
December 31, 20X9, before impairment	\$ 1,000,000	\$ 500,000	\$ 900,000	\$ 1,500,000
Impairment	<u>333,333*</u>	<u>166,667**</u>	<u>—</u>	<u>500,000</u>
December 31, 20X9	<u>\$ 666,667</u>	<u>\$ 333,333</u>	<u>\$ 900,000</u>	<u>\$ 1,000,000</u>

\*  $(\$1,000,000 \div \$1,500,000) \times \$500,000$ .\*\*  $(\$500,000 \div \$1,500,000) \times \$500,000$ .**Legal Entity Z**

	<b>Component 1 Goodwill</b>	<b>Component 2 Goodwill</b>	<b>Tax Basis</b>	<b>Book Basis</b>
December 31, 20X9, before impairment	\$ 4,000,000	\$ 500,000	\$ 3,600,000	\$ 4,500,000
Impairment	<u>1,333,333*</u>	<u>166,667**</u>	<u>—</u>	<u>1,500,000</u>
December 31, 20X9	<u>\$ 2,666,667</u>	<u>\$ 333,333</u>	<u>\$ 3,600,000</u>	<u>\$ 3,000,000</u>

\*  $(\$4,000,000 \div \$4,500,000) \times \$1,500,000$ .\*\*  $(\$500,000 \div \$4,500,000) \times \$1,500,000$ .

On the basis of the allocations in the above tables, Y and Z would record the following entries for the goodwill impairment:

**Legal Entity Y**

Impairment loss	500,000
Goodwill	500,000
DTL	30,000*
DTA	70,000**
Income tax expense	100,000

\* Represents the DTL that was originally recognized from the tax amortization.

\*\*  $(\$900,000 - \$666,667) \times 30\%$ .**Legal Entity Z**

Impairment loss	1,500,000
Goodwill	1,500,000
DTL	160,000*
DTA	373,333**
Income tax expense	533,333

\* Represents the DTL that was originally recognized from the tax amortization.

\*\*  $(\$3,600,000 - \$2,666,667) \times 40\%$ .

## 11.34 Tax Effects of Goodwill Remaining in a Reporting Unit Upon Disposal of a Subsidiary That Was Previously Integrated Into the Reporting Unit

In January 2017, the FASB issued ASU 2017-04, which simplifies the accounting for goodwill impairments by eliminating step 2 from the goodwill impairment test.

This guidance applies to periods both before and after an entity adopts the guidance in ASU 2017-04.

Company P acquires 100 percent of the voting common stock of Subsidiary S1 for \$1,000 in an acquisition accounted for as a business combination. Accordingly, P's outside tax basis in the stock of S1 is \$1,000. Company P recognizes \$100 of goodwill in the acquisition of S1. Since the transaction results in carryover tax basis, there is no corresponding tax basis in the goodwill. Company P assigns all the assets and liabilities of S1, including goodwill, to Reporting Unit 1.

As of the acquisition date of S1, Reporting Unit 1 consists of multiple legal entities, some of which were acquired and others of which were formed by P. The goodwill recognized in these acquisitions and assigned to Reporting Unit 1 consists of a combination of tax-deductible and non-tax-deductible goodwill. When tax-deductible goodwill has been acquired, it has been amortized in accordance with tax law subsequent to the acquisition.

After S1 is integrated into Reporting Unit 1, P decides to sell S1 for consideration of \$800. Assume that no goodwill impairments have been recognized under ASC 350 between the date of the acquisition of S1 and its disposition. Further assume that, in accordance with ASC 350-20-40-1 through 40-7,<sup>9</sup> \$70 of Reporting Unit 1 goodwill will be deconsolidated upon the sale of S1 and will affect the determination of the gain or loss on disposal for financial reporting purposes. Accordingly, upon the disposition of S1, only \$70 of the goodwill recognized in connection with the acquisition of S1 will be deconsolidated, while \$30 of the total goodwill recognized in connection with the acquisition of S1 will be retained as continuing goodwill of Reporting Unit 1.

For tax purposes, assume that the stock basis continues to be the original \$1,000 paid for S1. Accordingly, when P sells S1 for \$800, it will have a capital loss of \$200 and a related \$80 tax benefit (assume a 40 percent tax rate and that P can realize a tax benefit for a capital loss).

There are deferred tax consequences of deconsolidating only \$70 of the goodwill that was recognized when S1 was acquired. Under ASC 350-20-40-3, an entity determines the amount of goodwill that must be deconsolidated by allocating goodwill from the larger reporting unit to the part of the reporting unit being sold on the basis of relative fair value. However, for a reporting unit that contains goodwill that is tax deductible, ASC 350-20-40 does not provide guidance on how to determine what portion of the goodwill being disposed of represents component 1 goodwill and what portion represents component 2 goodwill. Further, because the allocation is made at the reporting unit level, the character of the goodwill to be deconsolidated (i.e., component 1 or component 2) will not always be determinable from the character of the goodwill recognized in the financial statements of the specific entity to be deconsolidated. Accordingly, several methods have developed in practice for determining the deferred tax consequences in these types of situations.

One such approach is the pro rata method, under which the character of the deconsolidated goodwill is determined on a pro rata basis by reference to the character of goodwill within the larger reporting unit. If P uses this method to determine the deferred tax consequences of deconsolidating only a portion

<sup>9</sup> ASU 2017-04 amends ASC 350-20-40-7 to refer to ASC 350-20-35-3A through 35-13 rather than ASC 350-20-35-3A through 35-19. ASU 2017-04, which eliminates step 2 from the goodwill impairment test, supersedes ASC 350-20-35-14 through 35-19. Entities that have adopted the amendments in ASU 2017-04 should refer to the updated guidance.

of the goodwill that was recognized when S1 was acquired, it would begin its analysis by assessing the characteristics of the \$70 of goodwill that is being deconsolidated.

For example, if any part of the \$70 being deconsolidated is considered component 1 goodwill, a DTL would be recorded as part of the disposed assets and liabilities of S1 (since the related tax basis to be deconsolidated is zero in this example). Further, the temporary difference associated with the goodwill retained by Reporting Unit 1 would be similarly adjusted. This adjustment would either reduce the retained DTL or give rise to a DTA, with the total change in the temporary difference directly corresponding to the amount of component 1 goodwill that is considered deconsolidated. If the facts had been different and some (or all) of the goodwill recorded in connection with the acquisition of S1 had been tax deductible, a DTA, or a reduced DTL, would be included with the assets and liabilities of S1 to be deconsolidated (as a result of removing the related tax basis). Further, the retained temporary difference would be adjusted to reflect the retained component 1 book basis without the corresponding tax basis, resulting in the recognition of an additional DTL related to the goodwill being retained by Reporting Unit 1.

Although ASC 350-20-40-1 through 40-7<sup>10</sup> suggest that acquired goodwill loses its entity-specific character for purposes of impairment testing or determining the amount of goodwill to be deconsolidated when part of a reporting unit is sold, a second approach is to determine the character of the goodwill to be retained by reference to the character of the goodwill of the entity being deconsolidated. Under this method, all of the goodwill recorded on S1's books would have been considered component 2; therefore, the remaining \$30 would be considered to still represent component 2 goodwill, resulting in no recorded DTL.

A third approach is to interpret ASC 350-20-40-1 through 40-7<sup>11</sup> as simply requiring P to retain a portion of its investment in S1 within the reporting unit and then classify that portion as goodwill in its consolidated financial statements until the goodwill is recovered in accordance with ASC 350. Under this alternative, a DTL would be recorded because the residual outside basis difference would represent a taxable temporary difference for which no exception exists. The recognition of a DTL for the residual outside basis is also consistent with the fact that the corresponding tax basis in the "investment" was deducted upon the sale of the S1 stock for income tax purposes.

A fourth approach is to treat the \$30 of goodwill retained by Reporting Unit 1 as a permanent difference (i.e., not a temporary difference). Under this method, the \$30 of goodwill remaining in Reporting Unit 1 is effectively characterized as internally generated goodwill that P must capitalize. Accordingly, ASC 740-10-25-3(d) would preclude P from recognizing a DTL on goodwill retained for financial reporting purposes but not deductible for tax purposes. ASC 740-10-25-3(d) prohibits "recognition of a deferred tax liability [or asset] related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes."

Complexities are likely to be encountered when any of the approaches described above is applied. Regardless of the method selected, an entity should consistently apply its chosen approach to all dispositions of businesses within a reporting unit and provide adequate footnote disclosures that describe the accounting method used and the effects of applying that method.

All of the approaches described above may be considered acceptable when a portion of the goodwill of the entity to be deconsolidated is retained. However, the determination of the character of the goodwill being deconsolidated by reference to the goodwill recognized in connection with the specific entity being deconsolidated will have to be supplemented by additional policies when the amount

<sup>10</sup> See [footnote 9](#).

<sup>11</sup> See [footnote 9](#).

being deconsolidated exceeds the amount recognized on the books of that specific entity. Entities are encouraged to consult with their accounting advisers.

If a subsidiary has not been previously integrated into a reporting unit, entities should apply ASC 350-20-40-4, which requires that the current carrying amount of the acquired goodwill (i.e., the actual subsidiary-specific goodwill) be included in the carrying amount of the subsidiary to be disposed of. In these types of situations, which are expected to be infrequent, entities are encouraged to consult with their accounting advisers.

### **11.35 Accounting for Changes in Forfeiture Estimates Affecting Share-Based Payment Awards Exchanged in a Business Combination**

On March 30, 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. The following guidance is applicable for entities who have not adopted the new guidance. See [Chapter 10, "Share-Based Compensation,"](#) for guidance on adopting ASU 2016-09.

ASC 805-30-55-11 states that the portion of the fair-value-based measure of the replacement share-based payment award attributable to both precombination and postcombination service must reflect the acquirer's forfeiture estimate as of the acquisition date. Accordingly, consideration transferred and postcombination compensation cost are recognized only for awards that are expected to vest.

Moreover, ASC 805-30-55-11 states that changes in the acquirer's forfeiture estimate in the postcombination period should be reflected in compensation cost for the period in which the change in estimate occurs. However, views differ on how the acquirer should reflect changes in its forfeiture estimate (i.e., an increase or a decrease in the number of awards expected to vest) in postcombination compensation cost.

The following are two acceptable views on circumstances involving an increase in the forfeiture estimate (in the event of a decrease in forfeiture estimate, only View B would apply) and the related tax implications of each view regarding this estimate:

*View A* — An increase in an acquirer's forfeiture estimate (i.e., a decrease in the number of awards expected to vest) should result in the reversal of compensation cost associated with the acquisition-date fair-value-based measure that was attributed to postcombination service as of the acquisition date. Under this view, the reversal of the corresponding DTA related to the acquisition-date fair-value-based measure attributed to precombination service must be recognized in APIC to the extent that the acquirer has sufficient prior excess tax benefits (i.e., APIC pool). To the extent that the acquirer does not have sufficient prior excess tax benefits, the reversal of the DTA is recorded in the current-period income tax provision. The reversal of the DTA related to postcombination service must be recognized in the current-period income tax provision.

*View B* — An increase in the acquirer's forfeiture estimate (i.e., a decrease in the number of awards expected to vest) should result in the reversal of compensation cost for the acquisition-date fair-value-based measure of the awards not expected to vest, regardless of whether that measure was attributed to precombination or postcombination service as of the acquisition date. This reversal of compensation cost may exceed the amounts previously recognized as compensation cost in the acquirer's postcombination financial statements. In addition, the reversal of the corresponding DTA related to the acquisition-date fair-value-based measure attributed to both the precombination and postcombination service must be recognized in the current-period income tax provision.

An acquirer may elect either view as an accounting policy. However, in accordance with ASC 235-10-50-1, an entity's accounting policy must be applied consistently and must be disclosed if it is material to the financial statements.

Examples 11-28 and 11-29 illustrate the accounting for an increase in the acquirer's forfeiture estimate under View A and View B.

### Example 11-28

#### View A

On January 1, 20X1, Entity B grants employees 100 nonqualified (tax-deductible) share options that vest at the end of the fifth year of service (cliff vesting). On December 31, 20X4, Entity A acquires B in a transaction accounted for as a business combination and is obligated to replace the employees' awards with 100 replacement awards that have the same service terms as B's original award (i.e., the replacement awards will vest at the end of one additional year of service). The fair-value-based measure of each award on the acquisition date is \$10. Accordingly, the fair-value-based measure of both A's awards (the replacement awards) and B's awards (the replaced awards) is \$1,000 as of the acquisition date. Further assume that A attributes \$800 of the acquisition-date fair-value-based measure of the replacement awards to precombination service and the remaining \$200 to postcombination service. The \$200 attributed to the postcombination service is recognized as postcombination compensation cost over the replacement award's remaining one-year service period. On the acquisition date, A estimates that 25 percent of the replacement awards granted will be forfeited. Assume that A's applicable tax rate is 40 percent and that A has sufficient prior excess tax benefits (i.e., APIC pool).

#### Journal Entries: December 31, 20X4, Acquisition Date

Goodwill	600	
APIC		600
DTA	240	
Goodwill		240

To record the portion of the acquisition-date fair-value-based measure of the replacement award of \$600 (\$800 acquisition-date fair-value-based measure allocated to precombination service  $\times$  75% awards expected to vest) that is attributable to precombination service and therefore included in consideration transferred and the corresponding income tax effects.

#### Journal Entries: Quarter Ended March 31, 20X5

Compensation cost	37.50	
APIC		37.50
DTA	15.00	
Income tax provision		15.00

To record the portion of the acquisition-date fair-value-based measure of the replacement award of \$37.50 (\$200 acquisition-date fair-value-based measure allocated to postcombination service  $\times$  75% awards expected to vest  $\times$  25% services rendered) attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the first quarter of service.

**Example 11-28 (continued)****Journal Entries: Quarter Ended June 30, 20X5**

Compensation cost	37.50
APIC	37.50
DTA	15.00
Income tax provision	15.00

To record the portion of the acquisition-date fair-value-based measure of the replacement award of \$37.50 [(\$200 acquisition-date fair-value-based measure allocated to postcombination service × 75% awards expected to vest × 50% services rendered) – \$37.50 compensation cost previously recognized] attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the second quarter of service.

During the third quarter, A goes through a restructuring and many of B's former employees terminate their employment before their replacement awards vest. Accordingly, A changes its forfeiture estimate for the replacement awards from 25 percent to 80 percent.

**Journal Entries: Quarter Ended September 30, 20X5**

APIC	45
Compensation cost	45
Income tax provision	18
DTA	18

To record the adjustment for the increase in forfeiture estimate in the third quarter of \$45 [(\$200 acquisition-date fair-value-based measure allocated to postcombination service × 20% revised awards expected to vest × 75% services rendered) – \$75 compensation cost previously recognized] and the corresponding income tax effects.

APIC	176
DTA	176
To record the reversal of \$176 [(\$800 acquisition-date fair-value-based measure allocated to precombination service × 20% revised awards expected to vest × 40% tax rate) – \$240 DTA previously recognized] for the DTA related to the acquisition-date fair-value-based measure attributed to precombination service. If A did not have sufficient prior excess tax benefits, the reversal of the DTA would be recorded in the current-period income tax provision.	

There were no additional changes to the forfeiture estimate in the fourth quarter; therefore, 20 of the 100 originally issued awards vested.

**Journal Entries: Quarter Ended December 31, 20X5**

Compensation cost	10
APIC	10
DTA	4
Income tax provision	4

To record the portion of the acquisition-date fair-value-based measure of the replacement award of \$10 [(\$200 acquisition-date fair-value-based measure allocated to postcombination service × 20% awards expected to vest × 100% of services rendered) – \$30 compensation cost previously recognized] attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the fourth quarter of service.

**Example 11-29****View B**

Assume the same facts as in Example 11-28, View A. Under this view, there is no difference in the accounting as of the acquisition date and for the first two quarters of service in the postcombination period (i.e., the journal entries are the same). However, A's accounting in the third quarter for the change in forfeiture estimate will differ from the accounting under View A, as illustrated in Example 11-28.

Because A's forfeiture estimate has increased to 80 percent in the third quarter, only \$200 of the \$1,000 acquisition-date fair-value-based measure of the replacement awards should be allocated between the precombination and postcombination service periods. Accordingly, A recognizes an adjustment in postcombination compensation cost for the sum of (1) the amount of the acquisition-date fair-value-based measure of the replacement awards that was originally included in consideration transferred but that is associated with replacement awards of \$440 that are no longer expected to vest [(\$800 acquisition-date fair-value-based measure allocated to consideration transferred  $\times$  20% revised awards expected to vest) – \$600 amount previously recognized as consideration transferred] and (2) the amount of the acquisition-date fair-value-based measure of the replacement awards that was originally included in postcombination compensation cost but that is associated with replacement awards of \$45 that are no longer expected to vest [(\$200 acquisition-date fair-value-based measure allocated to postcombination service  $\times$  20% revised awards expected to vest  $\times$  75% services rendered) – \$75 compensation cost previously recognized].

With respect to the income tax adjustments, the offsetting entry for the reversal of the DTA associated with the amount that was previously recorded in consideration transferred would be recorded in the income tax provision along with the offsetting entry for the reversal of the DTA associated with the amount that was previously recorded in postcombination compensation cost.

**Journal Entries: Quarter Ended September 30, 20X5**

APIC	485
Compensation cost	485
Income tax provision	194
DTA	194

To record the adjustment of \$485 (\$440 + \$45) for the increase in forfeiture estimate in the third quarter and the corresponding income tax effects.

As in Example 11-28, there were no additional changes to the forfeiture estimate in the fourth quarter; therefore, 20 of the 100 originally issued awards vested.

**Journal Entries: Quarter Ended December 31, 20X5**

Compensation cost	10
APIC	10
DTA	4
Income tax provision	4

To record the portion of the acquisition-date fair-value-based measure of the replacement award of \$10 [(\$200 acquisition-date fair-value-based measure allocated to postcombination service  $\times$  20% awards expected to vest  $\times$  100% services rendered) – \$30 compensation cost previously recognized] attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the fourth quarter of service.

## Presentation and Disclosure Considerations

### ASC 805-740

#### **Presentation**

**45-1** This Section addresses how an acquirer recognizes changes in valuation allowances and tax positions related to an acquisition and the accounting for tax deductions for replacement awards.

#### **Changes in Valuation Allowances**

**45-2** The effect of a change in a valuation allowance for an acquired entity's deferred tax asset shall be recognized as follows:

- a. Changes within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be recognized through a corresponding adjustment to goodwill. However, once goodwill is reduced to zero, an acquirer shall recognize any additional decrease in the valuation allowance as a bargain purchase in accordance with paragraphs 805-30-25-2 through 25-4. See paragraphs 805-10-25-13 through 25-19 and 805-10-30-2 through 30-3 for a discussion of the measurement period in the context of a business combination.
- b. All other changes shall be reported as a reduction or increase to income tax expense (or a direct adjustment to contributed capital as required by paragraphs 740-10-45-20 through 45-21). [FAS 109, paragraph 30A]

**45-3** Example 2 (see paragraph 805-740-55-4) illustrates this guidance relating to accounting for a change in an acquired entity's valuation allowance.

#### **Changes in Tax Positions**

**45-4** The effect of a change to an acquired tax position, or those that arise as a result of the acquisition, shall be recognized as follows:

- a. Changes within the measurement period that result from new information about facts and circumstances that existed as of the acquisition date shall be recognized through a corresponding adjustment to goodwill. However, once goodwill is reduced to zero, the remaining portion of that adjustment shall be recognized as a gain on a bargain purchase in accordance with paragraphs 805-30-25-2 through 25-4.
- b. All other changes in acquired income tax positions shall be accounted for in accordance with the accounting requirements for tax positions established in Subtopic 740-10. [FIN 48, paragraph 12B]

#### **Tax Deductions for Replacement Awards**

**45-5** Paragraph 805-30-30-9 identifies the types of awards that are referred to as replacement awards in this Topic. After the acquisition date, the deduction reported on a tax return for a replacement award classified as equity may exceed the fair-value-based measure of the award. In that situation, the acquirer shall recognize 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 additional paid-in capital. That accounting treatment is consistent with the accounting required by paragraphs 718-740-45-2 through 45-3 for an excess tax benefit for a share-based payment award classified as equity that is granted outside of a business combination.

### Pending Content (Transition Guidance: ASC 718-10-65-4)

**45-5** Paragraph 805-30-30-9 identifies the types of awards that are referred to as replacement awards in this Topic. After the acquisition date, the deduction reported on a tax return for a replacement award classified as equity may be different from the fair-value-based measure of the award. [FAS 141(R), paragraph A98] The tax effect of that difference shall be recognized as income tax expense or benefit in the income statement of the acquirer. [ASU 2016-09, paragraph 20]

**ASC 805-740 (continued)**

**45-6** The accounting if the amount deductible on the acquirer's tax return is less than the fair-value-based measure of the award also is the same as that prescribed by paragraph 718-740-45-4 for other awards. The write-off of a deferred tax asset related to that deficiency, net of any related valuation allowance, shall first be offset to the extent of any remaining additional paid-in capital from excess tax benefits from previous share-based payment awards. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in earnings. [FAS 141(R), paragraph A98]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**45-6** Paragraph superseded by Accounting Standards Update No. 2016-09.

**Disclosure****Change in Acquirer's Valuation Allowance as a Result of a Business Combination**

**50-1** Paragraph 805-740-30-3 describes a situation where an acquirer reduces its valuation allowance for deferred tax assets as a result of a business combination. Paragraph 740-10-50-9(h) requires disclosure of adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. That would include, for example, any acquisition-date income tax benefits or expenses recognized from changes in the acquirer's valuation allowance for its previously existing deferred tax assets as a result of a business combination. [FAS 109, paragraph 45]

### 11.36 Accounting for Changes in the Acquirer's and Acquiree's Valuation Allowances as of and After the Consummation or Acquisition Date

The following table summarizes the differences between accounting for changes in the acquiring entity's valuation allowance and accounting for the acquired entity's valuation allowances as of and after the acquisition date:

Changes in Valuation Allowance as a Result of Facts and Circumstances That:		
	Existed as of the Acquisition Date	Occurred After the Acquisition Date
Valuation allowance on the entity's DTAs that existed as of the date	Generally, record as an adjustment to income tax expense. Changes in the acquiring entity's deferred taxes are considered an event separate from business combination accounting (see <a href="#">11.02</a> and <a href="#">ASC 805-740-30-3</a> ).	Generally, record as an adjustment to income tax expense (see <a href="#">ASC 805-740-35-3</a> ).
Valuation allowance on the entity's DTAs that existed as of the date	Record as part of the business combination (adjustment to goodwill) only if the change occurred in the measurement period and resulted from new information about facts and circumstances that existed as of the acquisition date. If, as a result of the adjustment, goodwill is reduced to zero, any additional amounts should be recognized as a bargain purchase in accordance with <a href="#">ASC 805-30-25-2</a> through <a href="#">25-4</a> . All other changes should generally be recorded as an adjustment to income tax expense (see <a href="#">ASC 805-740-45-2</a> ).	Generally, record as an adjustment to income tax expense (see <a href="#">ASC 805-740-45-2</a> ).

## 11.37 Changes in Uncertain Income Tax Positions Acquired in a Business Combination

Before ASC 805 (formerly FASB Statement 141(R)), the acquirer generally recorded subsequent adjustments to uncertain tax positions arising from a business combination through goodwill, in accordance with EITF Issue 93-7, regardless of whether such adjustments occurred during the allocation period or thereafter. If goodwill attributable to the acquisition was reduced to zero, the acquirer then reduced other noncurrent intangible assets related to that acquisition to zero and recorded any remaining credit as a reduction of income tax expense.

An acquirer must record all changes to acquired uncertain tax positions arising from a business combination consummated before the adoption of Statement 141(R) in accordance with ASC 805-740-45-4, which requires that changes to an acquired tax position, or those that arise as a result of the acquisition (other than changes occurring during the measurement period that relate to facts and circumstances as of the acquisition date), be accounted for in accordance with ASC 740-10 (generally as an adjustment to income tax expense).

Under the transition guidance in ASC 805-10-65-1 (since removed from the Codification), the requirement to record subsequent adjustments to an acquired entity's uncertain tax position balance in accordance with ASC 740 is not limited to business combinations occurring after the effective date of Statement 141(R). Rather, ASC 805's income tax transitional provisions apply to all business combinations, regardless of the acquisition date (i.e., even business combinations that were initially accounted for in accordance with Statement 141). Therefore, this requirement affects the subsequent accounting for all acquired uncertain tax positions, unless the change occurs in the measurement period and results from additional information about facts and circumstances that existed as of the acquisition date. (See [11.38](#) for additional guidance.)

After the measurement period, changes in the acquired tax position balances because of additional information about facts and circumstances that existed as of the acquisition date would need to be assessed to determine whether the adjustment is a correction of an error. See [11.25](#) for guidance on revisions to accounting for a business combination after the measurement period.

### Example 11-30

Company X, a calendar-year-end company, acquired 100 percent of Company Y on July 1, 20X7, in a transaction accounted for as a business combination under Statement 141. As part of the transaction, X recorded (1) goodwill of \$500 and (2) a liability for an uncertain tax position of \$100 related to a position taken by Y on its previous tax returns.

On September 30, 20X8, after the allocation period, X changed its estimate of the liability for the uncertain tax position to \$75. Under Statement 141, X adjusted its business combination accounting by crediting goodwill for \$25.

Company X adopted Statement 141(R) on January 1, 20X9. On March 31, 20X9, as a result of new information, X again changed its estimate of the liability for the uncertain tax position, this time to \$30. Under ASC 805-740, X recorded the entire adjustment of \$45 (\$75 – \$30) as a credit to income tax expense.

**Example 11-31**

Company X, a calendar-year-end company, acquired 100 percent of Company Y on October 1, 20X8, in a transaction accounted for as a business combination under Statement 141. For the fiscal year ended December 31, 20X8, X disclosed that it recorded provisional amounts for goodwill and an uncertain tax position (liability) of \$200 and \$80, respectively.

Company X adopted Statement 141(R) on January 1, 20X9. On March 31, 20X9, X disclosed in its interim financial statements that it had finalized its accounting for the business combination and, on the basis of additional information about facts that existed as of the acquisition date, determined the liability for the uncertain tax position to be \$70. Because X's adjustment was (1) made during the allocation period and (2) a result of information about facts and circumstances that existed as of the acquisition date, X recorded the offsetting credit of \$10 ( $\$80 - \$70$ ) to goodwill.

On November 30, 20X9, X obtained new information about the uncertain tax position, which indicated that the appropriate balance should be \$100. Therefore, X adjusted the liability for the uncertain tax position upward by \$30, with the offsetting debit recorded to income tax expense. Company X must account for all such changes under ASC 805-740, which results in accounting for such effects through income tax expense.

### **11.38 Uncertainty in Income Taxes in a Business Combination — Measurement Period**

The “measurement period” applies to the potential tax effects of (1) uncertainties associated with temporary differences and carryforwards of an acquired entity that exist as of the acquisition date in a business combination or (2) income tax uncertainties related to a business combination (e.g., an uncertainty related to the tax basis of an acquired asset that will ultimately be agreed to by the tax authority) acquired or arising in a business combination.

Under ASC 805-740-45-4, any changes in acquired tax positions are subject to the measurement-period guidance. Accordingly, any changes during the measurement period because of additional information about facts and circumstances that existed as of the acquisition date should be recognized as an adjustment to goodwill or, if goodwill is reduced to zero, recognized as a gain on a bargain purchase. However, if the adjustment to the acquired tax position balance directly results from an event that occurred after the business combination’s acquisition date, regardless of whether the adjustment is identified during or after the measurement period, the entire adjustment is recognized as an adjustment to income tax expense in accordance with ASC 740 and is not an adjustment to goodwill.

After the measurement period, any changes in the acquired tax position balances because of additional information about facts and circumstances that existed as of the acquisition date would need to be assessed to determine whether the adjustment is a correction of an error. See [11.25](#) for guidance on revisions to accounting for a business combination after the measurement period.

# Chapter 12 — Foreign Currency Matters

This chapter primarily addresses deferred income tax accounting for changes in tax or financial reporting bases that are due to (1) changes in an entity's functional currency, (2) price-level-related changes, and (3) differences between a foreign entity's functional and local currency. See the following for guidance on other income tax foreign currency matters:

- Chapter 3 — Recognition and Derecognition:
  - Exceptions to Recognition of Deferred Taxes — [3.01](#).
  - Recognition of Deferred Taxes for Inside Basis Differences — [3.05](#).
  - Recognition of Deferred Taxes for Temporary Differences Related to the Cumulative Translation Adjustment — [3.07](#).
  - Hedge of a Net Investment in a Foreign Subsidiary — [3.08](#).
  - Deferred Taxes Recorded Through the Currency Translation Adjustment — [3.09](#).
  - Indexing of the Tax Basis of Assets and Liabilities — [3.18](#).
- Chapter 8 — Other Considerations or Special Areas:
  - Parent's Deferred Tax Considerations When Intra-Entity Loans That Are of a Long-Term-Investment Nature Are Not Denominated in the Functional Currency — [8.07](#).

## ASC 830-740

**05-1** Topic 740 addresses the majority of differences between the financial reporting (or book) basis and tax basis of assets and liabilities (basis differences).

**05-2** This Subtopic addresses the accounting for specific types of basis differences for entities operating in foreign countries. The accounting addressed in this Subtopic is limited to the deferred tax accounting for changes in tax or financial reporting bases due to their restatement under the requirements of tax laws or generally accepted accounting principles (GAAP) in the United States. These changes arise from tax or financial reporting basis changes caused by any of the following:

- a. Changes in an entity's functional currency
- b. Price-level related changes
- c. A foreign entity's functional currency being different from its local currency.

This Subtopic addresses whether these changes, which can affect the amount of basis differences, result in recognition of changes to deferred tax assets or liabilities.

### Scope and Scope Exceptions

#### Overall Guidance

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 830-10-15, with specific qualifications noted below.

#### Entities

**15-2** The guidance in this Subtopic applies to all entities operating in foreign countries.

**ASC 830-740 (continued)****Transactions**

**15-3** The guidance in this Subtopic applies to certain specified deferred tax accounting matters, specifically to the income tax consequences of changes to tax or financial reporting bases from their restatements caused by:

- a. Changes in an entity's functional currency
- b. Price-level related changes
- c. A foreign entity's functional currency being different from its local currency.

**Recognition****Remeasurement Changes Causing Deferred Tax Recognition**

**25-1** This Section addresses basis differences that result from remeasurement of assets and liabilities due to changes in functional currency and price levels. These remeasurement changes will often affect the amount of temporary differences for which deferred taxes are recognized.

**Functional Currency Related Changes**

**25-2** Subtopic 830-30 requires that a change in functional currency from the reporting currency to the local currency when an economy ceases to be considered highly inflationary shall be accounted for by establishing new functional currency bases for nonmonetary items. Those bases are computed by translating the historical reporting currency amounts of nonmonetary items into the local currency at current exchange rates.

**25-3** As a result of applying those requirements, the functional currency bases generally will exceed the local currency tax bases of nonmonetary items. The differences between the new functional currency bases and the tax bases represent temporary differences under Subtopic 740-10, for which deferred taxes shall be recognized. [EITF 92-8, paragraph Issue] Paragraph 830-740-45-2 addresses the presentation of the effect of recognizing these deferred taxes.

**Price-Level Related Changes**

**25-4** Entities located in countries with highly inflationary economies may prepare financial statements restated for general price-level changes in accordance with generally accepted accounting principles (GAAP) in the United States. The tax bases of assets and liabilities of those entities are often restated for the effects of inflation.

**25-5** When preparing financial statements restated for general price-level changes using end-of-current-year purchasing power units, temporary differences are determined based on the difference between the indexed tax basis amount of the asset or liability and the related price-level restated amount reported in the financial statements. [EITF 93-9, paragraph Discussion] Example 1 (see paragraph 830-740-55-1) illustrates the application of this guidance.

**25-6** Temporary differences within an entity's foreign subsidiaries are referred to as inside basis differences. Differences between the tax basis and the financial reporting basis of an investment in a foreign subsidiary are referred to as outside basis differences.

**25-7** Inside basis differences of a foreign subsidiary of a U.S. parent where the local currency is the functional currency may result from foreign laws that provide for the occasional restatement of fixed assets for tax purposes to compensate for the effects of inflation. The amount that offsets the increase in the tax basis of fixed assets is sometimes described as a credit to revaluation surplus, which some view as a component of equity for tax purposes. That amount becomes taxable in certain situations, such as in the event of a liquidation of the foreign subsidiary or if the earnings associated with the revaluation surplus are distributed. In this situation, it is assumed that no mechanisms are available under the tax law to avoid eventual treatment of the revaluation surplus as taxable income. The indefinite reversal criteria of Subtopic 740-30 shall not be applied to inside basis differences of a foreign subsidiary, as indicated in paragraph 740-30-25-17, and a deferred tax liability shall be provided on the amount of the revaluation surplus.

## ASC 830-740 (continued)

**25-8** Paragraph 740-10-25-24 indicates that some temporary differences are deferred taxable income and have balances only on the income tax balance sheet. Therefore, these differences cannot be identified with a particular asset or liability for financial reporting purposes. Because the inside basis difference related to the revaluation surplus results in taxable amounts in future years based on the provisions of the foreign tax law, it qualifies as a temporary difference even though it may be characterized as a component of equity for tax purposes. Subtopic 740-30 clearly limits the indefinite reversal criterion to the temporary differences described in paragraph 740-10-25-3(a) and shall not be applied to analogous types of temporary differences. [EITF 93-16, paragraph Discussion]

### Remeasurement Changes Not Resulting in Deferred Tax Recognition

**25-9** Some remeasurement-caused changes in basis differences do not result in recognition of deferred taxes.

**25-10** As indicated in paragraph 740-10-25-3(f), recognition is prohibited for a deferred tax liability or asset for differences related to assets and liabilities that, under the requirements of Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. [FAS 109, paragraph 9]

**25-11** Paragraph 830-10-45-16 provides additional guidance on accounting for the eventual recognition of indexing related deferred tax benefits after an entity's functional currency changes from the foreign currency to the reporting currency because the foreign economy becomes highly inflationary.

### Initial Measurement

#### Foreign Financial Statements Restated for General Price Level Changes

**30-1** In foreign financial statements that are restated for general price-level changes, the deferred tax expense or benefit shall be calculated as the difference between the following two measures:

- a. Deferred tax assets and liabilities reported at the end of the current year, determined in accordance with paragraph 830-740-25-5
- b. Deferred tax assets and liabilities reported at the end of the prior year, remeasured to units of current general purchasing power at the end of the current year.

**30-2** The remeasurement of deferred tax assets and liabilities at the end of the prior year is reported together with the remeasurement of all other assets and liabilities as a restatement of beginning equity. [EITF 93-9, paragraph Discussion]

**30-3** Example 1 (see paragraph 830-740-55-1) illustrates the application of this guidance.

### Other Presentation Matters

**45-1** As indicated in paragraph 830-20-45-3, when the reporting currency (not the foreign currency) is the functional currency, remeasurement of an entity's deferred foreign tax liability or asset after a change in the exchange rate will result in a transaction gain or loss that is recognized currently in determining net income. Paragraph 830-20-45-1 requires disclosure of the aggregate transaction gain or loss included in determining net income but does not specify how to display that transaction gain or loss or its components for financial reporting. Accordingly, a transaction gain or loss that results from remeasuring a deferred foreign tax liability or asset may be included in the reported amount of deferred tax benefit or expense if that presentation is considered to be more useful. If reported in that manner, that transaction gain or loss is still included in the aggregate transaction gain or loss for the period to be disclosed as required by that paragraph. [FAS 109, paragraph 230]

**45-2** The deferred taxes associated with the temporary differences that arise from a change in functional currency discussed in paragraph 830-740-25-3 when an economy ceases to be considered highly inflationary shall be presented as an adjustment to the cumulative translation adjustments component of shareholders' equity and therefore shall be recognized in other comprehensive income. [EITF 92-8, paragraph Status]

### Related Implementation Guidance and Illustrations

- [Example 1: Illustration of Foreign Financial Statements Restated for General Price-Level Changes](#) [ASC 830-740-55-1].

## 12.01 Price-Level-Adjusted Financial Statements

Entities located in countries with highly inflationary economies may prepare financial statements restated for general price-level changes in accordance with U.S. GAAP. The tax bases of those entities' assets and liabilities are often restated for the effects of inflation.

When a foreign entity prepares domestic price-level-adjusted financial statements in accordance with U.S. GAAP, the recognition exception in ASC 740-10-25-3(f) does not apply. ASC 830-740-25-5 concludes that “[w]hen preparing financial statements restated for general price-level changes using end-of-current-year purchasing power units, temporary differences [under ASC 740] are determined based on the difference between the indexed tax basis amount of the asset or liability and the related price-level restated amount reported in the financial statements.”

In addition, ASC 830-740-30-1 concludes that the deferred tax expense or benefit should be calculated as the difference between (1) “[d]eferred tax assets and liabilities reported at the end of the current year, determined in accordance with paragraph 830-740-25-5,” and (2) “[d]eferred tax assets and liabilities reported at the end of the prior year, remeasured to units of current general purchasing power at the end of the current year.” Further, ASC 830-740-30-2 states, the “remeasurement of deferred tax assets and liabilities at the end of the prior year is reported together with the remeasurement of all other assets and liabilities as a restatement of beginning equity.”

## 12.02 Accounting for Deferred Taxes Related to Nonmonetary Assets and Liabilities When the Functional Currency Is Not the Local Currency

When the functional currency is not the local currency, an entity is required to remeasure nonmonetary assets and liabilities (e.g., property, plant, and equipment) from the local currency into the functional currency by using the historical exchange rate (i.e., the exchange rate that was in effect when the transaction was executed). By using the historical exchange rate to remeasure nonmonetary assets and liabilities, the entity achieves the same result it would have achieved had it entered into the related transactions in its functional currency. Therefore, fluctuations in exchange rates will neither increase nor decrease the carrying amount of nonmonetary assets and liabilities (and will not give rise to transaction gains and losses for financial reporting purposes).

Under ASC 740, it is assumed that assets will be recovered and liabilities will be settled at their respective financial reporting carrying amounts. Therefore, if the exchange rate changes after a nonmonetary asset or liability is acquired or incurred, respectively, the amount of local currency needed to recover the asset or settle the liability will also change. However, the tax basis of the asset or liability will not change because it would have been established when the asset was acquired or the liability was incurred (in the local currency). Therefore, changes in the exchange rate result in a difference between the amount of local currency needed to recover the functional-currency-denominated carrying value and the local currency tax basis.

ASC 740-10-25-3(f) prohibits “recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes.” In other words, deferred taxes are not recorded for basis differences related to nonmonetary assets and liabilities that result from changes in exchange rates.

Although this basis difference technically meets the definition of a temporary difference under ASC 740, the FASB concluded that accounting for it as a temporary difference would result in the recognition of deferred taxes on exchange gains and losses that are not recognized in the income statement under

ASC 830. For this reason, the FASB decided to prohibit recognition of the deferred tax consequences for those differences.

However, entities are still required to record deferred taxes for differences between the local currency tax basis and the local currency book basis that do not arise from changes in exchange rates or indexing for tax purposes (e.g., when a nonmonetary asset is depreciated over different periods for book and tax purposes). The deferred taxes for these types of basis differences are determined in the local currency and then remeasured into the functional currency at the spot rate.

### Example 12-1A

#### **Temporary Differences Not Recognized Under ASC 740**

Entity S is a foreign subsidiary of Entity P. The functional currency of S is the U.S. dollar (USD), which is not the local currency (LC). Assume the following:

- On January 1, 20X1, S purchased a piece of equipment for 500,000 LC when the exchange rate was 1 USD = 1.25 LC.
- The equipment is depreciable over 10 years for both financial reporting and tax purposes.
- The foreign tax basis and book basis in the asset was 500,000 LC (the amount paid to acquire the asset). Therefore, no temporary difference existed at the time of purchase.
- The exchange rate on December 31, 20X1, was 1 USD = 1.5 LC.
- The weighted-average exchange rate during 20X1 was 1 USD = 1.35 LC.
- The tax rate in S's jurisdiction is 30 percent.

In this example, if S were to sell the equipment for its functional-currency book basis of \$360,000 (\$400,000 historical cost less \$40,000 of accumulated depreciation) as of December 31, 20X1, S would not recognize any book gain or loss in its functional-currency financial statements. However, S would realize a taxable gain of 90,000 LC in its local tax return, as illustrated in the following table:

Financial-reporting carrying value of the equipment	360,000 USD
Spot rate on December 31, 20X1	1.5
Hypothetical sale proceeds	540,000 LC
Tax basis	450,000 LC
Taxable gain (loss)	90,000 LC

The difference between the LC-denominated hypothetical sales proceeds and the tax basis meets the definition of a temporary difference. However, because ASC 740-10-25-3(f) prohibits the recognition of deferred taxes associated with differences related to nonmonetary assets and liabilities that are caused by changes in the exchange rate, S should not record deferred taxes for the 90,000 LC basis difference.

In this example, there are no other differences between the LC book basis and the LC tax basis of the equipment that would give rise to deferred taxes.

**Example 12-1B****Temporary Differences Recognized Under ASC 740**

Assume the same facts as in Example 12-1A, except that the equipment is depreciated over five years for tax purposes.

As of December 31, 20X1, S measures the deferred taxes related to the equipment, as illustrated in the following table (all amounts are in LC):

	<b>Book</b>	<b>Tax</b>	<b>Temporary Difference</b>	<b>DTA (DTL)</b>
Basis as of January 1, 20X1	500,000	500,000	0	0
20X1 depreciation expense	<u>50,000</u>	<u>100,000</u>		
Basis as of December 31, 20X1	<u>450,000</u>	<u>400,000</u>	<u>(50,000)</u>	<u>(15,000)</u>

As indicated above, S recognizes a DTL of 15,000 LC as of December 31, 20X1, related to the equipment for the difference between the LC book basis and LC tax basis caused by the difference in depreciation methods. The DTL is then remeasured into the functional currency at the reporting-date spot rate. In addition, S recognizes a deferred tax expense of 15,000 LC in 20X1 as a result of the increase in the DTL, which is then remeasured into the functional currency at the weighted-average exchange rate in effect during 20X1. The difference between these two amounts results in a foreign currency transaction gain during 20X1, as illustrated in the following table:

	<b>LC</b>	<b>Exchange Rate</b>	<b>Functional Currency</b>	<b>Transaction Gain</b>
Beginning-of-year DTL at beginning-of-year rate	0	1.25	0	
Beginning-of-year DTL at end-of-year rate	0	1.5	0	
FCT gain (loss)				0
Deferred tax expense at weighted-average rate	(15,000)	1.35	(11,111)	
Deferred tax expense at end-of-year rate	(15,000)	1.5	(10,000)	
FCT gain (loss)				1,111
Total foreign currency transaction gain (loss)				1,111

In accordance with ASC 830-740-45-1, S may present the transaction gain as a deferred tax benefit (as opposed to a transaction gain) if that presentation is considered more useful. If the transaction gain is reported in that manner, it would still be included in the aggregate transaction gain or loss for the period to be disclosed as required by ASC 830-20-45-1.

### 12.03 Change in the Functional Currency When an Economy Ceases to Be Considered Highly Inflationary

When an entity has a foreign subsidiary operating in an economy that is considered highly inflationary under ASC 830, the reporting currency will be used as the subsidiary's functional currency to measure foreign nonmonetary assets and liabilities, such as inventory, land, and depreciable assets. If the rate of inflation for the local currency significantly declines, the economy will no longer be considered highly inflationary and the entity will need to account for the change in its subsidiary's functional currency from the reporting currency to the local currency.

Deferred taxes should be recognized when the new local currency accounting bases are established for the foreign nonmonetary assets and liabilities. ASC 830-740-25-3 concludes that any resulting difference between the new functional currency basis and the tax basis is a temporary difference for which intraperiod tax allocation is required under ASC 740. Since the functional currency book basis generally will exceed the local currency tax basis in this situation, a DTL will be recognized at the time the change occurs. In addition, under ASC 830-740-45-2, the deferred taxes associated with the temporary difference that arises should be reflected as an adjustment to the cumulative translation component of OCI rather than as a charge to income. Example 12-1 illustrates this concept.

#### Example 12-1

A foreign subsidiary of a U.S. entity operating in a highly inflationary economy purchased equipment with a 10-year useful life for 100,000 local currency (LC) on January 1, 20X1. The exchange rate on the purchase date was 10LC to \$1.00, so the U.S.-dollar-equivalent cost was \$10,000. On December 31, 20X5, the equipment has a net book value on the subsidiary's local books of 50,000 LC (the original cost of 100,000 LC less accumulated depreciation of 50,000 LC) and the current exchange rate is 75 LC to the U.S. dollar. In the U.S. parent's consolidated financial statements, annual depreciation expense of \$1,000 has been reported for each of the last five years, and on December 31, 20X5, a \$5,000 amount is reported for the equipment (foreign currency basis measured at the historical exchange rate between the U.S. dollar and the foreign currency on the date of purchase).

At the beginning of 20X6, the economy in which the subsidiary operates ceases to be considered highly inflationary. Accordingly, a new functional currency accounting basis for the equipment would be established as of January 1, 20X6, by translating the reporting currency amount of \$5,000 into the functional currency at the current exchange rate of 75 LC to the U.S. dollar. The new functional currency accounting basis on the date of change would be 375,000 LC ( $5,000 \times 75$ ).

A DTL, as measured under the tax laws of the foreign jurisdiction, is recorded in the subsidiary's local books on January 1, 20X6. This measurement is based on the temporary difference between the new reporting basis of the asset of 375,000 LC and its underlying tax basis, 50,000 LC on that date. Thus, if a tax rate of 50 percent in the foreign jurisdiction is assumed, a DTL of 162,500 LC ( $325,000 \text{ LC} \times 50\%$ ) would be recorded on the local books of record. That DTL would then be translated at the current exchange rate between the U.S. dollar and the local currency and reported as \$2,167 in the consolidated financial statements ( $162,500 \text{ LC} \div 75$ ) with a corresponding charge to the cumulative translation account.

## 12.04 Deferred Income Tax Effects When the Functional Currency Changes From the Local Currency to the Reporting Currency

When the country in which a foreign entity operates becomes highly inflationary,<sup>1</sup> the entity must change its functional currency from the local currency to its parent's reporting currency (e.g., the U.S. dollar). In addition, regardless of whether the economy is highly inflationary, an entity may switch its functional currency from the local currency to the reporting currency when significant changes in facts and circumstances occur (such that the determination of the functional currency under ASC 830 is affected). When the reporting currency is the functional currency, ASC 830-10-45-18 requires that historical exchange rates be used to remeasure nonmonetary assets and liabilities from the local currency into the reporting currency and therefore the exception in ASC 740-10-25-3(f), as discussed in [12.02](#), applies.

ASC 830-10-45-10 states that "[i]f the functional currency changes from a foreign currency to the reporting currency, translation adjustments for prior periods shall not be removed from equity and the translated amounts for nonmonetary assets at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods."

<sup>1</sup> See ASC 830-10-45-11 through 45-13 for guidance on determining whether an economy is considered highly inflationary.

In this case, because the pretax carrying amounts of the subsidiary's assets and liabilities do not change when the functional currency changes, temporary differences also do not change. Therefore, the subsidiary's DTAs and DTLs should not be adjusted on the date the functional currency changes.

However, the guidance in ASC 740-10-25-3(f) would be applied prospectively from the date of the change. Therefore, after the functional currency is changed to the reporting currency, the exception applies and the local-currency-equivalent amount of the financial reporting carrying value (for use in determining the temporary difference) is measured by using the historical exchange rates as of the date of the change in the functional currency (even though the resulting local-currency amount differs from the amount that an entity needs to recover the reporting-currency carrying value of the asset or liability).

In addition, an entity would continue to recognize deferred taxes for (1) differences related to the effects of exchange rate changes associated with reporting-currency-denominated **monetary** assets and liabilities and (2) other differences (excluding the effects of indexing, which are discussed below) between the local-currency financial reporting carrying value and local-currency tax basis of nonmonetary assets (e.g., differences arising when a nonmonetary asset is depreciated over different periods for book and tax purposes).

Further, certain countries (especially those that are considered highly inflationary) permit the tax basis of assets to be indexed. ASC 830-10-45-16 states:

[D]eferred tax benefits attributable to any such indexing that occurs after the change in functional currency to the reporting currency shall be recognized when realized on the tax return and not before. Deferred tax benefits that were recognized for indexing before the change in functional currency to the reporting currency are eliminated when the related indexed amounts shall be realized as deductions for tax purposes.

Therefore, deferred tax effects (either a lesser DTL or a DTA) that were recognized as a result of indexing before the change in functional currency to the reporting currency are not derecognized. Rather, such effects reverse over time as those benefits are realized on the tax return (i.e., previously recognized DTAs should not be reversed when the functional currency is changed to the reporting currency). Going forward, no new DTAs should be recognized for the effects of indexing that occur after the change in the functional currency.<sup>2</sup>

Because the effects of indexing are ignored for deferred tax accounting purposes when the reporting currency is the functional currency, the current-year tax depreciation of indexation not recognized under ASC 740 (i.e., any indexation after the reporting currency became the functional currency) will result in a favorable permanent difference. Therefore, the excess tax depreciation (due to unrecognized indexing) will result in a lower effective tax rate in the year in which it is realized on the entity's tax return. The prohibition in ASC 740-10-25-3(f) causes the timing of recognizing the tax benefit related to indexing to shift from the period in which the indexing occurs to the period in which the additional tax basis is depreciated or amortized (even when the resulting deduction increases an NOL carryforward).

<sup>2</sup> Since the exception only applies to deferred tax accounting, the current tax benefit related to the depreciation or amortization of the tax basis from indexation should be recognized.

### Example 12-2

Entity A, a foreign entity, uses the local currency (LC) as its functional currency. Entity A's parent is a U.S. entity that uses the U.S. dollar (USD) as its reporting currency. On January 1, 20X5, A acquires a piece of equipment for 1,000,000 LC. The equipment is depreciated on a straight-line basis over four years for both book and tax purposes. The tax laws of the foreign country in which A operates allow for a 15 percent increase in the tax basis at the end of each year (i.e., the depreciable tax basis includes the additional tax basis from indexation). Assume that A's tax rate is 40 percent.

Entity A's deferred taxes on the temporary difference associated with the equipment are calculated as follows (all amounts are in LC):

	<b>Tax Basis</b>	<b>Book Basis</b>	<b>Temporary Difference</b>	<b>DTA / (DTL)</b>
Basis on January 1, 20X5	1,000,000	1,000,000	—	—
20X5 Depreciation expense	250,000	250,000	—	—
	750,000	750,000	—	—
20X5 Indexing	112,500	—	112,500	45,000
Basis on December 31, 20X5	862,500	750,000	112,500	45,000

Assume that on January 1, 20X6, the country in which A operates becomes highly inflationary (or that A otherwise determines that its functional currency has changed to the reporting currency). Under ASC 830, A's functional currency would change to the reporting currency of its parent (USD) in the period in which A determines that the jurisdiction is highly inflationary (or otherwise determines that its functional currency should be the reporting currency). The USD-translated amount for the equipment at the end of the prior period (December 31, 20X5) becomes the accounting basis in the current period and in subsequent periods. The following table illustrates the tax effects when A changes its functional currency from the local currency to the reporting currency (all amounts are in LC):

	<b>Tax Basis</b>				
	<b>Not Recognized Under ASC 740</b>	<b>Recognized Under ASC 740</b>	<b>Book Basis</b>	<b>Temporary Difference</b>	<b>DTA / (DTL)</b>
Basis on January 1, 20X6	—	862,500	750,000	112,500	45,000
20X6 Depreciation expense	—	287,500	250,000	37,500	(15,000)
	—	575,000	500,000	75,000	30,000
20X6 Indexing	86,250	—	—	N/A	N/A
Basis on December 31, 20X6	86,250	575,000	500,000	75,000	30,000

On December 31, 20X6, A would recognize a DTA of 30,000 LC (temporary difference of 75,000 LC  $\times$  40% tax rate). The DTA would be recognized at the average exchange rate (to determine the amount to recognize as an income tax benefit) and would then be retranslated at the exchange rate in effect on December 31, 20X5; any difference between the two amounts would be included in the income statement. Under ASC 830-740-45-1, A may present the transaction gain or loss that results from remeasuring the DTA as deferred tax expense or benefit (rather than as a transaction gain or loss) if such presentation is considered more useful. If reported in that manner, the transaction gain or loss would still be included in the aggregate transaction gain or loss for the period, which would be disclosed in accordance with ASC 830-20-45-1.

**Example 12-2 (continued)**

Because A's functional currency changed to USD (i.e., the reporting currency of its parent) in 20X6, it would not recognize any deferred taxes related to the additional indexing that occurred in 20X6 since that adjustment was made after the functional currency changed. Further, A would not immediately reverse the DTA that it previously recorded in connection with the 20X5 indexing adjustments before its functional currency changed. Rather, the DTA would be reversed over time as those benefits (in the form of increased tax depreciation expense) are realized on A's tax return. In 20X6, A claimed additional depreciation of 37,500 LC for tax purposes. Because this additional depreciation was realized on the return, A reverses the DTA by the corresponding, tax-effected amount ( $37,500 \text{ LC} \times 40\% = 15,000$ ).

In addition, when determining the local-currency-equivalent amount of the USD carrying value of the equipment (for use in measuring the temporary difference related to the equipment), A must use the exchange rate in effect at the time the functional currency changed (i.e., the historical exchange rate).<sup>3</sup> The fact that the presumed recovery of the equipment for its USD carrying amount implies a different local-currency-equivalent amount as the exchange rate fluctuates is not considered (which is the exception in ASC 740-10-25-3(f)).

Further assume that throughout 20X7, the country in which A operates continues to be highly inflationary and that its functional currency therefore continues to be the reporting currency. The following table illustrates A's tax effects in 20X7 (all amounts are in LC):

	Tax Basis				
	Not Recognized Under ASC 740	Recognized Under ASC 740	Book Basis	Temporary Difference	DTA / (DTL)
Basis on January 1, 20X7	86,250	575,000	500,000	75,000	30,000
20X7 Depreciation expense	<u>43,125</u>	<u>287,500</u>	<u>250,000</u>	<u>37,500</u>	<u>(15,000)</u>
	43,125	287,500	250,000	37,500	15,000
20X7 Indexing	<u>49,594</u>	<u>—</u>	<u>—</u>	<u>N/A</u>	<u>N/A</u>
Basis on December 31, 20X7	<u>92,719</u>	<u>287,500</u>	<u>250,000</u>	<u>37,500</u>	<u>15,000</u>

In 20X7, A realizes total tax depreciation of 330,625 LC on its tax return (the total of the first and second columns in the table above). However, of the total tax depreciation realized, 43,125 LC is related to the effects of the indexing that occurred in 20X6.<sup>4</sup> Because the indexing occurred after the functional currency changed to the reporting currency, the excess depreciation realized in 20X7 has no impact on the DTA. However, since this amount is realized on the entity's return, it creates a permanent difference in 20X7, which would lower A's effective tax rate and current payable (provided that A reported taxable income).

The remainder of the tax depreciation realized in 20X7 (287,500 LC) is related to the tax basis that existed before the functional currency changed to the reporting currency. The amount is the same as the amount calculated in 20X6 and would remain the same in 20X8 (the last year of the asset's useful life for tax purposes). Because this amount is 37,500 LC higher than the depreciation expense realized for book purposes, A reverses the DTA by the corresponding, tax-effected amount ( $37,500 \text{ LC} \times 40\% = 15,000$ ). The remaining temporary difference of 37,500 LC at the end of 20X7 would be reversed in 20X8.

Lastly, A does not recognize a DTA for the additional indexing that occurred at the end of 20X7 since that adjustment occurred after the functional currency was changed.

<sup>3</sup> With respect to assets held at the time the functional currency is changed to the reporting currency, the "historical exchange rate" means the rate in effect on the date of change in the functional currency. With respect to assets acquired after the change in functional currency, the "historical exchange rate" means the rate used to remeasure the local-currency cost of the asset into the reporting-currency amount (generally, the rate in effect when the asset was acquired).

## 12.05 Accounting for Deferred Taxes Related to Monetary Assets When the Reporting Currency Is the Functional Currency

As discussed in [12.04](#), the exception in ASC 740-10-25-3(f) does not apply to assets and liabilities that are remeasured by using current exchange rates (referred to as "monetary assets and liabilities"). However, when a foreign entity's functional currency is the reporting currency of its parent, the foreign entity's deferred tax accounting for monetary assets and liabilities depends on whether the asset or liability is denominated in the local currency or the reporting currency.

When a monetary asset or liability is denominated in an entity's local currency, it must be remeasured into the entity's functional currency each period by using the current exchange rate for financial reporting purposes. Therefore, when the reporting currency is the functional currency, monetary assets and liabilities denominated in the local currency must be remeasured into the reporting currency at the then-current exchange rate. Fluctuations in the exchange rate between the local currency and the reporting currency will result in (1) changes in the financial-reporting carrying value of the monetary asset or liability and (2) transaction gains and losses for financial reporting purposes.

However, although a pretax gain or loss is recognized for financial reporting purposes, there will be no current or deferred tax expense or benefit. This is because the exchange rate fluctuations will not result in taxable income or loss when the asset is recovered or the liability is settled since the local currency is used to determine taxable income (i.e., those gains and losses only exist when the asset or liability is measured in the reporting currency). Further, these exchange rate fluctuations do not contribute to any difference between the book and tax basis of the asset or liability when the book basis is measured in the local currency. Therefore, there are no current or deferred tax consequences related to the transaction gains and losses. Thus, such gains or losses will be permanent items that affect the effective tax rate (i.e., pretax income or loss with no related tax expense or benefit).

### ***Reporting-Currency-Denominated Monetary Assets and Liabilities***

Unlike the local-currency-denominated monetary assets and liabilities discussed above, monetary assets or liabilities denominated in an entity's reporting currency do not need to be remeasured for financial reporting purposes since they are already denominated in the functional currency. Therefore, in such cases, currency fluctuations do not give rise to pretax transaction gains or losses for financial reporting purposes.

<sup>4</sup> The amount of depreciation expense related specifically to the 20X6 indexing is calculated by dividing the amount of tax basis created as a result of the indexing (86,250 LC) by the number of years remaining on the asset's useful life for tax purposes at the time the basis increased (two years). This amount can also be calculated by comparing the amounts of tax depreciation expense before and after the change in functional currency.

However, fluctuations in the exchange rates will create a difference between the book and tax basis of the asset or liability when the local-currency equivalent of the reporting-currency book basis is compared with the local-currency tax basis. Therefore, although no pretax gain or loss is recognized for financial reporting purposes, current or deferred taxes may be required. Whether a current or deferred tax is required in this situation depends on whether the entity will be taxed on a realized or unrealized basis, as explained below:

- *Realized basis (or “settlement approach”)* — The gain or loss is included in taxable income only on the date the asset is recovered or the liability is settled. The amount of gain or loss is calculated by comparing the initial tax basis of the asset or liability with its tax basis when the asset or liability is recovered or settled, respectively. The initial tax basis of the asset or liability is generally the local-currency equivalent of the reporting-currency carrying value, determined by using the spot rate on the transaction date. The tax basis of the asset or liability upon settlement is generally the local-currency equivalent of the reporting-currency carrying value, determined by using the spot rate on the settlement/recovery date.
- *Unrealized basis (or “mark-to-spot approach”)* — The unrealized gain or loss is included in taxable income each year. The amount of unrealized gain or loss is calculated by comparing the initial tax basis of the asset or liability with its tax basis at the end of each year. The initial tax basis is determined in the same manner as the initial tax basis determined under the settlement approach described above. The tax basis of the asset or liability at the end of each year is generally the local-currency equivalent of the reporting-currency carrying value, determined by using the spot rate in effect at the end of the year.

If a foreign entity is taxed under the settlement approach, it is necessary to calculate a temporary difference and related DTL or DTA as of the end of each reporting period. The amount of deferred taxes required is equal to the difference between the initial tax basis of the asset or liability (in local currency) and the local-currency equivalent of the financial-statement carrying value, determined by using the exchange rate in effect at the end of the year and multiplied by the enacted tax rate.

Conversely, for jurisdictions that tax unrealized foreign exchange gains or losses under the mark-to-spot approach, there will generally be no temporary difference since the entire unrealized amount will be included in taxable income as it arises and a corresponding current tax expense or benefit will be recognized.

Because any tax expense or benefit (whether current or deferred) will not have a corresponding pretax book amount, the related tax expense or benefit will generally affect the effective tax rate that should be appropriately disclosed in the footnotes to the financial statements.

### Example 12-3

#### **Local-Currency-Denominated Debt**

Entity A, a foreign entity located in Canada, has a U.S. parent that uses the U.S. dollar (USD) as its reporting currency. In accordance with ASC 830, A determines that its functional currency is the reporting currency of its parent (USD) and not the local currency, the Canadian dollar (CAD). On September 30, 20X5, A obtained a loan for CAD 100 million from its U.S. parent when the exchange rate was USD 1 = CAD 1.25. The exchange rate on December 31, 20X5, is USD 1 = CAD 1.33.

On September 30, 20X5, the date of the borrowing, A records the loan at its USD-equivalent value of USD 80 million (CAD 100 million  $\div$  1.25). Entity A's tax basis in the borrowing is the initial amount borrowed of CAD 100 million (i.e., the tax basis is the local-currency-denominated amount).

On December 31, 20X5, A remeasures the liability from its local-currency-denominated value of CAD 100 million into USD by using the exchange rate in effect on that date. The remeasured value of USD 75 million (CAD 100 million  $\div$  1.33) results in an unrealized pretax transaction gain of USD 5 million for financial reporting purposes, which is the difference between the financial-statement carrying value (in USD) on September 30, 20X5, and that on December 31, 20X5.

However, on December 31, 20X5, there is no unrealized gain for tax purposes because there is no difference between the amount required to settle the liability (CAD 100 million) and the tax basis of the liability (CAD 100 million). Since taxable income is determined by using CAD and the loan is denominated in CAD, the balance is unchanged from its original tax basis of CAD 100 million and there is no unrealized gain for tax corresponding to the gain for financial reporting. Therefore, although the fluctuation in the exchange rate resulted in a pretax gain for financial reporting purposes, A would not record any deferred taxes.

#### **Observation**

As discussed above, A will have pretax gain or loss on a separate-company basis but will not have any corresponding tax expense or benefit. On a consolidated basis, because the loan is denominated in CAD, there will be an equal and offsetting pretax gain or loss for the U.S. parent. So, on a consolidated basis, there will be no net pretax gain or loss. While such a pretax gain or loss will not have any tax effects for A (since A's tax return is filed in CAD), there will be a tax effect related to the U.S. parent's pretax amount since the parent uses USD in filing its tax return. The U.S. parent will have a deferred tax effect related to the CAD-denominated loan since the USD amount required to settle the loan fluctuates from the tax basis of the liability (the USD equivalent of the CAD 100 million when the loan is entered into). In summary, there will be no pretax gain or loss on a consolidated basis and no Canadian tax effect for A; however, there will be a tax effect for the U.S. parent, which will affect the effective tax rate.

**Example 12-4****Reporting-Currency-Denominated Debt**

Assume the same facts as in Example 12-3 except that the loan is denominated in USD and A's tax rate is 30 percent.

On September 30, 20X5, the date of the borrowing, A records the loan at its USD-equivalent value of USD 100 million. Entity A's initial tax basis in the loan is CAD 125 million, the local-currency equivalent of the amount borrowed, which is calculated by using the exchange rate in effect on the date of the borrowing (USD 100 million  $\times$  1.25).

On December 31, 20X5, the financial-reporting carrying value of the loan is still USD 100 million since the loan is denominated in the functional currency. However, the local-currency-equivalent value of the loan has changed to CAD 133 million as a result of the fluctuation in the exchange rate. Therefore, the change in the exchange rate has created an unrealized tax loss of CAD 8 million (equal to the difference between the book and tax basis of the loan when converted into the local currency).

If A is taxed under the settlement approach, it would record a DTA of CAD 2.4 million, which is equal to the tax effect of the difference between the tax basis of the loan and the local-currency-equivalent value on December 31, 20X5 ([CAD 125 million – CAD 133 million]  $\times$  30%). The DTA would be recognized at the average exchange rate (to determine the amount to recognize as an income tax benefit) and would then be remeasured at the exchange rate in effect on December 31, 20X5; any difference between the two amounts would be included in the income statement. Under ASC 830-740-45-1, A may present the transaction gain or loss that results from remeasuring the DTA as deferred tax expense or benefit (as opposed to foreign currency transaction gain or loss) if such presentation is considered more useful. If reported in that manner, that transaction gain or loss is still included in the aggregate transaction gain or loss for the period, which is disclosed in accordance with ASC 830-20-45-1.

Conversely, if A is taxed under the mark-to-spot approach, it would recognize a taxable loss of CAD 8 million and should record a CAD 2.4 million reduction in current tax payable and a CAD 2.4 million income tax benefit.

***Observation***

In this example, there will be no pretax income for either A or the U.S. parent, nor will there be such income in consolidation (since A, the U.S. parent, and the consolidated financial statements use USD). Further, the U.S. parent in this example (unlike the U.S. parent in Example 12-3) will have no tax effect since the loan is denominated in USD and the U.S. parent files its tax return in USD. However, A will have a tax effect (either current or deferred, depending on Canadian tax law) related to the loan, since it files its tax return in CAD but the loan is denominated in USD.

In summary, in both examples, there is no consolidated pretax gain or loss. (In Example 12-3, there are equal and offsetting pretax amounts; in Example 12-4, because the loan is denominated in USD, there is no pretax gain or loss in either A or the U.S. parent.) In each example, there is a tax effect in the consolidated financial statements (and that tax effect affects the effective tax rate, since there is a tax effect with no corresponding pretax amount). In Example 12-3, the loan is denominated in CAD so the tax effect is in the U.S. parent; in Example 12-4, the loan is denominated in USD so the tax effect is in A.

## **12.06 Deferred Tax Considerations Related to a Foreign Subsidiary When Intra-Entity Loans That Are of a Long-Term-Investment Nature Are Denominated in the Parent's Currency**

In accordance with ASC 830-20-35-4, an intra-entity loan to a foreign subsidiary "for which settlement is not planned or anticipated in the foreseeable future" is treated as part of the overall net investment in the foreign subsidiary. If the loan is denominated in the subsidiary's functional currency, any gain or loss related to fluctuations in the exchange rate will reside with the parent (assuming the subsidiary's functional currency is different from its parent). If the loan is denominated in the parent's functional currency, any gain or loss related to fluctuations in the exchange rate will reside with the foreign subsidiary (assuming the subsidiary's functional currency is different from its parent). In either case, however, given that the loan is characterized as "part of the overall net investment," any pretax foreign

exchange gain or loss and the related tax consequences related to the loan are recognized in the currency translation adjustments component of OCI rather than as a foreign exchange gain or loss in the period in which the gain or loss arises.

Because the loan is characterized as part of the overall net investment, questions can arise regarding the recognition of deferred taxes. When the loan is denominated in the parent's currency, the treatment of the loan as part of the overall net investment might raise the question of whether the loan should be treated as equity. Also, a question might arise regarding whether the subsidiary should consider any of the exceptions that might apply to a parent's investment in a foreign subsidiary (generally, ASC 740-30-25-17 and ASC 740-30-25-9 prohibit the recognition of deferred taxes when it is not foreseeable that the related taxable or deductible temporary difference will reverse).

When an intra-entity loan that is of a long-term-investment nature is denominated in the parent's functional currency, the foreign subsidiary should generally record deferred taxes related to the pretax foreign exchange gain or loss unless the foreign subsidiary's jurisdiction will not tax the foreign exchange gain or loss at any point in time. In such cases, the foreign subsidiary should neither analogize to ASC 740-30-25-17 or ASC 740-30-25-9 nor consider the loan a component of its equity that is therefore not subject to evaluation as a temporary difference.

It would not be appropriate for the foreign subsidiary to apply the exceptions in ASC 740-30-25-17 and ASC 740-30-25-9 because those exceptions apply to a parent's outside basis difference in an investment in a foreign subsidiary (i.e., the exceptions apply to the parent as the "investor" in a foreign subsidiary and are not relevant to the foreign subsidiary "investee"). Even from the parent's perspective, the exceptions generally do not apply when the parent is the entity exposed to an exchange gain or loss related to an intra-entity loan that is of a long-term-investment nature. (See [8.07](#) for a discussion of the parent's deferred tax considerations in situations in which an intra-entity loan that is of a long-term-investment nature is denominated in the currency of the foreign subsidiary such that the parent is exposed to the exchange gain or loss).

In addition, although an intra-entity loan that is of a long-term-investment nature is treated as part of the parent's net investment in the foreign subsidiary in the accounting for foreign currency fluctuations, it is still a loan, albeit one that has an indefinite duration. While an intra-entity loan that is of a long-term-investment nature might ultimately be contributed to the equity of the foreign subsidiary, in the intervening periods, an intra-entity loan that is of a long-term-investment nature is reflected in the books of the parent and subsidiary as an intra-entity receivable and payable (subject to the assessment of any uncertain tax positions). Therefore, the foreign subsidiary should not treat the liability as a component of its equity.

Accordingly, the temporary difference related to the foreign subsidiary's liability will need to be determined as of each reporting date by comparing the tax basis, which is equal to the original amount borrowed (in terms of the local currency that is used to measure taxable income), with the book basis in the liability, which is equal to the amount required to repay the loan (again, determined in terms of the local currency and the exchange rate as of the reporting date). The difference, which represents a transaction gain or loss for tax purposes, will generally be included in the local tax return on either a realized basis or an unrealized basis as discussed in [12.05](#).

Because the actual mechanics may vary by jurisdiction (i.e., some jurisdictions might limit the deductibility of losses but require that all gains be taxed), an entity must consider the actual local tax law related to whether the foreign currency transaction gain or loss is taxable or deductible as well as the timing of recognizing any gain or loss.

Since it is not foreseeable that the loan will be repaid, it is expected that the loan would be extended upon its scheduled maturity or contributed to equity. If those events are not considered taxable transactions in the foreign subsidiary's jurisdiction, it would be appropriate to apply the exception in ASC 740-10-25-30, which states that basis differences that do "not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled . . . may not be temporary differences for which a deferred tax liability or asset is recognized" (e.g., corporate-owned life insurance that can be recovered tax-free upon the death of the insured in accordance with the intent of the policy owner).

While the preceding discussion focuses on a foreign subsidiary (i.e., a foreign corporation that is controlled and consolidated by the parent), the same potential for tax consequences would apply to loans made to a disregarded entity (i.e., an entity that is treated as a branch of the parent) or to loans between brother-sister entities. However, in the case of a loan made to a disregarded entity, the parent should also consider the FTC consequences of any current or deferred tax recognized by the foreign subsidiary.

A U.S. parent should also be aware that any gain or loss recognized by a foreign subsidiary might be treated as Subpart F income under the IRC.

# Chapter 13 — Qualified Affordable Housing Project Investments

In 2014, the FASB issued ASU 2014-01, which amended the guidance on accounting for investments in projects that qualify for affordable housing tax credits under U.S. federal tax law. The ASU amended ASC 323-740 to permit entities to elect, as an accounting policy, to account for investments in qualified affordable housing projects that meet certain criteria by using a proportional amortization method instead of the effective yield method previously permitted by ASC 323-740. The ASU also amended the criteria formerly used for determining whether a qualified affordable housing investment qualified for use of the effective yield method. The amended criteria are now used for determining whether an affordable housing investment qualifies for use of the proportional amortization method. The ASU was effective for public entities in fiscal years beginning after December 15, 2014, and interim periods within those years. For nonpublic entities, the new guidance will apply in years beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption was permitted. Retrospective application was required; however, an entity that used the effective yield method to account for its affordable housing project investments before adopting ASU 2014-01 may continue to apply that method for those prior investments.

Since the guidance has now become effective for all entities, this chapter does not provide guidance for circumstances in which an entity has not adopted ASU 2014-01.

On January 5, 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new guidance requires that entities, upon the effective date of the ASU (generally after December 15, 2017, for public entities), carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and limited liability companies, at fair value through net income (FVTNI). Although the pending guidance is included in the ASC excerpts contained below, the interpretative guidance within this chapter reflects U.S. GAAP before adoption of ASU 2016-01.

## **13.01 Tax Benefits Resulting From Investments in Affordable Housing Projects (Before the Adoption of ASU 2014-01 [Deleted])**

**ASC 323-740**

**05-1** This Subtopic contains standalone Qualified Affordable Housing Project Investments Subsections, which provide income tax accounting guidance on a specific type of investment in real estate. Income tax accounting guidance on other types of equity method investments and joint ventures is contained in Subtopics 740-10 and 740-30.

**05-2** The Qualified Affordable Housing Project Investments Subsections provide income tax accounting guidance on a specific type of investment in real estate. This guidance applies to investments in limited liability entities that manage or invest in qualified affordable housing projects and are flow-through entities for tax purposes. [ASU 2014-01, paragraph 2]

**05-3** The following discussion refers to and describes a provision within the Revenue Reconciliation Act of 1993; however, it shall not be considered a definitive interpretation of any provision of the Act for any purpose. The Revenue Reconciliation Act of 1993, enacted in August 1993, retroactively extended and made permanent the affordable housing credit. Investors in entities that manage or invest in qualified affordable housing projects receive tax benefits in the form of tax deductions from operating losses and tax credits. The tax credits are allowable on the tax return each year over a 10-year period as a result of renting a sufficient number of units to qualifying tenants and are subject to restrictions on gross rentals paid by those tenants. These credits are subject to recapture over a 15-year period starting with the first year tax credits are earned. Corporate investors generally purchase an interest in a limited liability entity that manages or invests in [ASU 2014-01, paragraph 2] the qualified affordable housing projects. [EITF 94-01, paragraph Issue]

### **Scope and Scope Exceptions**

#### **Overall Guidance**

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 323-10-15, with specific transaction qualifications noted in the other Subsections of this Section.

**15-2** The Qualified Affordable Housing Project Investments Subsections follow the same Scope and Scope Exceptions as outlined in the General Subsection of this Subtopic, see Section 323-10-15, with specific transaction qualifications noted below.

#### **Transactions**

**15-3** The guidance in the Qualified Affordable Housing Project Investments Subsections applies to reporting entities that are investors in qualified affordable housing projects through limited liability entities that are flow-through entities for tax purposes. [ASU 2014-01, paragraph 2]

#### **Recognition**

**25-1** A reporting entity that invests in qualified affordable housing projects through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method [ASU 2014-01, paragraph 2] (described in paragraphs 323-740-35-2 and 323-740-45-2) provided all of the following conditions are met: [EITF 94-01, paragraph Discussion]

- a. It is probable that the tax credits allocable to the investor will be available. [ASU 2014-01, paragraph 2]
- aa. The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity. [ASU 2014-01, paragraph 2]
- aaa. Substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment). [ASU 2014-01, paragraph 2]
- b. The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive. [EITF 94-01, paragraph Discussion]
- c. The investor is a [EITF 94-01, paragraph Discussion] limited liability investor in the limited liability entity [ASU 2014-01, paragraph 2] for both legal and tax purposes, and the investor's liability is limited to its capital investment. [EITF 94-01, paragraph Discussion]

### **ASC 323-740 (continued)**

**25-1A** In determining whether an investor has the ability to exercise significant influence over the operating and financial policies of the limited liability entity, a reporting entity shall consider the indicators of significant influence in paragraphs 323-10-15-6 through 15-7. [ASU 2014-01, paragraph 2]

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

- a. The reporting entity is in the business of entering into those other transactions (for example, a financial institution that regularly extends loans to other projects).
- b. The terms of those other transactions are consistent with the terms of arm's-length transactions.
- c. The reporting entity does not acquire the ability to exercise significant influence over the operating and financial policies of the limited liability entity as a result of those other transactions. [ASU 2014-01, paragraph 2]

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

- a. A change in the nature of the investment (for example, if the investment is no longer in a flow-through entity for tax purposes)
- b. A change in the relationship with the limited liability entity that could result in the reporting entity no longer meeting the conditions in paragraphs 323-740-25-1 through 25-1B. [ASU 2014-01, paragraph 2]

**25-2** For an investment in a qualified affordable housing project through a limited liability entity not accounted for using the proportional amortization method, [ASU 2014-01, paragraph 2] the investment shall be accounted for in accordance with Subtopic 970-323. In accounting for such an investment under that Subtopic, the requirements in paragraphs 323-740-25-3 through 25-5 and paragraphs 323-740-50-1 through 50-2 of this Subsection that are not related to the [EITF 94-01, paragraph Discussion] proportional amortization method, shall be applied. [ASU 2014-01, paragraph 2]

### **Pending Content (Transition Guidance: ASC 825-10-65-2)**

**25-2A** Accounting for an investment in a qualified affordable housing project using the cost method may be appropriate. In accounting for such an investment using the cost method, the requirements in paragraphs 323-740-25-3 through 25-5 and paragraphs 323-740-50-1 through 50-2 of this Subsection that are not related to the proportional amortization method shall be applied. [ASU 2016-01, paragraph 27]

**25-3** A liability shall be recognized for delayed equity contributions that are unconditional and legally binding. A liability also shall be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable. Topic 450 and paragraph 840-30-55-15 provide additional guidance on the accounting for delayed equity contributions.

### **Pending Content (Transition Guidance: ASC 842-10-65-1)**

**25-3** A liability shall be recognized for delayed equity contributions that are unconditional and legally binding. A liability also shall be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable. Topic 450 and paragraph 842-50-55-2 provide additional guidance on the accounting for delayed equity contributions. [EITF 94-01, paragraph Discussion]

**25-4** The decision to apply the proportional amortization method of accounting is an accounting policy decision to be applied consistently to all investments in qualified affordable housing projects that meet the conditions in paragraph 323-740-25-1 rather than a decision to be applied to individual investments that qualify for use of the proportional amortization method. [ASU 2014-01, paragraph 2]

**ASC 323-740 (continued)**

**25-5** At the time of initial investment, immediate recognition of the entire benefit of the tax credits to be received during the term of an investment in a qualified affordable housing project is not appropriate (that is, affordable housing credits shall not be recognized in the financial statements before their inclusion in the investor's tax return). [EITF 94-01, paragraph Discussion]

**25-6** Example 1 (see paragraph 323-740-55-2) illustrates the application of accounting guidance to a limited partnership investment in a qualified affordable housing project using the cost, equity, and effective yield methods.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

**25-6** Example 1 (see paragraph 323-740-55-2) illustrates the application of accounting guidance to a limited partnership investment in a qualified affordable housing project using the cost, equity, and proportional amortization methods.

**Initial Measurement**

**30-1** Paragraph 323-740-25-5 prohibits immediate recognition of tax credits, at the time of initial investment, for the entire benefit of tax credits to be received during the term of an investment in a qualified affordable housing project. See paragraph 323-740-35-2 for the required subsequent measurement calculation methodology when an entity uses the proportional amortization method of accounting for an investment in a qualified affordable housing project through a limited liability entity. [ASU 2014-01, paragraph 2]

**30-2** Example 1 (see paragraph 323-740-55-2) illustrates the application of accounting guidance to a limited partnership investment in a qualified affordable housing project using the cost, equity, and effective yield methods.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

**30-2** Example 1 (see paragraph 323-740-55-2) illustrates the application of accounting guidance to a limited partnership investment in a qualified affordable housing project using the cost, equity, and proportional amortization methods.

**Subsequent Measurement**

**35-1** This guidance addresses the methodology for measuring an investment in a qualified affordable housing project through a limited liability entity that is accounted for using the proportional amortization method. [ASU 2014-01, paragraph 2]

**35-2** Under the proportional amortization method, the investor amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits allocated to the investor. The amortization amount shall be calculated as follows:

- a. The initial investment balance less any expected residual value of the investment, multiplied by
- b. The percentage of actual tax credits and other tax benefits allocated to the investor in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the investor over the life of the investment. [ASU 2014-01, paragraph 2]

**35-3** Example 1 (see paragraph 323-740-55-2) illustrates the application of accounting guidance to a limited liability investment in a qualified affordable housing project using the cost, equity, and proportional amortization methods. [ASU 2014-01, paragraph 2]

**35-4** As a practical expedient, an investor is permitted to amortize the initial cost of the investment in proportion to only the tax credits allocated to the investor if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result from applying the requirement in paragraph 323-740-35-2. [ASU 2014-01, paragraph 2]

### ASC 323-740 (continued)

**35-5** Any expected residual value of the investment shall be excluded from the proportional amortization calculation. Cash received from operations of the limited liability entity shall be included in earnings when realized or realizable. Gains or losses on the sale of the investment, if any, shall be included in earnings at the time of sale. [ASU 2014-01, paragraph 2]

**35-6** An investment in a qualified affordable housing project through a limited liability entity shall be tested for impairment when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized. An impairment loss shall be measured as the amount by which the carrying amount of an investment exceeds its fair value. A previously recognized impairment loss shall not be reversed. [ASU 2014-01, paragraph 2]

### Other Presentation Matters

**45-1** This guidance addresses the income statement presentation of the affordable housing tax credit when an investment in a qualified affordable housing project through a limited liability entity is accounted for using the proportional amortization method. [ASU 2014-01, paragraph 2]

**45-2** Under the proportional amortization method, the amortization of the investment in the limited liability entity is recognized in the income statement as a component of income tax expense (or benefit). The current tax expense (or benefit) shall be accounted for pursuant to the general requirements of Topic 740. [ASU 2014-01, paragraph 2]

**45-3** Example 1 (see paragraph 323-740-55-2) illustrates the application of accounting guidance to a limited partnership investment in a qualified affordable housing project using the cost, equity, and effective yield methods.

### Pending Content (Transition Guidance: ASC 825-10-65-2)

**45-3** Example 1 (see paragraph 323-740-55-2) illustrates the application of accounting guidance to a limited partnership investment in a qualified affordable housing project using the cost, equity, and proportional amortization methods.

### Disclosure

**50-1** A reporting entity that invests in a qualified affordable housing project shall disclose information that enables users of its financial statements to understand the following:

- a. The nature of its investments in qualified affordable housing projects
- b. The effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of operations. [ASU 2014-01, paragraph 3]

**50-2** To meet the objectives in the preceding paragraph, a reporting entity may consider disclosing the following:

- a. The amount of affordable housing tax credits and other tax benefits recognized during the year
- b. The balance of the investment recognized in the statement of financial position
- c. For qualified affordable housing project investments accounted for using the proportional amortization method, the amount recognized as a component of income tax expense (benefit)
- d. For qualified affordable housing project investments accounted for using the equity method, the amount of investment income or loss included in pretax income
- e. Any commitments or contingent commitments (for example, guarantees or commitments to provide additional capital contributions), including the amount of equity contributions that are contingent commitments related to qualified affordable housing project investments and the year or years in which contingent commitments are expected to be paid
- f. The amount and nature of impairment losses during the year resulting from the forfeiture or ineligibility of tax credits or other circumstances. For example, those impairment losses may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions, or other issues. [ASU 2014-01, paragraph 3]

**ASC 323-740 (continued)****Related Implementation Guidance and Illustrations**

- [Example 1: Application of Accounting Guidance to a Limited Partnership Investment in a Qualified Affordable Housing Project](#) [ASC 323-740-55-2].

**ASC 323-740 — SEC Materials****S25 Recognition****Qualified Affordable Housing Project Investments**

**S25-1** See paragraph 323-740-S99-2, SEC Observer Comment: Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects, for SEC Staff views on extending the application of the effective yield method policy election used in affordable housing project investment to analogous situations. [EITF 94-01, paragraph Discussion]

**S99 SEC Materials****SEC Observer Comment: Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects**

**S99-2** The following is the text of SEC Observer Comment: Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects.

It has been observed that the decision to apply the effective yield method of accounting to a qualified affordable housing project through a limited partnership investment would be an accounting policy decision rather than a decision to be applied to individual investments that qualify for use of the effective yield method paragraph 323-740-25-1. The SEC staff believes that it would be inappropriate to extend the effective yield method of accounting to situations analogous to those described in paragraph 323-740-05-3. [EITF 94-01, paragraph Discussion]

## 13.02 Tax Benefits Resulting From Investments in Affordable Housing Projects

Notwithstanding the guidance in ASC 323-740, a reporting entity must first consider whether it is required under ASC 810 (including the variable interest entity subsections of ASC 810-10) to consolidate the qualified affordable housing project investee. If consolidation of the qualified affordable housing project investee is required, the proportional amortization method cannot be used.

If the affordable housing project investment is not consolidated, ASC 323-740-25-1 permits a “reporting entity that invests in qualified affordable housing projects through limited liability entities (that is, the investor) [to] elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2)” as long as all of the following criteria are met:

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

Under the proportional amortization method as described in ASC 323-740-35-2, an investor amortizes the initial cost of the investment in proportion to the tax credits **and** other tax benefits received. As a practical expedient, an investor applying the proportional amortization method may choose to amortize the initial cost of the investment in proportion to **only the tax credits** allocated to the investor if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result from applying the full proportional amortization method described in ASC 323-740-35-2.

As for a limited liability investment in a qualified affordable housing project that is not accounted under the proportional amortization method, ASC 323-740-25-2 provides that "the investment shall be accounted for in accordance with Subtopic 970-323."

ASC 970-323-25-6 generally requires use of the equity method of accounting for limited partnership real estate investments unless the limited partner's interest is "so minor [(generally considered to be no more than 3 to 5 percent)] that the limited partner may have virtually no influence over partnership operating and financial policies." A related issue was discussed in an SEC staff announcement addressing the SEC staff's position on the application of the equity method to all types of investments in limited partnerships. See ASC 323-30-S99-1 for more information. If the equity method is not required, the cost method would generally be used.

In addition, as noted in ASC 325-20-35-5 and 35-6:

An investor using the cost method to account for an investment in a qualified affordable housing project held through a limited [liability entity] shall amortize any excess of the carrying amount of the investment over its estimated residual value during the periods in which tax credits are allocated to the investor. The estimated residual value used in determining the amount to be amortized is the estimated residual value at the end of the last period in which tax credits are allocated to the investor and shall not reflect anticipated inflation. Annual amortization shall be based on the proportion of tax credits received in the current year to total estimated tax credits to be allocated to the investor.

A limited [liability entity] investment in a qualified affordable housing project shall be reviewed periodically for impairment.

Further, ASC 323-740-25-3 and 25-4 state:

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

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

In addition, the proportional amortization method applies only to investments in qualified affordable housing projects through limited liability entities and should not be analogized to investments in other projects for which substantially all of the benefits come from tax benefits. This restriction is similar to the SEC staff's view described in ASC 323-740-S99-2 that it would be inappropriate to extend the prior effective yield method of accounting to analogous situations.

## 13.02A Determining Whether an Investor Has the Ability to Exercise Significant Influence Over an Entity That Invests in Qualified Affordable Housing Projects

Under ASC 323-740-25-1 as amended by ASU 2014-01, an entity may elect to use the proportional amortization method to account for its investments in qualified affordable housing projects through limited liability entities ("QAHF entities") if all of the following conditions are met:

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

An investor that holds the majority of the limited partnership interest (e.g., 99 percent of the limited partner units) in a QAHF entity can conclude that it does not have the ability to exercise significant influence over the operating and financial policies of the QAHF entity. ASC 323-740-25-1A requires a reporting entity to consider the following indicators in ASC 323-10-15-6 when determining whether it has significant influence over a QAHF entity:<sup>1</sup>

- a. Representation on the board of directors
- b. Participation in policy-making processes
- c. Material intra-entity transactions
- d. Interchange of managerial personnel
- e. Technological dependency
- f. Extent of ownership by an investor in relation to the concentration of other shareholdings.

While an investment in a QAHF entity may be in excess of thresholds that generally result in the presumption of significant influence when the guidance on equity method investments is applied, the guidance in ASC 323-740-25-1A excludes reference to any such thresholds. As noted in paragraph BC12 of the basis for conclusions of ASU 2014-01, the EITF's intent in reaching the conclusions in the ASU was "to identify those investments that are made for the primary purpose of receiving tax credits and other tax benefits" and to allow a reporting entity to elect the proportional amortization method to account for such investments. Further, the EITF believed that "an investor who has the ability to influence the operating and financial policies of the [QAHF] entity should not be precluded from [electing the proportional amortization method] as long as that investor does not have the ability to exercise significant influence." In accordance with its objective, the EITF concluded that the significant influence presumption at a 20 percent or more voting stock ownership would not be applicable to investments in QAHF entities since that presumption "was intended for application to investments in common stock and not to investments in limited liability partnership interests." Although the EITF did not specifically indicate that the quantitative thresholds typically associated with an investor possessing significant influence over a limited partnership would not be applicable to an investment in a QAHF entity, it is reasonable to conclude, on the basis of the EITF's stated objective, that an investor in a QAHF entity

<sup>1</sup> ASC 323-740-25-1A also requires a reporting entity to consider the guidance in ASC 323-10-15-7, which states that "[d]etermining the ability of an investor to exercise significant influence is not always clear and applying judgment is necessary to assess the status of each investment."

would not be required to consider the guidance in ASC 323-30 that a 3 to 5 percent ownership interest in a limited partnership constitutes significant influence over the partnership.

As a result, rather than focusing solely on the investor's ownership interest in a QAHP entity, an investor's analysis should focus on whether the investor participates in the policy-making processes of the QAHP entity. If an investor concludes that it participates in the policy-making processes, it would be deemed to have significant influence and would not be eligible to apply the proportional amortization method to account for its investment in the QAHP entity. Factors to consider in the determination of whether an investor participates in the policy-making processes of a QAHP entity include the following:

- Does the investor have the ability to make decisions about the day-to-day operations of the QAHP entity (e.g., accepting tenants, setting rent)?
- Does the investor have the ability to remove the general partner (GP) of the QAHP entity without cause?
- Does the investor have the unilateral ability to veto the operating and capital budgets or otherwise prevent the GP from making decisions about the day-to-day operations of the QAHP entity without cause?

The existence of protective rights (e.g., the ability to remove the GP with cause or to veto the sale of a property owned by the QAHP entity for significantly less than its fair value) would not provide the investor with significant influence over a QAHP entity.

### **13.03 Applicability of the Proportional Amortization Method to a Qualified Affordable Housing Project Investment That Generates Other Tax Credits in Addition to Affordable Housing Credits**

Investors in flow-through limited liability entities that construct and operate QAHPs receive tax benefits in the form of QAHP tax credits and deductions from operating losses. ASC 323-740 permits investors to account for QAHP investments (QAHPIs) by using the proportional amortization method as long as certain criteria are met.

One of the criteria for applying the proportional amortization method is that substantially all of the projected benefits of the QAHP must be derived from the QAHP tax credits and other tax benefits (such as tax benefits generated from the operating losses of the investment). ASC 323-740-15-3 limits the scope of ASC 323-740 and states:

The guidance in the Qualified Affordable Housing Project Investments Subsections applies to reporting entities that are investors in qualified affordable housing projects through limited liability entities that are flow-through entities for tax purposes.

Further, the Background Information and Basis for Conclusions of ASU 2014-01 states:

The Task Force also discussed whether the scope of the amendments in this Update should be extended to tax credit investments other than investments in qualified affordable housing projects. . . . The task force reached a consensus to limit the scope of the amendments in this Update to only investments in qualified affordable housing projects because it will more quickly address the concerns in practice about the income statement presentation of those investments.

In some situations, the QAHPI generates other tax credits (e.g., alternative energy credits and credits from restoring and rehabilitating historic buildings), which are also allocated to investors in the QAHPI. Because the scope of ASC 323-740 is limited to QAHPIs, it is unclear whether a QAHPI that generates other credits in addition to QAHPI credits would be automatically excluded from the scope of ASC 323-740. While we believe that an entity needs to carefully consider the nature of the investment, we do not think that a QAHPI that generates tax benefits other than QAHPI credits would automatically be excluded from the scope of ASC 323-740.

This is not a bright-line determination; however, as the significance of the other tax credits increases in relation to the significance of the QAHPI credits and tax benefits from operating losses of the investment, it becomes more difficult to conclude that the investment is within the scope of ASC 323-740. For example, if 45 percent of the projected benefits of a QAHPI are attributable to QAHPI credits and tax benefits from operating losses of the investment and the remaining 55 percent are due to other tax credits, we believe that it would be difficult to conclude that the investment is within the scope of ASC 323-740. Alternatively, if 90 percent of the projected benefits of a QAHPI are related to QAHPI credits and tax benefits from operating losses of the investment and the remaining 10 percent are associated with other tax credits, we believe that it would generally be appropriate to conclude that the investment is within the scope of ASC 323-740.

### **13.04 Recognizing Deferred Taxes When the Proportional Amortization Method Is Used to Account for an Investment in a Qualified Affordable Housing Project**

An entity may elect to use the proportional amortization method described in ASC 323-740-35-2 and ASC 323-740-45-2 to account for an investment in a qualified affordable housing project that meets the criteria in ASC 323-740-25-1.

For an investment accounted for under the proportional amortization method, an entity generally should not record deferred taxes for the temporary difference between the investment's carrying amount for financial reporting purposes and its tax basis. The proportional amortization method reflects the view that an investment in a QAHPI through a limited liability entity is in substance the purchase of tax benefits. Accordingly, the initial investment is amortized in proportion to the affordable housing tax credits and other tax benefits allocated to the investor, as described in ASC 323-740-35-2. This approach is similar to the accounting for purchased tax benefits described in ASC 740-10-25-52, which requires that future tax benefits (net of the amount paid) purchased from a party other than a tax authority be initially recognized as a deferred credit and then recognized in tax expense when the related tax attributes are realized.

Further, while ASC 323-740 does not explicitly state that an entity is not required to recognize deferred taxes for the temporary difference related to its investment in a QAHPI, ASU 2014-01 amended the example in ASC 323-740-55-2 through 55-9 so that it no longer addresses the recognition of deferred taxes for the temporary difference.

In the Background Information and Basis for Conclusions of ASU 2014-01, the Emerging Issues Task Force expressed the view that the proportional amortization method better reflects the investment's economics than the equity or cost methods of accounting for such an investment and thus should help users better understand an entity's investment in QAHPIs. As shown in column K of Example 13-1 below, if an entity does not record deferred taxes when using the proportional amortization method, there will be a return in all periods that is positive and in proportion to the investment amortization in each respective period. Column O of Example 13-1, on the other hand, shows that when deferred taxes are recorded on the investment, a net decrease in income tax expense (or increase in benefit) occurs in

the early years and a net increase in income tax expense (or reduction of benefit) occurs in later years. We believe that result is less indicative of the overall economics, is more difficult for financial statement users to understand, and is therefore generally inconsistent with the Task Force's overall objectives in ASU 2014-01.

Nonetheless, we are aware that others believe that since the asset is an investment, an entity would not be precluded from accruing deferred taxes on the related temporary difference. Entities that take this view are encouraged to consult with their income tax accounting advisers.

Conversely, we believe that when an entity uses the practical expedient described in ASC 323-740-35-4, it should recognize deferred taxes on the investment. Under the practical expedient, the entire cost of the QAHP investment is amortized over only the period during which the QAHP credits are received (generally 10 years). The period over which "other tax benefits" such as depreciation will be received may be longer (e.g., depreciation deductions would normally be taken over a period of 15 years or longer).

When deferred taxes are recognized for the temporary difference, the current tax benefit for the "other tax benefits" received after the amortization of the investment's cost is offset by deferred tax expense resulting from the reversal of the DTA recognized for the remaining tax basis. As demonstrated in column O of Example 13-2 below, we believe that when using the practical expedient, an entity should record deferred taxes, since this results in a better reflection of the investment's performance and thus should provide users with a better understanding of an entity's QAHP investment.

If the practical expedient is used and deferred taxes are not recorded (see column K of Example 13-2 below), a reporting entity will recognize "other tax benefits" in years after the cost of the investment has been amortized and those "other tax benefits" will not be reduced by the cost of obtaining them in the period in which they are recognized. As can also be seen in column K, incremental expense may result from the investment in early years and incremental benefit may result in later years. We believe these results are less reflective of the overall economics of the investment and, again, inconsistent with the overall objectives of ASU 2014-01.

## **Examples**

In each of the examples below, assume that Company A makes a \$200,000 investment in a QAHP in exchange for a 10 percent limited partnership interest. Further assume that:

- The partnership is financed entirely with equity.
- Annual tax credits equal 7 percent of the original cost of the property each year for 10 years.
- Tax depreciation is determined by using a straight-line method over 25 years.
- Company A's effective tax rate is 40 percent.

### Example 13-1

### Proportional Amortization Method With and Without Deferred Taxes

Year	Book Basis			Tax Basis			Net Benefit - Excluding Deferred Taxes			Net Benefit - Including Deferred Taxes				
	Beginning	Amortization	Ending	Beginning	Depreciation	Ending	Tax credits	Other tax benefit	Amortization	Net Benefit	Deductible Temporary Difference	Deferred Tax Asset	Deferred Tax Benefit	Net Benefit (Expense)
1	\$ 200,000	\$ 15,636	\$ 184,364	\$ 200,000	\$ 8,000	\$ 192,000	\$ 14,000	\$ 3,200	\$ 15,636	\$ 1,564	\$ 7,636	\$ 3,055	\$ 4,618	
2	184,364	15,636	168,727	192,000	8,000	184,000	14,000	3,200	17,200	15,636	1,564	15,273	6,109	3,055
3	168,727	15,636	153,091	184,000	8,000	176,000	14,000	3,200	17,200	15,636	1,564	22,909	9,164	3,055
4	153,091	15,636	137,455	176,000	8,000	168,000	14,000	3,200	17,200	15,636	1,564	30,545	12,218	3,055
5	137,455	15,636	121,818	168,000	8,000	160,000	14,000	3,200	17,200	15,636	1,564	38,182	15,273	3,055
6	121,818	15,636	106,182	160,000	8,000	152,000	14,000	3,200	17,200	15,636	1,564	45,818	18,327	3,055
7	106,182	15,636	90,545	152,000	8,000	144,000	14,000	3,200	17,200	15,636	1,564	53,455	21,382	3,055
8	90,545	15,636	74,909	144,000	8,000	136,000	14,000	3,200	17,200	15,636	1,564	61,091	24,436	3,055
9	74,909	15,636	59,273	136,000	8,000	128,000	14,000	3,200	17,200	15,636	1,564	68,727	27,491	3,055
10	59,273	15,636	43,636	128,000	8,000	120,000	14,000	3,200	17,200	15,636	1,564	76,364	30,545	3,055
11	43,636	2,909	40,727	120,000	8,000	112,000	—	3,200	3,200	2,909	291	71,273	28,509	(2,036)
12	40,727	2,909	37,818	112,000	8,000	104,000	—	3,200	3,200	2,909	291	66,182	26,473	(1,745)
13	37,818	2,909	34,909	104,000	8,000	96,000	—	3,200	3,200	2,909	291	61,091	24,436	(2,036)
14	34,909	2,909	32,000	96,000	8,000	88,000	—	3,200	3,200	2,909	291	56,900	22,400	(2,036)
15	32,000	2,909	29,091	88,000	8,000	80,000	—	3,200	3,200	2,909	291	50,900	20,364	(2,036)
16	29,091	2,909	26,182	80,000	8,000	72,000	—	3,200	3,200	2,909	291	45,818	18,327	(2,036)
17	26,182	2,909	23,273	72,000	8,000	64,000	—	3,200	3,200	2,909	291	40,727	16,291	(2,036)
18	23,273	2,909	20,364	64,000	8,000	56,000	—	3,200	3,200	2,909	291	35,636	14,255	(1,745)
19	20,364	2,909	17,455	56,000	8,000	48,000	—	3,200	3,200	2,909	291	30,545	12,218	(1,745)
20	17,455	2,909	14,545	48,000	8,000	40,000	—	3,200	3,200	2,909	291	25,455	10,182	(2,036)
21	14,545	2,909	11,636	40,000	8,000	32,000	—	3,200	3,200	2,909	291	20,364	8,145	(2,036)
22	11,636	2,909	8,727	32,000	8,000	24,000	—	3,200	3,200	2,909	291	15,273	6,109	(2,036)
23	8,727	2,909	5,818	24,000	8,000	16,000	—	3,200	3,200	2,909	291	10,182	4,073	(2,036)
24	5,818	2,909	2,909	16,000	8,000	8,000	—	3,200	3,200	2,909	291	5,091	2,036	(2,036)
25	2,909	2,909	—	8,000	8,000	—	—	3,200	3,200	2,909	291	—	—	(2,036)
							\$ 140,000	\$ 80,000	\$ 220,000	\$ 200,000	\$ 20,000	\$ 20,000	\$ 20,000	
							\$ 200,000							\$ 20,000

A = Beginning book basis each year, representing initial \$200,000 investment in year 1 and prior years ending balance in Column C for remaining years  
B = Initial investment of \$200,000 x (total tax benefits received during the year in Column I ÷ total anticipated tax benefits over the life of the investment of \$220,000 shown as the total of Column N)  
C = End-of-year book basis of investment, net of amortization in Column B  
D = Beginning tax basis each year, representing initial \$200,000 investment in year 1 and prior years ending balance in Column F for remaining years  
E = Tax depreciation (on \$200,000 initial investment) by using the straight-line method over 25 years  
F = End-of-year tax basis of investment, net of tax depreciation in Column E  
G = 7 percent annual tax credit on \$200,000 tax basis of underlying initial investment  
H = Column E × 40% tax rate  
I = Column G + Column H  
J = Column I – Column J  
K = Column F – Column C  
L = Column L × 40% tax rate  
M = Change in deferred tax asset in Column M for the year  
N = Column N + Column K

### Example 13-2

#### Practical Expedient With and Without Deferred Taxes

Year	Book Basis		Tax Basis			Net Benefit — Excluding Deferred Taxes			Net Benefit — Including Deferred Taxes							
	Beginning A	Amortization B	Ending C	Beginning D	Depreciation E	Ending F	Tax credits G	Other tax benefit H	& Other I	Less: J	Net Benefit (Expense) K	Deferred tax Benefit (Expense) L	Deferred tax Asset M	Net Benefit (Expense) N	Deferred tax Benefit (Expense) O	
1	\$ 200,000	\$ 20,000	\$ 180,000	\$ 200,000	\$ 8,000	\$ 192,000	\$ 14,000	\$ 3,200	\$ 17,200	\$ 20,000	\$ (2,800)	\$ 12,000	\$ 4,800	\$ 4,800	\$ 2,000	
2	180,000	20,000	160,000	192,000	8,000	184,000	14,000	3,200	17,200	20,000	(2,800)	24,000	9,600	4,800	2,000	
3	160,000	20,000	140,000	184,000	8,000	176,000	14,000	3,200	17,200	20,000	(2,800)	36,000	14,400	4,800	2,000	
4	140,000	20,000	120,000	176,000	8,000	168,000	14,000	3,200	17,200	20,000	(2,800)	48,000	19,200	4,800	2,000	
5	120,000	20,000	100,000	168,000	8,000	160,000	14,000	3,200	17,200	20,000	(2,800)	60,000	24,000	4,800	2,000	
6	100,000	20,000	80,000	160,000	8,000	152,000	14,000	3,200	17,200	20,000	(2,800)	72,000	28,800	4,800	2,000	
7	80,000	20,000	60,000	152,000	8,000	144,000	14,000	3,200	17,200	20,000	(2,800)	84,000	33,600	4,800	2,000	
8	60,000	20,000	40,000	144,000	8,000	136,000	14,000	3,200	17,200	20,000	(2,800)	96,000	38,400	4,800	2,000	
9	40,000	20,000	20,000	136,000	8,000	128,000	14,000	3,200	17,200	20,000	(2,800)	108,000	43,200	4,800	2,000	
10	20,000	-	-	128,000	8,000	120,000	14,000	3,200	17,200	20,000	(2,800)	120,000	48,000	4,800	2,000	
11	-	-	-	120,000	8,000	112,000	-	-	-	-	-	3,200	112,000	44,800	(3,200)	-
12	-	-	-	112,000	8,000	104,000	-	-	-	-	-	3,200	104,000	41,600	(3,200)	-
13	-	-	-	104,000	8,000	96,000	-	-	-	-	-	3,200	96,000	38,400	(3,200)	-
14	-	-	-	96,000	8,000	88,000	-	-	-	-	-	3,200	88,000	35,200	(3,200)	-
15	-	-	-	88,000	8,000	80,000	-	-	-	-	-	3,200	80,000	32,000	(3,200)	-
16	-	-	-	80,000	8,000	72,000	-	-	-	-	-	3,200	72,000	28,800	(3,200)	-
17	-	-	-	72,000	8,000	64,000	-	-	-	-	-	3,200	64,000	25,600	(3,200)	-
18	-	-	-	64,000	8,000	56,000	-	-	-	-	-	3,200	56,000	22,400	(3,200)	-
19	-	-	-	56,000	8,000	48,000	-	-	-	-	-	3,200	48,000	19,200	(3,200)	-
20	-	-	-	48,000	8,000	40,000	-	-	-	-	-	3,200	40,000	16,000	(3,200)	-
21	-	-	-	40,000	8,000	32,000	-	-	-	-	-	3,200	32,000	12,800	(3,200)	-
22	-	-	-	32,000	8,000	24,000	-	-	-	-	-	3,200	24,000	9,600	(3,200)	-
23	-	-	-	24,000	8,000	16,000	-	-	-	-	-	3,200	16,000	6,400	(3,200)	-
24	-	-	-	16,000	8,000	8,000	-	-	-	-	-	3,200	8,000	3,200	(3,200)	-
25	-	-	-	8,000	8,000	-	-	-	-	-	-	3,200	-	(3,200)	(3,200)	-
	\$ 200,000		\$ 200,000	\$ 200,000		\$ 140,000	\$ 80,000	\$ 220,000	\$ 200,000	\$ 200,000	\$ 20,000	\$ -	\$ -	\$ 20,000	\$ 20,000	

A = Beginning book basis each year, representing initial \$200,000 investment in year 1 and prior years ending balance in Column C for remaining years.  
 B = Initial investment of \$200,000 × (total tax credits received during the year in Column G + total anticipated tax credits over the life of the investment of \$140,000 shown as the total of Column G)

C = End-of-year book basis of investment, net of amortization in Column B  
 D = Beginning tax basis each year, representing initial \$200,000 investment in year 1 and prior years ending balance in Column F for remaining years.

E = Tax depreciation (on \$200,000 initial investment) by using the straight-line method over 25 years  
 F = End-of-year tax basis of investment, net of tax depreciation in Column E

G = 7 percent annual tax credit on \$200,000 tax basis of underlying initial investment  
 H = Column E × 40% tax rate  
 I = Column G + Column H  
 J = Column B  
 K = Column I – Column J  
 L = Column F – Column C  
 M = Column I × 40% tax rate  
 N = Change in deferred tax asset in Column M for the year  
 O = Column N + Column K

# Appendix A — Implementation Guidance and Illustrations

This Roadmap contains the implementation guidance and illustrative examples from [ASC 740-10](#), [ASC 740-20](#), [ASC 740-270](#), [ASC 805-740](#), [ASC 830-740](#), and [ASC 323-740](#), as included in the *FASB Accounting Standards Codification*. This guidance is not all-inclusive; an entity should also consider its specific facts and circumstances.

## ASC 740-10 — Implementation Guidance and Illustrations

### General

**55-1** This Section is an integral part of the requirements of this Subtopic. This Section provides additional guidance and illustrations that address the application of accounting requirements to specific aspects of accounting for income taxes, including the statement of financial position classification of deferred tax accounts and disclosures. The guidance and illustrations that follow, unless stated otherwise, assume that the tax law requires offsetting net deductions in a particular year against net taxable amounts in the 3 preceding years and then in the 15 succeeding years. These assumptions about the tax law are for illustrative purposes only. This Subtopic requires that the enacted tax law for a particular tax jurisdiction be used for recognition and measurement of deferred tax liabilities and assets. [FAS 109, paragraph 223]

### Pending Content (Transition Guidance: ASC 740-10-65-4)

**55-1** This Section is an integral part of the requirements of this Subtopic. This Section provides additional guidance and illustrations that address the application of accounting requirements to specific aspects of accounting for income taxes, including disclosures. The guidance and illustrations that follow, unless stated otherwise, assume that the tax law requires offsetting net deductions in a particular year against net taxable amounts in the 3 preceding years and then in the 15 succeeding years. These assumptions about the tax law are for illustrative purposes only. This Subtopic requires that the enacted tax law for a particular tax jurisdiction be used for recognition and measurement of deferred tax liabilities and assets. [FAS 109, paragraph 223]

### Implementation Guidance

**55-2** The following guidance is organized in three categories:

- a. Application of accounting requirements for income taxes to specific situations
- b. Statement of financial position classification of deferred income taxes
- c. Income tax related disclosures.

### Pending Content (Transition Guidance: ASC 740-10-65-4)

**55-2** The guidance is organized as follows:

- a. Application of accounting requirements for income taxes to specific situations
- b. Subparagraph superseded by Accounting Standards Update No. 2015-17.
- c. Income tax related disclosures.

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

### ***Application of Accounting Requirements for Income Taxes to Specific Situations***

#### Recognition and Measurement of Tax Positions — a Two-Step Process

**55-3** The application of the requirements of this Subtopic related to tax positions requires a two-step process that separates recognition from measurement. The first step is determining whether a tax position has met the recognition threshold; the second step is measuring a tax position that meets the recognition threshold. The recognition threshold is met when the taxpayer (the reporting entity) concludes that, consistent with paragraphs 740-10-25-6 through 25-7 and 740-10-25-13, it is more likely than not that the taxpayer will sustain the benefit taken or expected to be taken in the tax return in a dispute with taxing authorities if the taxpayer takes the dispute to the court of last resort. [FIN 48, paragraph A2]

**55-4** Relatively few disputes are resolved through litigation, and very few are taken to the court of last resort. Generally, the taxpayer and the taxing authority negotiate a settlement to avoid the costs and hazards of litigation. As a result, the measurement of the tax position is based on management's best judgment of the amount the taxpayer would ultimately accept in a settlement with taxing authorities. [FIN 48, paragraph A3]

**55-5** The recognition and measurement requirements of this Subtopic related to tax positions require that the entity recognize the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement. [FIN 48, paragraph A4]

**55-6** See Examples 1 through 12 (paragraphs 740-10-55-81 through 55-123) for illustrations of this guidance.

#### Recognition of Deferred Tax Assets and Deferred Tax Liabilities

**55-7** Subject to certain specific exceptions identified in paragraph 740-10-25-3, a deferred tax liability is recognized for all taxable temporary differences, and a deferred tax asset is recognized for all deductible temporary differences and operating loss and tax credit carryforwards. A valuation allowance is recognized if it is more likely than not that some portion or all of the deferred tax asset will not be realized. [FAS 109, paragraph 224] See Example 12 (paragraph 740-10-55-120) for an illustration of this guidance.

**55-8** To the extent that evidence about one or more sources of taxable income is sufficient to eliminate any need for a valuation allowance, other sources need not be considered. Detailed forecasts, projections, or other types of analyses are unnecessary if expected future taxable income is more than sufficient to realize a tax benefit.

**55-9** The terms *forecast* and *projection* refer to any process by which available evidence is accumulated and evaluated for purposes of estimating whether future taxable income will be sufficient to realize a deferred tax asset. Judgment is necessary to determine how detailed or formalized that evaluation process should be. Furthermore, information about expected future taxable income is necessary only to the extent positive evidence available from other sources (see paragraph 740-10-30-18) is not sufficient to support a conclusion that a valuation allowance is not needed. The requirements of this Subtopic do not require either a financial forecast or a financial projection within the meaning of those terms in the Statements on Standards for Attestation Engagements and Related Attest Engagements Interpretations [AT], AT section 301, *Financial Forecasts and Projections* issued by the American Institute of Certified Public Accountants. [FAS 109, paragraph 225]

**55-10** See Example 12 (paragraph 740-10-55-120) for an illustration of a situation where detailed analyses are not necessary.

**55-11** See Example 13 (paragraph 740-10-55-124) for an illustration of determining a valuation allowance for deferred tax assets.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)****Offset of Taxable and Deductible Amounts**

**55-12** The tax law determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years. The tax law also determines the extent to which deductible temporary differences and carryforwards will offset the tax consequences of income that is expected to be earned in future years. For example, the tax law may provide that capital losses are deductible only to the extent of capital gains. In that case, a tax benefit is not recognized for temporary differences that will result in future deductions in the form of capital losses unless those deductions will offset any of the following:

- a. Other existing temporary differences that will result in future capital gains
- b. Capital gains that are expected to occur in future years
- c. Capital gains of the current year or prior years if carryback (of those capital loss deductions from the future reversal years) is expected. [FAS 109, paragraph 227]

**Pattern of Taxable or Deductible Amounts**

**55-13** The particular years in which temporary differences result in taxable or deductible amounts generally are determined by the timing of the recovery of the related asset or settlement of the related liability. However, there are exceptions to that general rule. For example, a temporary difference between the tax basis and the reported amount of inventory for which cost is determined on a last-in, first-out (LIFO) basis does not reverse when present inventory is sold in future years if it is replaced by purchases or production of inventory in those same future years. A LIFO inventory temporary difference becomes taxable or deductible in the future year that inventory is liquidated and not replaced. [FAS 109, paragraph 228]

**55-14** For some assets or liabilities, temporary differences may accumulate over several years and then reverse over several years. That pattern is common for depreciable assets. Future originating differences for existing depreciable assets and their subsequent reversals are a factor to be considered when assessing the likelihood of future taxable income (see paragraph 740-10-30-18(b)) for realization of a tax benefit for existing deductible temporary differences and carryforwards. [FAS 109, paragraph 229]

**The Need to Schedule Temporary Difference Reversals**

**55-15** Reversal patterns of existing temporary differences may need to be scheduled under the requirements of this Subtopic as follows:

- a. Deferred taxes are classified as current or noncurrent based on the classification of the related asset or liability. Therefore, scheduling is required only for deferred taxes not related to a specific asset or liability.
- b. Deferred tax assets are recognized without reference to offsetting, and then an assessment is made about the need for a valuation allowance. Paragraph 740-10-30-18 lists four possible sources of taxable income that may be available to realize such deferred tax assets. In many cases it may be possible to determine without scheduling that expected future taxable income (see paragraph 740-10-30-18(b)) will be adequate to eliminate the need for a valuation allowance. Disclosure of the amounts and expiration dates (or a reasonable aggregation of expiration dates) of operating loss and tax credit carryforwards is required only on a tax basis and does not require scheduling.
- c. The adoption of a tax rate convention for measuring deferred taxes when graduated tax rates are a significant factor will, in many cases, eliminate the need for the scheduling. In addition, alternative minimum tax rates and laws are a factor only in considering the need for a valuation allowance for a deferred tax asset for alternative minimum tax credit carryforwards. When there is a phased-in change in tax rates, however, scheduling will often be necessary. See paragraphs 740-10-55-24; 740-10-55-31 through 55-33; and Examples 14 through 16 (paragraphs 740-10-55-129 through 55-138). [QA 109, paragraph 1]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

### Pending Content (Transition Guidance: ASC 740-10-65-4)

- 55-15** Reversal patterns of existing temporary differences may need to be scheduled under the requirements of this Subtopic as follows: [QA 109, paragraph 1]
- a. Subparagraph superseded by Accounting Standards Update No. 2015-17.
  - b. Deferred tax assets are recognized without reference to offsetting, and then an assessment is made about the need for a valuation allowance. Paragraph 740-10-30-18 lists four possible sources of taxable income that may be available to realize such deferred tax assets. In many cases it may be possible to determine without scheduling that expected future taxable income (see paragraph 740-10-30-18(b)) will be adequate to eliminate the need for a valuation allowance. Disclosure of the amounts and expiration dates (or a reasonable aggregation of expiration dates) of operating loss and tax credit carryforwards is required only on a tax basis and does not require scheduling.
  - c. The adoption of a tax rate convention for measuring deferred taxes when graduated tax rates are a significant factor will, in many cases, eliminate the need for the scheduling. In addition, alternative minimum tax rates and laws are a factor only in considering the need for a valuation allowance for a deferred tax asset for alternative minimum tax credit carryforwards. When there is a phased-in change in tax rates, however, scheduling will often be necessary. See paragraphs 740-10-55-24; 740-10-55-31 through 55-33; and Examples 14 through 16 (paragraphs 740-10-55-129 through 55-138). [QA 109, paragraph 1]

**55-16** Paragraph 740-10-30-18 lists four possible sources of taxable income that may be available to realize a future tax benefit for deductible temporary differences and carryforwards. One source is future taxable income exclusive of reversing temporary differences and carryforwards. Future originating temporary differences and their subsequent reversal are implicit in estimates of future taxable income. Where it can be easily demonstrated that future taxable income will more likely than not be adequate to realize future tax benefits of existing deferred tax assets, scheduling of reversals of existing taxable temporary differences would be unnecessary.

**55-17** In other cases it may be easier to demonstrate that no valuation allowance is needed by considering the reversal of existing taxable temporary differences. Even in that case, the extent of scheduling will depend on the relative magnitudes involved. For example, if existing taxable temporary differences that will reverse over a long number of future years greatly exceed deductible differences that are expected to reverse over a short number of future years, it may be appropriate to conclude, in view of a long (for example, 15 years) carryforward period for net operating losses, that realization of future tax benefits for the deductible differences is thereby more likely than not without the need for scheduling. [QA 109, paragraph 2]

**55-18** A general understanding of reversal patterns is, in many cases, relevant in assessing the need for a valuation allowance. Judgment is crucial in making that assessment. The amount of scheduling, if any, that will be required will depend on the facts and circumstances of each situation.

**55-19** The following concepts however, underlie the determination of reversal patterns for existing temporary differences:

- a. The particular years in which temporary differences result in taxable or deductible amounts generally are determined by the timing of the recovery of the related asset or settlement of the related liability (see paragraph 740-10-55-13).
- b. The tax law determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years (see paragraph 740-10-55-14). [QA 109, paragraph 1]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-20** State income taxes are deductible for U.S. federal income tax purposes and therefore a deferred state income tax liability or asset gives rise to a temporary difference for purposes of determining a deferred U.S. federal income tax asset or liability, respectively. The pattern of deductible or taxable amounts in future years for temporary differences related to deferred state income tax liabilities or assets should be determined by estimates of the amount of those state income taxes that are expected to become payable or recoverable for particular future years and, therefore, deductible or taxable for U.S. federal tax purposes in those particular future years. [QA 109, paragraph 7]

**55-21** An entity may have claimed certain deductions, such as repair expenses, on its income tax returns. However, the entity may have recognized a liability (including interest) for the unrecognized tax benefit of those tax positions. If scheduling of future taxable or deductible differences is necessary, liabilities for unrecognized tax benefits should be considered. Accrual of a liability for unrecognized tax benefits of expenses, such as repairs, has the effect of capitalizing those expenses for tax purposes. Those capitalized expenses are considered to result in deductible amounts in the later years, for example, as depreciation expense. If the liability for unrecognized tax benefits is based on an overall evaluation of the technical merits of the tax position, scheduling should reflect the evaluations made in determining the liability for unrecognized tax benefits that was recognized. The effect of those evaluations may indicate a source of taxable income (see paragraph 740-10-30-18(c)) for purposes of assessing the need for a valuation allowance for deductible temporary differences. Those evaluations may also indicate lower amounts of taxable income in other years. A deductible amount for any accrued interest related to unrecognized tax benefits would be scheduled for the future year in which that interest is expected to become deductible. [QA 109, paragraph 4]

**55-22** Minimizing complexity is an appropriate consideration in selecting a method for determining reversal patterns. The methods used for determining reversal patterns should be systematic and logical. The same method should be used for all temporary differences within a particular category of temporary differences for a particular tax jurisdiction. Different methods may be used for different categories of temporary differences. If the same temporary difference exists in two tax jurisdictions (for example, U.S. federal and a state tax jurisdiction), the same method should be used for that temporary difference in both tax jurisdictions. The same method for a particular category in a particular tax jurisdiction should be used consistently from year to year. A change in method is a change in accounting principle under the requirements of Topic 250. [QA 109, paragraph 1] Two examples of a category of temporary differences are those related to liabilities for deferred compensation and investments in direct financing and sales-type leases. [QA 109, paragraph 1, footnote 2]

**Measurement of Deferred Tax Liabilities and Assets**

**55-23** The tax rate or rates that are used to measure deferred tax liabilities and deferred tax assets are the enacted tax rates expected to apply to taxable income in the years that the liability is expected to be settled or the asset recovered. Measurements are based on elections (for example, an election for loss carryforward instead of carryback) that are expected to be made for tax purposes in future years. Presently enacted changes in tax laws and rates that become effective for a particular future year or years must be considered when determining the tax rate to apply to temporary differences reversing in that year or years. Tax laws and rates for the current year are used if no changes have been enacted for future years. An asset for deductible temporary differences that are expected to be realized in future years through carryback of a future loss to the current or a prior year (or a liability for taxable temporary differences that are expected to reduce the refund claimed for the carryback of a future loss to the current or a prior year) is measured using tax laws and rates for the current or a prior year, that is, the year for which a refund is expected to be realized based on loss carryback provisions of the tax law. [FAS 109, paragraph 233] See Examples 14 through 16 (paragraphs 740-10-55-129 through 55-138) for illustrations of this guidance.

**55-24** Deferred tax liabilities and assets are measured using enacted tax rates applicable to capital gains, ordinary income, and so forth, based on the expected type of taxable or deductible amounts in future years. For example, evidence based on all facts and circumstances should determine whether an investor's liability for the tax consequences of temporary differences related to its equity in the earnings of an investee should be measured using enacted tax rates applicable to a capital gain or a dividend. Computation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related dividends received deductions or foreign tax credits, and taxes that would be withheld from the dividend. [FAS 109, paragraph 237]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

### *State and Local Income Taxes*

**55-25** If deferred tax assets or liabilities for a state or local tax jurisdiction are significant, this Subtopic requires a separate deferred tax computation when there are significant differences between the tax laws of that and other tax jurisdictions that apply to the entity. In the United States, however, many state or local income taxes are based on U.S. federal taxable income, and aggregate computations of deferred tax assets and liabilities for at least some of those state or local tax jurisdictions might be acceptable. In assessing whether an aggregate calculation is appropriate, matters such as differences in tax rates or the loss carryback and carryforward periods in those state or local tax jurisdictions should be considered. Also, the provisions of paragraph 740-10-45-6 about offset of deferred tax liabilities and assets of different tax jurisdictions should be considered. In assessing the significance of deferred tax expense for a state or local tax jurisdiction, it is appropriate to consider the deferred tax consequences that those deferred state or local tax assets or liabilities have on other tax jurisdictions, for example, on deferred federal income taxes. [QA 109, paragraph 3]

**55-26** Local (including franchise) taxes based on income are within the scope of this Topic. [EITF 91-8, paragraph Issue] A tax, to the extent it is based on capital, is a franchise tax. As indicated in paragraph 740-10-15-4(a), if there is an additional tax based on income, that excess is considered an income tax. [EITF 91-8, paragraph Discussion] A historical example that illustrates this guidance is presented in Example 17 (see paragraph 740-10-55-139).

### *Special Deductions — Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004*

**55-27** The following discussion and Example 18 (see paragraph 740-10-55-145) refer to and describe a provision within the American Jobs Creation Act of 2004; however, they shall not be considered a definitive interpretation of any provision of the Act for any purpose. [FSP FAS 109-1, paragraph 1, footnote 1]

**55-28** On October 22, 2004, the Act was signed into law by the president. This Act includes a tax deduction of up to 9 percent (when fully phased-in) of the lesser of qualified production activities income, as defined in the Act, or taxable income (after the deduction for the utilization of any net operating loss carryforwards). This tax deduction is limited to 50 percent of W-2 wages paid by the taxpayer. [FSP FAS 109-1, paragraph 2]

**55-29** The qualified production activities deduction's characteristics are similar to special deductions discussed in paragraph 740-10-25-37 because the qualified production activities deduction is contingent upon the future performance of specific activities, including the level of wages. Accordingly, the deduction should be accounted for as a special deduction in accordance with that paragraph. [FSP FAS 109-1, paragraph 4]

**55-30** The special deduction should be considered by an entity in measuring deferred taxes when graduated tax rates are a significant factor and assessing whether a valuation allowance is necessary as required by paragraph 740-10-25-37. Example 18 (see paragraph 740-10-55-145) illustrates the application of the requirements of this Subtopic for the impact of the qualified production activities deduction upon enactment of the Act in 2004. [FSP FAS 109-1, paragraph 5]

### *Alternative Minimum Tax*

**55-31** Temporary differences such as depreciation differences are one reason why tentative minimum tax may exceed regular tax. Temporary differences, however, ultimately reverse and, absent a significant amount of preference items, total taxes paid over the entire life of the entity will be based on the regular tax system. Preference items are another reason why tentative minimum tax may exceed regular tax. If preference items are large enough, an entity could be subject, over its lifetime, to the alternative minimum tax system; and the cumulative amount of alternative minimum tax credit carryforwards would expire unused. No one can know beforehand which scenario will prevail because that determination can only be made after the fact. In the meantime, this Subtopic requires procedures that provide a practical solution to that problem. [FAS 109, paragraph 238]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-32** Under the requirements of this Subtopic, an entity shall:

- a. Measure the total deferred tax liability and asset for regular tax temporary differences and carryforwards using the regular tax rate
- b. Measure the total deferred tax asset for all alternative minimum tax credit carryforward
- c. Reduce the deferred tax asset for alternative minimum tax credit carryforward by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of that deferred tax asset will not be realized.

**55-33** Paragraph 740-10-30-18 identifies four sources of taxable income that shall be considered in determining the need for and amount of a valuation allowance. No valuation allowance is necessary if the deferred tax asset for alternative minimum tax credit carryforward can be realized in any of the following ways:

- a. Under paragraph 740-10-30-18(a), by reducing a deferred tax liability from the amount of regular tax on regular tax temporary differences to not less than the amount of tentative minimum tax on alternative minimum taxable temporary differences
- b. Under paragraph 740-10-30-18(b), by reducing taxes on future income from the amount of regular tax on regular taxable income to not less than the amount of tentative minimum tax on alternative minimum taxable income
- c. Under paragraph 740-10-30-18(c), by loss carryback
- d. Under paragraph 740-10-30-18(d), by a tax-planning strategy such as switching from tax-exempt to taxable interest income. [FAS 109, paragraph 239]

***Operating Loss and Tax Credit Carryforwards and Carrybacks******Recognition of a Tax Benefit for Carrybacks***

**55-34** An operating loss, certain deductible items that are subject to limitations, and some tax credits arising but not utilized in the current year may be carried back for refund of taxes paid in prior years or carried forward to reduce taxes payable in future years. A receivable, to the extent it meets the recognition requirements of this Subtopic for tax positions, is recognized for the amount of taxes paid in prior years that is refundable by carryback of an operating loss or unused tax credits of the current year. [FAS 109, paragraph 240]

***Recognition of a Tax Benefit for Carryforwards***

**55-35** A deferred tax asset, to the extent it meets the recognition requirements of this Subtopic for tax positions and paragraph 718-740-25-10 for certain share option exercises, is recognized for an operating loss or tax credit carryforward. This requirement pertains to all investment tax credit carryforwards regardless of whether the flow-through or deferral method is used to account for investment tax credits. [FAS 109, paragraph 241]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**55-35** A deferred tax asset, to the extent it meets the recognition requirements of this Subtopic for tax positions, is recognized for an operating loss or tax credit carryforward. This requirement pertains to all investment tax credit carryforwards regardless of whether the flow-through or deferral method is used to account for investment tax credits. [FAS 109, paragraph 241]

**55-36** In assessing the need for a valuation allowance, provisions in the tax law that limit utilization of an operating loss or tax credit carryforward are applied in determining whether it is more likely than not that some portion or all of the deferred tax asset will not be realized by reduction of taxes payable on taxable income during the carryforward period. [FAS 109, paragraph 241] Example 19 (see paragraph 740-10-55-149) illustrates recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years when a valuation allowance is necessary in the loss year.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-37** An operating loss or tax credit carryforward from a prior year (for which the deferred tax asset was offset by a valuation allowance) may sometimes reduce taxable income and taxes payable that are attributable to certain revenues or gains that the tax law requires be included in taxable income for the year that cash is received. For financial reporting, however, there may have been no revenue or gain and a liability is recognized for the cash received. Future sacrifices to settle the liability will result in deductible amounts in future years. Under those circumstances, the reduction in taxable income and taxes payable from utilization of the operating loss or tax credit carryforward gives no cause for recognition of a tax benefit because, in effect, the operating loss or tax credit carryforward has been replaced by temporary differences that will result in deductible amounts when a nontax liability is settled in future years. The requirements for recognition of a tax benefit for deductible temporary differences and for operating loss carryforwards are the same, and the manner of reporting the eventual tax benefit recognized (that is, in income or as required by paragraph 740-20-45-3) is not affected by the intervening transaction reported for tax purposes. [FAS 109, paragraph 243] Example 20 (see paragraph 740-10-55-156) illustrates recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years when a valuation allowance is necessary in the loss year.

*Reporting the Tax Benefit of Operating Loss Carryforwards or Carrybacks*

**55-38** Except as noted in paragraph 740-20-45-3, the manner of reporting the tax benefit of an operating loss carryforward or carryback is determined by the source of the income or loss in the current year and not by the source of the operating loss carryforward or taxes paid in a prior year or the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. Deferred tax expense (or benefit) that results because a change in circumstances causes a change in judgment about the future realization of the tax benefit of an operating loss carryforward is allocated to continuing operations (see paragraph 740-10-45-20). Thus, for example:

- a. The tax benefit of an operating loss carryforward that resulted from a loss on discontinued operations in a prior year and that is first recognized in the financial statements for the current year:
  1. Is allocated to continuing operations if it offsets the current or deferred tax consequences of income from continuing operations
  2. Is allocated to a gain on discontinued operations if it offsets the current or deferred tax consequences of that gain
  3. Is allocated to continuing operations if it results from a change in circumstances that causes a change in judgment about future realization of a tax benefit.
- b. The current or deferred tax benefit of a loss from continuing operations in the current year is allocated to continuing operations regardless of whether that loss offsets the current or deferred tax consequences of a gain on discontinued operations that:
  1. Occurred in the current year
  2. Occurred in a prior year (that is, if realization of the tax benefit will be by carryback refund)
  3. Is expected to occur in a future year. [FAS 109, paragraph 245]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)****Tax-Planning Strategies**

**55-39** Expectations about future taxable income incorporate numerous assumptions about actions, elections, and strategies to minimize income taxes in future years. For example, an entity may have a practice of deferring taxable income whenever possible by structuring sales to qualify as installment sales for tax purposes. Actions such as that are not tax-planning strategies, as that term is used in this Topic because they are actions that management takes in the normal course of business. For purposes of applying the requirements of this Subtopic, a tax-planning strategy is an action that management ordinarily might not take but would take, if necessary, to realize a tax benefit for a carryforward before it expires. For example, a strategy to sell property and lease it back for the expressed purpose of generating taxable income to utilize a carryforward before it expires is not an action that management takes in the normal course of business. A qualifying tax-planning strategy is an action that:

- a. Is prudent and feasible. Management must have the ability to implement the strategy and expect to do so unless the need is eliminated in future years. For example, management would not have to apply the strategy if income earned in a later year uses the entire amount of carryforward from the current year.
- b. An entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused. All of the various strategies that are expected to be employed for business or tax purposes other than utilization of carryforwards that would otherwise expire unused are, for purposes of this Subtopic, implicit in management's estimate of future taxable income and, therefore, are not tax-planning strategies as that term is used in this Topic.
- c. Would result in realization of deferred tax assets. The effect of qualifying tax-planning strategies must be recognized in the determination of the amount of a valuation allowance. Tax-planning strategies need not be considered, however, if positive evidence available from other sources (see paragraph 740-10-30-18) is sufficient to support a conclusion that a valuation allowance is not necessary. [FAS 109, paragraph 246]

**55-40** Paragraph 740-10-30-19 indicates that tax-planning strategies include elections for tax purposes. The following are some examples of elections under current U.S. federal tax law that, if they meet the criteria for tax-planning strategies, should be considered in determining the amount, if any, of valuation allowance required for deferred tax assets:

- a. The election to file a consolidated tax return
- b. The election to claim either a deduction or a tax credit for foreign taxes paid
- c. The election to forgo carryback and only carry forward a net operating loss. [QA 109, paragraph 25]

**55-41** Because the effects of known qualifying tax-planning strategies must be recognized (see Example 22 [paragraph 740-10-55-163]), management should make a reasonable effort to identify those qualifying tax-planning strategies that are significant. Management's obligation to apply qualifying tax-planning strategies in determining the amount of valuation allowance required is the same as its obligation to apply the requirements of other Topics for financial accounting and reporting. However, if there is sufficient evidence that taxable income from one of the other sources of taxable income listed in paragraph 740-10-30-18 will be adequate to eliminate the need for any valuation allowance, a search for tax-planning strategies is not necessary. [QA 109, paragraph 27]

**55-42** Tax-planning strategies may shift estimated future taxable income between future years. For example, assume that an entity has a \$1,500 operating loss carryforward that expires at the end of next year and that its estimate of taxable income exclusive of the future reversal of existing temporary differences and carryforwards is approximately \$1,000 per year for each of the next several years. That estimate is based, in part, on the entity's present practice of making sales on the installment basis and on provisions in the tax law that result in temporary deferral of gains on installment sales. A tax-planning strategy to increase taxable income next year and realize the full tax benefit of that operating loss carryforward might be to structure next year's sales in a manner that does not meet the tax rules to qualify as installment sales. Another strategy might be to change next year's depreciation procedures for tax purposes. [FAS 109, paragraph 247]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

**55-43** Tax-planning strategies also may shift the estimated pattern and timing of future reversals of temporary differences. For example, if an operating loss carryforward otherwise would expire unused at the end of next year, a tax-planning strategy to sell the entity's installment sale receivables next year would accelerate the future reversal of taxable temporary differences for the gains on those installment sales. In other circumstances, a tax-planning strategy to accelerate the future reversal of deductible temporary differences in time to offset taxable income that is expected in an early future year might be the only means to realize a tax benefit for those deductible temporary differences if they otherwise would reverse and provide no tax benefit in some later future year(s). Examples of actions that would accelerate the future reversal of deductible temporary differences include the following:

- a. An annual payment that is larger than an entity's usual annual payment to reduce a long-term pension obligation (recognized as a liability in the financial statements) might accelerate a tax deduction for pension expense to an earlier year than would otherwise have occurred.
- b. Disposal of obsolete inventory that is reported at net realizable value in the financial statements would accelerate a tax deduction for the amount by which the tax basis exceeds the net realizable value of the inventory.
- c. Sale of loans at their reported amount (that is, net of an allowance for bad debts) would accelerate a tax deduction for the allowance for bad debts. [FAS 109, paragraph 248]

**55-44** A significant expense might need to be incurred to implement a particular tax-planning strategy, or a significant loss might need to be recognized as a result of implementing a particular tax-planning strategy. In either case, that expense or loss (net of any future tax benefit that would result from that expense or loss) reduces the amount of tax benefit that is recognized for the expected effect of a qualifying tax-planning strategy. For that purpose, the future effect of a differential in interest rates (for example, between the rate that would be earned on installment sale receivables and the rate that could be earned on an alternative investment if the tax-planning strategy is to sell those receivables to accelerate the future reversal of related taxable temporary differences) is not considered. [FAS 109, paragraph 249]

**55-45** Example 21 (see paragraph 740-10-55-159) illustrates recognition of a deferred tax asset based on the expected effect of a qualifying tax-planning strategy when a significant expense would be incurred to implement the strategy.

**55-46** Under this Subtopic, the requirements for consideration of tax-planning strategies pertain only to the determination of a valuation allowance for a deferred tax asset. A deferred tax liability ordinarily is recognized for all taxable temporary differences. The only exceptions are identified in paragraph 740-10-25-3. Certain seemingly taxable temporary differences, however, may or may not result in taxable amounts when those differences reverse in future years. One example is an excess of cash surrender value of life insurance over premiums paid (see paragraph 740-10-25-30). Another example is an excess of the book over the tax basis of an investment in a domestic subsidiary (see paragraph 740-30-25-7). The determination of whether those differences are taxable temporary differences does not involve a tax-planning strategy as that term is used in this Topic. [FAS 109, paragraph 251]

**55-47** Example 22 (see paragraph 740-10-55-163) provides an example where an entity has identified multiple tax-planning strategies.

**55-48** Under current U.S. federal tax law, approval of an entity's change from taxable C corporation status to nontaxable S corporation status is automatic if the criteria for S corporation status are met. If an entity meets those criteria but has not changed to S corporation status, a strategy to change to nontaxable S corporation status would not permit an entity to not recognize deferred taxes because a change in tax status is a discrete event. Paragraph 740-10-25-32 requires that the effect of a change in tax status be recognized at the date that the change in tax status occurs, that is, at the date that the change is approved by the taxing authority (or on the date of filing the change if approval is not necessary). [QA 109, paragraph 28] For example, as required by paragraph 740-10-25-34, if an election to change an entity's tax status is approved by the taxing authority (or filed, if approval is not necessary) early in Year 2 and before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) for Year 1, the effect of that change in tax status shall not be recognized in the financial statements for Year 1. [QA 109, paragraph 11]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)****Examples of Temporary Differences**

**55-49** The following guidance presents examples of temporary differences. These examples are intended to be illustrative and not all-inclusive. Any references to various tax laws shall not be considered definitive interpretations of such laws for any purpose.

**Premiums and Discounts**

**55-50** Differences between the recognition for financial accounting purposes and income tax purposes of discount or premium resulting from determination of the present value of a note should be treated as temporary differences in accordance with this Topic. [APB 21, paragraph 15]

**Beneficial Conversion Features**

**55-51** The issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying this Topic. The recognition of a beneficial conversion feature effectively creates two separate instruments—a debt instrument and an equity instrument—for financial statement purposes while it is accounted for as a debt instrument, for example, under the U.S. Federal Income Tax Code. Consequently, the reported amount in the financial statements (book basis) of the debt instrument is different from the tax basis of the debt instrument. The basis difference that results from the issuance of convertible debt with a beneficial conversion feature is a temporary difference for purposes of applying this Topic because that difference will result in a taxable amount when the reported amount of the liability is recovered or settled. That is, the liability is presumed to be settled at its current carrying amount (reported amount). The recognition of deferred taxes for the temporary difference of the convertible debt with a beneficial conversion feature should be recorded as an adjustment to additional paid-in capital. Because the beneficial conversion feature (an allocation to additional paid-in capital) created the basis difference in the debt instrument, the provisions of paragraph 740-20-45-11(c) apply and therefore the establishment of the deferred tax liability for the basis difference should result in an adjustment to the related components of shareholders' equity. [EITF 05-8, paragraph Discussion]

**LIFO Inventory of Subsidiary**

**55-52** An entity may use the LIFO method to value inventories for tax purposes which may result in LIFO inventory temporary differences, that is, for the excess of the amount of LIFO inventory for financial reporting over its tax basis.

**55-53** Even though a deferred tax liability for the LIFO inventory of a subsidiary will not be settled if that subsidiary is sold before the LIFO inventory temporary difference reverses, recognition of a deferred tax liability is required regardless of whether the LIFO inventory happens to belong to the parent entity or one of its subsidiaries. [EITF D-31]

**Accrued Postretirement Benefit Cost and the Effect of the Nontaxable Subsidy Arising from the Medicare Prescription Drug, Improvement, and Modernization Act of 2003**

**55-54** The following guidance and Example 23 (see paragraph 740-10-55-165) refer to provisions of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003; however, they shall not be considered definitive interpretations of the Act for any purpose. That Example provides a simple illustration of this guidance.

**55-55** As indicated in paragraph 715-60-05-9, on December 8, 2003, the president signed the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 into law. The Act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. [FSP FAS106-2, paragraph 5] An employer's eligibility for the 28 percent subsidy depends on whether the prescription drug benefit available under its plan is at least actuarially equivalent to the Medicare Part D benefit. [FSP FAS106-2, paragraph 9]

**55-56** The Act excludes receipt of the subsidy from the taxable income of the employer for federal income tax purposes. That provision affects the accounting for the temporary difference related to the employer's accrued postretirement benefit cost under the requirements of this Topic. [FSP FAS 106-2, paragraph 12]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

**55-57** In the periods in which the subsidy affects the employer's accounting for the plan, it shall have no effect on any plan-related temporary difference accounted for under this Topic because the subsidy is exempt from federal taxation. That is, the measure of any temporary difference shall continue to be determined as if the subsidy did not exist. Example 23 (see paragraph 740-10-55-165) provides a simple illustration of this guidance. [FSP FAS 106-2, paragraph 19]

### *Changes in Accounting Methods for Tax Purposes*

**55-58** The following guidance refers to provisions of the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1987; however, it shall not be considered a definitive interpretation of the Acts for any purpose.

**55-59** A change in tax law may require a change in accounting method for tax purposes, for example, the uniform cost capitalization rules required by the Tax Reform Act of 1986. For calendar-year taxpayers, inventories on hand at the beginning of 1987 are revalued as though the new rules had been in effect in prior years. That initial catch-up adjustment is deferred and taken into taxable income over not more than four years. This deferral of the initial catch-up adjustment for a change in accounting method for tax purposes gives rise to two temporary differences. [QA 109, paragraph 5]

**55-60** One temporary difference is related to the additional amounts initially capitalized into inventory for tax purposes. As a result of those additional amounts, the tax basis of the inventory exceeds the amount of the inventory for financial reporting. That temporary difference is considered to result in a deductible amount when the inventory is expected to be sold. Therefore, the excess of the tax basis of the inventory over the amount of the inventory for financial reporting as of December 31, 1986, is considered to result in a deductible amount in 1987 when the inventory turns over. As of subsequent year-ends, the deductible temporary difference to be considered would be the amount capitalized for tax purposes and not for financial reporting as of those year-ends. [QA 109, paragraph 5] The expected timing of the deduction for the additional amounts capitalized in this example assumes that the inventory is not measured on a LIFO basis; temporary differences related to LIFO inventories reverse when the inventory is sold and not replaced as provided in paragraph 740-10-55-13. [QA 109, paragraph 5, footnote 3]

**55-61** The other temporary difference is related to the deferred income for tax purposes that results from the initial catch-up adjustment. As stated above, that deferred income likely will be included in taxable income over four years. Ordinarily, the reversal pattern for this temporary difference should be considered to follow the tax pattern and would also be four years. This assumes that it is expected that inventory sold will be replaced. However, under the tax law, if there is a one-third reduction in the amount of inventory for two years running, any remaining balance of that deferred income is included in taxable income for the second year. If such inventory reductions are expected, then the reversal pattern will be less than four years. [QA 109, paragraph 5]

**55-62** Paragraph 740-10-35-4 requires recognition of the effect of a change in tax law or rate in the period that includes the enactment date. For example, the Tax Reform Act of 1986 was enacted in 1986. Therefore, the effects are recognized in a calendar-year entity's 1986 financial statements. [QA 109, paragraph 5, footnote 4]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-63** The Omnibus Budget Reconciliation Act of 1987 requires family-owned farming businesses to use the accrual method of accounting for tax purposes. The initial catch-up adjustment to change from the cash to the accrual method of accounting is deferred. It is included in taxable income if the business ceases to be family-owned (for example, it goes public). It also is included in taxable income if gross receipts from farming activities in future years drop below certain 1987 levels as set forth in the tax law. The deferral of the initial catch-up adjustment for that change in accounting method for tax purposes gives rise to a temporary difference because an assumption inherent in an entity's statement of financial position is that the reported amounts of assets and liabilities will be recovered and settled. Under the requirements of this Topic, deferred tax liabilities may not be eliminated or reduced because an entity may be able to delay the settlement of those liabilities by delaying the events that would cause taxable temporary differences to reverse. Accordingly, the deferred tax liability is recognized. If the events that trigger the payment of the tax are not expected in the foreseeable future, the reversal pattern of the related temporary difference is indefinite and the deferred tax liability should be classified as noncurrent. [QA 109, paragraph 6]

**Pending Content (Transition Guidance: ASC 740-10-65-4)**

**55-63** The Omnibus Budget Reconciliation Act of 1987 requires family-owned farming businesses to use the accrual method of accounting for tax purposes. The initial catch-up adjustment to change from the cash to the accrual method of accounting is deferred. It is included in taxable income if the business ceases to be family-owned (for example, it goes public). It also is included in taxable income if gross receipts from farming activities in future years drop below certain 1987 levels as set forth in the tax law. The deferral of the initial catch-up adjustment for that change in accounting method for tax purposes gives rise to a temporary difference because an assumption inherent in an entity's statement of financial position is that the reported amounts of assets and liabilities will be recovered and settled. Under the requirements of this Topic, deferred tax liabilities may not be eliminated or reduced because an entity may be able to delay the settlement of those liabilities by delaying the events that would cause taxable temporary differences to reverse. Accordingly, the deferred tax liability is recognized. If the events that trigger the payment of the tax are not expected in the foreseeable future, the reversal pattern of the related temporary difference is indefinite. [QA 109, paragraph 6]

*Built-in Gains of Nontaxable S Corporations*

**55-64** An entity may change from taxable C corporation status to nontaxable S corporation status. An entity that makes that status change shall continue to recognize a deferred tax liability to the extent that the entity would be subject to a corporate-level tax on net unrecognized built-in gains. [QA 109, paragraph 12]

**55-65** A C corporation that has temporary differences as of the date of change to S corporation status shall determine its deferred tax liability in accordance with the tax law. Since the timing of realization of a built-in gain can determine whether it is taxable, and therefore significantly affect the deferred tax liability to be recognized, actions and elections that are expected to be implemented shall be considered. For purposes of determining that deferred tax liability, the lesser of an unrecognized built-in gain (as defined by the tax law) or an existing temporary difference is used in the computations described in the tax law to determine the amount of the tax on built-in gains. [QA 109, paragraph 12] Example 24 (see paragraph 740-10-55-168) illustrates this guidance.

*Unrecognized Gains or Losses from Involuntary Conversions*

**55-66** Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets that is not recognized for income tax reporting purposes in the same period in which the gain or loss is recognized for financial reporting purposes is a temporary difference for which comprehensive interperiod tax allocation, as required by this Subtopic, is required. [FIN 30, paragraph 5]

*Treatment of Certain Payments to Taxing Authorities*

**55-67** An entity may make payments to taxing authorities for different reasons. The following guidance addresses certain of these payments.

## **ASC 740-10 — Implementation Guidance and Illustrations (continued)**

### *Payment Made to Taxing Authority to Retain Fiscal Year*

**55-68** The following guidance refers to provisions of the Tax Reform Act of 1986 and the Revenue Act of 1987; however, it shall not be considered a definitive interpretation of the Acts for any purpose.

**55-69** The guidance addresses how a payment should be recorded in the financial statements of an entity for a payment to a taxing authority to retain their fiscal year. [EITF 88-4, paragraph Issue]

**55-70** On December 22, 1987, the Revenue Act of 1987 was enacted, which allowed partnerships and S corporations to elect to retain their fiscal year rather than adopt a calendar year for tax purposes as previously required by the Tax Reform Act of 1986. Entities that elected to retain a fiscal year are required to make an annual payment in a single installment each year that approximates the income tax that the partners-owners would have paid on the short-period income had the entity switched to a calendar year. [EITF 88-4, paragraph Issue] The payment is made by the entity and is not identified with individual partners-owners. Additionally the amount is not adjusted if a partner-owner leaves the entity. [EITF 88-4, paragraph Discussion]

**55-71** In this fact pattern, partnerships and S corporations should account for the payment as an asset since the payment is viewed as a deposit that is adjusted annually and will be realized when the entity liquidates, its income declines to zero, or it converts to a calendar year-end. [EITF 88-4, paragraph Discussion]

### *Payment Made Based on Dividends Distributed*

**55-72** The following guidance refers to provisions which may be present in the French tax structure; however, it shall not be considered a definitive interpretation of the historical or current French tax structure for any purpose.

**55-73** The French income tax structure is based on the concept of an integrated tax system. The system utilizes a tax credit at the shareholder level to eliminate or mitigate the double taxation that would otherwise apply to a dividend. The tax credit is automatically available to a French shareholder receiving a dividend from a French corporation. The precompte mobilier (or precompte) is a mechanism that provides for the integration of the tax credit to the shareholder with the taxes paid by the corporation. The precompte is a tax paid by the corporation at the time of a dividend distribution that is equal to the difference between a tax based on the regular corporation tax rate applied to the amount of the declared dividend and taxes previously paid by the corporation on the income being distributed. In addition, if a corporation pays a dividend from earnings that have been retained for more than five years, the corporation loses the benefit of any taxes previously paid in the computation of the precompte. [EITF 95-9, paragraph Issue]

**55-74** Paragraph 740-10-15-4(b) sets forth criteria for determining whether a tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend to be recorded in equity as part of the dividend distribution in that entity's separate financial statements. A tax that is assessed on a corporation based on dividends distributed that meets the criteria in that paragraph, such as the French precompte tax, should be considered to be in effect a withholding of tax for the recipient of the dividend and recorded in equity as part of the dividend paid to shareholders. [EITF 95-9, paragraph Issue]

### *Excise Tax on Withdrawal of Excess Pension Plan Assets*

**55-75** An employer that withdraws excess plan assets from its pension plan may be subject to an excise tax. If the excise tax is independent of taxable income, that is, it is a tax due on a specific transaction regardless of whether there is any taxable income for the period in which the transaction occurs, it is not an income tax and the employer should recognize it as an expense (not classified as income taxes) in the period of the withdrawal. [QA 88, paragraph 66]

### *Other Direct Payments to Taxing Authorities*

**55-76** Example 26 (see paragraph 740-10-55-202) illustrates a transaction directly with a governmental taxing authority. [EITF 98-11, Exhibit 98-11A, Example 7]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)*****Statement of Financial Position Classification of Deferred Income Taxes***

Accounting Change for Tax Purposes

**55-77** The deferred tax liability or asset associated with an accounting change for tax purposes would be classified like the associated asset or liability if reduction of that associated asset or liability will cause the temporary difference to reverse. If there is no associated asset or liability or if the temporary difference will reverse only over a period of time, the deferred tax liability or asset would be classified based on the expected reversal date of the specific temporary difference. [FAS 37, paragraph 19] Example 27 (see paragraph 740-10-55-205) illustrates this guidance.

**Pending Content (Transition Guidance: ASC 740-10-65-4)**

**55-77** *Editor's Note: Paragraph 740-10-55-77 will be superseded upon transition, together with its two preceding headings:*

***Statement of Financial Position Classification of Deferred Income Taxes***

Accounting Change for Tax Purposes

Paragraph superseded by Accounting Standards Update No. 2015-17.

**Method of Reporting Construction Contracts Differs for Tax and Book**

**55-78** An entity reports profits on construction contracts on the completed contract method for tax purposes and the percentage-of-completion method for financial reporting purposes. The temporary differences do not relate to an asset or liability that appears on the entity's statement of financial position; the temporary differences will only reverse when the contracts are completed. Receivables that result from progress billings can be collected with no effect on the temporary differences; likewise, contract retentions can be collected with no effect on the temporary differences, and the temporary differences will reverse when the contracts are deemed to be complete even if there is a waiting period before retentions will be received. Accordingly, the entity would classify the deferred tax liability based on the estimated reversal of the related temporary differences. Deferred tax liabilities related to temporary differences that will reverse within the same time period used in classifying other contract-related assets and liabilities as current (for example, an operating cycle) would be classified as current. [FAS 37, paragraph 22]

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

**55-78** An entity reports [FAS 37, paragraph 22] revenue on contracts with customers using a measure of progress to depict performance over time in accordance with the guidance in paragraphs 606-10-25-31 through 25-37 and paragraphs 606-10-55-16 through 55-21 for financial reporting that is different from the recognition pattern used for tax purposes (for example, when the contract is completed). [ASU 2014-09, paragraph 180] The temporary differences do not relate to an asset or liability that appears on the entity's statement of financial position; the temporary differences will only reverse when the contracts are completed. Receivables or contract assets that result from progress billings can be collected with no effect on the temporary differences; likewise, contract retentions can be collected with no effect on the temporary differences, and the temporary differences will reverse when the contracts are deemed to be complete even if there is a waiting period before retentions will be received. Accordingly, the entity would classify the deferred tax liability based on the estimated reversal of the related temporary differences. Deferred tax liabilities related to temporary differences that will reverse within the same time period used in classifying other contract-related assets and liabilities as current (for example, an operating cycle) would be classified as current. [FAS 37, paragraph 22]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

### Pending Content (Transition Guidance: ASC 740-10-65-4)

**55-78 Editor's Note:** Paragraph 740-10-55-78 will be superseded upon transition, together with its heading. The preceding pending content, which has a later transition date and transition guidance in paragraph 606-10-65-1, will also be superseded.

Method of Reporting Construction Contracts Differs for Tax and Book

Paragraph superseded by Accounting Standards Update No. 2015-17.

## ASC 740-10 — Implementation Guidance and Illustrations

### *Income Tax Related Disclosures*

**55-79** Paragraph 740-10-50-9 requires disclosure of the significant components of income tax expense attributable to continuing operations. The sum of the amounts disclosed for the components of tax expense should equal the amount of tax expense that is reported in the statement of earnings for continuing operations. Insignificant components that are not separately disclosed should be combined and disclosed as a single amount so that the sum of the amounts disclosed will equal total income tax expense attributable to continuing operations. Separate disclosure of the tax benefit of operating loss carryforwards and tax credits and tax credit carryforwards that have been recognized as a reduction of current tax expense and deferred tax expense is required. There are a number of ways to satisfy that disclosure requirement. Three acceptable approaches, referred to as the gross method, the net method, and the statutory tax rate reconciliation method, are illustrated in Example 29 (see paragraph 740-10-55-212). [QA 109, paragraph 18]

**55-80** Income tax expense is defined as the sum of current and deferred tax expense, and the amount to be disclosed under any of the above approaches is only the amount by which total income tax expense from continuing operations has been reduced by tax credits or an operating loss carryforward. For example, assume that a tax benefit is recognized for an operating loss or tax credit carryforward by recognizing a deferred tax asset in Year 1, with no valuation allowance required because of an existing deferred tax liability. Further, assume that the carryforward is realized on the tax return in Year 2. For financial reporting in Year 2:

- a. Current tax expense will be reduced for the tax benefit of the operating loss or tax credit carryforward realized on the tax return.
- b. Deferred tax expense will be larger (or a deferred tax benefit will be smaller) by the same amount.

In those circumstances, the operating loss or tax credit carryforward affects only income tax expense (the sum of current and deferred tax expense) in Year 1 when a tax asset (with no valuation allowance) is recognized. There is no effect on income tax expense in Year 2 because the separate effects on current and deferred tax expense offset each other. Accordingly, the requirement for separate disclosure of the effects of tax credits or an operating loss carryforward is not applicable for Year 2. However, that disclosure requirement applies to financial statements for Year 1 that are presented for comparative purposes. [QA 109, paragraph 18]

### ***Example 1: The Unit of Account for a Tax Position***

**55-81** This Example illustrates the initial and subsequent determination by an entity of the unit of account for a tax position. Paragraph 740-10-25-13 requires an entity to determine an appropriate unit of account for an individual tax position. The following Cases illustrate:

- a. The determination of the unit of account (Case A).
- b. A change in the unit of account (Case B).

**55-82** Cases A and B share all of the following assumptions.

## ASC 740-10 — Implementation Guidance and Illustrations

**55-83** An entity anticipates claiming a \$1 million research and experimentation credit on its tax return for the current fiscal year. The credit comprises equal spending on 4 separate projects (that is, \$250,000 of tax credit per project). The entity expects to have sufficient taxable income in the current year to fully utilize the \$1 million credit. Upon review of the supporting documentation, management believes it is more likely than not that the entity will ultimately sustain a benefit of approximately \$650,000. The anticipated benefit consists of approximately \$200,000 per project for the first 3 projects and \$50,000 for the fourth project. [FIN 48, paragraph A5]

### Case A: Determining the Unit of Account — A Prerequisite to Recognition Assessment

**55-84** This Case illustrates an entity's initial determination of the unit of account for a tax position.

**55-85** In its evaluation of the appropriate amount to recognize, management first determines the appropriate unit of account for the tax position. Because of the magnitude of expenditures in each project, management concludes that the appropriate unit of account is each individual research project. In reaching this conclusion, management considers both the level at which it accumulates information to support the tax return and the level at which it anticipates addressing the issue with taxing authorities. In this Case, upon review of the four projects including the magnitude of expenditures, management determines that it accumulates information at the project level. Management also anticipates the taxing authority will address the issues during an examination at the level of individual projects. [FIN 48, paragraph A6]

**55-86** In evaluating the projects for recognition, management determines that three projects meet the more-likely-than-not recognition threshold. However, due to the nature of the activities that constitute the fourth project, it is uncertain that the tax benefit related to this project will be allowed. Because the tax benefit related to that fourth project does not meet the more-likely-than-not recognition threshold, it should not be recognized in the financial statements, even though tax positions associated with that project will be included in the tax return. The entity would recognize a \$600,000 financial statement benefit related to the first 3 projects but would not recognize a financial statement benefit related to the fourth project. [FIN 48, paragraph A7]

### Case B: Change in the Unit of Account

**55-87** This Case illustrates a change in an entity's initial determination of the unit of account for a tax position.

**55-88** In Year 2, the entity increases its spending on research and experimentation projects and anticipates claiming significantly larger research credits in its Year 2 tax return. In light of the significant increase in expenditures, management reconsiders the appropriateness of the unit of account and concludes that the project level is no longer the appropriate unit of account for research credits. This conclusion is based on the magnitude of spending and anticipated claimed credits and on previous experience and is consistent with the advice of external tax advisors. Management anticipates the taxing authority will focus the examination on functional expenditures when examining the Year 2 return and thus needs to evaluate whether it can change the unit of account in subsequent years' tax returns. [FIN 48, paragraph A8]

**55-89** Determining the unit of account requires evaluation of the entity's facts and circumstances. In making that determination, management evaluates the manner in which it prepares and supports its income tax return and the manner in which it anticipates addressing issues with taxing authorities during an examination. The unit of account should be consistently applied to similar positions from period to period unless a change in facts and circumstances indicates that a different unit of account is more appropriate. Because of the significant change in the tax position in Year 2, management's conclusion that the taxing authority will likely examine tax credits in the Year 2 tax return at a more detailed level than the individual project is reasonable and appropriate. Accordingly, the entity should reevaluate the unit of account for the Year 2 financial statements based on the new facts and circumstances. [FIN 48, paragraph A9]

### **Example 2: Administrative Practices — Asset Capitalization**

**55-90** The guidance in paragraph 740-10-25-7(b) on evaluating a taxing authority's widely understood administrative practices and precedents shall be taken into account when assessing the more-likely-than-not recognition threshold established in paragraph 740-10-25-6. This Example illustrates such consideration.

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

**55-91** An entity has established a capitalization threshold of \$2,000 for its tax return for routine property and equipment purchases. Assets purchased for less than \$2,000 are claimed as expenses on the tax return in the period they are purchased. The tax law does not prescribe a capitalization threshold for individual assets, and there is no materiality provision in the tax law. The entity has not been previously examined. Management believes that based on previous experience at a similar entity and current discussions with its external tax advisors, the taxing authority will not disallow tax positions based on that capitalization policy and the taxing authority's historical administrative practices and precedents. [FIN 48, paragraph A12]

**55-92** Some might deem the entity's capitalization policy a technical violation of the tax law, since that law does not prescribe capitalization thresholds. However, in this situation the entity has concluded that the capitalization policy is consistent with the demonstrated administrative practices and precedents of the taxing authority and the practices of other entities that are regularly examined by the taxing authority. Based on its previous experience with other entities and consultation with its external tax advisors, management believes the administrative practice is widely understood. Accordingly, because management expects the taxing authority to allow this position when and if examined, the more-likely-than-not recognition threshold has been met. [FIN 48, paragraph A13]

### **Example 3: Administrative Practices — Nexus**

**55-93** The guidance in paragraph 740-10-25-7(b) on evaluating a taxing authority's widely understood administrative practices and precedents shall be taken into account when assessing the more-likely-than-not recognition threshold established in paragraph 740-10-25-6. This Example illustrates such consideration.

**55-94** An entity has been incorporated in Jurisdiction A for 50 years; it has filed a tax return in Jurisdiction A in each of those 50 years. The entity has been doing business in Jurisdiction B for approximately 20 years and has filed a tax return in Jurisdiction B for each of those 20 years. However, the entity is not certain of the exact date it began doing business, or the date it first had nexus, in Jurisdiction B. [FIN 48, paragraph A14]

**55-95** The entity understands that if a tax return is not filed, the statute of limitations never begins to run; accordingly, failure to file a tax return effectively means there is no statute of limitations. The entity has become familiar with the administrative practices and precedents of Jurisdiction B and understands that Jurisdiction B will look back only six years in determining if there is a tax return due and a deficiency owed. Because of the administrative practices of the taxing authority and the facts and circumstances, the entity believes it is more likely than not that a tax return is not required to be filed in Jurisdiction B at an earlier date and that a liability for tax exposures for those periods is not required. [FIN 48, paragraph A15]

### **Example 4: Valuation Allowance and Tax-Planning Strategies**

**55-96** Paragraph 740-10-30-20 requires that entities determine the amount of available future taxable income from a tax-planning strategy based on the application of the recognition and measurement requirements of this Subtopic for tax positions. This Example illustrates the recognition aspect of that requirement.

**55-97** An entity has a wholly owned subsidiary with certain deferred tax assets as a result of several years of losses from operations. Management has determined that it is more likely than not that sufficient future taxable income will not be available to realize those deferred tax assets. Therefore, management recognizes a full valuation allowance for those deferred tax assets both in the separate financial statements of the subsidiary and in the consolidated financial statements of the entity. [FIN 48, paragraph A16]

**55-98** Management has identified certain tax-planning strategies that might enable the realization of those deferred tax assets. Management has determined that the strategies will meet the minimum statutory threshold to avoid penalties and that it is not more likely than not that the strategies would be sustained upon examination based on the technical merits. [FIN 48, paragraph A17] Accordingly, those strategies may not be used to reduce the valuation allowance on the deferred tax assets. Only a tax-planning strategy that meets the more-likely-than-not recognition threshold would be considered in evaluating the sufficiency of future taxable income for realization of deferred tax assets. [FIN 48, paragraph A18]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)*****Example 5: Highly Certain Tax Positions***

**55-99** This Example illustrates the recognition and measurement criteria of this Subtopic to tax positions where the tax law is unambiguous. The recognition and measurement criteria of this Subtopic applicable to tax positions begin in paragraph 740-10-25-5 for recognition and paragraph 740-10-30-7 for measurement.

**55-100** An entity has taken a tax position that it believes is based on clear and unambiguous tax law for the payment of salaries and benefits to employees. The class of salaries being evaluated in this tax position is not subject to any limitations on deductibility (for example, executive salaries are not included), and none of the expenditures are required to be capitalized (for example, the expenditures do not pertain to the production of inventories); all amounts accrued at year-end were paid within the statutorily required time frame subsequent to the reporting date. Management concludes that the salaries are fully deductible. [FIN 48, paragraph A19]

**55-101** All tax positions are subject to the requirements of this Subtopic. However, because the deduction is based on clear and unambiguous tax law, management has a high confidence level in the technical merits of this position. Accordingly, the tax position clearly meets the recognition criterion and should be evaluated for measurement. In determining the amount to measure, management is highly confident that the full amount of the deduction will be allowed and it is clear that it is greater than 50 percent likely that the full amount of the tax position will be ultimately realized. Accordingly, the entity would recognize the full amount of the tax position in the financial statements. [FIN 48, paragraph A20]

***Example 6: Measurement with Information About the Approach to Settlement***

**55-102** This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on identified information about settlement.

**55-103** In applying the recognition criterion of this Subtopic for tax positions, an entity has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. The entity has considered the amounts and probabilities of the possible estimated outcomes as follows.

Possible Estimated Outcome	Individual Probability of Occurring (%)	Cumulative Probability of Occurring (%)
\$ 100	5	5
80	25	30
60	25	55
50	20	75
40	10	85
20	10	95
—	5	100

[FIN 48, paragraph A21]

**55-104** Because \$60 is the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement, the entity would recognize a tax benefit of \$60 in the financial statements. [FIN 48, paragraph A22]

***Example 7: Measurement with More Limited Information About the Approach to Settlement***

**55-105** As in the preceding Example, this Example also demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position determined to meet recognition requirements. While measurement in this Example is also based on identified information about settlement, the information is more limited than in the preceding Example.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-106** In applying the recognition criterion of this Subtopic for tax positions an entity has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. There is limited information about how a taxing authority will view the position. After considering all relevant information, management's confidence in the technical merits of the tax position exceeds the more-likely-than-not recognition threshold, but management also believes it is likely it would settle for less than the full amount of the entire position when examined. Management has considered the amounts and the probabilities of the possible estimated outcomes.

Possible Estimated Outcome	Individual Probability of Occurring (%)	Cumulative Probability of Occurring (%)
\$ 100	25	25
75	50	75
50	25	100

[FIN 48, paragraph A23]

**55-107** Because \$75 is the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement, the entity would recognize a tax benefit of \$75 in the financial statements. [FIN 48, paragraph A24]

***Example 8: Measurement of a Tax Position After Settlement of a Similar Position***

**55-108** This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on settlement of a similar tax position with the taxing authority.

**55-109** In applying the recognition criterion of this Subtopic for tax positions, an entity has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. In a recent settlement with the taxing authority, the entity has agreed to the treatment for that position for current and future years. There are no recently issued relevant sources of tax law that would affect the entity's assessment. The entity has not changed any assumptions or computations, and the current tax position is consistent with the position that was recently settled. In this case, the entity would have a very high confidence level about the amount that will be ultimately realized and little information about other possible outcomes. Management will not need to evaluate other possible outcomes because it can be confident of the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement without that evaluation. [FIN 48, paragraph A25]

***Example 9: Differences Relating to Timing of Deductibility***

**55-110** This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on the timing of the deduction.

**55-111** In Year 1, an entity acquired a separately identifiable intangible asset for \$15 million that has an indefinite life for financial statement purposes and is, therefore, not subject to amortization. Based on some uncertainty in the tax code, the entity decides for tax purposes to deduct the entire cost of the asset in Year 1. While the entity is certain that the full amount of the intangible is ultimately deductible for tax purposes, the timing of deductibility is uncertain under the tax code. In applying the recognition criterion of this Subtopic for tax positions, the entity has determined that the tax position qualifies for recognition and should be measured. The entity believes it is 25 percent likely it would be able to realize immediate deduction upon settlement, and it is certain it could sustain a 15-year amortization for tax purposes. Thus, the largest Year 1 benefit that is greater than 50 percent likely of being realized upon settlement is the tax effect of \$1 million (the Year 1 deduction from straight-line amortization of the asset over 15 years). [FIN 48, paragraph A26]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-112** At the end of Year 1, the entity should reflect a deferred tax liability for the tax effect of the temporary difference created by the difference between the financial statement basis of the asset (\$15 million) and the tax basis of the asset computed in accordance with the guidance in this Subtopic for tax positions (\$14 million, the cost of the asset reduced by \$1 million of amortization). The entity also should reflect a tax liability for the tax-effected difference between the as-filed tax position (\$15 million deduction) and the amount of the deduction that is considered more likely than not of being sustained (\$1 million). The entity should evaluate the tax position for accrual of statutory penalties as well as interest expense on the difference between the amounts reported in the financial statements and the tax position taken in the tax return. [FIN 48, paragraph A27]

***Example 10: Change in Timing of Deductibility***

**55-113** This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on a change in timing of deductibility.

**55-114** In 20X1 an entity took a tax position in which it amortizes the cost of an acquired asset on a straight-line basis over three years, while the amortization period for financial reporting purposes is seven years. After one year, the entity has deducted one-third of the cost of the asset in its income tax return and one-seventh of the cost in the financial statements and, consequently, has a deferred tax liability for the difference between the financial reporting and tax bases of the asset. [FIN 48, paragraph A28]

**55-115** In accordance with the requirements of this Subtopic, the entity evaluates the tax position as of the reporting date of the financial statements. In 20X2, the entity determines that it is still certain that the entire cost of the acquired asset is fully deductible, so the more-likely-than-not recognition threshold has been met according to paragraph 740-10-25-6. However, in 20X2, the entity now believes based on new information that the largest benefit that is greater than 50 percent likely of being realized upon settlement is straight-line amortization over 7 years. [FIN 48, paragraph A29]

**55-116** In this Example, the entity would recognize a liability for unrecognized tax benefits based on the difference between the three- and seven-year amortization. In 20X2, no deferred tax liability should be recognized, as there is no longer a temporary difference between the financial statement carrying value of the asset and the tax basis of the asset based on this Subtopic's measurement requirements for tax positions. Additionally, the entity should evaluate the need to accrue interest and penalties, if applicable under the tax law. [FIN 48, paragraph A30]

***Example 11: Information Becomes Available Before Issuance of Financial Statements***

**55-117** Paragraphs 740-10-25-6 and 740-10-25-8 require that tax positions be recognized and measured based on information available at the reporting date. This Example demonstrates the effect of information becoming available after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).

**55-118** Entity A has evaluated a tax position at its most recent reporting date and has concluded that the position meets the more-likely-than-not recognition threshold. In evaluating the tax position for recognition, Entity A considered all relevant sources of tax law, including a court case in which the taxing authority has fully disallowed a similar tax position with an unrelated entity (Entity B). The taxing authority and Entity B are aggressively litigating the matter. Although Entity A was aware of that court case at the recent reporting date, management determined that the more-likely-than-not recognition threshold had been met. After the reporting date, but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the taxing authority prevailed in its litigation with Entity B, and Entity A concludes that it is no longer more likely than not that it will sustain the position. [FIN 48, paragraph A31]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

**55-119** Paragraph 740-10-40-2 provides the guidance that an entity shall derecognize a previously recognized tax position in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination, and paragraphs 740-10-25-14; 740-10-35-2; and 740-10-40-2 establish that subsequent recognition, derecognition, and measurement shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Because the resolution of Entity B's litigation with the taxing authority is the information that caused Entity A to change its judgment about the sustainability of the position and that information was not available at the reporting date, the change in judgment would be recognized in the first quarter of the current fiscal year. [FIN 48, paragraph A32]

### **Example 12: Basic Deferred Tax Recognition**

**55-120** This Example illustrates the guidance in paragraphs 740-10-55-7 through 55-9 relating to recognition of deferred tax assets and liabilities, including when a detailed analysis of sources of taxable income may not be necessary in considering the need for a valuation allowance for deferred tax assets. In this Example, an entity has \$2,400 of deductible temporary differences and \$1,500 of taxable temporary differences at the end of Year 3 (the current year).

**55-121** A deferred tax liability is recognized at the end of Year 3 for the \$1,500 of taxable temporary differences, and deferred tax asset is recognized for the \$2,400 of deductible temporary differences. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of the deferred tax asset. If evidence about one or more sources of taxable income (see paragraph 740-10-30-18) is sufficient to support a conclusion that a valuation allowance is not needed, other sources of taxable income need not be considered. For example, if the weight of available evidence indicates that taxable income will exceed \$2,400 in each future year, a conclusion that no valuation allowance is needed can be reached without considering the pattern and timing of the reversal of the temporary differences, the existence of qualifying tax-planning strategies, and so forth.

**55-122** Similarly, if the deductible temporary differences will reverse within the next 3 years and taxable income in the current year exceeds \$2,400, nothing needs to be known about future taxable income exclusive of reversing temporary differences because the deferred tax asset could be realized by carryback to the current year. A valuation allowance is needed, however, if the weight of available evidence indicates that some portion or all of the \$2,400 of tax deductions from future reversals of the deductible temporary differences will not be realized by offsetting any of the following:

- a. The \$1,500 of taxable temporary differences and \$900 of future taxable income exclusive of reversing temporary differences
- b. \$2,400 of future taxable income exclusive of reversing temporary differences
- c. \$2,400 of taxable income in the current or prior years by loss carryback to those years
- d. \$2,400 of taxable income in one or more of the circumstances described above and as a result of a qualifying tax-planning strategy (see paragraphs 740-10-55-39 through 55-48).

Paragraph 740-10-55-8 provides guidance on when a detailed analysis of sources of taxable income may not be necessary in considering the need for a valuation allowance for deferred tax assets.

**55-123** Detailed analyses are not necessary, for example, if the entity earned \$500 of taxable income in each of Years 1-3 and there is no evidence to suggest it will not continue to earn that level of taxable income in future years. That level of future taxable income is more than sufficient to realize the tax benefit of \$2,400 of tax deductions over a period of at least 19 years (the year(s) of the deductions, 3 carryback years, and 15 carryforward years) in the U.S. federal tax jurisdiction. [FAS 109, paragraph 225]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)*****Example 13: Valuation Allowance for Deferred Tax Assets***

**55-124** This Example illustrates the guidance in paragraphs 740-10-55-7 through 55-9 relating to recognition of a valuation allowance for a portion of a deferred tax asset in one year and a subsequent change in circumstances that requires adjustment of the valuation allowance at the end of the following year. This Example has the following assumptions:

- a. At the end of the current year (Year 3), an entity's only temporary differences are deductible temporary differences in the amount of \$900.
- b. Pretax financial income, taxable income, and taxes paid for each of Years 1-3 are all positive, but relatively negligible, amounts.
- c. The enacted tax rate is 40 percent for all years.

**55-125** A deferred tax asset in the amount of \$360 (\$900 at 40 percent) is recognized at the end of Year 3. If management concludes, based on an assessment of all available evidence (see guidance in paragraphs 740-10-30-17 through 30-24), that it is more likely than not that future taxable income will not be sufficient to realize a tax benefit for \$400 of the \$900 of deductible temporary differences at the end of the current year, a \$160 valuation allowance (\$400 at 40 percent) is recognized at the end of Year 3.

**55-126** Assume that pretax financial income and taxable income for Year 4 turn out to be as follows.

Pretax financial loss	\$	(50)
Reversing deductible temporary differences		<u>(300)</u>
Loss carryforward for tax purposes	\$	<u>(350)</u>

**55-127** The \$50 pretax loss in Year 4 is additional negative evidence that must be weighed against available positive evidence to determine the amount of valuation allowance necessary at the end of Year 4. Deductible temporary differences and carryforwards at the end of Year 4 are as follows.

Loss carryforward from Year 4 for tax purposes (see above)	\$	350
Unreversed deductible temporary differences (\$900 - \$300)		<u>600</u>
	\$	<u>950</u>

**55-128** The \$360 deferred tax asset recognized at the end of Year 3 is increased to \$380 (\$950 at 40 percent) at the end of Year 4. Based on an assessment of all evidence available at the end of Year 4, management concludes that it is more likely than not that \$240 of the deferred tax asset will not be realized and, therefore, that a \$240 valuation allowance is necessary. The \$160 valuation allowance recognized at the end of Year 3 is increased to \$240 at the end of Year 4. The \$60 net effect of those 2 adjustments (the \$80 increase in the valuation allowance less the \$20 increase in the deferred tax asset) results in \$60 of deferred tax expense that is recognized in Year 4. [FAS 109, paragraph 226]

***Example 14: Phased-In Change in Tax Rates***

**55-129** This Example illustrates the guidance in paragraph 740-10-55-23 for determination of the tax rate for measurement of a deferred tax liability for taxable temporary differences when there is a phased-in change in tax rates. At the end of Year 3 (the current year), an entity has \$2,400 of taxable temporary differences, which are expected to result in taxable amounts of approximately \$800 on the future tax returns for each of Years 4-6. Enacted tax rates are 35 percent for Years 1-3, 40 percent for Years 4-6, and 45 percent for Year 7 and thereafter.

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

**55-130** The tax rate that is used to measure the deferred tax liability for the \$2,400 of taxable temporary differences differs depending on whether the tax effect of future reversals of those temporary differences is on taxes payable for Years 1–3, Years 4–6, or Year 7 and thereafter. The tax rate for measurement of the deferred tax liability is 40 percent whenever taxable income is expected in Years 4–6. If tax losses are expected in Years 4–6, however, the tax rate is:

- a. 35 percent if realization of a tax benefit for those tax losses in Years 4–6 will be by loss carryback to Years 1–3
- b. 45 percent if realization of a tax benefit for those tax losses in Years 4–6 will be by loss carryforward to Year 7 and thereafter. [FAS 109, paragraph 234]

### **Example 15: Change in Tax Rates**

**55-131** This Example illustrates the guidance in paragraph 740-10-55-23 for determination of the tax rate for measurement of a deferred tax asset for deductible temporary differences when there is a change in tax rates. This Example has the following assumptions:

- a. Enacted tax rates are 30 percent for Years 1–3 and 40 percent for Year 4 and thereafter.
- b. At the end of Year 3 (the current year), an entity has \$900 of deductible temporary differences, which are expected to result in tax deductions of approximately \$300 on the future tax returns for each of Years 4–6.

**55-132** The tax rate is 40 percent if the entity expects to realize a tax benefit for the deductible temporary differences by offsetting taxable income earned in future years. Alternatively, the tax rate is 30 percent if the entity expects to realize a tax benefit for the deductible temporary differences by loss carryback refund.

**55-133** Further assume for this Example both of the following:

- a. The entity recognizes a \$360 (\$900 at 40 percent) deferred tax asset to be realized by offsetting taxable income in future years.
- b. Taxable income and taxes payable in each of Years 1–3 were \$300 and \$90, respectively.

**55-134** Realization of a tax benefit of at least \$270 (\$900 at 30 percent) is assured because carryback refunds totaling \$270 may be realized even if no taxable income is earned in future years. Recognition of a valuation allowance for the other \$90 (\$360 – \$270) of the deferred tax asset depends on management's assessment of whether, based on the weight of available evidence, a portion or all of the tax benefit of the \$900 of deductible temporary differences will not be realized at 40 percent tax rates in future years.

**55-135** Alternatively, if enacted tax rates are 40 percent for Years 1–3 and 30 percent for Year 4 and thereafter, measurement of the deferred tax asset at a 40 percent tax rate could only occur if tax losses are expected in future Years 4–6. [FAS 109, paragraph 235]

### **Example 16: Graduated Tax Rates**

**55-136** This Example illustrates the guidance in paragraph 740-10-55-23 for determination of the average graduated tax rate for measurement of deferred tax liabilities and assets by an entity for which graduated tax rates ordinarily are a significant factor. At the end of Year 3 (the current year), an entity has \$1,500 of taxable temporary differences and \$900 of deductible temporary differences, which are expected to result in net taxable amounts of approximately \$200 on the future tax returns for each of Years 4–6. Enacted tax rates are 15 percent for the first \$500 of taxable income, 25 percent for the next \$500, and 40 percent for taxable income over \$1,000. This Example assumes that there is no income (for example, capital gains) subject to special tax rates.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-137** The deferred tax liability and asset for those reversing taxable and deductible temporary differences in Years 4–6 are measured using the average graduated tax rate for the estimated amount of annual taxable income in future years. Thus, the average graduated tax rate will differ depending on the expected level of annual taxable income (including reversing temporary differences) in Years 4–6. The average tax rate will be:

- a. 15 percent if the estimated annual level of taxable income in Years 4–6 is \$500 or less
- b. 20 percent if the estimated annual level of taxable income in Years 4–6 is \$1,000
- c. 30 percent if the estimated annual level of taxable income in Years 4–6 is \$2,000.

**55-138** Temporary differences usually do not reverse in equal annual amounts as in the Example above, and a different average graduated tax rate might apply to reversals in different future years. However, a detailed analysis to determine the net reversals of temporary differences in each future year usually is not warranted. It is not warranted because the other variable (that is, taxable income or losses exclusive of reversing temporary differences in each of those future years) for determination of the average graduated tax rate in each future year is no more than an estimate. For that reason, an aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income in future years is sufficient. Judgment is permitted, however, to deal with unusual situations, for example, an abnormally large temporary difference that will reverse in a single future year, or an abnormal level of taxable income that is expected for a single future year. The lowest graduated tax rate should be used whenever the estimated average graduated tax rate otherwise would be zero. [FAS 109, paragraph 236]

**Example 17: Determining Whether a Tax Is an Income Tax**

**55-139** The guidance in paragraph 740-10-55-26 addressing when a tax is an income tax is illustrated using the following historical example.

**55-140** In August 1991, a state amended its franchise tax statute to include a tax on income apportioned to the state based on the federal tax return. The new tax was effective January 1, 1992. The amount of franchise tax on each corporation was set at the greater of 0.25 percent of the corporation's net taxable capital and 4.5 percent of the corporation's net taxable earned surplus. Net taxable earned surplus was a term defined by the tax statute for federal taxable income. [EITF 91-08, paragraph Issue]

**55-141** In this Example, the total computed tax is an income tax only to the extent that the tax exceeds the capital-based tax in a given year.

**55-142** A deferred tax liability is required to be recognized under this Subtopic for the amount by which the income-based tax payable on net reversing temporary differences in each future year exceeds the capital-based tax computed for each future year based on the level of capital that exists as of the end of the year for which deferred taxes are being computed.

**55-143** The portion of the current tax liability based on income is required to be accrued with a charge to income during the period in which the income is earned. The portion of the deferred tax liability related to temporary differences is required to be recognized as of the date of the statement of financial position for temporary differences that exist as of the date of the statement of financial position. [EITF 91-8, paragraph Discussion]

**55-144** Because the state tax is an income tax only to the extent that the tax exceeds the capital-based tax in a given year, under the requirements of this Subtopic, deferred taxes are recognized for temporary differences that will reverse in future years for which annual taxable income is expected to exceed 5.5% (.25% of net taxable capital/4.5% of taxable income) of expected net taxable capital. In measuring deferred taxes, see paragraph 740-10-55-138 to determine whether a detailed analysis of the net reversals of temporary differences in each future year is warranted. [EITF 91-08, paragraph Status] While the tax statutes of states differ, the accounting described above would be appropriate if the tax structure of another state was essentially the same as in this Example. [EITF 91-8, paragraph Discussion]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)*****Example 18: Special Deductions***

**55-145** Paragraph 740-10-55-27 introduces guidance relating to a special deduction for qualified production activities that may be available to an entity under the American Jobs Creation Act of 2004.

**55-146** This Example illustrates how an entity with a calendar year-end would apply paragraphs 740-10-25-37 and 740-10-35-4 to the qualified production activities deduction at December 31, 2004. In particular, this Example illustrates the methodology used to evaluate the qualified production activities deduction's effect on determining the need for a valuation allowance on an entity's existing net deferred tax assets. [FSP FAS 109-1, Appendix A] This Example intentionally is not comprehensive (for example, it excludes state and local taxes). [FSP FAS 109-1, Appendix A, footnote 2]

**55-147** This Example has the following assumptions:

- a. Expected taxable income (excluding the qualified production activities deduction and net operating loss carryforwards) for 2005: \$21,000
- b. Expected qualified production activities income for 2005: \$50,000
- c. Net operating loss carryforwards at December 31, 2004, which expire in 2005: \$20,000
- d. Expected W-2 wages for 2005: \$10,000
- e. Assumed statutory income tax rate: 35%
- f. Qualified production activities deduction: 3% of the lesser of qualified production activities income or taxable income (after deducting the net operating loss carryforwards); limited to 50% of W-2 wages: \$30.

**55-148** Based on these assumptions, the entity would not recognize a valuation allowance for the net operating loss carryforwards at December 31, 2004, because expected taxable income in 2005 (after deducting the qualified production activities deduction) exceeds the net operating loss carryforwards, as follows.

**Analysis to compute the qualified production activities deduction**

Expected taxable income (excluding the qualified production activities deduction and net operating loss carryforwards) for the year 2005	\$ 21,000
Less net operating loss carryforwards <sup>(a)</sup>	<u>20,000</u>
Expected taxable income (after deducting the net operating loss carryforwards)	<u>\$ 1,000</u>
Qualified production activities deduction	<u>\$ 30</u>

- <sup>(a)</sup> The Act requires that net operating loss carryforwards be deducted from the taxable income in determining the qualified production activities deduction. Therefore, the qualified production activities deduction will not result in a need for a valuation allowance for an entity's deferred tax asset for net operating loss carryforwards. However, certain types of tax credit carryforwards are not deducted in determining the qualified production activities deduction and, therefore, could require a valuation allowance.

**Analysis to determine the effect of the qualified production activities deduction on the need for a valuation allowance for deferred tax assets for the net operating loss carryforwards**

Expected taxable income after deducting the qualified production activities deduction	\$ 20,970
Net operating loss carryforwards	<u>20,000</u>
Expected taxable income exceeds the net operating loss carryforwards	<u>\$ 970</u>

[FSP FAS 109-1, paragraph Appendix A]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)*****Example 19: Recognizing Tax Benefits of Operating Loss***

**55-149** This Example illustrates the guidance in paragraphs 740-10-55-35 through 55-36 for recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years when a valuation allowance is necessary in the loss year. This Example has the following assumptions:

- a. The enacted tax rate is 40 percent for all years.
- b. An operating loss occurs in Year 5.
- c. The only difference between financial and taxable income results from use of accelerated depreciation for tax purposes. Differences that arise between the reported amount and the tax basis of depreciable assets in Years 1-7 will result in taxable amounts before the end of the loss carryforward period from Year 5.
- d. Financial income, taxable income, and taxes currently payable or refundable are as follows.

	<b>Year 1</b>	<b>Years 2-4</b>	<b>Year 5</b>	<b>Year 6</b>	<b>Year 7</b>
Pretax financial income (loss)	\$ 2,000	\$ 5,000	\$ (8,000)	\$ 2,200	\$ 7,000
Depreciation differences	(800)	(2,200)	(800)	(700)	(600)
Loss carryback	—	—	2,800	—	—
Loss carryforward	—	—	—	(6,000)	(4,500)
Taxable income (loss)	<u>\$ 1,200</u>	<u>\$ 2,800</u>	<u>\$ (6,000)</u>	<u>\$ (4,500)</u>	<u>\$ 1,900</u>
Taxes payable (refundable)	<u>\$ 480</u>	<u>\$ 1,120</u>	<u>\$ (1,120)</u>	<u>\$ —</u>	<u>\$ 760</u>

- e. At the end of Year 5, profits are not expected in Years 6 and 7 and later years, and it is concluded that a valuation allowance is necessary to the extent realization of the deferred tax asset for the operating loss carryforward depends on taxable income (exclusive of reversing temporary differences) in future years.

**55-150** The deferred tax liability for the taxable temporary differences is calculated at the end of each year as follows.

	<b>Year 1</b>	<b>Years 2-4</b>	<b>Year 5</b>	<b>Year 6</b>	<b>Year 7</b>
Unreversed differences:					
Beginning amount	\$ —	\$ 800	\$ 3,000	\$ 3,800	\$ 4,500
Additional amount	<u>800</u>	<u>2,200</u>	<u>800</u>	<u>700</u>	<u>600</u>
Total	<u>\$ 800</u>	<u>\$ 3,000</u>	<u>\$ 3,800</u>	<u>\$ 4,500</u>	<u>\$ 5,100</u>
Deferred tax liability (40 percent)	<u>\$ 320</u>	<u>\$ 1,200</u>	<u>\$ 1,520</u>	<u>\$ 1,180</u>	<u>\$ 2,040</u>

**55-151** The deferred tax asset and related valuation allowance for the loss carryforward are calculated at the end of each year as follows.

	<b>Year 1</b>	<b>Years 2-4</b>	<b>Year 5</b>	<b>Year 6</b>	<b>Year 7</b>
Loss carryforward for tax purposes	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 6,000</u>	<u>\$ 4,500</u>	<u>\$ —</u>
Deferred tax asset (40 percent)	\$ —	\$ —	\$ 2,400	\$ 1,800	\$ —
Valuation allowance equal to the amount by which the deferred tax asset exceeds the deferred tax liability	<u>—</u>	<u>—</u>	<u>(880)</u>	<u>—</u>	<u>—</u>
Net deferred tax asset	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 1,520</u>	<u>\$ 1,800</u>	<u>\$ —</u>

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-152** Total tax expense for each period is as follows.

	<b>Year 1</b>	<b>Years 2-4</b>	<b>Year 5</b>	<b>Year 6</b>	<b>Year 7</b>
Deferred tax expense (benefit):					
Increase in deferred tax liability	\$ 320	\$ 880	\$ 320	\$ 280	\$ 240
(A)crease in net deferred tax asset	—	—	(1,520)	(280)	1,800
	320	880	(1,200)	—	2,040
Currently payable (refundable)	480	1,120	(1,120)	—	760
Total tax expense (benefit)	<u>\$ 800</u>	<u>\$ 2,000</u>	<u>\$ (2,320)</u>	<u>\$ —</u>	<u>\$ 2,800</u>

**55-153** In Year 5, \$2,800 of the loss is carried back to reduce taxable income in Years 2-4, and \$1,120 of taxes paid for those years is refunded. In addition, a \$1,520 deferred tax liability is recognized for \$3,800 of taxable temporary differences, and a \$2,400 deferred tax asset is recognized for the \$6,000 loss carryforward. However, based on the conclusion described in paragraph 740-10-55-149(e), a valuation allowance is recognized for the amount by which that deferred tax asset exceeds the deferred tax liability.

**55-154** In Year 6, a portion of the deferred tax asset for the loss carryforward is realized because taxable income is earned in that year. The remaining balance of the deferred tax asset for the loss carryforward at the end of Year 6 equals the deferred tax liability for the taxable temporary differences. A valuation allowance is not needed.

**55-155** In Year 7, the remaining balance of the loss carryforward is realized, and \$760 of taxes are payable on net taxable income of \$1,900. A \$2,040 deferred tax liability is recognized for the \$5,100 of taxable temporary differences. [FAS 109, paragraph 242]

***Example 20: Interaction of Loss Carryforwards and Temporary Differences***

**55-156** This Example illustrates the guidance in paragraph 740-10-55-37 for the interaction of loss carryforwards and temporary differences that will result in net deductible amounts in future years. This Example has the following assumptions:

- The financial loss and the loss reported on the tax return for an entity's first year of operations are the same.
- In Year 2, a gain of \$2,500 from a transaction that is a sale for tax purposes but a sale and leaseback for financial reporting is the only difference between pretax financial income and taxable income.

**Pending Content (Transition Guidance: ASC 842-10-65-1)**

**55-156** This Example illustrates the guidance in paragraph 740-10-55-37 for the interaction of loss carryforwards and temporary differences that will result in net deductible amounts in future years. This Example has the following assumptions:

- The financial loss and the loss reported on the tax return for an entity's first year of operations are the same.
- In Year 2, a gain of \$2,500 from a transaction that is a sale for tax purposes but does not meet the sale recognition criteria for financial reporting purposes is the only difference between pretax financial income and taxable income. [FAS 109, paragraph 244]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-157** Financial and taxable income in this Example are as follows.

	<b>Financial Income</b>	<b>Taxable Income</b>
Year 1: Income (loss) from operations	<u>\$ (4,000)</u>	<u>\$ (4,000)</u>
Year 2: Income (loss) from operations	<u>\$   —</u>	<u>\$   —</u>
Taxable gain on sale		2,500
Taxable income before loss carryforward		2,500
Loss carryforward from Year 1		<u>(4,000)</u>
Taxable income		<u>\$   —</u>

**55-158** The \$4,000 operating loss carryforward at the end of Year 1 is reduced to \$1,500 at the end of Year 2 because \$2,500 of it is used to reduce taxable income. The \$2,500 reduction in the loss carryforward becomes \$2,500 of deductible temporary differences that will reverse and result in future tax deductions when lease payments are made. The entity has no deferred tax liability to be offset by those future tax deductions, the future tax deductions cannot be realized by loss carryback because no taxes have been paid, and the entity has had pretax losses for financial reporting since inception. Unless positive evidence exists that is sufficient to overcome the negative evidence associated with those losses, a valuation allowance is recognized at the end of Year 2 for the full amount of the deferred tax asset related to the \$2,500 of deductible temporary differences and the remaining \$1,500 of operating loss carryforward. [FAS 109, paragraph 244]

**Pending Content (Transition Guidance: ASC 842-10-65-1)**

**55-158** The \$4,000 operating loss carryforward at the end of Year 1 is reduced to \$1,500 at the end of Year 2 because \$2,500 of it is used to reduce taxable income. The \$2,500 reduction in the loss carryforward becomes \$2,500 of deductible temporary differences that will reverse and result in future tax deductions when the sale occurs (that is, control of the asset transfers to the buyer-lessor). The entity has no deferred tax liability to be offset by those future tax deductions, the future tax deductions cannot be realized by loss carryback because no taxes have been paid, and the entity has had pretax losses for financial reporting since inception. Unless positive evidence exists that is sufficient to overcome the negative evidence associated with those losses, a valuation allowance is recognized at the end of Year 2 for the full amount of the deferred tax asset related to the \$2,500 of deductible temporary differences and the remaining \$1,500 of operating loss carryforward. [FAS 109, paragraph 244]

***Example 21: Tax-Planning Strategy With Significant Implementation Cost***

**55-159** This Example illustrates the guidance in paragraph 740-10-55-44 for recognition of a deferred tax asset based on the expected effect of a qualifying tax-planning strategy when a significant expense would be incurred to implement the strategy. This Example has the following assumptions:

- A \$900 operating loss carryforward expires at the end of next year.
- Based on historical results and the weight of other available evidence, the estimated level of taxable income exclusive of the future reversal of existing temporary differences and the operating loss carryforward next year is \$100.
- Taxable temporary differences in the amount of \$1,200 ordinarily would result in taxable amounts of approximately \$400 in each of the next 3 years.
- There is a qualifying tax-planning strategy to accelerate the future reversal of all \$1,200 of taxable temporary differences to next year.
- Estimated legal and other expenses to implement that tax-planning strategy are \$150.
- The enacted tax rate is 40 percent for all years.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-160** Without the tax-planning strategy, only \$500 of the \$900 operating loss carryforward could be realized next year by offsetting \$100 of taxable income exclusive of reversing temporary differences and \$400 of reversing taxable temporary differences. The other \$400 of operating loss carryforward would expire unused at the end of next year. Therefore, the \$360 deferred tax asset (\$900 at 40 percent) would be offset by a \$160 valuation allowance (\$400 at 40 percent), and a \$200 net deferred tax asset would be recognized for the operating loss carryforward.

**55-161** With the tax-planning strategy, the \$900 operating loss carryforward could be applied against \$1,300 of taxable income next year (\$100 of taxable income exclusive of reversing temporary differences and \$1,200 of reversing taxable temporary differences). The \$360 deferred tax asset is reduced by a \$90 valuation allowance recognized for the net-of-tax expenses necessary to implement the tax-planning strategy. The amount of that valuation allowance is determined as follows.

Legal and other expenses to implement the tax-planning strategy	\$ 150
Future tax benefit of those legal and other expenses — \$150 at 40 percent	<u>60</u>
	<u><u>\$ 90</u></u>

**55-162** In summary, a \$480 deferred tax liability is recognized for the \$1,200 of taxable temporary differences, a \$360 deferred tax asset is recognized for the \$900 operating loss carryforward, and a \$90 valuation allowance is recognized for the net-of-tax expenses of implementing the tax-planning strategy. [FAS 109, paragraph 250]

***Example 22: Multiple Tax-Planning Strategies Available***

**55-163** This Example illustrates the guidance in paragraphs 740-10-55-39 through 55-48 relating to tax-planning strategies. An entity might identify several qualifying tax-planning strategies that would either reduce or eliminate the need for a valuation allowance for a deferred tax asset. For example, assume that an entity's required valuation allowance would be reduced \$5,000 based on Strategy A, \$7,000 based on Strategy B, and \$12,000 based on both strategies. The entity may not recognize the effect of one of those strategies in the current year and postpone recognition of the effect of the other strategy to a later year.

**55-164** The entity should recognize the effect of both tax-planning strategies and reduce the valuation allowance by \$12,000 at the end of the current year. Paragraph 740-10-30-19 provides guidance on tax-planning strategies and establishes the requirement that strategies meeting the criteria set forth in that paragraph shall be considered in determining the required valuation allowance. [QA 109, paragraph 26]

***Example 23: Effects of Subsidy on Temporary Difference***

**55-165** Paragraph 740-10-55-54 introduces guidance relating to a nontaxable subsidy that may be available to an entity under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. This Example illustrates that guidance.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-166** Before the accounting for the effects of the Act, an employer's carrying amount of accrued postretirement benefit cost (the amount recognized in the statement of financial position) is \$100 for a noncontributory, unfunded prescription drug benefit plan with only inactive participants who are not yet eligible to collect benefits. Assuming a tax rate of 35 percent and no corresponding tax basis for the accrued postretirement benefit cost, the employer would report a \$35 deferred tax asset related to that \$100 deductible temporary difference. Because the employer has a policy of amortizing gains and losses under paragraph 715-60-35-29, upon recognition of a \$28 actuarial gain resulting from the estimate of the expected subsidy, neither the carrying amount of accrued postretirement benefit cost nor the deferred tax asset would change. Subsequently, ignoring interest on the accumulated postretirement benefit obligation (which includes interest on the subsidy), as the actuarial gain related to the subsidy is amortized as a component of net periodic postretirement benefit cost, the carrying amount of accrued postretirement cost would be reduced. However, the associated temporary difference and deferred tax asset would remain unchanged. That is, after the gain related to the subsidy is amortized in its entirety, the carrying amount of accrued postretirement benefit cost would be \$72, and the deferred tax asset would remain at \$35.

**55-167** For purposes of simplicity, this Example ignores complexities regarding the amount and timing of the subsidies reflected in the carrying amount of accrued postretirement benefit cost arising from any of the following:

- Netting gains and losses and application of the corridor amortization approach described in paragraph 715-60-35-29
- Recognition of additional subsidies through amortization of prior service costs that include effects of the subsidy
- Reduction in future service and interest costs.

Those complexities must be considered in determining the temporary difference on which the deferred tax effects under this Topic will be based. [FSP FAS106-2, paragraph 19]

***Example 24: Built-In Gains of S Corporation***

**55-168** This Example illustrates an entity's change from taxable C corporation status to nontaxable S corporation status, in accordance with the guidance provided in paragraph 740-10-55-65. This Example has the following assumptions:

- An entity's S corporation election is effective for calendar-year 1990 and that at the conversion date its assets comprise marketable securities, finished goods inventory, and depreciable assets as follows.

	Fair Market Value	Tax Basis	Reported Amount	Temporary Differences	Topic 740 Built-In Gain (Loss)
Marketable securities	\$ 90	\$ 100	\$ 80	\$ (20)	\$ (10)
Inventory, (first-in first-out (FIFO))		50	100	50	50
	100				
Depreciable assets	95	80	90	10	10
	<u>\$ 285</u>	<u>\$ 230</u>	<u>\$ 270</u>	<u>\$ 40</u>	<u>\$ 50</u>

- The entity has no tax loss or credit carryforwards available to offset the built-in gains.
- The depreciable assets will be recovered by use in operations (and, therefore, will not result in a taxable amount pursuant to the tax law applied to built-in gains).
- The marketable securities will be sold in the same year that the inventory is sold, the \$50 built-in gain on the inventory is reduced by the \$10 built-in loss on the marketable securities, and \$40 would be taxed in the year that the inventory turns over and the securities are sold. Accordingly, the entity should continue to display in its statement of financial position a deferred tax liability for that \$40 net taxable amount.

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

**55-169** At subsequent financial statement dates until the end of the 10 years following the conversion date, the entity should remeasure the deferred tax liability for net built-in gains based on the provisions of the tax law. Deferred tax expense (or benefit) should be recognized for any change in that deferred tax liability. [QA 109, paragraph 12]

### **Example 25: Purchase Transactions That Are Not Accounted for as Business Combinations**

**55-170** Paragraph 740-10-25-51 addresses the accounting when an asset is acquired outside of a business combination and the tax basis of the asset differs from the amount paid. The following Cases illustrate the required accounting for purchase transactions that are not accounted for as business combinations in the following circumstances:

- a. The amount paid is less than the tax basis of the asset (Case A).
- b. The amount paid is more than the tax basis of the asset (Case B).
- c. The transaction results in a deferred credit (Case C).
- d. A deferred credit is created by a financial asset (Case D).
- e. [Subparagraph Not Used]
- f. The result is a purchase of future tax benefits (Case F).

#### Case A: Amount Paid Is Less than Tax Basis of Asset

**55-171** This Case illustrates an asset purchase that is not a business combination in which the amount paid differs from the tax basis of the asset (tax basis is greater).

**55-172** As an incentive for acquiring specific types of equipment in certain sectors, a foreign jurisdiction permits a deduction, for tax purposes, of an amount in excess of the cost of the acquired asset. To illustrate, assume that Entity A purchases a machine for \$100 and its tax basis is automatically increased to \$150. Upon sale of the asset, there is no recapture of the extra tax deduction. The tax rate is 35 percent.

**55-173** In accordance with paragraph 740-10-25-51, the amounts assigned to the equipment and the related deferred tax asset should be determined using the simultaneous equations method as follows (where FBB is Final Book Basis; CPP is Cash Purchase Price; and DTA is Deferred Tax Asset):

Equation A (determine the final book basis of the equipment):

$$FBB - [\text{Tax Rate} \times (FBB - \text{Tax Basis})] = CPP$$

Equation B (determine the amount assigned to the deferred tax asset):

$$(\text{Tax Basis} - FBB) \times \text{Tax Rate} = DTA.$$

**55-174** In this Case, the following variables are known:

- a. Tax Basis = \$150
- b. Tax Rate = 35 percent
- c. CPP = \$100.

**55-175** The unknown variables (FBB and DTA) are solved as follows:

$$\text{Equation A: } FBB = \$73$$

$$\text{Equation B: } DTA = \$27.$$

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-176** Accordingly, the entity would record the following journal entry.

Equipment	\$	73
Deferred tax asset		27
Cash	\$	100

[EITF 98-11, paragraph Exhibit 98-11A, Example 1]

**Case B: Amount Paid Is More Than Tax Basis of Asset**

**55-177** This Case illustrates an asset purchase that is not a business combination in which the amount paid differs from the tax basis of the asset (tax basis is less).

**55-178** Assume that an entity pays \$1,000,000 for the stock of an entity in a nontaxable acquisition (that is, carryover basis for tax purposes). The acquired entity's sole asset is a Federal Communications Commission (FCC) license that has a tax basis of zero. Since the acquisition of the entity is in substance the acquisition of an FCC license, no goodwill is recognized. A deferred tax liability would need to be recorded for the temporary difference (in this Case, the entire \$1,000,000 plus the tax-on-tax effect from increasing the carrying amount of the FCC license acquired) related to the FCC license. The tax rate is 35 percent.

**55-179** In accordance with paragraph 740-10-25-51, the amounts assigned to the FCC license and the related deferred tax liability should be determined using the simultaneous equations method as follows (where FBB is Final Book Basis; CPP is Cash Purchase Price; and DTL is Deferred Tax Liability):

Equation A (determine the FBB of the FCC license):

$$\text{FBB} - [\text{Tax Rate} \times (\text{FBB} - \text{Tax Basis})] = \text{CPP}$$

Equation B (determine the amount assigned to the DTL):

$$(\text{FBB} - \text{Tax Basis}) \times \text{Tax Rate} = \text{DTL}.$$

**55-180** In this Case, the following variables are known:

- Tax Basis = \$0
- Tax Rate = 35 percent
- CPP = \$1,000,000.

**55-181** The unknown variables (FBB and DTL) are solved as follows:

$$\text{Equation A: FBB} = \$1,538,462$$

$$\text{Equation B: DTL} = \$538,462.$$

**55-182** Accordingly, the entity would record the following journal entry.

FCC license	\$ 1,538,462
Deferred tax liability	\$ 538,462
Cash	1,000,000

[EITF 98-11, paragraph Exhibit 98-11A, Example 2]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

### Case C: Transaction Results In Deferred Credit

**55-183** This Case provides an illustration of a transaction that results in a deferred credit.

**55-184** Entity A buys a machine for \$50 with a tax basis of \$200. The tax rate is 35 percent.

**55-185** In accordance with paragraph 740-10-25-51, the amounts assigned to the machine and the deferred tax asset should be determined using the simultaneous equations method as follows (where FBB is Final Book Basis; CPP is Cash Purchase Price; and DTA is Deferred Tax Asset):

Equation A (determine the FBB of the machine):

$$\text{FBB} - [\text{Tax Rate} \times (\text{FBB} - \text{Tax Basis})] = \text{CPP}$$

Equation B (determine the amount assigned to the DTA):

$$(\text{Tax Basis} - \text{FBB}) \times \text{Tax Rate} = \text{DTA}.$$

**55-186** In this Case, the following variables are known:

- a. Tax Basis = \$200
- b. Tax Rate = 35 percent
- c. CPP = \$50.

**55-187** The unknown variables (FBB and DTA) are solved as follows:

Equation A: FBB = \$(31). However, because the FBB cannot be less than zero, the FBB is recorded at zero.

$$\text{Equation B: DTA} = \$70.$$

**55-188** The excess of the amount assigned to the deferred tax asset over the cash purchase price paid for the machine is recorded as a deferred credit. Accordingly, the entity would record the following journal entry.

Machine	\$	—
Deferred tax asset		70
Deferred credit	\$	20
Cash		50

[EITF 98-11, paragraph Exhibit 98-11A, Example 3]

### Case D: Deferred Credit Created by Financial Asset

**55-189** This Case provides an illustration of a deferred credit created by the acquisition of a financial asset.

**55-190** Entity A acquires the stock of another corporation for \$250. The principal asset of the corporation is a marketable equity security with a readily determinable fair value of \$200 and a tax basis of \$500. The tax rate is 35 percent. The acquired entity has no operations and so the acquisition is accounted for as an asset purchase and not as a business combination.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-191** In accordance with paragraph 740-10-25-51, the acquired financial asset should be recognized at fair value, and a deferred tax asset should be recorded at the amount required by this Subtopic. The excess of the fair value of the financial asset and the deferred tax asset recorded over the cash purchase price should be recorded as a deferred credit. Accordingly, the entity would record the following journal entry.

Marketable equity security	\$ 200
Deferred tax asset ( $300 \times .35$ )	105
Deferred credit	\$ 55
Cash	250

[EITF 98-11, paragraph Exhibit 98-11A, Example 4]

**Case E: Simultaneous Equations Method and Reduction in Preexisting Valuation Allowance**

**55-192** [Paragraph Not Used Not Used]

**55-193** [Paragraph Not Used Not Used]

**55-194** [Paragraph Not Used Not Used]

**55-195** [Paragraph Not Used Not Used]

**55-196** [Paragraph Not Used Not Used]

**55-197** [Paragraph Not Used Not Used]

**55-198** [Paragraph Not Used Not Used]

**Case F: Purchase of Future Tax Benefits**

**55-199** This Case provides an illustration of the purchase of future tax benefits.

**55-200** A foreign entity that has nominal assets other than its net operating loss carryforwards is acquired by a foreign subsidiary of a U.S. entity for the specific purpose of utilizing the net operating loss carryforwards (this type of transaction is often referred to as a tax loss acquisition). It is presumed that this transaction does not constitute a business combination, since the acquired entity has no operations and is merely a shell entity. As a result of the time value of money and because the target entity is in financial difficulty and has ceased operations, the foreign subsidiary is able to acquire the shell entity at a discount from the amount corresponding to the gross deferred tax asset for the net operating loss carryforwards. Assume, for example, that \$2,000,000 is paid for net operating loss carryforwards having a deferred tax benefit of \$5,000,000 for which it is more likely than not that the full benefit will be realized. The tax rate is 35 percent.

**55-201** In accordance with paragraph 740-10-25-51, the amount assigned to the deferred tax asset should be recorded at its gross amount (in accordance with this Subtopic) and the excess of the amount assigned to the deferred tax asset over the purchase price should be recorded as a deferred credit as follows.

Deferred tax asset	\$ 5,000,000
Deferred credit	\$ 3,000,000
Cash	2,000,000

[EITF 98-11, paragraph Exhibit 98-11A, Example 6]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

### Example 26: Direct Transaction With Governmental Taxing Authority

**55-202** Guidance is provided on various types of payments made to taxing authorities in paragraphs 740-10-55-67 through 55-75. This Example illustrates one possible payment situation.

**55-203** In this Example, tax laws in a foreign country enable corporate taxpayers to elect to step up the tax basis for certain fixed assets (\$1,000,000) to fair value (\$2,000,000) in exchange for a current payment to the government of 3 percent of the step-up (\$30,000). An entity would be expected to avail itself of this election (and make the upfront payment) as long as it believed that it was likely that it would be able to utilize the additional deductions (at a tax rate of 35 percent) that were created as a result of the step-up to reduce future taxable income and that the timing and amount of the resulting future tax savings justified the current payment. (For purposes of this Example, it is assumed that the transaction that accomplishes this step-up for tax purposes does not create a taxable temporary difference and is not an intra-entity transaction as discussed in paragraph 740-10-25-3(e). A taxable temporary difference would exist, for example, if the tax benefit associated with the transaction with the governmental taxing authority becomes taxable in certain situations, such as those described in paragraph 830-740-25-7).

### Pending Content (Transition Guidance: ASC 740-10-65-5)

**55-203** In this Example, tax laws in a foreign country enable corporate taxpayers to elect to step up the tax basis for certain fixed assets (\$1,000,000) to fair value (\$2,000,000) in exchange for a current payment to the government of 3 percent of the step-up (\$30,000). An entity would be expected to avail itself of this election (and make the upfront payment) as long as it believed that it was likely that it would be able to utilize the additional deductions (at a tax rate of 35 percent) that were created as a result of the step-up to reduce future taxable income and that the timing and amount of the resulting future tax savings justified the current payment. (For purposes of this Example, it is assumed that the transaction that accomplishes this step-up for tax purposes does not create a taxable temporary difference and is not an intra-entity transfer of inventory as discussed in paragraph 740-10-25-3(e). A taxable temporary difference would exist, for example, if the tax benefit associated with the transaction with the governmental taxing authority becomes taxable in certain situations, such as those described in paragraph 830-740-25-7). [EITF 98-11, paragraph Exhibit 98-11A, Example 7]

**55-204** In this Example, the tax effects of transactions directly with a taxing authority are recorded directly in income as follows.

Deferred tax asset	\$ 350,000
Deferred tax benefit	\$ 320,000
Cash	30,000

[EITF 98-11, paragraph Exhibit 98-11A, Example 7]

### Example 27: Accounting Change for Tax Purposes

**55-205** This Example illustrates the statement of financial position classification guidance in 740-10-55-77 for certain types of deferred income taxes but does not encompass all possible circumstances. [FAS 37, paragraph 16]

### Pending Content

**55-205 Editor's Note:** Paragraph 740-10-55-205 will be superseded upon transition, together with its heading:

### Example 27: Accounting Change for Tax Purposes

Paragraph superseded by Accounting Standards Update No. 2015-17.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)**

**55-206** An entity changes its method of handling bad debts for tax purposes from the cash method to the reserve method. Ten percent of the effect of the change at the beginning of calendar year 19X1 will be included as a deduction from taxable income each year for 10 years. The entity uses a one-year time period as the basis for classifying current assets and current liabilities on its statement of financial position. At December 31, 19X1, the amount of the effect of the change that is yet to be included as a deduction from taxable income and the balance of the related deferred income taxes are as follows.

Amount of the effect of the change that is yet to be included as a deduction from taxable income (9/10 of total effect of the change)	<u>\$ 5,125,000</u>
Deferred tax asset (40 percent is the enacted tax rate—no valuation allowance deemed necessary)	<u>\$ 2,050,000</u>

[FAS 37, paragraph 20]

**Pending Content (Transition Guidance: ASC 740-10-65-4)**

**55-206** Paragraph superseded by Accounting Standards Update No. 2015-17.

**55-207** The deferred tax asset does not relate to trade receivables or provisions for doubtful accounts because collection or write-off of the receivables will not cause the temporary differences to reverse; the temporary differences will reverse over time. Accordingly, the entity would classify the deferred tax asset based on the scheduled reversal of the related temporary differences. One-ninth of the remaining temporary differences are scheduled to reverse in 19X2, so one-ninth of the related deferred tax asset would be classified as current at December 31, 19X1 (\$227,778). [FAS 37, paragraph 21]

**Pending Content (Transition Guidance: ASC 740-10-65-4)**

**55-207** Paragraph superseded by Accounting Standards Update No. 2015-17.

***Example 28: Unremitted Earnings of Foreign Subsidiaries***

**55-208** This Example illustrates the statement of financial position classification guidance in Section 740-10-45 for certain types of deferred income taxes but does not encompass all possible circumstances.

**Pending Content (Transition Guidance: ASC 740-10-65-4)**

**55-208 Editor's Note:** Paragraph 740-10-55-208 will be superseded upon transition, together with its heading:

***Example 28: Unremitted Earnings of Foreign Subsidiaries***

Paragraph superseded by Accounting Standards Update No. 2015-17.

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

**55-209** An entity provides U.S. income taxes on the portion of its unremitted foreign earnings that are not considered to be permanently reinvested in its consolidated foreign subsidiary. The foreign earnings are included in U.S. taxable income in the year in which dividends are paid. The entity uses a one-year time period as the basis for classifying current assets and current liabilities on its statement of financial position. At December 31, 19X1, the accumulated amount of unremitted earnings on which taxes have been provided and the balance of the related deferred income taxes are as follows.

Accumulated unremitted earnings on which taxes have been provided:

Expected to be remitted within one year	\$ 9,800,000
Not expected to be remitted within one year	<u>2,700,000</u>
Total	<u><u>\$12,500,000</u></u>
Accumulated deferred tax liability related to unremitted earnings	<u><u>\$ 1,250,000</u></u>

[FAS 37, paragraph 23]

### Pending Content (Transition Guidance: ASC 740-10-65-4)

**55-209** Paragraph superseded by Accounting Standards Update No. 2015-17.

**55-210** The deferred tax liability does not relate to an asset or liability on the consolidated statement of financial position; the temporary difference will only reverse when the unremitted earnings are received from the foreign subsidiary by the parent. A payment between consolidated affiliates does not change the consolidated statement of financial position, so no item on the consolidated statement of financial position would be liquidated. Unremitted earnings expected to be remitted within the next year represent 78 percent of the total unremitted earnings for which tax has been provided (\$9,800,000/\$12,500,000). Therefore, 78 percent of the related deferred tax liability would be classified as current on the consolidated statement of financial position (\$975,000). [FAS 37, paragraph 24]

### Pending Content (Transition Guidance: ASC 740-10-65-4)

**55-210** Paragraph superseded by Accounting Standards Update No. 2015-17.

**55-211** If the subsidiary were accounted for on the equity method rather than consolidated (for example, a subsidiary reported on the equity method in separate parent entity financial statements), the deferred income taxes would relate to the recorded investment in the subsidiary. The payment of dividends that causes the reversal of the temporary difference would be accompanied by a reduction of the recorded investment in the subsidiary. Therefore, the deferred tax liability would be classified the same as the related investment in the subsidiary. [FAS 37, paragraph 25]

### Pending Content (Transition Guidance: ASC 740-10-65-4)

**55-211** Paragraph superseded by Accounting Standards Update No. 2015-17.

**ASC 740-10 — Implementation Guidance and Illustrations (continued)*****Example 29: Disclosure Related to Components of Income Taxes Attributable to Continuing Operations***

**55-212** Paragraph 740-10-55-79 provides guidance on satisfying the required disclosure of the significant components of income taxes and identifies three acceptable approaches illustrated in this Example:

- a. The gross method (Case A)
- b. The net method (Case B)
- c. The statutory tax rate reconciliation method (Case C).

**55-213** Cases A, B, and C share the following assumptions:

- a. An entity has \$1,588 of taxable income and \$100 of investment tax credits for the current year. The \$100 deferred tax asset for \$295 of operating loss carryforwards was fully reserved at the beginning of the current year.
- b. Pretax financial income from continuing operations is \$5,000.
- c. Income tax expense from continuing operations is \$1,500.
- d. Effective tax rate is 30%.
- e. Statutory tax rate is 34%.

**Case A: Gross Method**

**55-214** The first acceptable approach, illustrated as follows, to disclosure of components of income tax expense from continuing operations is referred to as the gross method.

	<b>Current</b>	<b>Deferred</b>
Tax expense before application of investment tax credits and operating loss carryforwards	\$ 540	\$ 1,160
Investment tax credits	(100)	—
Tax benefit of operating loss carryforwards	<u>(100)</u>	<u>—</u>
Tax expense from continuing operations	<u>\$ 340</u>	<u>\$ 1,160</u>

[QA 109, paragraph 18]

**Case B: Net Method**

**55-215** The second acceptable approach, illustrated as follows, to disclosure of components of income tax expense from continuing operations is referred to as the net method.

Current tax expense (net of \$100 investment tax credits and \$100 tax benefit of operating loss carryforwards)	\$ 340
Deferred tax expense	<u>1,160</u>
Tax expense from continuing operations	<u>\$ 1,500</u>

[QA 109, paragraph 18]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)****Case C: Statutory Tax Rate Reconciliation Method**

**55-216** The third acceptable approach, illustrated as follows, to disclosure of components of income tax expense from continuing operations is referred to as the statutory tax rate reconciliation method.

Current tax expense	\$ 340
Deferred tax expense	<u>1,160</u>
Tax expense from continuing operations	<u>\$ 1,500</u>

Tax expense at statutory rate	\$ 1,700
Benefit of investment tax credits	(100)
Benefit of operating loss carryforwards	<u>(100)</u>
Tax expense from continuing operations	<u>\$ 1,500</u>

[QA 109, paragraph 18]

**Example 30: Disclosure Relating to Uncertainty in Income Taxes**

**55-217** This Example illustrates the guidance in paragraph 740-10-50-15 for disclosures about uncertainty in income taxes.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 20X1. The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X2 through 20X4 in the first quarter of 20X7 that is anticipated to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant adjustments to the Company's transfer pricing and research credits tax positions. Management is currently evaluating those proposed adjustments to determine if it agrees, but if accepted, the Company does not anticipate the adjustments would result in a material change to its financial position. However, the Company anticipates that it is reasonably possible that an additional payment in the range of \$80 to \$100 million will be made by the end of 20X8. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows.

	<b>20X7</b>	<b>20X6</b>	<b>20X5</b>
	(in thousands)		
Balance at January 1	\$ 370,000	\$ 380,000	\$ 415,000
Additions based on tax positions related to the current year	10,000	5,000	10,000
Additions for tax positions of prior years	30,000	10,000	5,000
Reductions for tax positions of prior years	(60,000)	(20,000)	(30,000)
Settlements	<u>(40,000)</u>	<u>(5,000)</u>	<u>(20,000)</u>
Balance at December 31	<u>\$ 310,000</u>	<u>\$ 370,000</u>	<u>\$ 380,000</u>

At December 31, 20X7, 20X6, and 20X5, there are \$60, \$55, and \$40 million of unrecognized tax benefits that if recognized would affect the annual effective tax rate.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended December 31, 20X7, 20X6, and 20X5, the Company recognized approximately \$10, \$11, and \$12 million in interest and penalties. The Company had approximately \$60 and \$50 million for the payment of interest and penalties accrued at December 31, 20X7, and 20X6, respectively. [FIN 48, paragraph A33]

**ASC 740-10 — Implementation Guidance and Illustrations (continued)*****Example 31: Disclosure Relating to Realizability Estimates of Deferred Tax Asset***

**55-218** This Example illustrates the guidance in paragraph 275-10-50-8 for disclosure relating to the realizability estimates of a deferred tax asset.

**55-219** In this Example, Entity A develops, manufactures, and markets limited-use vaccines. The entity has a dominant share of the narrow market it serves. As of December 31, 19X4, the entity has no temporary differences and has aggregate loss carryforwards of \$12 million that originated in prior years and that expire in varying amounts between 19X5 and 19X7. As of December 31, 19X4, the entity has a deferred tax asset of \$4.8 million that represents the benefit of the remaining \$12 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 incurred high levels of research and development expenses prior to commencing sales. While the entity has earned, on average, \$6 million income before tax (taxable income before carryforwards) in each of the last 5 years, future profitability in this competitive industry depends on continually developing new products. The entity has a number of promising new vaccines under development, but it is aware that other entities recently began testing vaccines that would compete with the vaccines being developed by the entity as well as products that will compete with the vaccines that are currently generating the entity's profits. Rapid introduction of competing products or failure of the entity's development efforts could reduce estimates of future profitability in the near term, which could affect the entity's ability to fully utilize its loss carryforward. [SOP 94-6, paragraph 27 A43]

**55-220** Illustrative disclosure for the entity follows.

The entity has recorded a deferred tax asset of \$4.8 million reflecting the benefit of \$12 million in loss carryforwards, which expire in varying amounts between 19X5 and 19X7. Realization 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 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. [SOP 94-6, paragraph 27 A44]

**55-221** In addition to other disclosures, information as to the amount of loss carryforwards and their expiration dates and the amount of any valuation allowance with respect to the recorded deferred tax asset is required under This Subtopic. [SOP 94-6, paragraph 27 A44, footnote 22]

**55-222** The disclosure in this Example informs users that:

- a. Realization of the deferred tax asset depends on achieving a certain minimum level of future taxable income within the next three years.
- b. Although management currently believes that achievement of the required future taxable income is more likely than not, it is at least reasonably possible that this belief could change in the near term, resulting in establishment of a valuation allowance. [SOP 94-6, paragraph 27 A45]

***Example 32: Definition of a Tax Position***

**55-223** Entity A has sales in Jurisdiction S but no physical presence. Management has reviewed the nexus rules for filing a return in Jurisdiction S and must determine whether filing a tax return in Jurisdiction S is required. In evaluating the tax position to file a tax return, management should consider all relevant sources of tax law. The evaluation of nexus has to be made for all jurisdictions where Entity A 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 this Subtopic. [ASU 2009-06, paragraph 6]

## ASC 740-10 — Implementation Guidance and Illustrations (continued)

### ***Example 33: Definition of a Tax Position***

**55-224** Entity S converted to an S Corporation from a C Corporation effective January 1, 20X0. In 20X7, Entity S disposed of assets subject to built-in gains and reported a tax liability on its 20X7 tax returns. Tax positions to consider related to the built-in gains tax include, but are not limited to:

- a. Whether other assets were sold subject to the built-in gains tax
- b. Whether the income associated with the calculation of the taxable amount of the built-in gains is correct
- c. Whether the basis associated with the built-in gains calculation is correct.

It should be noted that whether or not Entity S is subject to the built-in gains tax also is a tax position subject to the provisions of this Subtopic. [ASU 2009-06, paragraph 6]

### ***Example 34: Definition of a Tax Position***

**55-225** Entity N, a tax-exempt not-for-profit entity, enters into transactions that may be subject to income tax on unrelated business income. Tax positions to consider include but are not limited to:

- a. Entity N's characterization of its activities as related or unrelated to its exempt purpose
- b. Entity N's allocation of revenue between activities that relate to its exempt purpose and those that are allocated to unrelated business income
- c. The allocation of Entity N's expenses between activities that relate to its exempt purpose and those that are allocated to unrelated business activities.

Even if Entity N were not subject to income taxes on unrelated business income, it still has a tax position of whether it qualifies as a tax-exempt not-for-profit entity. [ASU 2009-06, paragraph 6]

### ***Example 35: Attribution of Income Taxes to the Entity or Its Owners***

**55-226** Entity A, a partnership with two partners—Partner 1 and Partner 2—has nexus in Jurisdiction J. Jurisdiction J assesses an income tax on Entity A and allows Partners 1 and 2 to file a tax return and use their pro rata share of Entity A's income tax payment as a credit (that is, payment against the tax liability of the owners). Because the owners may file a tax return and utilize Entity A's payment as a payment against their personal income tax, the income tax would be attributed to the owners by Jurisdiction J's laws whether or not the owners file an income tax return. Because the income tax has been attributed to the owners, payments to Jurisdiction J for income taxes should be treated as a transaction with the owners. The result would not change even if there were an agreement between Entity A and its two partners requiring Entity A to reimburse Partners 1 and 2 for any taxes the partners may owe to Jurisdiction J. This is because attribution is based on the laws and regulations of the taxing authority rather than on obligations imposed by agreements between an entity and its owners. [ASU 2009-06, paragraph 6]

### ***Example 36: Attribution of Income Taxes to the Entity or Its Owners***

**55-227** If the fact pattern in paragraph 740-10-55-226 changed such that Jurisdiction J has no provision for the owners to file tax returns and the laws and regulations of Jurisdiction J do not indicate that the payments are made on behalf of Partners 1 and 2, income taxes are attributed to Entity A on the basis of Jurisdiction J's laws and are accounted for based on the guidance in this Subtopic. [ASU 2009-06, paragraph 6]

### ***Example 37: Attribution of Income Taxes to the Entity or Its Owners***

**55-228** Entity S, an S Corporation, files a tax return in Jurisdiction J. An analysis of the laws and regulations of Jurisdiction J indicates that Jurisdiction J can hold Entity S and its owners jointly and severally liable for payment of income taxes. The laws and regulations also indicate that if payment is made by Entity S, the payments are made on behalf of the owners. Because the laws and regulations attribute the income tax to the owners regardless of who pays the tax, any payments to Jurisdiction J for income taxes should be treated as a transaction with its owners. [ASU 2009-06, paragraph 6]

**ASC 740-20 — Implementation Guidance and Illustrations*****Example 38: Financial Statements of a Group of Related Entities***

**55-229** Entity A, a partnership with 2 partners, owns a 100 percent interest in Entity B and is required to issue consolidated financial statements. Entity B is a taxable entity that has unrecognized tax positions and a related liability for unrecognized tax benefits. Because entities within a consolidated or combined group should consider the tax positions of all entities within the group regardless of the tax status of the reporting entity, Entity A should include in its financial statements the assets, liabilities, income, and expenses of both Entity A and Entity B, including those relating to the implementation of this Subtopic to Entity B. This is required even though Entity A is a pass-through entity. [ASU 2009-06, paragraph 6]

**General*****Example 1: Allocation to Continuing Operations***

**55-1** Paragraph 740-20-45-8 states that the amount of income tax expense or benefit allocated to continuing operations is the tax effect of pretax income or loss from continuing operations that occurred during the year plus or minus certain adjustments. [QA 109, paragraph 19]

**55-2** The adjustments include the tax effects of:

- a. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years
- b. Changes in tax laws or rates
- c. Changes in tax status
- d. Tax-deductible dividends paid to shareholders (except as set forth in paragraph 740-20-45-11 for dividends paid on unallocated shares held by an employee stock ownership plan or any other stock compensation arrangement). [QA 109, paragraph 19 footnote 7]

**Pending Content (Transition Guidance: ASC 718-10-65-4)**

**55-2** The adjustments include the tax effects of:

- a. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years
- b. Changes in tax laws or rates
- c. Changes in tax status
- d. Tax-deductible dividends paid to shareholders. [QA 109, paragraph 19, footnote 7]

**55-3** The allocation of income tax expense between pretax income from continuing operations and other items shall include deferred taxes.

**ASC 740-20 — Implementation Guidance and Illustrations (continued)**

**55-4** This Example illustrates allocation of current and deferred tax expense. The assumptions are as follows:

- Tax rates are 40 percent for Years 1, 2, and 3 and 30 percent for Year 4 and subsequent years. No valuation allowances are required for deferred tax assets.
- At the end of Year 1, there is a \$500 taxable temporary difference relating to the entity's contracting operations and a \$200 deductible temporary difference related to its other operations. Determination of the entity's deferred tax assets and liabilities at the end of Year 1 is as follows.

<b>Temporary Differences</b>	<b>Future Years</b>			<b>Total</b>
	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	
Contracting operations	\$ —	\$ —	\$ 500	\$ 500
Other operations	(100)	(100)	—	(200)
	<u>\$ (100)</u>	<u>\$ (100)</u>	<u>\$ 500</u>	<u>\$ 300</u>
Enacted tax rate for future years	40%	40%	30%	
Deferred tax liability (asset)	<u>\$ (40)</u>	<u>\$ (40)</u>	<u>\$ 150</u>	<u>\$ 70</u>

- During Year 2, the entity decides that it will sell its contracting operations in Year 3. As a result, all temporary differences related to the contracting operations (the \$500 taxable temporary difference that existed at the end of Year 1, plus an additional \$200 taxable temporary difference that arose during Year 2) are now considered to result in taxable amounts in Year 3 because the contracting operations will be sold in Year 3.
- At the end of Year 2, the entity also has \$300 of deductible temporary differences (\$100 of the temporary difference that existed at the end of Year 1, plus an additional \$200 that arose during Year 2) from continuing operations.
- For Year 2, the entity has \$50 of pretax reported income from continuing operations and \$200 of pretax reported income from discontinued operations.
- Determination of the entity's deferred tax asset and liability at the end of Year 2 is as follows.

<b>Temporary Differences</b>	<b>Future Years</b>			<b>Total</b>
	<b>Year 3</b>	<b>Year 4</b>		
Discontinued operations	\$ 700	\$ —		\$ 700
Continuing operations	(200)	(100)		(300)
	<u>\$ 500</u>	<u>\$ (100)</u>		<u>\$ 400</u>
Enacted tax rate for future years	40%	30%		
Deferred tax liability (asset) — net	<u>\$ 200</u>	<u>\$ (30)</u>		<u>\$ 170</u>

**55-5** Total deferred tax expense for Year 2 is \$100 (\$170 – \$70). The deferred tax benefit of the deductible temporary differences related to the entity's continuing operations during Year 2 is determined as follows.

Deferred tax asset related to the entity's continuing operations at the end of Year 2 (40 percent of \$200 and 30 percent of \$100)	\$ (110)
Deferred tax asset related to the entity's continuing operations at the beginning of Year 2 (40 percent of \$200)	(80)
Deferred tax benefit for Year 2	\$ (30)

**ASC 740-20 — Implementation Guidance and Illustrations (continued)**

**55-6** The deferred tax expense for taxable temporary differences related to the entity's discontinued operations during Year 2 is determined as follows.

Deferred tax liability at the end of Year 2 (40 percent of \$700)	\$ 280
Deferred tax liability at the end of Year 1 (30 percent of \$500)	(150)
Deferred tax expense for Year 2	\$ 130

**55-7** Total tax expense and tax expense allocated to continuing and discontinued operations for Year 2 are determined as follows.

	<b>Discontinued Operations</b>	<b>Continuing Operations</b>	<b>Total</b>
Pretax reported income	\$ 200	\$ 50	\$ 250
Originating and reversing temporary differences, net	(200)	100	(100)
Taxable income	<u><u>\$ —</u></u>	<u><u>\$ 150</u></u>	<u><u>\$ 150</u></u>
Current tax expense (40 percent)	\$ —	\$ 60	\$ 60
Deferred tax expense (benefit) as determined above	130	(30)	100
Income tax expense	<u><u>\$ 130</u></u>	<u><u>\$ 30</u></u>	<u><u>\$ 160</u></u>

[QA 109, paragraph 19]

**Example 2: Allocations of Income Taxes to Continuing Operations and One Other Item**

**55-8** If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations is allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. [FAS 109, paragraph 273]

**55-9** The following Cases both present allocations of income tax to continuing operations when there is only one item other than income from continuing operations:

- Loss from continuing operations with an extraordinary gain (Case A)
- Income from continuing operations with a loss from discontinued operations (Case B).

**Case A: Loss from Continuing Operations With a Gain on Discontinued Operations**

**55-10** This Case illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are as follows:

- The entity's pretax financial income and taxable income are the same.
- The entity's ordinary loss from continuing operations is \$500.
- The entity also has a gain on discontinued operations of \$900 that is a capital gain for tax purposes.
- The tax rate is 40 percent on ordinary income and 30 percent on capital gains. Income taxes currently payable are \$120 (\$400 at 30 percent). [FAS 109, paragraph 274]

**55-11** Income tax expense is allocated between the pretax loss from operations and the gain on discontinued operations as follows.

Total income tax expense	\$ 120
Tax benefit allocated to the loss from operations	(150)
Incremental tax expense allocated to the extraordinary gain	<u><u>\$ 270</u></u>

**ASC 740-20 — Implementation Guidance and Illustrations (continued)**

**55-12** The effect of the \$500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at a 30 percent tax rate. Thus, \$150 (\$500 at 30 percent) of tax benefit is allocated to continuing operations. The \$270 incremental effect of the gain on discontinued operations is the difference between \$120 of total tax expense and the \$150 tax benefit from continuing operations. [FAS 109, paragraph 274]

**Case B: Income From Continuing Operations With a Loss From Discontinued Operations**

**55-13** This Case further illustrates the general requirement to determine the tax effects of pretax income from continuing operations by a computation that does not consider the tax effects of items that are not included in continuing operations.

**55-14** To illustrate, assume that in the current year an entity has \$1,000 of income from continuing operations and a \$1,000 loss from discontinued operations. At the beginning of the year, the entity has a \$2,000 net operating loss carryforward for which the deferred tax asset, net of its valuation allowance, is zero, and the entity did not reduce that valuation allowance during the year. No tax expense should be allocated to income from continuing operations because the \$2,000 loss carryforward is sufficient to offset that income. Thus, no tax benefit is allocated to the loss from discontinued operations. [EITF D-32] See paragraph 740-20-45-7 for the exception to the general requirement when an entity has a loss from continuing operations.

***Example 3: Allocation of the Benefit of a Tax Credit Carryforward***

**55-15** This Example illustrates the guidance in paragraphs 740-20-45-7 through 45-8 for allocation of the tax benefit of a tax credit carryforward that is recognized as a deferred tax asset in the current year. The assumptions are as follows:

- The entity's pretax financial income and taxable income are the same.
- Pretax financial income for the year comprises \$300 from continuing operations and \$400 from a gain on discontinued operations.
- The tax rate is 40 percent. Taxes payable for the year are zero because \$330 of tax credits that arose in the current year more than offset the \$280 of tax otherwise payable on \$700 of taxable income.
- A \$50 deferred tax asset is recognized for the \$50 (\$330 - \$280) tax credit carryforward. Based on the weight of available evidence, management concludes that no valuation allowance is necessary. [FAS 109, paragraph 275]

**55-16** Income tax expense or benefit is allocated between pretax income from continuing operations and the extraordinary gain as follows. [FAS 109, paragraph 275]

Total income tax benefit	\$ (50)
Tax expense (benefit) allocated to income from continuing operations:	
Tax (before tax credits) on \$300 of taxable income at 40 percent	\$ 120
Tax credits	<u>(330)</u> <u>(210)</u>
Tax expense allocated to the extraordinary gain	<u>\$ 160</u>

**55-17** Absent the gain on discontinued operations and assuming it was not the deciding factor in reaching a conclusion that a valuation allowance is not needed, the entire tax benefit of the \$330 of tax credits would be allocated to continuing operations. The presence of the gain on discontinued operations does not change that allocation. [FAS 109, paragraph 275]

**ASC 740-20 — Implementation Guidance and Illustrations (continued)*****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>1,000</u>	FC1 = \$1.20	<u>\$ 1,200</u>
Earnings for the year	<u>600</u>	FC1 = \$1.10	<u>660</u>
Unremitted earnings, end of year	<u>1,600</u>	FC1 = \$1.00	<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 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
Transaction adjustment and related taxes	<u>(260)</u>	<u>(52)</u>
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. [FAS 109, paragraph 276]

**General**

**55-1** This Section, which is an integral part of the requirements of this Subtopic, provides Examples of applying the required accounting for interim period income taxes to some specific situations. In general, the Examples illustrate matters unique to accounting for income taxes at interim dates. The Examples do not include consideration of the nature of tax credits and events that do not have tax consequences or illustrate all possible combinations of circumstances. [FIN 18, paragraph 41]

## ASC 740-270 — Implementation Guidance and Illustrations

### ***Example 1: Accounting for Income Taxes Applicable to Ordinary Income (or Loss) at an Interim Date if Ordinary Income Is Anticipated for the Fiscal Year***

**55-2** The following Cases illustrate the guidance in Sections 740-270-30 and 740-270-35 for accounting for income taxes applicable to ordinary income (or loss) at an interim date if ordinary income is anticipated for the fiscal year:

- Ordinary income in all interim periods (Case A)
- Ordinary income and losses in interim periods (Case B)
- Changes in estimates (Case C).

**55-3** Cases A and B share all of the following assumptions:

- For the full fiscal year, an entity anticipates ordinary income of \$100,000. All income is taxable in one jurisdiction at a 50 percent rate. Anticipated tax credits for the fiscal year total \$10,000. No events that do not have tax consequences are anticipated. No changes in estimated ordinary income, tax rates, or tax credits occur during the year.
- Computation of the estimated annual effective tax rate applicable to ordinary income is as follows.

Tax at statutory rate (\$100,000 at 50%)	\$ 50,000
Less anticipated tax credits	<u>(10,000)</u>
Net tax to be provided	<u>\$ 40,000</u>
Estimated annual effective tax rate (\$40,000 ÷ \$100,000)	<u>40%</u>

- Tax credits are generally subject to limitations, usually based on the amount of tax payable before the credits. In computing the estimated annual effective tax rate, anticipated tax credits are limited to the amounts that are expected to be realized or are expected to be recognizable at the end of the current year in accordance with the provisions of Subtopic 740-10. If an entity is unable to estimate the amount of its tax credits for the year, see paragraphs 740-270-30-17 through 30-18. [FIN 18, paragraph 43]

#### Case A: Ordinary Income in All Interim Periods

**55-4** The entity has ordinary income in all interim periods. Quarterly tax computations are as follows.

<b>Reporting Period</b>	<b>Ordinary Income</b>			<b>Tax</b>		
	<b>Reporting Period</b>	<b>Year-to-Date</b>	<b>Estimated Annual Effective Tax Rate</b>	<b>Year-to-Date</b>	<b>Less Previously Provided</b>	<b>Reporting Period</b>
First quarter	\$ 20,000	\$ 20,000	40%	\$ 8,000	\$ —	\$ 8,000
Second quarter	20,000	40,000	40%	16,000	8,000	8,000
Third quarter	20,000	60,000	40%	24,000	16,000	8,000
Fourth quarter	<u>40,000</u>	100,000	40%	40,000	24,000	<u>16,000</u>
Fiscal year	<u>\$100,000</u>					<u>\$ 40,000</u>

[FIN 18, paragraph 44]

#### Case B: Ordinary Income and Losses in Interim Periods

**55-5** The following Cases illustrate ordinary income and losses in interim periods:

- Year-to-date ordinary income (Case B1)
- Year-to-date ordinary losses, realization more likely than not (Case B2)
- Year-to-date ordinary losses, realization not more likely than not (Case B3).

**ASC 740-270 — Implementation Guidance and Illustrations (continued)***Case B1: Year-to-Date Ordinary Income*

**55-6** The entity has ordinary income and losses in interim periods; there is not an ordinary loss for the fiscal year to date at the end of any interim period. Quarterly tax computations are as follows.

Reporting Period	Ordinary Income (Loss)			Tax (or Benefit)		
	Reporting Period	Year-to-Date	Estimated Annual Effective Tax Rate	Year-to-Date	Less Previously Provided	Reporting Period
First quarter	\$ 40,000	\$ 40,000	40%	\$ 16,000	\$ —	\$ 16,000
Second quarter	40,000	80,000	40%	32,000	16,000	16,000
Third quarter	(20,000)	60,000	40%	24,000	32,000	(8,000)
Fourth quarter	<u>40,000</u>	100,000	40%	40,000	24,000	<u>16,000</u>
Fiscal year	<u>\$100,000</u>					<u>\$ 40,000</u>

[FIN 18, paragraph 45]

*Case B2: Year-to-Date Ordinary Losses, Realization More Likely Than Not*

**55-7** The entity has ordinary income and losses in interim periods, and there is an ordinary loss for the year to date at the end of an interim period. Established seasonal patterns provide evidence that realization in the current year of the tax benefit of the year-to-date loss and of anticipated tax credits is more likely than not. Quarterly tax computations are as follows.

Reporting Period	Ordinary Income (Loss)			Tax (or Benefit)		
	Reporting Period	Year-to-Date	Estimated Annual Effective Tax Rate	Year-to-Date	Less Previously Provided	Reporting Period
First quarter	\$ (20,000)	\$ (20,000)	40%	\$ (8,000)	\$ —	\$ (8,000)
Second quarter	10,000	(10,000)	40%	(4,000)	(8,000)	4,000
Third quarter	15,000	5,000	40%	2,000	(4,000)	6,000
Fourth quarter	<u>95,000</u>	100,000	40%	40,000	2,000	<u>38,000</u>
Fiscal year	<u>\$100,000</u>					<u>\$ 40,000</u>

[FIN 18, paragraph 46]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)****Case B3: Year-to-Date Ordinary Losses, Realization Not More Likely Than Not**

**55-8** The entity has ordinary income and losses in interim periods, and there is a year-to-date ordinary loss during the year. There is no established seasonal pattern and it is more likely than not that the tax benefit of the year-to-date loss and the anticipated tax credits will not be realized in the current or future years. Quarterly tax computations are as follows.

<b>Reporting Period</b>	<b>Reporting Period</b>	<b>Ordinary Income (Loss)</b>		<b>Estimated Annual Effective Tax Rate</b>	<b>Tax (or Benefit)</b>		
		<b>Year-to-Date</b>	<b>Year-to-Date</b>		<b>Less Previously Provided</b>	<b>Reporting Period</b>	
First quarter	\$ (20,000)	\$ (20,000)	— <sup>(a)</sup>	\$ —	\$ —	\$ —	\$ —
Second quarter	10,000	(10,000)	— <sup>(a)</sup>	—	—	—	—
Third quarter	15,000	5,000	40%	2,000	—	2,000	2,000
Fourth quarter	<u>95,000</u>	100,000	40%	40,000	2,000	<u>38,000</u>	
Fiscal year		<u>\$100,000</u>					<u>\$ 40,000</u>

<sup>(a)</sup> No benefit is recognized because the tax benefit of the year-to-date loss is not expected to be realized during the current year or recognizable as a deferred tax asset at the end of the current year in accordance with the provisions of Subtopic 740-10.

[FIN 18, paragraph 47]

**Case C: Changes in Estimates**

**55-9** During the fiscal year, all of an entity's operations are taxable in one jurisdiction at a 50 percent rate. No events that do not have tax consequences are anticipated. Estimates of ordinary income for the year and of anticipated credits at the end of each interim period are as shown below. Changes in the estimated annual effective tax rate result from changes in the ratio of anticipated tax credits to tax computed at the statutory rate. Changes consist of an unanticipated strike that reduced income in the second quarter, an increase in the capital budget resulting in an increase in anticipated investment tax credit in the third quarter, and better than anticipated sales and income in the fourth quarter. The entity has ordinary income in all interim periods. Computations of the estimated annual effective tax rate based on the estimate made at the end of each quarter are as follows.

	<b>Estimated, End of</b>		
	<b>First Quarter</b>	<b>Second Quarter</b>	<b>Third Quarter</b>
Estimated ordinary income for the fiscal year	<u>\$100,000</u>	<u>\$ 80,000</u>	<u>\$ 80,000</u>
Tax at 50% statutory rate	\$ 50,000	\$ 40,000	\$ 40,000
Less anticipated credits	<u>(5,000)</u>	<u>(5,000)</u>	<u>(10,000)</u>
Net tax to be provided	<u>\$ 45,000</u>	<u>\$ 35,000</u>	<u>\$ 30,000</u>
Estimated annual effective tax rate	<u>45%</u>	<u>43.75%</u>	<u>37.5%</u>
			<u>40%</u>

**ASC 740-270 — Implementation Guidance and Illustrations (continued)**

**55-10** Quarterly tax computations are as follows.

<b>Reporting Period</b>	<b>Ordinary Income (Loss)</b>		<b>Estimated Annual Effective Tax Rate</b>	<b>Tax</b>		
	<b>Reporting Period</b>	<b>Year-to-Date</b>		<b>Year-to-Date</b>	<b>Less Previously Provided</b>	<b>Reporting Period</b>
First quarter	\$ 25,000	\$ 25,000	45%	\$ 11,250	\$ —	\$ 11,250
Second quarter	5,000	30,000		13,125	11,250	1,875
Third quarter	25,000	55,000	37.5%	20,625	13,125	7,500
Fourth quarter	<u>45,000</u>	100,000	40%	40,000	20,625	<u>19,375</u>
Fiscal year	<u><u>\$100,000</u></u>					<u><u>\$ 40,000</u></u>

[FIN 18, paragraph 48]

**Example 2: Accounting for Income Taxes Applicable to Ordinary Income (or Loss) at an Interim Date If an Ordinary Loss Is Anticipated for the Fiscal Year**

**55-11** The following Cases illustrate the guidance in Section 740-270-30 for accounting for income taxes applicable to ordinary income (or loss) at an interim date if an ordinary loss is anticipated for the fiscal year:

- Realization of the tax benefit of the loss is more likely than not (Case A)
- Realization of the tax benefit of the loss is not more likely than not (Case B)
- Partial realization of the tax benefit of the loss is more likely than not (Case C)
- Reversal of net deferred tax credits (Case D).

**55-12** Cases A, B, and C share the following assumptions.

- For the full fiscal year, an entity anticipates an ordinary loss of \$100,000. The entity operates entirely in one jurisdiction where the tax rate is 50 percent. Anticipated tax credits for the fiscal year total \$10,000. No events that do not have tax consequences are anticipated.
- If there is a recognizable tax benefit for the loss and the tax credits pursuant to the requirements of Subtopic 740-10, computation of the estimated annual effective tax rate applicable to the ordinary loss would be as follows.

Tax benefit at statutory rate (\$100,000 at 50%)	\$ (50,000)
Tax credits	<u>(10,000)</u>
Net tax benefit	<u><u>\$ (60,000)</u></u>
Estimated annual effective tax rate (\$60,000 ÷ \$100,000)	<u><u>60%</u></u>

[FIN 18, paragraph 49]

**55-13** Cases A, B, and C state varying assumptions with respect to assurance of realization of the components of the net tax benefit. When the realization of a component of the benefit is not expected to be realized during the current year or recognizable as a deferred tax asset at the end of the current year in accordance with the provisions of Subtopic 740-10, that component is not included in the computation of the estimated annual effective tax rate. [FIN 18, paragraph 49]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)****Case A: Realization of the Tax Benefit of the Loss Is More Likely Than Not**

**55-14** The following Cases illustrate when realization of the tax benefit of the loss is more likely than not:

- a. Ordinary losses in all interim periods (Case A1)
- b. Ordinary income and losses in interim periods (Case A2).

*Case A1: Ordinary Losses in All Interim Periods*

**55-15** The entity has ordinary losses in all interim periods. The full tax benefit of the anticipated ordinary loss and the anticipated tax credits will be realized by carryback. Quarterly tax computations are as follows.

<b>Reporting Period</b>	<b>Ordinary Loss</b>			<b>Tax Benefit</b>		
	<b>Reporting Period</b>	<b>Year-to-Date</b>	<b>Estimated Annual Effective Tax Rate</b>	<b>Year-to-Date</b>	<b>Less Previously Provided</b>	<b>Reporting Period</b>
First quarter	\$ (20,000)	\$ (20,000)	60%	\$ (12,000)	\$ —	\$ (12,000)
Second quarter	(20,000)	(40,000)	60%	(24,000)	(12,000)	(12,000)
Third quarter	(20,000)	(60,000)	60%	(36,000)	(24,000)	(12,000)
Fourth quarter	<u>(40,000)</u>	(100,000)	60%	(60,000)	(36,000)	<u>(24,000)</u>
Fiscal year	<u><u>\$ (100,000)</u></u>					<u><u>\$ (60,000)</u></u>

[FIN 18, paragraph 50]

*Case A2: Ordinary Income and Losses in Interim Periods*

**55-16** The entity has ordinary income and losses in interim periods and for the year to date. The full tax benefit of the anticipated ordinary loss and the anticipated tax credits will be realized by carryback. The full tax benefit of the maximum year-to-date ordinary loss can also be realized by carryback. Quarterly tax computations are as follows.

<b>Reporting Period</b>	<b>Ordinary Income (Loss)</b>			<b>Tax (or Benefit)</b>			
	<b>Reporting Period</b>	<b>Year-to-Date</b>	<b>Estimated Annual Effective Tax Rate</b>	<b>Year-to-Date</b>			
			<b>Computed</b>	<b>Limited to</b>	<b>Less Previously Provided</b>	<b>Reporting Period</b>	
First quarter	\$ 20,000	\$ 20,000	60%	\$ 12,000	\$ —	\$ 12,000	
Second quarter	(80,000)	(60,000)	60%	(36,000)	12,000	(48,000)	
Third quarter	(80,000)	(140,000)	60%	(84,000)	\$ (80,000) <sup>(a)</sup>	(36,000)	
Fourth quarter	<u>40,000</u>	(100,000)	60%	(60,000)	(80,000)	<u>20,000</u>	
Fiscal year	<u><u>\$ (100,000)</u></u>					<u><u>\$ (60,000)</u></u>	

<sup>(a)</sup> Because the year-to-date ordinary loss exceeds the anticipated ordinary loss for the fiscal year, the tax benefit recognized for the year-to-date is limited to the amount that would be recognized if the year-to-date ordinary loss were the anticipated ordinary loss for the fiscal year. The limitation is computed as follows:

Year-to-date ordinary loss times the statutory rate (\$140,000 at 50%)	\$ (70,000)
Estimated tax credits for the year	<u>(10,000)</u>
Year-to-date benefit limited to	<u>\$ (80,000)</u>

[FIN 18, paragraph 51]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)****Case B: Realization of the Tax Benefit of the Loss Is Not More Likely Than Not**

**55-17** In Cases A1 and A2, if neither the tax benefit of the anticipated loss for the fiscal year nor anticipated tax credits were recognizable pursuant to Subtopic 740-10, the estimated annual effective tax rate for the year would be zero and no tax (or benefit) would be recognized in any quarter. That conclusion is not affected by changes in the mix of income and loss in interim periods during a fiscal year. However, see paragraph 740-270-30-18. [FIN 18, paragraph 52]

**Case C: Partial Realization of the Tax Benefit of the Loss Is More Likely Than Not**

**55-18** The following Cases illustrate when partial realization of the tax benefit of the loss is more likely than not:

- a. Ordinary losses in all interim periods (Case C1)
- b. Ordinary income and losses in interim periods (Case C2).

*Case C1: Ordinary Losses in All Interim Periods*

**55-19** The entity has an ordinary loss in all interim periods. It is more likely than not that the tax benefit of the loss in excess of \$40,000 of prior income available to be offset by carryback (\$20,000 of tax at the 50 percent statutory rate) will not be realized. Therefore the estimated annual effective tax rate is 20 percent (\$20,000 benefit more likely than not to be realized divided by \$100,000 estimated fiscal year ordinary loss). Quarterly tax computations are as follows.

Reporting Period	Ordinary Loss		Estimated Annual Effective Tax Rate	Tax Benefit		
	Reporting Period	Year-to-Date		Year-to-Date	Less Previously Provided	Reporting Period
First quarter	\$ (20,000)	\$ (20,000)	20%	\$ (4,000)	\$ —	\$ (4,000)
Second quarter	(20,000)	(40,000)	20%	(8,000)	(4,000)	(4,000)
Third quarter	(20,000)	(60,000)	20%	(12,000)	(8,000)	(4,000)
Fourth quarter	<u>(40,000)</u>	<u>(100,000)</u>	20%	<u>(20,000)</u>	<u>(12,000)</u>	<u>(8,000)</u>
Fiscal year	<u><u>\$ (100,000)</u></u>					<u><u>\$ (20,000)</u></u>

[FIN 18, paragraph 53]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)***Case C2: Ordinary Income and Losses in Interim Periods*

**55-20** The entity has ordinary income and losses in interim periods and for the year to date. It is more likely than not that the tax benefit of the anticipated ordinary loss in excess of \$40,000 of prior income available to be offset by carryback (\$20,000 of tax at the 50 percent statutory rate) will not be realized. Therefore the estimated annual effective tax rate is 20 percent (\$20,000 benefit more likely than not to be realized divided by \$100,000 estimated fiscal year ordinary loss), and the benefit that can be recognized for the year to date is limited to \$20,000 (the benefit that is more likely than not to be realized). Quarterly tax computations are as follows.

Reporting Period	Ordinary Income (Loss)		Estimated Annual Effective Tax Rate	Tax (or Benefit)			Reporting Period		
	Ordinary Income (Loss)	Year-to-Date		Year-to-Date		Less Previously Provided			
				Computed	Limited to				
First quarter	\$ 20,000	\$ 20,000	20%	\$ 4,000		\$ —	\$ 4,000		
Second quarter	(80,000)	(60,000)	20%	(12,000)		4,000	(16,000)		
Third quarter	(80,000)	(140,000)	20%	(28,000)	\$ (20,000)	(12,000)	(8,000)		
Fourth quarter	<u>40,000</u>	(100,000)	20%	(20,000)		(20,000)	<u>—</u>		
Fiscal year	<u><u>\$(100,000)</u></u>					<u><u>\$ (20,000)</u></u>			

[FIN 18, paragraph 54]

*Case D: Reversal of Net Deferred Tax Credits*

**55-21** The entity anticipates a fiscal year ordinary loss. The loss cannot be carried back, and future profits exclusive of reversing temporary differences are unlikely. Net deferred tax liabilities arising from existing net taxable temporary differences are present. A portion of the existing net taxable temporary differences relating to those liabilities will reverse within the loss carryforward period. Computation of the estimated annual effective tax rate to be used (see paragraphs 740-270-30-32 through 30-33) is as follows.

Estimated fiscal year ordinary loss \$100,000

The tax benefit to be recognized is the lesser of:

Tax effect of the loss carryforward (\$100,000 at 50% statutory rate) \$ 50,000

Amount of the net deferred tax liabilities that would otherwise have been settled during the carry-forward period \$ 24,000

Estimated annual effective tax rate ( $\$24,000 \div \$100,000$ ) 24%

[FIN 18, paragraph 55]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)**

**55-22** Quarterly tax computations are as follows.

<b>Reporting Period</b>	<b>Ordinary Loss</b>		<b>Estimated Annual Effective Tax Rate</b>	<b>Tax Benefit</b>		
	<b>Reporting Period</b>	<b>Year-to-Date</b>		<b>Year-to-Date</b>	<b>Less Previously Provided</b>	<b>Reporting Period</b>
First quarter	\$ (20,000)	\$ (20,000)	24%	\$ (4,800)	\$ —	\$ (4,800)
Second quarter	(20,000)	(40,000)	24%	(9,600)	(4,800)	(4,800)
Third quarter	(20,000)	(60,000)	24%	(14,400)	(4,800)	(4,800)
Fourth quarter	<u>(40,000)</u>	<u>(100,000)</u>	24%	<u>(24,000)</u>	<u>(14,400)</u>	<u>(9,600)</u>
Fiscal year	<u><u>\$ (100,000)</u></u>					<u><u>\$ (24,000)</u></u>

**55-23** Note that changes in the timing of the loss by quarter would not change this computation. [FIN 18, paragraph 55]

***Example 3: Accounting for Income Taxes Applicable to Unusual or Infrequently Occurring Items***

**55-24** The following Cases illustrate accounting for income taxes applicable to unusual or infrequently occurring items when ordinary income is expected for the fiscal year:

- Realization of the tax benefit is more likely than not at date of occurrence (Case A)
- Realization of the tax benefit not more likely than not at date of occurrence (Case B).

**55-25** Cases A and B illustrate the computation of the tax (or benefit) applicable to unusual or infrequently occurring items when ordinary income is anticipated for the fiscal year. These Cases are based on the assumptions and computations presented in paragraph 740-270-55-3 and Example 1, Cases A and B (see paragraphs 740-270-55-4 through 55-8), plus additional information supplied in Cases A and B of this Example. The computation of the tax (or benefit) applicable to the ordinary income is not affected by the occurrence of an unusual or infrequently occurring item; therefore, each Case refers to one or more of the illustrations of that computation in Example 1, Cases A and B (see paragraphs 740-270-55-4 through 55-8), and does not reproduce the computation and the assumptions. The income statement display for tax (or benefit) applicable to unusual or infrequently occurring items is illustrated in Example 7 (see paragraph 740-270-55-52). [FIN 18, paragraph 56]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)****Case A: Realization of the Tax Benefit Is More Likely Than Not at Date of Occurrence**

**55-26** As explained in paragraph 740-270-55-25, this Case is based on the computations of tax applicable to ordinary income that are illustrated in Example 1, Case A (see paragraph 740-270-55-4). In addition, the entity experiences a tax-deductible unusual or infrequently occurring loss of \$50,000 (tax benefit \$25,000) in the second quarter. Because the loss can be carried back, it is more likely than not that the tax benefit will be realized at the time of occurrence. Quarterly tax provisions are as follows.

<b>Reporting Period</b>	<b>Ordinary Income</b>	<b>Tax (or Benefit) Applicable to</b>		
		<b>Unusual or Infrequently Occurring</b>	<b>Ordinary Income</b>	<b>Unusual or Infrequently Occurring</b>
First quarter	\$ 20,000		\$ 8,000	
Second quarter	20,000	\$ (50,000)	8,000	\$ (25,000)
Third quarter	20,000		8,000	
Fourth quarter	<u>40,000</u>	<u>      </u>	<u>16,000</u>	<u>      </u>
Fiscal year	<u>\$100,000</u>	<u>\$ (50,000)</u>	<u>\$40,000</u>	<u>\$ (25,000)</u>

**55-27** Note that changes in assumptions would not change the timing of the recognition of the tax benefit applicable to the unusual or infrequently occurring item as long as realization is more likely than not. [FIN 18, paragraph 57]

**ASC 740-270 – Implementation Guidance and Illustrations (continued)**

Case B: Realization of the Tax Benefit Not More Likely Than Not at Date of Occurrence

**55-28** As explained in paragraph 740-270-55-25, this Case is based on the computations of tax applicable to ordinary income that are illustrated in Example 1, Cases A and B1 (see paragraphs 740-270-55-4 through 55-6). In addition, the entity experiences a tax-deductible unusual or infrequently occurring loss of \$50,000 (potential benefit \$25,000) in the second quarter. The loss cannot be carried back, and available evidence indicates that a valuation allowance is needed for all of the deferred tax asset. As a result, the tax benefit of the unusual or infrequently occurring loss is recognized only to the extent of offsetting ordinary income for the year to date. Quarterly tax provisions under two different assumptions for the occurrence of ordinary income are as follows.

Assumptions and Reporting Period	Ordinary Income (Loss)	Unusual or Infrequently Occurring Loss	Tax (or Benefit) Applicable to				
			Ordinary Income (Loss)	Unusual or Infrequently Occurring Loss			
			Reporting Period	Year-to-Date	Year-to-Date	Less Previously Provided	Reporting Period
Income in all quarters:							
First quarter	\$ 20,000		\$ 8,000	\$ 8,000			
Second quarter	20,000	\$ (50,000)	8,000	16,000	\$ (16,000)	\$ —	\$ (16,000)
Third quarter	20,000		8,000	24,000	(24,000)	(16,000)	(8,000)
Fourth quarter	<u>40,000</u>	<u>      </u>	<u>16,000</u>	40,000	(25,000)	(24,000)	<u>(1,000)</u>
Fiscal year	<u><u>\$ 100,000</u></u>	<u><u>\$ (50,000)</u></u>	<u><u>\$ 40,000</u></u>				<u><u><u><u>\$ (25,000)</u></u></u></u>
Income and loss quarters:							
First quarter	\$ 40,000		\$ 16,000	\$ 16,000			
Second quarter	40,000	\$ (50,000)	16,000	32,000	\$ (25,000)	\$ —	\$ (25,000)
Third quarter	(20,000)		(8,000)	24,000	(24,000)	(25,000)	1,000
Fourth quarter	<u>40,000</u>	<u>      </u>	<u>16,000</u>	40,000	(25,000)	(24,000)	<u>(1,000)</u>
Fiscal year	<u><u>\$ 100,000</u></u>	<u><u>\$ (50,000)</u></u>	<u><u>\$ 40,000</u></u>				<u><u><u><u>\$ (25,000)</u></u></u></u>

FIN 18, paragraph 58

**ASC 740-270 — Implementation Guidance and Illustrations (continued)*****Example 4: Accounting for Income Taxes Applicable to Income (or Loss) From Discontinued Operations at an Interim Date***

**55-29** This Example illustrates the guidance in paragraph 740-270-45-7. An entity anticipates ordinary income for the year of \$100,000 and tax credits of \$10,000. The entity has ordinary income in all interim periods. The estimated annual effective tax rate is 40 percent, computed as follows.

Estimate pretax income	\$ 100,000
Tax at 50% statutory rate	\$ 50,000
Less anticipated credit	(10,000)
Net tax to be provided	\$ 40,000
Estimated annual effective tax rate	40%

**55-30** Quarterly tax computations for the first two quarters are as follows.

Reporting Period	Ordinary Loss			Tax		
	Reporting Period	Year-to-Date	Estimated Annual Effective Tax Rate	Year-to-Date	Less Previously Provided	Reporting Period
First quarter	\$ 20,000	\$ 20,000	40%	\$ 8,000	\$ —	\$ 8,000
Second quarter	25,000	45,000	40%	18,000	8,000	10,000

[FIN 18, paragraph 62]

**55-31** In the third quarter a decision is made to discontinue the operations of Division X, a segment of the business that has recently operated at a loss (before income taxes). The pretax income (and losses) of the continuing operations of the entity and of Division X through the third quarter and the estimated fourth quarter results are as follows.

Reporting Period	Division X		
	Revised Ordinary Income From Continuing Operations	Loss From Operations	Provision for Loss on Disposal
First quarter	\$ 25,000	\$ (5,000)	
Second quarter	35,000	(10,000)	
Third quarter	50,000	(10,000)	\$ (55,000)
Fourth quarter	50,000 <sup>(a)</sup>	—	—
Fiscal year	\$ 160,000	\$ (25,000)	\$ (55,000)

(a) Estimated.

**ASC 740-270 — Implementation Guidance and Illustrations (continued)**

**55-32** No changes have occurred in continuing operations that would affect the estimated annual effective tax rate. Anticipated annual tax credits of \$10,000 included \$2,000 of credits related to the operations of Division X. The revised estimated annual effective tax rate applicable to ordinary income from continuing operations is 45 percent, computed as follows.

Estimated ordinary income from continuing operations	<u>\$ 160,000</u>
Tax at 50% statutory rate	\$ 80,000
Less anticipated tax credit applicable to continuing operations	<u>(8,000)</u>
Net tax to be provided	<u>\$ 72,000</u>
Estimated annual effective tax rate	<u>45%</u>

[FIN 18, paragraph 62]

**55-33** Quarterly computations of tax applicable to ordinary income from continuing operations are as follows.

<b>Reporting Period</b>	<b>Ordinary Loss</b>		<b>Estimated Annual Effective Tax Rate</b>	<b>Tax</b>		
	<b>Reporting Period</b>	<b>Year-to-Date</b>		<b>Year-to-Date</b>	<b>Less Previously Provided</b>	<b>Reporting Period</b>
First quarter	\$ 25,000	\$ 25,000	45%	\$ 11,250	\$ —	\$ 11,250
Second quarter	35,000	60,000	45%	27,000	11,250	15,750
Third quarter	50,000	110,000	45%	49,500	27,000	22,500
Fourth quarter	<u>50,000</u>	160,000	45%	72,000	49,500	<u>22,500</u>
Fiscal year	<u><u>\$ 160,000</u></u>					<u><u>\$ 72,000</u></u>

[FIN 18, paragraph 62]

**55-34** Tax benefit applicable to Division X for the first two quarters is computed as follows.

<b>Reporting Period</b>	<b>Tax Applicable to Ordinary Loss</b>			<b>Tax Benefit Applicable to Division X</b>
	<b>Previously Reporting (A)</b>	<b>Recomputed (Above) (B)</b>	<b>(A-B)</b>	
First quarter	\$ 8,000	\$ 11,250	\$ (3,250)	
Second quarter	10,000	15,750	<u>(5,750)</u>	
			<u><u>\$ (9,000)</u></u>	

FIN 18, paragraph 62

**ASC 740-270 — Implementation Guidance and Illustrations (continued)**

**55-35** The third quarter tax benefits applicable to both the loss from operations and the provision for loss on disposal of Division X are computed based on estimated annual income with and without the effects of the Division X losses. Current year tax credits related to the operations of Division X have not been recognized. It is assumed that the tax benefit of those credits will not be realized because of the discontinuance of Division X operations. Any reduction in tax benefits resulting from recapture of previously recognized tax credits resulting from discontinuance or current year tax credits applicable to the discontinued operations would be reflected in the tax benefit recognized for the loss on disposal or loss from operations as appropriate. If, because of capital gains and losses, and so forth, the individually computed tax effects of the items do not equal the aggregate tax effects of the items, the aggregate tax effects are allocated to the individual items in the same manner that they will be allocated in the annual financial statements. The computations are as follows.

	<b>Loss From Operations Division X</b>	<b>Provision for Loss on Disposal</b>
Estimated annual income from continuing operations	\$ 160,000	\$ 160,000
Loss from Division X operations	(25,000)	
Provision for loss on disposal of Division X		(55,000)
Total	<u>\$ 135,000</u>	<u>\$ 105,000</u>
Tax at 50% statutory rate	\$ 67,500	\$ 52,500
Anticipated credits from continuing operations		(8,000)
Tax credits of Division X and recapture of previously recognized tax credits resulting from discontinuance		
Taxes on income after effect of Division X losses	59,500	44,500
Taxes on income before effect of Division X losses — see computation above	72,000	72,000
Tax benefit applicable to the losses of Division X	(12,500)	(27,500)
Amounts previously recognized — see computation above	(9,000)	
Tax benefit recognized in third quarter	<u>\$ (3,500)</u>	<u>\$ (27,500)</u>

[FIN 18, paragraph 62]

**55-36** The resulting revised quarterly tax provisions are summarized as follows.

<b>Reporting Period</b>	<b>Pretax Income (Loss)</b>			<b>Tax (or Benefit) Applicable to</b>		
	<b>Continuing Operations</b>	<b>Operations of Division X</b>	<b>Provisions for Loss on Disposal</b>	<b>Continuing Operations</b>	<b>Operations of Division X</b>	<b>Provisions for Loss on Disposal</b>
First quarter	\$ 25,000	\$ (5,000)		\$ 11,250	\$ (3,250)	
Second quarter	35,000	(10,000)		15,750	(5,750)	
Third quarter	50,000	(10,000)	\$ (55,000)	22,500	(3,500)	\$ (27,500)
Fourth quarter	<u>50,000</u>			<u>22,500</u>		
Fiscal year	<u>\$160,000</u>	<u>\$ (25,000)</u>	<u>\$ (55,000)</u>	<u>\$ 72,000</u>	<u>\$ (12,500)</u>	<u>\$ (27,500)</u>

[FIN 18, paragraph 62]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)*****Example 5: Accounting for Income Taxes Applicable to Ordinary Income if an Entity Is Subject to Tax in Multiple Jurisdictions***

**55-37** The following Cases illustrate the guidance in paragraph 740-270-30-36 for accounting for income taxes applicable to ordinary income if an entity is subject to tax in multiple jurisdictions:

- a. Ordinary income in all jurisdictions (Case A)
- b. Ordinary loss in a jurisdiction; realization of the tax benefit not more likely than not (Case B)
- c. Ordinary income or tax cannot be estimated in one jurisdiction (Case C).

**55-38** Cases A, B, and C assume that an entity operates through separate corporate entities in two countries. Applicable tax rates are 50 percent in the United States and 20 percent in Country A. The entity has no unusual or infrequently occurring items during the fiscal year and anticipates no tax credits or events that do not have tax consequences. (The effect of foreign tax credits and the necessity of providing tax on undistributed earnings are ignored because of the wide range of tax planning alternatives available.) For the full fiscal year the entity anticipates ordinary income of \$60,000 in the United States and \$40,000 in Country A. The entity is able to make a reliable estimate of its Country A ordinary income and tax for the fiscal year in dollars. Computation of the overall estimated annual effective tax rate in Cases B and C is based on additional assumptions stated in those Cases. [FIN 18, paragraph 65]

**Case A: Ordinary Income in All Jurisdictions**

**55-39** Computation of the overall estimated annual effective tax rate is as follows.

Anticipated ordinary income for the fiscal year:

In the United States	\$ 60,000
In Country A	<u>40,000</u>
Total	<u><u>\$100,000</u></u>

Anticipated tax for the fiscal year:

In the United States (\$60,000 at 50% statutory rate)	\$ 30,000
In Country A (\$40,000 at 20% statutory rate)	<u>8,000</u>
Total	<u><u>\$ 38,000</u></u>
Overall estimated annual effective tax rate (\$38,000 ÷ \$100,000)	<u><u>38%</u></u>

**ASC 740-270 — Implementation Guidance and Illustrations (continued)**

**55-40** Quarterly tax computations are as follows.

<b>Reporting Period</b>	<b>Ordinary Income</b>			<b>Tax</b>				
	<b>United States</b>	<b>Country A</b>	<b>Total</b>	<b>Year-to-Date</b>	<b>Overall Estimated Annual Effective Tax Rate</b>	<b>Year-to-Date</b>	<b>Less Previously Reported</b>	<b>Reporting Period</b>
First quarter	\$ 5,000	\$15,000	\$20,000	\$ 20,000	38%	\$ 7,600	\$ —	\$ 7,600
Second quarter	10,000	10,000	20,000	40,000	38%	15,200	7,600	7,600
Third quarter	10,000	10,000	20,000	60,000	38%	22,800	15,200	7,600
Fourth quarter	<u>35,000</u>	<u>5,000</u>	<u>40,000</u>	100,000	38%	38,000	22,800	<u>15,200</u>
Fiscal year	<u><u>\$ 60,000</u></u>	<u><u>\$40,000</u></u>	<u><u>\$ 100,000</u></u>					<u><u>\$38,000</u></u>

[FIN 18, paragraph 65]

**Case B: Ordinary Loss in a Jurisdiction; Realization of the Tax Benefit Not More Likely Than Not**

**55-41** In this Case, the entity operates through a separate corporate entity in Country B. Applicable tax rates in Country B are 40 percent. Operations in Country B have resulted in losses in recent years and an ordinary loss is anticipated for the current fiscal year in Country B. It is expected that the tax benefit of those losses will not be recognizable as a deferred tax asset at the end of the current year pursuant to Subtopic 740-10; accordingly, no tax benefit is recognized for losses in Country B, and interim period tax (or benefit) is separately computed for the ordinary loss in Country B and for the overall ordinary income in the United States and Country A. The tax applicable to the overall ordinary income in the United States and Country A is computed as in Case A of this Example. Quarterly tax provisions are as follows.

<b>Reporting Period</b>	<b>Ordinary Income (or Loss)</b>					<b>Tax (or Benefit)</b>		
	<b>United States</b>	<b>Country A</b>	<b>Combined Excluding Country B</b>	<b>Country B</b>	<b>Total</b>	<b>Combined Excluding Country B</b>	<b>Country B</b>	<b>Total</b>
First quarter	\$ 5,000	\$15,000	\$20,000	(\$5,000)	\$15,000	\$ 7,600	\$ —	\$ 7,600
Second quarter	10,000	10,000	20,000	(25,000)	(5,000)	7,600	—	7,600
Third quarter	10,000	10,000	20,000	(5,000)	15,000	7,600	—	7,600
Fourth quarter	<u>35,000</u>	<u>5,000</u>	<u>40,000</u>	<u>(5,000)</u>	<u>35,000</u>	<u>15,200</u>	<u>—</u>	<u>15,200</u>
Fiscal year	<u><u>\$60,000</u></u>	<u><u>\$40,000</u></u>	<u><u>\$100,000</u></u>	<u><u>(\$40,000)</u></u>	<u><u>\$60,000</u></u>	<u><u>\$38,000</u></u>	<u><u>\$ —</u></u>	<u><u>\$38,000</u></u>

[FIN 18, paragraph 66]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)****Case C: Ordinary Income or Tax Cannot Be Estimated in One Jurisdiction**

**55-42** In this Case, the entity operates through a separate corporate entity in Country C. Applicable tax rates in Country C are 40 percent in foreign currency. Depreciation in that country is large and exchange rates have changed in prior years. The entity is unable to make a reasonable estimate of its ordinary income for the year in Country C and thus is unable to reasonably estimate its annual effective tax rate in Country C in dollars. Accordingly, tax (or benefit) in Country C is separately computed as ordinary income (or loss) occurs in Country C. The tax applicable to the overall ordinary income in the United States and Country A is computed as in Case A of this Example. Quarterly computations of tax applicable to Country C are as follows.

Reporting Period	Foreign Currency (FC) Amounts			Translated Amounts in Dollars		
	Ordinary Income in Reporting Period	Tax (at 40% rate)		Ordinary Income in Reporting Period	Tax	
		FC	(at 40% rate)		FC	\$
First quarter	FC 10,000	FC 4,000		\$ 12,500	FC 3,000	\$ 3,000
Second quarter	5,000	2,000		8,750		1,500
Third quarter	30,000	12,000		27,500		9,000
Fourth quarter	15,000	6,000		16,250		4,500
Fiscal year	FC 60,000	FC 24,000		\$ 65,000		\$ 18,000

**55-43** Quarterly tax provisions are as follows.

Reporting Period	Ordinary Income					Tax		
	United States	Country A	Combined Excluding Country C		Total	Combined Excluding Country C	Country C	Total
			Country C	Total				
First quarter	\$ 5,000	\$ 15,000	\$ 20,000	\$ 12,500	\$ 32,500	\$ 7,600	\$ 3,000	\$ 10,600
Second quarter	10,000	10,000	20,000	8,750	28,750	7,600	1,500	9,100
Third quarter	10,000	10,000	20,000	27,500	47,500	7,600	9,000	16,600
Fourth quarter	35,000	5,000	40,000	16,250	56,250	15,200	4,500	19,700
Fiscal year	\$60,000	\$40,000	\$100,000	\$65,000	\$165,000	\$38,000	\$18,000	\$56,000

[FIN 18, paragraph 67]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)*****Example 6: Effect of New Tax Legislation***

**55-44** The following Cases illustrate the guidance in paragraphs 740-270-25-5 through 25-6 for accounting in interim periods for the effect of new tax legislation on income taxes:

- a. Legislation effective in a future interim period (Case A)
- b. Effective date of new legislation (Case B).

**Case A: Legislation Effective in a Future Interim Period**

**55-45** The assumed facts applicable to this Case follow.

**55-46** For the full fiscal year, an entity anticipates ordinary income of \$100,000. All income is taxable in one jurisdiction at a 50 percent rate. Anticipated tax credits for the fiscal year total \$10,000. No events that do not have tax consequences are anticipated.

**55-47** Computation of the estimated annual effective tax rate applicable to ordinary income is as follows.

Tax at statutory rate (\$100,000 at 50%)	\$ 50,000
Less anticipated tax credits	(10,000)
Net tax to provided	<u>\$ 40,000</u>
Estimated annual effective tax rate ( $\$40,000 \div \$100,00$ )	<u>40%</u>

[FIN 18, paragraph 68]

**55-48** Further, assume that new legislation creating additional tax credits is enacted during the second quarter of the entity's fiscal year. The new legislation is effective on the first day of the third quarter. As a result of the estimated effect of the new legislation, the entity revises its estimate of its annual effective tax rate to the following.

Tax at statutory rate (\$100,000 at 50%)	\$ 50,000
Less anticipated tax credits	(12,000)
Net tax to provided	<u>\$ 38,000</u>
Estimated annual effective tax rate ( $\$38,000 \div \$100,00$ )	<u>38%</u>

[FIN 18, paragraph 69]

**55-49** The effect of the new legislation shall not be reflected until it is effective or administratively effective. Accordingly, quarterly tax computations are as follows.

Reporting Period	Ordinary Income			Tax		
	Reporting Period	Year-to-Date	Estimated Annual Effective Tax Rate	Year-to-Date	Less Previously Provided	Reporting Period
First quarter	\$ 20,000	\$ 20,000	40%	\$ 8,000	\$ —	\$ 8,000
Second quarter	20,000	40,000	40%	16,000	8,000	8,000
Third quarter	20,000	60,000	38%	22,800	16,000	6,800
Fourth quarter	<u>40,000</u>	100,000	38%	38,000	22,800	<u>15,200</u>
Fiscal year	<u>\$100,000</u>					<u>\$ 38,000</u>

[FIN 18, paragraph 69]

**ASC 740-270 — Implementation Guidance and Illustrations (continued)****Case B: Effective Date of New Legislation**

**55-50** Legislation generally becomes effective on the date prescribed in the statutes. However, tax legislation may prescribe changes that become effective during an entity's fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. For example, if the statutory tax rate applicable to calendar-year corporations were increased from 48 to 52 percent, effective January 1, the increased statutory rate might be administratively applied to a corporation with a fiscal year ending at June 30 in the year of the change by applying a 50 percent rate to its taxable income for the fiscal year, rather than 48 percent for the first 6 months and 52 percent for the last 6 months. In that case the legislation becomes effective for that entity at the beginning of the entity's fiscal year. [FIN 18, paragraph 24]

**55-51** Applying this to specific legislation, an entity with a fiscal year other than a calendar year would account during interim periods for the reduction in the corporate tax rate resulting from the Revenue Act of 1978 [FTB 79-09, paragraph 1] through a revised annual effective tax rate calculation in the same way that the change will be applied to the entity's taxable income for the year. The revised annual effective tax rate would then be applied to pretax income for the year to date at the end of the current interim period. [FTB 79-09, paragraph 3]

**Example 7: Illustration of Income Taxes in Income Statement Display**

**55-52** The following illustrates the location in an income statement display of the various tax amounts computed under this Subtopic. [FIN 18, paragraph 71]

Net sales <sup>(a)</sup>	\$	XXXX
Other Income <sup>(a)</sup>		XXX
		<u>XXXX</u>
Costs and Expenses		
Cost of sales <sup>(a)</sup>	\$	XXXX
Selling, general and administrative expenses <sup>(a)</sup>		XXXX
Interest expenses <sup>(a)</sup>		XXX
Other deductions <sup>(a)</sup>		XXX
Unusual items		XXXX
Infrequently occurring items		<u>XXX</u> <u>XXXX</u>
Income (loss) from continuing operations before income taxes and other items listed below <sup>(b)</sup>		XXXX
Provision for income taxes (benefit) <sup>(b)</sup>		<u>XXXX</u>
Income (loss) from continuing operations before other items below		XXXX
Discontinued operations:		
Income (loss) from operations of discontinued Component X (less applicable income taxes of \$XXXX)		XXXX
Income (loss) before extraordinary items		<u>XXXX</u>
Extraordinary items (less applicable income of \$XXXX)		<u>XXXX</u>
Net income (loss)	\$	<u>XXXX</u>

<sup>(a)</sup> Components of ordinary income (loss).

<sup>(b)</sup> Consists of the total income taxes (or benefit) applicable to ordinary income, unusual items, and infrequently occurring items.

[FIN 18, paragraph 71]

## ASC 805-740 — Implementation Guidance and Illustrations

### **General**

**55-1** This Section is an integral part of the requirements of this Subtopic. This Section provides illustrations that address the application of accounting requirements to specific aspects of accounting for income taxes in connection with business combinations. The illustrations that follow make various assumptions about the tax law. These assumptions about the tax law are for illustrative purposes only.

#### **Example 1: Nontaxable Business Combination**

**55-2** This Example illustrates the guidance in paragraphs 805-740-25-2 through 25-3 and 805-740-30-1 relating to the recognition and measurement of a deferred tax liability and deferred tax asset in a nontaxable business combination. The assumptions are as follows:

- a. The enacted tax rate is 40 percent for all future years, and amortization of goodwill is not deductible for tax purposes.
- b. A wholly owned entity is acquired for \$20,000, and the entity has no leveraged leases.
- c. The tax basis of the net assets acquired (other than goodwill) is \$5,000, and the recognized value is \$12,000. Future recovery of the assets and settlement of the liabilities at their assigned values will result in \$20,000 of taxable amounts and \$13,000 of deductible amounts that can be offset against each other. Therefore, no valuation allowance is necessary.

**55-3** The amounts recorded to account for the business combination transaction are as follows.

Recognized value of the net assets (other than goodwill) acquired	\$ 12,000
Deferred tax liability for \$20,000 of taxable temporary differences	(8,000)
Deferred tax asset for \$13,000 of deductible temporary differences	5,200
Goodwill	<u>10,800</u>
Consideration paid for the acquiree	<u>\$ 20,000</u>

[FAS 109, paragraph 260]

#### **Example 2: Valuation Allowance at Acquisition Date Subsequently Reduced**

**55-4** This Example illustrates the guidance in paragraphs 805-740-25-3 and 805-740-45-2 relating to the recognition of a deferred tax asset and the related valuation allowance for acquired deductible temporary differences at the date of a nontaxable business combination and in subsequent periods when the tax law limits the use of an acquired entity's deductible temporary differences and carryforwards to subsequent taxable income of the acquired entity in a consolidated tax return. The assumptions are as follows:

- a. The enacted tax rate is 40 percent for all future years.
- b. The purchase price is \$20,000, and the assigned value of the net assets acquired is also \$20,000.
- c. The tax basis of the net assets acquired is \$60,000. The \$40,000 (\$60,000 – \$20,000) of deductible temporary differences at the combination date is primarily attributable to an allowance for loan losses. Provisions in the tax law limit the use of those future tax deductions to subsequent taxable income of the acquired entity.
- d. The acquired entity's actual pretax results for the two preceding years and the expected results for the year of the business combination are as follows.

Year 1	\$ (15,000)
Year 2	(10,000)
Year 3 to the combination date	(5,000)
Expected results for the remainder of Year 3	(5,000)

- e. Based on assessments of all evidence available at the date of the business combination in Year 3 and at the end of Year 3, management concludes that a valuation allowance is needed at both dates for the entire amount of the deferred tax asset related to the acquired deductible temporary differences.

**ASC 805-740 — Implementation Guidance and Illustrations (continued)**

**55-5** The acquired entity's pretax financial income and taxable income for Year 3 (after the business combination) and Year 4 are as follows.

	<b>Year 3</b>	<b>Year 4</b>
Pretax financial income	\$ 15,000	\$ 10,000
Reversals of acquired deductible temporary differences	<u>(15,000)</u>	<u>(10,000)</u>
Taxable income	<u>\$    —</u>	<u>\$    —</u>

**55-6** At the end of Year 4, the remaining balance of acquired deductible temporary differences is \$15,000 (\$40,000 – \$25,000). The deferred tax asset is \$6,000 (\$15,000 at 40 percent). Based on an assessment of all available evidence at the end of Year 4, management concludes that no valuation allowance is needed for that \$6,000 deferred tax asset. Elimination of the \$6,000 valuation allowance results in a \$6,000 deferred tax benefit that is reported as a reduction of deferred income tax expense because the reversal of the valuation allowance occurred after the measurement period (see paragraph 805-740-45-2). Tax benefits realized in Years 3 and 4 attributable to reversals of acquired deductible temporary differences are reported as a zero current income tax expense. The consolidated statement of earnings would include the following amounts attributable to the acquired entity for Year 3 (after the business combination) and Year 4.

	<b>Year 3</b>	<b>Year 4</b>
Pretax financial income	\$ 15,000	\$ 10,000
Income tax expense (benefit):		
Current	—	—
Deferred	<u>—</u>	<u>(6,000)</u>
Net income	<u>\$ 15,000</u>	<u>\$ 16,000</u>

[FAS 109, paragraph 265]

**Example 3: Acquirer's Taxable Temporary Differences Eliminate Need for Acquiree Valuation Allowance**

**55-7** This Example illustrates the guidance in paragraph 805-740-25-3 if there is an elimination of the need for a valuation allowance for the deferred tax asset for an acquired loss carryforward based on offset against taxable temporary differences of the acquiring entity in a nontaxable business combination. This Example assumes that the tax law permits use of an acquired entity's deductible temporary differences and carryforwards to reduce taxable income or taxes payable attributable to the acquiring entity in a consolidated tax return. The other assumptions are as follows:

- The enacted tax rate is 40 percent for all future years.
- The purchase price is \$20,000. The tax basis of the identified net assets acquired is \$5,000, and the assigned value is \$12,000, that is, there are \$7,000 of taxable temporary differences. The acquired entity also has a \$16,000 operating loss carryforward, which, under the tax law, may be used by the acquiring entity in the consolidated tax return.
- The acquiring entity has temporary differences that will result in \$30,000 of net taxable amounts in future years.
- All temporary differences of the acquired and acquiring entities will result in taxable amounts before the end of the acquired entity's loss carryforward period.

**ASC 805-740 — Implementation Guidance and Illustrations (continued)**

**55-8** In assessing the need for a valuation allowance, future taxable income exclusive of reversing temporary differences and carryforwards (see paragraph 740-10-30-18(b)) need not be considered because the \$16,000 operating loss carryforward will offset the acquired entity's \$7,000 of taxable temporary differences and another \$9,000 of the acquiring entity's taxable temporary differences. The amounts recorded to account for the purchase transaction are as follows.

Assigned value of the identified net assets acquired	\$ 12,000
Deferred tax liability recognized for the acquired entity's taxable temporary differences (\$7,000 at 40 percent)	(2,800)
Deferred tax asset recognized for the acquired loss carryforward based on offset against the acquired company's taxable temporary differences (\$7,000 at 40 percent)	2,800
Deferred tax asset recognized for the acquired loss carryforward based on offset against the acquiring entity's taxable temporary differences (\$9,000 at 40 percent)	3,600
Goodwill	<u>4,400</u>
Purchase price of the acquired entity	<u><u>\$ 20,000</u></u>

[FAS 109, paragraph 267]

**Example 4: Tax Deductible Goodwill Exceeds Financial Reporting Goodwill**

**55-9** This Example illustrates the guidance in paragraphs 805-740-25-8 through 25-9 on accounting for the tax consequences of goodwill when tax-deductible goodwill exceeds the goodwill recorded for financial reporting at the acquisition date. The assumptions are as follows:

- At the acquisition date, the reported amount of goodwill for financial reporting purposes is \$600 before taking into consideration the tax benefit associated with goodwill and the tax basis of goodwill is \$900.
- The tax rate is 40 percent for all years.

**55-10** As of the acquisition date, the goodwill for financial reporting purposes is adjusted for the tax benefit associated with goodwill by using the following simultaneous equations method. [FAS 109, paragraph 263] In the following equation, the Preliminary Temporary Difference variable is the excess of tax goodwill over book goodwill, before taking into consideration the tax benefit associated with goodwill, and the Deferred Tax Asset variable is the resulting deferred tax asset.

$$(\text{Tax Rate} \div [1 - \text{Tax Rate}]) \times \text{Preliminary Temporary Difference} = \text{Deferred Tax Asset}$$

**55-11** In this Example, the following variables are known:

Tax rate = 40 percent

Preliminary Temporary Difference = \$300 (\$900 – \$600)

**55-12** The unknown variable (Deferred Tax Asset) equals \$200, and the goodwill for financial reporting purposes would be adjusted with the following entry.

Deferred tax asset	200
Goodwill	200

**55-13** Goodwill for financial reporting would be established at the acquisition date at \$400 (\$600 less the \$200 credit adjustment). [FAS 109, paragraph 263]

**ASC 830-740 — Implementation Guidance and Illustrations*****Example 1: Illustration of Foreign Financial Statements Restated for General Price-Level Changes***

**55-1** This Example illustrates the guidance in paragraphs 830-740-25-5 and 830-740-30-1 through 30-2. An entity has one asset, a nonmonetary asset that is not depreciated for financial reporting or tax purposes. The local currency is CFC. Units of current purchasing power are referred to as CFC. The enacted tax rate is 40 percent. The asset had a price-level-adjusted financial reporting amount of CFC 350 and an indexed basis for tax purposes of CFC 100 at December 31, 19X2, both measured using CFC at December 31, 19X2. The entity has a taxable temporary difference of CFC 250 (CFC 350 – CFC 100) and a related deferred tax liability of CFC 100 (CFC 250 × 40 percent) using CFC at December 31, 19X2.

**55-2** General price levels increase by 50 percent in 19X3, and indexing allowed for 19X3 for tax purposes is 25 percent. At December 31, 19X3, the asset has a price-level-adjusted financial reporting amount of CFC 525 (CFC 350 × 150 percent) and an indexed basis for tax purposes of CFC 125 (CFC 100 × 125 percent), using CFC at December 31, 19X3. The entity has a taxable temporary difference of CFC 400 (CFC 525 – CFC 125) and a related deferred tax liability of CFC 160 (CFC 400 × 40 percent) at December 31, 19X3, using CFC at December 31, 19X3. The deferred tax liability at December 31, 19X2 is restated to units of current general purchasing power as of December 31, 19X3. The restated December 31, 19X2 deferred tax liability is CFC 150 (CFC 100 × 150 percent). For 19X3, the difference between CFC 160 and CFC 150 is reported as deferred tax expense in income from continuing operations. The difference between the deferred tax liability of CFC 100 at December 31, 19X2 and the restated December 31, 19X2 deferred tax liability of CFC 150 is reported in 19X3 as a restatement of beginning equity.

**55-3** The amounts recorded to account for the business combination transaction are as follows.

	<b>19X2</b>	<b>19X3</b>
Financial reporting basis	CFC 350	CFC 525
Tax basis	<u>CFC 100</u>	<u>CFC 125</u>
Temporary difference	CFC 250	CFC 400
Tax rate	<u>× .40</u>	<u>× .40</u>
Deferred tax liability, end of year	CFC 100	CFC 160
Deferred tax liability (restarted), beginning of year	CFC 100	<u>CFC 150</u>
Deferred tax expense		<u>CFC 10</u>

[EITF 93-9, Exhibit 93-9A]

**ASC 323-740 — Implementation Guidance and Illustrations**

**55-1** This Section is an integral part of the requirements of this Subtopic.

***Example 1: Application of Accounting Guidance to a Limited Partnership Investment in a Qualified Affordable Housing Project***

**55-2** This Example illustrates the application of the cost, equity, and [EITF 94-1, Exhibit 94-1A] proportional amortization methods of accounting for a limited liability investment [ASU 2014-01, paragraph 4] in a qualified affordable housing project. [EITF 94-1, Exhibit 94-1A]

**55-3** The following are the terms for this Example. [EITF 94-1, Exhibit 94-1A]

Date of investment	January 1, 20X1
Purchase price of investment	\$100,000

## ASC 323-740 — Implementation Guidance and Illustrations (continued)

**55-4** This Example has the following assumptions:

- a. All cash flows (except initial investment) occur at the end of each year.
- b. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).
- c. The investor made a \$100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.
- d. The partnership finances the project cost of \$4,000,000 with 50 percent equity and 50 percent debt.
- e. The annual tax credit allocation (equal to 4 percent of the project's original cost) will be received for a period of 10 years.
- f. The investor's tax rate is 40 percent.
- g. The project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.
- h. The project's taxable loss will be equal to depreciation expense. The cumulative book loss (and thus the cumulative depreciation expense) recognized by the investor is limited to the \$100,000 investment. [EITF 94-1, Exhibit 94-1A]
- i. Subparagraph superseded by Accounting Standards Update No. 2014-01.
- j. It is assumed that all requirements are met to retain allocable tax credits so there will be no recapture of tax credits. [ASU 2014-01, paragraph 4]
- k. The investor expects that the estimated residual value of the investment will be zero. [EITF 94-1, Exhibit 94-1A]
- l. All of the conditions described in paragraph 323-740-25-1 are met to qualify the investment for the use of the proportional amortization method. [ASU 2014-01, paragraph 4]

**ASC 323-740 — Implementation Guidance and Illustrations (continued)**

**55-5** An analysis of the proportional amortization method follows.

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

- (1) End-of-year investment for a 5% limited liability interest in the project net of amortization in Column (2).
- (2) Initial investment of  $\$100,000 \times (\text{total tax benefits received during the year in Column (6)} / \text{total anticipated tax benefits over the life of the investment of } \$120,000)$ .
- (3) 4 percent tax credit on \$200,000 tax basis of the underlying assets.
- (4) Depreciation (on \$200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years up to the amount of the initial investment of \$100,000.
- (5) Column (4)  $\times$  40% tax rate.
- (6) Column (3) + Column (5).
- (7) Column (6) – Column (2).

**55-6** Paragraph superseded by Accounting Standards Update No. 2014-01.

**ASC 323-740 — Implementation Guidance and Illustrations (continued)**

**55-7** A detailed analysis of the cost method with amortization follows.

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

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

**ASC 323-740 — Implementation Guidance and Illustrations (continued)**

**55-8** A detailed analysis of the equity method follows.

Year	Net Investment (1)	Book Loss (2)	Tax Loss (Depreciation) (3)	Tax Credit (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
1	\$ 92,727	\$ 7,273	\$ 7,273	\$ 8,000	\$ 10,909		\$ 3,636
2	85,454	7,273	7,273	8,000	10,909		3,636
3	78,181	7,273	7,273	8,000	10,909		3,636
4	70,908	7,273	7,273	8,000	10,909		3,636
5	63,635	7,273	7,273	8,000	10,909		3,636
6	56,362	7,273	7,273	8,000	10,909		3,636
7	49,089	7,273	7,273	8,000	10,909		3,636
8	41,816	7,273	7,273	8,000	10,909		3,636
9 <sup>(a)</sup>	16,000	25,816	7,273	8,000	10,909	\$ 7,418	(7,489)
10		16,000	7,273	8,000	10,909	3,492	(1,599)
11			7,273		2,909	(2,909)	
12			7,273		2,909	(2,909)	
13			7,273		2,909	(2,909)	
14			5,451		2,183	(2,183)	
15							
Total		<u>\$100,000</u>	<u>\$100,000</u>	<u>\$ 80,000</u>	<u>\$120,000</u>	<u>\$ 0</u>	<u>\$ 20,000</u>

- (1) End-of-year investment for a 5 percent limited partnership interest in the project less the investor's share of losses.
  - (2) The investor's share of book losses recognized under the equity method. The cumulative losses recognized are limited to the investment of \$100,000. (See also <sup>(a)</sup> below)
  - (3) Depreciation (on \$200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years up to the amount of the initial investment of \$100,000.
  - (4) 4 percent tax credit on \$200,000 tax basis of the underlying assets.
  - (5) (Column [3] × 40% tax rate) + column (4).
  - (6) The change in deferred taxes resulting from the difference between the book and tax bases of the investment and tax losses in excess of the at-risk investment. In this Example, that amount can be determined as follows: (column [2] – column [3]) × 40% tax rate.
  - (7) Column (5) + column (6) – column (2).
- (a) Projections of future operating results at the end of Year 9 indicate that a net loss will be recognized over the remaining term of the investment indicating a need to assess the investment for impairment. For purposes of this Example, impairment is measured based on the remaining tax credits allocable to the investor, although an alternative measure could include other tax benefits to be generated by the investment. The impairment loss recognized in this Example (\$18,543) is derived as follows: Investment at the end of Year 8 (\$41,816) less the loss recognized in Year 9 (\$7,273), the remaining tax credits allocable to the investor (\$16,000), and the estimated residual value (\$0).

**55-9** This Example is but one method for recognition and measurement of impairment of an investment accounted for by the equity method. Inclusion of this method in this Example does not indicate that it is a preferred method.

**55-10** Paragraph superseded by Accounting Standards Update No. 2014-01.

# Appendix B — Frequently Asked Questions About Tax Reform

See the [Table of Contents](#) for a list of FAQs by topic.

## B.1 Introduction

On December 22, 2017, President Trump signed into law the tax legislation commonly known as the Tax Cuts and Jobs Act (the “Act”).<sup>1</sup> Under ASC 740, the effects of new legislation are recognized upon enactment, which (for federal legislation) is the date the president signs a bill into law. Accordingly, recognition of the tax effects of the Act is required in the interim and annual periods that include December 22, 2017.

This appendix contains responses to frequently asked questions (FAQs) about how an entity should account for the tax effects of the Act in accordance with ASC 740. While the answers to the FAQs reflect our current views, these views are subject to change on the basis of additional input received or further developments in practice. For a version of this appendix that reflects the most current guidance, see Deloitte’s January 3, 2018 (updated August 30, 2018), [Financial Reporting Alert](#), which is updated periodically to reflect developments as they occur and as additional questions surface.

## B.2 SAB 118

Shortly after enactment, the SEC staff issued SAB 118, which provides guidance on accounting for the Act’s impact. Under SAB 118, an entity would use something similar to the measurement period in a business combination. That is, an entity would recognize those matters for which the accounting can be completed (“Bucket 1”), as might be the case for the effect of rate changes on DTAs and DTLs. For matters that have not been completed, the entity would either (1) recognize provisional amounts to the extent that they are reasonably estimable and adjust them over time as more information becomes available (“Bucket 2”) or (2) for any specific income tax effects of the Act for which a reasonable estimate cannot be determined, continue to apply ASC 740 on the basis of the provisions of the tax laws that were in effect immediately before the Act was signed into law — that is, the entity would not adjust current or deferred taxes for those tax effects of the Act until a reasonable estimate can be determined (“Bucket 3”).

### FAQ B-1

#### **How do SAB 118 and the need to record “reasonable estimates” interact with the guidance in ASC 740 regarding uncertain tax positions (i.e., FIN 48) with respect to the Act?**

SAB 118 addresses certain practical problems created by the enactment of a vast amount of new and complex legislation only nine days before December 31, 2017 — the end of a reporting period for most entities. The Act was developed over a very condensed time frame, and preparers and practitioners had little time to analyze its preliminary or final versions. As a consequence, there may be tax technical matters with respect to the Act for which it is not feasible to prepare a complete “more-likely-than-not” assessment during the enactment period or potentially even in subsequent quarters within the measurement period.

<sup>1</sup> H.R. 1/Public Law 115-97, “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.”

**FAQ B-1 (continued)**

Accordingly, we believe that uncertainties about how the Act should be interpreted may be accounted for provisionally under SAB 118. More specifically, during the one-year measurement period, an entity may account for an uncertain tax technical matter with respect to the Act on the basis of a reasonable estimate of how the Act will ultimately be interpreted. As new information becomes available, an entity would then adjust its provisional estimate until it can complete its more-likely-than-not assessment. It would need to complete that assessment, along with appropriate measurement of the resulting positions, by the end of the measurement period. In a manner consistent with SAB 118, an entity should make a good faith effort to develop reasonable estimates until it prepares a complete more-likely-than-not assessment.

Determining whether a tax technical matter is within the scope of SAB 118 during the one-year measurement period will, of course, depend on the specific facts and circumstances of each individual entity and will require considerable judgment.

### B.3 FASB ASU and Staff Q&As

Since the Act was signed into law, the FASB has issued the following new guidance on accounting for certain aspects of it:

- [FASB Staff Q&A No. 1](#) (January 2018) stating that entities that are not SEC registrants may apply SAB 118 to financial statements.
- [Four staff Q&As](#) (January 2018) outlining the FASB staff's interpretations of ASC 740 and U.S. GAAP with respect to (1) discounting of the deemed repatriation transition tax and refundable AMT credit carryforwards, (2) global intangible low-taxed income (GILTI), and (3) the base erosion anti-abuse tax (BEAT). See additional discussion in [FAQ B-16](#), [FAQ B-25](#), [FAQ B-36](#), and [FAQ B-40](#).
- [ASU 2018-02](#) (February 2018), which addresses industry concerns about the requirement in ASC 740 that the effect of a change in tax laws or rates on DTAs and DTLs be included in income from continuing operations in the reporting period that contains the enactment date of the change. That guidance applies even when the tax effects were initially recognized directly in OCI at the previous rate, resulting in "stranded" amounts in AOCI related to the income tax rate differential. See additional discussion in [FAQ B-76 through FAQ B-83](#).

### B.4 Change in Corporate Tax Rate

The Act reduces the corporate tax rate to 21 percent, effective January 1, 2018, for all corporations. Because ASC 740-10-25-47 requires the effect of a change in tax laws or rates to be recognized as of the date of enactment, all corporations, regardless of their year-end, must adjust their DTAs and DTLs as of December 22, 2017. The effect of changes in tax laws or rates on DTAs or DTLs is allocated to continuing operations as a discrete item rather than through the AETR.

**FAQ B-2**

**For calendar-year-end entities, what is the impact of the change in the corporate tax rate on DTAs and DTLs that exist as of the enactment date?**

DTAs and DTLs that exist as of the enactment date and are expected to reverse after the Act's effective date (January 1, 2018, for calendar-year-end entities) should be adjusted to the new statutory tax rate of 21 percent. Any DTAs and DTLs expected to reverse before the Act's effective date should not be adjusted to the new statutory tax rate.

#### FAQ B-3

**If some deferred tax balances are attributable to items of pretax comprehensive income or loss other than continuing operations (e.g., discontinued operations, OCI, or items charged or credited directly to equity), should the adjustment for the effect of the tax rate change still be allocated to continuing operations?**

Yes. Under ASC 740-10-45-15, the tax effects of changes in tax laws or rates are allocated to income from continuing operations irrespective of the source of the income or loss to which the deferred tax item is related. In a manner consistent with ASC 740-10-30-26, the tax effects of items not included in continuing operations that arose before the enactment date are measured on the basis of the enacted rate at the time the transaction was recognized. (For more information, see [3.65](#) and [3.66](#).)

#### FAQ B-4

**How should a reporting entity compute its temporary differences as of the enactment date when measuring its DTAs and DTLs?**

A reporting entity should calculate temporary differences by comparing the relevant book and tax basis amounts as of the enactment date. To determine book basis amounts as of the enactment date, the reporting entity should apply U.S. GAAP on a year-to-date basis up to the enactment date. For example:

- Any book basis accounts that must be remeasured at fair value under U.S. GAAP would be adjusted to fair value as of the enactment date (e.g., certain investments in securities or derivative assets or liabilities).
- Book balances that are subject to depreciation or amortization would be adjusted to reflect current period-to-date depreciation or amortization up to the enactment date.
- Book basis account balances such as pension and other postretirement assets and obligations for which remeasurement is required as of a particular date (and for which no events have occurred that otherwise would require an interim remeasurement) would not be remeasured as of the enactment date (i.e., no separate valuation of the benefit obligation is required as of the enactment date) for purposes of adjusting the temporary difference that will be measured to the new statutory tax rate as of December 22, 2017. For example, a calendar-year reporting entity that has a pension plan with an annual measurement date of December 31 would adjust its balance sheet accounts for the effects of current-year net periodic pension cost and other contribution and benefit payment activity through the date of enactment.
- Any book basis balances associated with share-based payment awards that are classified as liabilities would be remeasured (on the basis of fair value, calculated value, or intrinsic value, as applicable) as of the enactment date. In addition, for those share-based payment awards that ordinarily would result in future tax deductions, compensation cost would be determined on the basis of the year-to-date requisite service rendered up to the enactment date.

#### FAQ B-5

**Given that the enactment date may be close to, but does not coincide with, the end of a reporting period, may an entity measure the effect by using temporary differences and the resulting deferred tax balances as of the end of the reporting period?**

No. Subject to materiality, an entity should adjust DTAs and DTLs for the effect of a change in tax laws or rates as of the enactment date even if such date does not coincide with the end of a financial reporting period.

**FAQ B-6****How should the tax effects of adjustments to book and tax bases up to the enactment date be allocated among the components of comprehensive income?**

The tax effects of year-to-date activity *before* enactment would be allocated in accordance with the intraperiod tax allocation guidance in ASC 740-20.

**FAQ B-7****Are the calculations for fiscal-year-end entities the same as those discussed in [FAQ B-2](#)?**

Not exactly. Given the mechanics of Internal Revenue Code (IRC) Section 15, we believe that the change in tax rate resulting from the Act will be administratively effective for a fiscal-year-end entity at the beginning of the entity's fiscal year. Accordingly, in a manner consistent with the guidance in ASC 740-270-55-50 and 55-51, the applicable tax rates for deferred tax balances are as follows:

- For balances expected to reverse after the enactment date and within the current fiscal year, the applicable rate is the "blended tax rate" (see [FAQ B-8](#) below), which will be effective for the fiscal year.
- For balances not expected to reverse within the current fiscal year, the applicable rate is the new statutory tax rate of 21 percent, which will be effective for the first fiscal year beginning after January 1, 2018.

**FAQ B-8****What is meant by the "blended tax rate," and how is it calculated?**

For the period that includes enactment, the blended tax rate should be determined in accordance with IRC Section 15 and therefore based on the applicable rates before and after the change and the number of days in the period within the taxable year before and after the effective date of the change in tax rate.

As illustrated in the table below, the domestic federal statutory tax rate (blended tax rate) for all non-calendar-year-end entities with the same fiscal year-end will be the same, regardless of income (or projected income used for interim reporting). It is assumed in the table that the entities' fiscal year-end is March 31, 2018, and the effective date of the new tax rate is January 1, 2018.

	<b>Tax Rate</b>	<b>Days Under Tax Rate</b>	<b>Tax Ratio</b>	<b>Tentative Tax Rate</b>
Effective rate before enactment (April 1, 2017, to December 31, 2017)	35%	275	75.34%	26.37%
Effective rate after enactment (January 1, 2018, to March 31, 2018)	21%	90	24.66%	5.18%
Domestic federal statutory tax rate (blended tax rate)		365		31.55%

**FAQ B-9****Since a fiscal-year-end entity will also have to calculate an AETR for its current fiscal year, how should the change in tax rate be factored into its AETR (exclusive of any adjustment for permanent items) for interim periods ending after the enactment date?**

In a manner consistent with the guidance in IRC Section 15 discussed above, such an entity should use its blended tax rate to calculate the U.S. federal tax expense/benefit to include in its AETR computation. The new AETR would then be applied to pretax income or loss for the year to date at the end of the interim period that includes the enactment date, and for all subsequent interim periods in the year.

#### FAQ B-10

**What rate should a fiscal-year-end company use as the statutory tax rate when preparing rate reconciliation disclosures as required by ASC 740-10-50-11?**

The entity should use the blended tax rate as explained in [FAQ B-8](#).

#### FAQ B-11

**If the exception in ASC 740-20-45-7 is applicable in the annual period that includes the enactment date, should an entity consider the change in the corporate tax rate in applying the exception?**

Yes. An entity must consider taxable income expected in future years for measurement of a DTA related to the carryforward of a current-year loss from continuing operations. For example, assume that a calendar-year-end company with a full valuation allowance has a current-year \$1,000 loss in continuing operations and a \$100 gain reported in OCI related to an AFS security that is in an overall gain position, resulting in a DTA and DTL of \$210 and \$21, respectively, as of December 31, 2017. A \$21 tax benefit and \$21 tax expense would be allocated to continuing operations and OCI, respectively. See [7.07](#) and [7.21A](#) for more information.

## B.5 Modification of Carryforwards and Certain Deductions

### B.5.1 Modification of Net Operating Loss Carryforwards

The Act modifies aspects of current law regarding NOL carryforwards. Under current law, NOLs generally have a carryback period of 2 years and a carryforward period of 20 years. For NOLs incurred in years subject to the new rules, the Act eliminates, with certain exceptions, the NOL carryback period and permits an indefinite carryforward period. The amount of the NOL deduction is limited to 80 percent of taxable income, which is computed without regard to the NOL deduction.

#### FAQ B-12

**Should a taxable temporary difference associated with an indefinite-lived asset be considered a source of taxable income to support realization of an NOL with an unlimited carryforward period? What if a deductible temporary difference is expected to reverse into an NOL with an unlimited carryforward period?**

A taxable temporary difference associated with an indefinite-lived asset is generally considered to be a source of taxable income to support realization of an NOL with an unlimited carryforward period. This would also generally be true for a deductible temporary difference that is scheduled to reverse into an NOL with an unlimited carryforward period. However, because the Act includes restrictions on the ability to use NOLs with unlimited carryforward periods (i.e., NOLs arising in years subject to the new rules are limited in use to 80 percent of taxable income), only 80 percent of the indefinite-lived taxable temporary difference would serve as a source of taxable income. See [4.27](#) for more information.

### B.5.2 Limitation on Business Interest

Under current law, IRC Section 163(j) limits the ability of certain corporations to deduct interest paid or accrued on indebtedness. In general, this limit applies to interest paid or accrued by certain corporations (when no U.S. federal income tax is imposed on the interest income) whose debt-to-equity ratio exceeds 1.5 to 1.0 and when net interest expense exceeds 50 percent of the adjusted taxable income.

The Act removes the debt-to-equity safe harbor, expands interest deductibility limitations, and generally limits the interest deduction on business interest to (1) business interest income plus (2) 30 percent of the taxpayer's adjusted taxable income.

**FAQ B-13****When an entity develops an objective and verifiable estimate of future taxable income in its assessment of the realizability of its DTAs, can the entity adjust its historical operating results to factor in the effects of adjustments to IRC Section 163(j) resulting from the Act?**

Yes. An entity should consider the effects of the new IRC Section 163(j) limitation in a manner similar to nonrecurring items for which the entity makes an adjustment in its historical results. However, the ability to adjust historical operating results to obtain an objectively verifiable estimate of future taxable income does not change the fact that the entity would still need to consider such losses as part of its prior earnings history (i.e., the entity may not exclude such losses in determining whether it has cumulative losses in recent years). For more information, see [4.40](#) and [4.41](#).

**FAQ B-14****Should a taxable temporary difference associated with an indefinite-lived asset be considered a source of taxable income to support realization of disallowed interest carryforwards? What if an entity has both disallowed interest carryforwards and NOLs with an unlimited carryforward period?**

Yes, as discussed in [FAQ B-12](#), a taxable temporary difference related to an indefinite-lived asset can be a source of taxable income to support realization of DTAs with an unlimited carryforward period, such as disallowed interest carryforwards. However, because the Act restricts the amount of net business interest entities can deduct to 30 percent of modified taxable income, no more than 30 percent of the indefinite-lived taxable temporary difference would serve as a source of taxable income with respect to disallowed interest carryforwards.

That said, an entity may sometimes have both NOLs with an unlimited carryforward period *and* disallowed interest carryforwards with an unlimited carryforward period such that portions of the indefinite-lived taxable temporary difference might serve as a source of taxable income for both because of the limitations provided in the Act. For example, because the annual interest limitation is calculated before NOLs are taken into account, the taxable temporary difference associated with an indefinite-lived asset would first be a source of taxable income for the disallowed interest carryforward (limited to 30 percent of the taxable temporary difference, as discussed above), but then any *remaining* taxable temporary difference on the indefinite-lived asset might also be a source of taxable income for NOLs with an unlimited carryforward period (limited to 80 percent of the *remaining* taxable temporary difference, as noted above in [FAQ B-12](#)). See [4.27](#) for more information.

## B.6 Deemed Repatriation Transition Tax (IRC Section 965)

A U.S. shareholder of a specified foreign corporation (SFC)<sup>2</sup> must include in gross income, at the end of the SFC's last tax year beginning before January 1, 2018, the U.S. shareholder's pro rata share of certain of the SFC's undistributed and previously untaxed post-1986 foreign earnings and profits (E&P). The inclusion generally may be reduced by foreign E&P deficits that are properly allocable to the U.S. shareholder. In addition, the mandatory inclusion may be reduced by the pro rata share of deficits of another U.S. shareholder that is a member of the same affiliated group. A foreign corporation's E&P are taken into account only to the extent that they were accumulated during periods in which the corporation was an SFC (referred to below as a "foreign subsidiary"). The amount of E&P taken into account is the greater of the amounts determined as of November 2, 2017, or December 31, 2017, unreduced by dividends (other than dividends to other SFCs) during the SFC's last taxable year beginning before January 1, 2018.

<sup>2</sup> An SFC includes all controlled foreign corporations and all other foreign corporations (other than passive foreign investment companies) in which at least one domestic corporation is a U.S. shareholder.

The U.S. shareholder's income inclusion is offset by a deduction designed to generally result in an effective U.S. federal income tax rate of either 15.5 percent or 8 percent. The 15.5 percent rate applies to the extent that the SFCs hold cash and certain other assets (the U.S. shareholder's "aggregate foreign cash position"), and the 8 percent rate applies to the extent that the income inclusion exceeds the aggregate foreign cash position.

The Act permits a U.S. shareholder to elect to pay the net tax liability<sup>3</sup> interest free over a period of up to eight years.

#### **FAQ B-15**

**Should an entity that is required to include post-1986 foreign earnings in its current-year taxable income but elects to pay the one-time deemed repatriation transition tax (under IRC Section 965) over a period of up to eight years classify the tax as a DTL or a current/noncurrent income tax payable?**

In the period of enactment, a U.S. shareholder should record a current/noncurrent income tax payable for the transition tax due. ASC 210 provides general guidance on the classification of accounts in statements of financial position. An entity should classify as a current liability only those cash payments that management expects to make within the next 12 months to settle the transition tax. The installments that the entity expects to settle beyond the next 12 months should be classified as a noncurrent income tax payable.

#### **FAQ B-16**

**If an entity elects to pay the one-time deemed repatriation transition tax over the eight-year period, should the income tax payable be discounted?**

Although ASC 740-10-30-8 clearly prohibits discounting of DTAs and DTLs, it does not address income tax liabilities payable over an extended period. In the absence of explicit guidance in ASC 740, we believe that an entity would need to consider ASC 835-30. Specifically, we note the following:

- ASC 835-30 is generally applied to "exchange transactions" rather than nonreciprocal transactions.
- ASC 835-30-15-3(e) notes that the guidance in ASC 835-30 does not apply to "[t]ransactions where interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (for example, industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements)."
- Because the amount of the deemed repatriation transition tax is inherently subject to uncertain tax positions, measurement of the ultimate amount to be paid is potentially subject to future adjustment.

Accordingly, we do not believe that the deemed repatriation transition tax should be discounted.

In January 2018, the FASB staff issued [Staff Q&A No. 2](#), which states that the deemed repatriation transition tax liability should not be discounted.

<sup>3</sup> Net tax liability under IRC Section 965 is the excess, if any, of the taxpayer's net income tax for the taxable year in which the IRC Section 965 inclusion amount is included over such taxpayer's net income tax for the taxable year, excluding (1) the IRC Section 965 amount and (2) any income or deduction properly attributable to a dividend received by such U.S. shareholder from any deferred foreign income corporation.

**FAQ B-17**

**Depending on the year-ends of a U.S. entity and its foreign subsidiaries, the deemed repatriation transition tax may or may not be reported on the current-year tax return. If the deemed repatriation transition tax will not be reported on the current-year tax return, should the liability for the one-time deemed repatriation transition tax be limited to the amount that corresponds to the entity's outside basis difference in the foreign subsidiary, or should the entire amount be recorded?**

Although we generally believe that the recognition of a liability related to a foreign subsidiary would be limited to the amount that corresponds to the entity's outside basis difference in the foreign subsidiary, we believe that it would be appropriate to record the entire amount of the deemed repatriation transition tax in the period of enactment given the unique circumstances presented in this FAQ (i.e., the amount due is calculated by reference to the greater of the E&P amounts determined as of November 2, 2017, or December 31, 2017 — that is, E&P related to past transactions — and will simply be payable in a subsequent year).

**FAQ B-18**

**If the deemed repatriation transition tax will not be reported on the current-year tax return, should the entity classify the one-time deemed repatriation transition tax as a DTL or a noncurrent income tax payable?**

On the basis of the unique nature of tax reform and the mandatory one-time deemed repatriation income inclusion, we believe that the deemed repatriation transition tax liability may be classified as a noncurrent income tax payable.

**FAQ B-19**

**With the Act's establishment of a participation exemption system of taxation, does an entity still need to consider whether the outside basis differences in its foreign subsidiaries (and foreign corporate joint ventures that are essentially permanent in duration) are indefinitely reinvested?**

Yes. Even under the new tax system, an entity may still be subject to income tax on its foreign investments (e.g., foreign exchange gains or losses on distributions, capital gains on sale of investment, foreign income taxes, and withholding taxes) and should consider whether it needs to record any deferred taxes on outside basis differences in foreign investments. In making this determination, an entity should consider its outside basis differences at each level in the organization chart, starting with the subsidiary at the lowest level in the chain.

## FAQ B-20

### How should the SAB 118 guidance be applied to an entity's indefinite reinvestment assertions under ASC 740-30-25-6, ASC 740-30-25-18(a), and ASC 740-30-25-17?

Example 1 in SAB 118 discusses a Bucket 3 fact pattern and states the following:

Prior to the reporting period in which the Act was enacted, Company X did not recognize a deferred tax liability related to unremitting foreign earnings because it overcame the presumption of the repatriation of foreign earnings. [Footnote omitted] Upon enactment, the Act imposes a tax on certain foreign earnings and profits at various tax rates. Based on Company X's facts and circumstances, it was not able to determine a reasonable estimate of the tax liability for this item for the reporting period in which the Act was enacted by the time that it issues its financial statements for that reporting period; that is, Company X did not have the necessary information available, prepared, or analyzed to develop a reasonable estimate of the tax liability for this item (*or evaluate how the Act will impact Company X's existing accounting position to indefinitely reinvest unremitting foreign earnings*). As a result, Company X would not include a provisional amount for this item in its financial statements that include the reporting period in which the Act was enacted, but would do so in its financial statements issued for subsequent reporting periods that fall within the measurement period, beginning with the first reporting period falling within the measurement period by which the necessary information became available, prepared, or analyzed in order to develop the reasonable estimate, and ending with the first reporting period within the measurement period in which Company X was able to obtain, prepare, and analyze the necessary information to complete the accounting under ASC Topic 740. [Emphasis added]

In addition, SAB 118 indicates that the SEC staff's views were informed by FASB FSP FAS 109-2, which contains similar guidance and states, in part:

The FASB staff believes that the lack of clarification of certain provisions within the [2004] Act and the timing of the enactment necessitate a practical exception to the Statement 109 [ASC 740] requirement to reflect in the period of enactment the effect of a new tax law. Accordingly, an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the [2004] Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying Statement 109 [ASC 740].

Accordingly, we believe that, in a manner similar to the guidance in FSP FAS 109-2, and as specified in Example 1 of SAB 118, an entity should apply ASC 740 as it completes its plans for reinvestment of its outside basis difference, including its plans for reinvestment or repatriation of unremitting foreign earnings. More specifically, to the extent that an entity has finalized its plans and can calculate the resulting tax effects, the entity should disclose those plans and record the associated tax effects (Bucket 1). If an entity has completed all or portions of its assessment (e.g., made the decision to repatriate from all or certain entities) and has the ability to reasonably estimate the effects of that assessment (or portions thereof), it should record provisional amounts for those effects and disclose the status of its efforts (Bucket 2). If an entity has made insufficient progress to reasonably estimate its plans, it should disclose the status of its evaluation and should not adjust its previous indefinite reinvestment assertions for the effects of the Act (Bucket 3).

An entity should be mindful that its plans for reinvestment or repatriation of unremitting foreign earnings could be affected by matters other than those associated with the Act. For example, if an entity's cash flow needs in the United States change significantly for reasons other than those caused by the Act (e.g., the need for cash in the United States to pay off debt, settle litigation, or fund an acquisition), the entity should evaluate those matters outside the SAB 118 framework to ensure that its prior intent related to reinvestment is still appropriate.

**FAQ B-21**

**If an entity changes its indefinite reinvestment assertion with respect to its investment in a foreign subsidiary (or foreign corporate joint venture that is essentially permanent in duration) because it now intends to distribute earnings subject to the deemed repatriation transition tax, may the entity change its historic accounting policy and approach for determining the DTL for withholding taxes that are within the scope of ASC 740?**

Historically, we have accepted the following two approaches for determining whether a parent should recognize a DTL for withholding taxes that would be imposed by the local tax authority on a distribution:

- *Parent jurisdiction approach* — A parent<sup>4</sup> would apply ASC 740-10-55-24 by treating the withholding tax as a tax that the parent would incur upon the reversal of a taxable temporary difference in the parent's jurisdiction that is attributable to its investment in the foreign subsidiary. The parent would be unable to recognize a DTL when the financial reporting carrying value of the investment does not exceed the tax basis in the investment as determined by application of tax law in the parent's jurisdiction. However, if an outside basis difference does exist in the parent's investment in the foreign subsidiary, the parent would apply ASC 740-10-55-24 when measuring the DTL to be recognized.
- *Subsidiary jurisdiction approach* — An entity considers the perspective of the jurisdiction that is taxing the recipient (i.e., the local jurisdiction imposing the withholding tax) when determining whether the parent has a taxable temporary difference. From the perspective of the local jurisdiction, the parent has a financial reporting carrying amount in its investment in the distributing entity that is greater than its local tax basis (i.e., from the perspective of the local jurisdiction, the IRC Section 965(a) transition income inclusion that increased the tax basis is not relevant in the local jurisdiction). Therefore, there is an "outside" taxable temporary difference and, in accordance with ASC 740-10-55-24, the measurement of the DTL should reflect withholding taxes to be incurred when the taxable temporary difference reverses.

These approaches would continue to be appropriate for determining whether a parent should recognize a DTL for withholding taxes after the effective date of the tax law change. For more information about the two approaches, see [3.06](#).

Note that the tax effect of any change in the indefinite reinvestment assertion (e.g., a withholding tax DTL) would be considered an indirect effect of tax reform for purposes of the disclosure required under ASC 740-10-50-9(g).

**FAQ B-22**

**Should an entity consider the one-time deemed repatriation income inclusion to be a source of income when analyzing the realization of DTAs in the year of the inclusion?**

Yes. An entity should consider the one-time deemed repatriation income inclusion to be a source of taxable income when analyzing the realization of DTAs. The entity should verify that the one-time deemed repatriation income inclusion coincides with the timing of the deductions and other benefits associated with the DTAs. For more information about sources of taxable income that may enable realization of a DTA, see [4.22](#).

**FAQ B-23**

**If a company has the ability and intent to make an election under Revenue Procedure 2006-45 to change a controlled foreign corporation's (CFC's) tax year-end (i.e., to a one-month deferral year as described in Section 898(c)(2)), when should the impact of the change in the CFC's year-end be recognized for financial statement purposes?**

Generally speaking, an election made under Revenue Procedure 2006-45 would be considered an automatic change from one permissible method to another. Accordingly, the financial statement impact would be reflected in the period in which the entity has concluded that it qualifies for the change in accounting method and that it has the intent and ability to file the change. For more information about when to recognize the impact of tax method changes, see [3.51](#).

<sup>4</sup> The "parent" in this context is the immediate owner of the investment.

#### FAQ B-24

##### **What factors should an entity consider in measuring the one-time deemed repatriation transition tax?**

Typically, we would expect the one-time deemed repatriation transition tax to be based on the facts that exist as of the balance sheet date (e.g., E&P amounts, cash and other asset balances) or a prior date if required by law. However, in some instances, certain actions (or elections) that management expects to take (make) and for which no other impediments or regulatory hurdles to execution exist (i.e., the plans are within the entity's control) can be considered in the measurement of the tax liability. In such cases, an entity would need to use significant judgment and assess its individual facts and circumstances.

## B.7 Global Intangible Low-Taxed Income

Although the Act generally eliminates U.S. federal income tax on dividends from foreign subsidiaries of domestic corporations, it creates a new requirement that certain income (i.e., GILTI) earned by CFCs must be included currently in the gross income of the CFCs' U.S. shareholder. GILTI is the excess of the shareholder's "net CFC tested income" over the net deemed tangible income return (the "routine return"), which is defined as the excess of (1) 10 percent of the aggregate of the U.S. shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC with respect to which it is a U.S. shareholder over (2) the amount of certain interest expense taken into account in the determination of net CFC-tested income.

A domestic corporation is permitted a deduction of up to 50 percent of the sum of the GILTI inclusion and the amount treated as a dividend, because the corporation has claimed a foreign tax credit (FTC) as a result of the inclusion of the GILTI amount in income ("IRC Section 78 gross-up"). If the sum of the GILTI inclusion (and related IRC Section 78 gross-up) and the corporation's foreign-derived intangible income (FDII) (see [FAQ B-35](#)) exceeds the corporation's taxable income, the deductions for GILTI and for FDII are reduced by the excess. As a result, the GILTI deduction can be no more than 50 percent of the corporation's taxable income (and will be less if the corporation is also entitled to an FDII deduction). The maximum GILTI deduction is reduced to 37.5 percent for taxable years beginning after December 31, 2025.

#### FAQ B-25

##### **Is a company required to record U.S. deferred taxes for investments in foreign subsidiaries and corporate joint ventures that are essentially permanent in duration (collectively, "foreign investments") and that are subject to the GILTI provision but otherwise indefinitely reinvested?**

If a GILTI inclusion is not expected in future years, no U.S. deferred taxes would be recorded. In addition, even if a GILTI inclusion is expected in future years, U.S. deferred taxes would not be *required*.

In January 2018, the FASB staff issued [Staff Q&A No. 5](#), which states that a company may elect, as an accounting policy, to either (1) treat taxes due on future U.S. inclusions in taxable income under the GILTI provision as a current-period expense when incurred or (2) factor such amounts into the company's measurement of its deferred taxes (the deferred method). The FASB staff acknowledged that companies that elect to factor GILTI into the measurement of deferred taxes will face additional implementation issues but did not explain how those issues should be addressed.

**FAQ B-26****If a company expects to have a U.S. inclusion in taxable income under the GILTI provision in future years and elects to factor such amounts into the measurement of DTAs and DTLs, how should it determine the amount of U.S. investor-level deferred taxes necessary for the related foreign investment?<sup>5</sup>**

A U.S. investor in a CFC has a financial reporting carrying value (i.e., book basis) and an outside tax basis for U.S. tax purposes in its foreign investment. If those amounts are not the same, the U.S. investor would have an outside basis difference in the foreign investment. In addition, the U.S. investor has a U.S. tax basis in the CFC's underlying assets and liabilities held that will be used for calculating GILTI inclusions. Accordingly, a U.S. investor may have book/U.S. tax inside basis differences that, upon reversal, will increase or decrease the GILTI inclusion and, because GILTI inclusions increase the U.S. tax basis in the foreign investment, will also affect the outside basis difference in the foreign investment.

Accordingly, in determining the amount of U.S.-investor-level deferred taxes necessary for foreign investments under this model, companies should "look through" the outside basis of the CFC to determine how the book/U.S. tax inside basis differences will reverse and how such reversals will affect future GILTI inclusions and the outside basis difference.

Any residual outside basis difference that is not related to the CFC's underlying assets or liabilities (i.e., inside/outside tax basis disparities) should then be analyzed in the determination of whether the basis difference would result in a taxable or deductible amount when the investment is recovered and, if so, whether an ASC 740 outside basis exception (i.e., ASC 740-30-25-18(a) or ASC 740-30-25-9) applies. Unlike other situations involving outside basis differences in foreign subsidiaries, this "look through" approach would be employed even if no overall outside basis difference in the CFC exists, or if only an overall deductible outside basis difference in the CFC exists.

In addition, in assessing the GILTI impact of the CFC's underlying assets and liabilities, a company would, in a fashion similar to branch accounting, establish U.S. DTAs or DTLs to account for the U.S. income tax effects of the future reversal of any in-country DTAs and DTLs (also referred to as "anticipatory foreign tax credit/deduction" or "anticipatory" DTAs and DTLs). When determining the amount of a U.S. anticipatory DTA or DTL, an entity must carefully consider all applicable provisions in the tax law, since the amount of the incremental foreign taxes that will be creditable and realizable, or forgone, because of the future reversal of the local in-country DTAs and DTLs may be difficult to assess and subject to limitations (e.g., an 80 percent limitation, limitations as a result of expense allocations, and a limitation on utilization as a result of the absence of a carryforward or carryback period). For example, a local-country DTL that will reverse in the same year(s) in which a GILTI inclusion is expected may be creditable against the U.S. tax in that year, subject to the 80 percent limitation. In addition, U.S. DTAs that reverse in the same year as the local in-country deferred might further limit the FTC. Future FTCs directly related to future book income and future expense allocation limitations directly related to future book expense generally should not be included in the measurement of the anticipatory DTA or DTL until such income or expense, or both, are recognized (i.e., such FTCs and expense allocation limitations should be limited to those directly tied to existing temporary differences). For more information about accounting for foreign branch operations, see [3.51A](#).

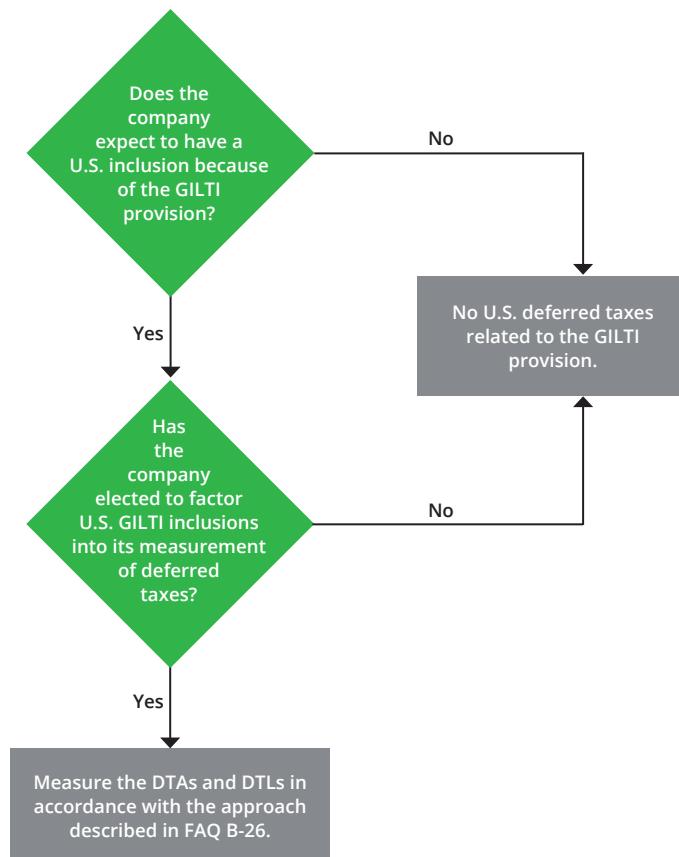
In summary, recorded GILTI DTAs and DTLs under this model will consist of the following three items:

- DTAs and DTLs related to inside book/U.S. tax basis differences that will affect future GILTI inclusions, identified by "looking through" the CFC's outside basis to the CFC's underlying assets and liabilities.
- DTAs and DTLs related to the U.S. tax consequences of settling the CFC's in-country DTAs or DTLs (i.e., anticipatory DTAs and DTLs).
- Any DTA or DTL related to a residual outside basis temporary difference for which an exception has not been applied.

<sup>5</sup> This FAQ reflects our current views on the accounting for DTAs and DTLs with basis differences that are expected to affect the amount of GILTI inclusion upon reversal. We have discussed a number of the more significant aspects of these FAQs with the FASB and SEC staff. Accordingly, while other acceptable accounting approaches may exist, entities that plan to apply methods that are inconsistent with those discussed in the FAQs below are strongly encouraged to consult with their income tax accounting advisers.

#### FAQ B-26 (continued)

The decision tree below illustrates the approach for determining the deferred tax accounting for outside basis differences in foreign investments as a result of the GILTI provision.



#### FAQ B-27

**Should GILTI DTAs and DTLs, including U.S. anticipatory DTAs and DTLs, be established on a CFC-by-CFC basis (individual) or a U.S.-shareholder basis (aggregate)?<sup>6</sup>**

We believe that in a manner consistent with the mechanics of the GILTI computation, GILTI DTAs and DTLs should generally be computed on a U.S.-shareholder-by-U.S.-shareholder basis. Therefore, multiple CFCs under one U.S. shareholder would be analyzed in the aggregate. If a U.S. shareholder has a mixture of profitable and unprofitable CFCs that, in the aggregate, are not profitable such that future GILTI inclusions are not expected at the U.S. shareholder level, no GILTI DTAs and DTLs would be recorded. Conversely, if a U.S. shareholder has a mixture of profitable and unprofitable CFCs that, in the aggregate, are profitable such that future GILTI inclusions are expected, that U.S. shareholder should measure GILTI DTAs and DTLs in accordance with [FAQ B-26](#).

<sup>6</sup> See [footnote 5](#).

**FAQ B-28****Given that the CFC's routine return is excluded from the GILTI inclusion, how should an entity account for the routine return when recording GILTI DTAs and DTLs?<sup>7</sup>**

We believe that there is more than one acceptable approach to accounting for the routine return in the measurement of GILTI DTAs and DTLs, including the following:

- *Special deduction* — The routine return could be treated akin to a special deduction, with the benefit recognized when the GILTI inclusion is reduced by the routine return. Under this approach, the routine return is viewed as dependent on future events, including future investments in QBAI and interest expense deductions, and it therefore would not be factored into the tax rate expected to apply to the temporary differences.
- *Graduated tax rate* — Under this approach, the amount of taxable income equal to the routine return would be considered income taxed at a zero rate. Accordingly, if the routine return represents a significant factor, companies would measure GILTI DTAs and DTLs by using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the aforementioned deferred taxes are estimated to be settled or realized. Companies will need to use judgment in determining the periods in which GILTI DTAs and DTLs will reverse and the estimated annual taxable income in each of those periods. See [4.09](#) and [4.10](#).

Other models may also be acceptable in certain situations (e.g., a portion of the book/U.S. tax basis difference that will reverse and represent a routine return might not be considered a taxable temporary difference for which a deferred tax would be recorded in accordance with ASC 740-10-25-30).

The approach an entity selects would be an accounting policy election that, like all other such elections, must be applied consistently.

**FAQ B-29****Would an acceptable alternative approach to measuring deferred taxes for an outside basis difference in a CFC be to measure deferred taxes "as if" the CFC were a branch?<sup>8</sup>**

No. While many "branch-like" principles are employed in the model described in [FAQ B-26](#), unlike a branch, a CFC that will have substantially all of its income taxable in the United States as a result of a GILTI inclusion still has an outside tax basis that is relevant in certain instances, such as a sale or distribution. Accordingly, measurement of deferred taxes should also factor in the residual outside basis difference as described in [FAQ B-26](#).

For more information about accounting for foreign branch operations, see [3.51A](#).

<sup>7</sup> See [footnote 5](#).

<sup>8</sup> See footnote 5.

## FAQ B-30

### Should the GILTI deduction be considered in the measurement of GILTI DTAs and DTLs?<sup>9</sup>

The GILTI deduction is intended to lower the GILTI income inclusion (with the intent of lowering the effective tax rate on the included income) and, in many cases, will immediately apply when a company has a GILTI inclusion. Accordingly, we believe that if a company generally expects to be able to apply the full GILTI deduction in the period in which the GILTI DTAs and DTLs reverse, it should consider the deduction in the measurement of the GILTI DTAs and DTLs in accordance with ASC 740-10-55-24. As noted above, however, the GILTI deduction is "up to," rather than "guaranteed" to be, 50 percent and could be reduced by the taxable income limitation, which is applied in combination with the FDII deduction (see [FAQ B-35](#)). An entity should carefully consider this limitation when factoring the GILTI deduction into the measurement of U.S. GILTI DTAs and DTLs. For example, when the taxable income limitation and expense allocation limitations are expected to apply and be significant (e.g., in situations in which the U.S. operations generate significant losses or an entity expects to forgo the GILTI deduction because it expects to use existing NOL carryforwards), entities may conclude that factoring the GILTI deduction into the rate is not appropriate. See additional discussion in [FAQ B-34](#).

## FAQ B-31

### If an entity elects to factor taxes due on future U.S. GILTI inclusions in taxable income into the entity's measurement of its deferred taxes, how should it recognize, upon adoption of ASU 2016-16 and the establishment of a DTA for previously unrecognized tax basis in the buyer's jurisdiction, any corresponding change in the measurement of deferred taxes attributable to GILTI?<sup>10</sup>

Entities are required to adopt ASU 2016-16 on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the year of adoption. ASC 250-10-45-8 requires entities to include the direct effects of a change in accounting principle, *including any related income tax effects*, when applying that principle retrospectively. Although ASU 2016-16 will be applied on a modified retrospective basis, we believe that a similar concept would apply in this situation. Therefore, the corresponding change in the measurement of deferred taxes attributable to GILTI would be considered a direct effect and, accordingly, would be recognized as an adjustment directly to retained earnings as well.

<sup>9</sup> See [footnote 5](#).

<sup>10</sup> See footnote 5.

**FAQ B-32****Does SAB 118 apply to the selection of an accounting policy for GILTI in such a manner that an entity can use the measurement period of one year to make its selection?**

While SAB 118 does not explicitly refer to accounting policy choices, we believe that the following application of its guidance to a company's GILTI policy election would be appropriate:

- A company is not required to adopt an accounting policy for GILTI in the financial statements for the period that includes the enactment date. To create and preserve the flexibility to make that election at some time during the measurement period, however, the company must disclose that it has not yet adopted an accounting policy. This guidance applies even if the company already knows, or has reasonable estimates of, the effect of the two different accounting policies on the financial statements and the difference is material.
- If a company's accounting policy is still "open" during any subsequent quarters within the one-year measurement period, a policy is not established by including the current-year estimated actual tax effects of GILTI as a current-period expense in the company's AETR used for calculating its interim tax provision.
- Once a company records deferred taxes with respect to GILTI, and the recognition of such deferred taxes is considered material, the company has elected an accounting policy regardless of whether the amount recorded is considered a provisional amount under SAB 118. Changes made to that policy during or after the measurement period would be subject to ASC 250.
- Subsequent adjustments of the deferred tax amount recorded for GILTI, including adjustments related to the company's policies used to calculate such amount (e.g., inside basis vs. outside basis), would not be subject to ASC 250 provided that (1) they occur during the one-year measurement period and (2) the amounts recorded in prior periods were marked as provisional.
- Once the deferred tax amount for GILTI is considered final, ASC 250 would apply to any future adjustments related to the company's policies used to calculate such amount.

This application of SAB 118 has been discussed with the SEC staff, and we understand that the staff will not object to it as long as a company provides the disclosures required by the SAB.

### **B.7.1 GILTI Valuation Allowance Considerations**

Under the GILTI tax regime, foreign taxes paid or accrued in the year of the inclusion may be creditable against U.S. taxes otherwise payable, subject to certain limitations (e.g., foreign source income, expense allocations). If not utilized in the year of inclusion, however, the FTC would be permanently lost. Further, because Section 250 deductions are limited to 50 percent of taxable income after NOL deductions, utilization of NOLs could reduce or eliminate the eligibility for a Section 250 deduction. In fact, as a result of expected future GILTI inclusions, a U.S. entity that has historically experienced cumulative losses may expect that existing NOL carryforwards, for which a valuation allowance has historically been recorded, will now be utilized. Utilization of the NOL carryforwards may, however, result in an actual cash tax savings that is less than the DTA (before reduction for any valuation allowance) and, in some cases, may result in no cash tax savings at all because, without the NOL, the entity would have been eligible for a Section 250 deduction that would have reduced the net taxable income inclusion and would have been able to utilize FTCs.

#### FAQ B-33

##### **When assessing the realizability of NOL DTAs, how should an entity consider future GILTI inclusions?**

There are two acceptable views. The first is that an entity would consider future GILTI inclusions on the basis of tax law ordering rules when estimating available sources of future taxable income to assess the realizability of DTAs. Under a tax law ordering approach, the future reduction or elimination of the Section 250 deduction and FTCs will not result in the need for a valuation allowance for an entity's existing NOL DTAs. Use of a tax law ordering approach is consistent with Example 18 in the implementation guidance (see ASC 740-10-55-145 through 55-148). The same conclusion would apply to DTAs for other tax attributes and deductible temporary differences.

Alternatively, an entity could assess the realizability of DTAs on the basis of the incremental economic benefit they would produce. In other words, because future GILTI inclusions are an integrated part of the regular tax system, an entity would determine how much, if any, benefit is expected to be realized from an entity's existing NOL carryforwards on a "with-and-without" basis. That is, a DTA would be recognized for only the amount of incremental tax savings the DTAs are expected to produce after the entity considers all facts and circumstances, elements of the tax law, and other factors that would otherwise limit the availability of the Section 250 deduction and utilization of the FTCs.

#### FAQ B-34

##### **What should the relationship be between an entity's assessment of the realizability of NOL DTAs that may be affected by future GILTI inclusions and its measurement of other U.S. GILTI DTAs and DTLs?<sup>11</sup>**

We believe that when measuring U.S. GILTI DTAs and DTLs (more specifically, evaluating whether future Section 250 deductions should affect the measurement of GILTI DTAs and DTLs as discussed in [FAQ B-30](#)), an entity should apply an approach that is consistent with its assessment of how future Section 250 deductions affect the realizability of a NOL DTA, as described in [FAQ B-33](#) above.

For example, if the entity evaluates the realizability of NOL DTAs on the basis of the incremental economic benefit the NOLs would produce (i.e., the "with-and-without" approach described in [FAQ B-33](#)), it would be appropriate for the entity to factor in the Section 250 deduction that would be available without the NOL when measuring its GILTI DTAs and DTLs. Alternatively, if the entity evaluates the realizability of NOL DTAs on the basis of tax law ordering rules, the measurement of GILTI DTAs and DTLs should only take into account the impact of the Section 250 deduction that will actually be available after use of the NOL in the year the GILTI DTAs and DTLs reverse, because the ordering rules would suggest that the maximum amount of GILTI deduction will not be obtained in those circumstances.

## B.8 Foreign-Derived Intangible Income

The Act allows a domestic corporation an immediate deduction in U.S. taxable income for a portion of its FDII. The amount of the deduction depends, in part, on U.S. taxable income. The percentage of income that can be deducted is reduced in taxable years beginning after December 31, 2025.

#### FAQ B-35

##### **How should companies account for the FDII deduction?**

We believe that FDII deductions related to future book income are analogous to the special deductions cited in ASC 740-10-25-37 and should be accounted for as such. For more information, see [4.17](#).

<sup>11</sup> See [footnote 5](#).

## B.9 Base Erosion Anti-Abuse Tax

For tax years beginning after December 31, 2017, a corporation is potentially subject to tax under the BEAT provision if the controlled group of which it is a part has sufficient gross receipts and derives a sufficient level of “base erosion tax benefits.” Under the BEAT, a corporation must pay a base erosion minimum tax amount (BEMTA) in addition to its regular tax liability after credits. The BEMTA is generally equal to the excess of (1) a fixed percentage of a corporation’s modified taxable income (taxable income determined without regard to any base erosion tax benefit related to any base erosion payment, and without regard to a portion of its NOL deduction) over (2) its regular tax liability (reduced by certain credits). The fixed percentage is generally 5 percent for taxable years beginning in 2018, 10 percent for years beginning after 2018 and before 2026, and 12.5 percent for years after 2025. However, the fixed percentage is 1 percentage point higher for banks and securities dealers (i.e., 6, 11, and 13.5 percent, respectively).

### FAQ B-36

#### **What tax rate should companies that are subject to the BEAT provisions use when measuring temporary differences?**

We believe that the BEAT system can be analogized to an AMT system. ASC 740 notes that when alternate tax systems like the AMT exist, deferred taxes should still be measured at the regular tax rate. Because the BEAT provisions are designed to be an “incremental tax,” an entity can never pay less than its statutory tax rate of 21 percent. Like AMT preference items, related-party payments made in the year of the BEMTA are generally the BEMTA’s driving factor. The AMT system and the BEAT system were both designed to limit the tax benefit of such “preference items.” Further, as was the case under the AMT system, an entity may not know whether it will always be subject to the BEAT tax, and we believe that most (if not all) taxpayers will ultimately take measures to reduce their BEMTA exposure and therefore ultimately pay taxes at or as close to the regular rate as possible. Accordingly, while there is no credit under the Act such as the one that existed under the AMT regime, we believe that the similarities between the two systems are sufficient to allow BEAT taxpayers to apply the existing AMT guidance in ASC 740 and measure deferred taxes at the 21 percent statutory tax rate. (See ASC 740-10-30-8 through 30-12 and ASC 740-10-55-31 through 55-33.)

In January 2018, the FASB staff issued [Staff Q&A No. 4](#), which states that companies should measure deferred taxes without regard to BEAT (i.e., should continue to measure deferred taxes at the regular tax rate), with any payment of incremental BEAT reflected as a period expense.

## B.9.1 Impact of BEAT on the Realizability Assessment of Certain DTAs

In the calculation of the BEMTA, certain credits and NOLs may not be available to reduce the BEMTA. Consequently, the actual economic benefit received from utilizing a credit loss or NOL may be less than the DTA (before reduction for any valuation allowance) for that particular tax attribute and, in some cases, may result in no cash tax savings at all because, without the attribute, the entity would have paid more regular tax and less BEMTA.

### FAQ B-37

#### **If an entity expects to be subject to BEMTA and the incremental economic benefit it expects to realize for certain tax credits and NOLs is less than the corresponding DTAs, how should the entity take this into consideration when evaluating the realizability of its DTAs?**

FASB Staff Q&A No. 4, which addresses the broader accounting implications of BEAT, states that an entity “would not need to evaluate the effect of potentially paying BEAT in future years on the realization of [DTAs].” The DTAs are measured in accordance with the regular tax system, and any utilization of NOLs or tax credits would reduce the regular tax liability even if additional BEMTA is owed.

## B.10 Corporate AMT

The corporate AMT has been repealed for tax years beginning after December 31, 2017. Taxpayers with AMT credit carryforwards that have not yet been used may claim a refund in future years for those credits even though no income tax liability exists.<sup>12</sup> Companies can continue using AMT credits to offset any regular income tax liability in years 2018 through 2020, with 50 percent of remaining AMT credits refunded in each of the 2018, 2019, and 2020 tax years and all remaining credits refunded in tax year 2021.

### FAQ B-38

#### If a valuation allowance has been recorded on the DTA for AMT credit carryforwards, should the valuation allowance be released?

Yes. Since the AMT credit will now be fully refundable regardless of whether there is a future income tax liability before AMT credits, the benefit of the AMT credit will be realized. Therefore, any valuation allowance should be released, and an income tax benefit should be recognized.

### FAQ B-39

#### Now that existing AMT credit carryovers are refundable, how should an entity present the AMT credits in the balance sheet?

Because an entity may either apply an AMT credit carryforward against its future income tax liability or receive a refund if it never has taxable income, we would accept either presentation as long as it is accompanied by appropriate disclosure.

### FAQ B-40

#### If the amount is presented as a receivable, and given that it will be collected over a period of longer than 12 months, should the amount be discounted?

No. As discussed in [FAQ B-16](#), ASC 740 prohibits discounting, but only in the context of DTAs and DTLs. Accordingly, in the absence of explicit guidance in ASC 740, we believe that ASC 835-30 would need to be considered, and in accordance with our conclusion above regarding the deemed repatriation transition tax, we do not believe that the amount, even if presented as a receivable, should be discounted.

In January 2018, the FASB staff issued [Staff Q&A No. 3](#), which states that, in a manner similar to the Board's conclusion regarding the one-time deemed repatriation transition tax, refundable AMT carryforward credits should not be discounted.

<sup>12</sup> Note that taxpayers should consider whether other limitations (e.g., IRC Section 383) apply to their ability to claim a refund of AMT.

## B.11 Non-ASC 740 Topics Affected by Tax Reform

### B.11.1 Non-GAAP Financial Measures

#### FAQ B-41

##### **May companies adjust their non-GAAP financial measures related to the impact of tax reform?**

Non-GAAP financial measures are commonly used, since many registrants assert that such measures are meaningful and provide valuable insight into the information that management considers important in running the business. While many non-GAAP financial measures are expressed on a pretax basis (e.g., EBITDA), others are expressed on a post-tax basis (e.g., adjusted net income, adjusted EPS). For example, registrants may seek to adjust post-tax non-GAAP measures related to the impact of tax reform.

Registrants may also elect to make non-GAAP adjustments related to discrete amounts that affect income from, for example, (1) the adjustment of deferred taxes upon the change in corporate tax rates and (2) the recognition of incremental tax expense related to foreign earnings previously considered to be indefinitely reinvested abroad and not subject to U.S. taxation (the deemed repatriation tax). If such adjustments are accompanied by the disclosures required by SEC Regulation G and Regulation S-K, Item 10(e), and are not misleading as described in Section 100 of the SEC's May 2016 [Compliance and Disclosure Interpretations](#) (C&DI), the adjustments for tax reform may be permissible depending on the registrant's specific facts and circumstances. If a registrant includes an adjustment for the impact of tax reform in its non-GAAP measures, it should ensure that the adjustment is for the total impact of tax reform and not just for select provisions (i.e., no cherry picking). For example, if a registrant adjusts its non-GAAP measure to remove the deemed repatriation transition tax, it must also adjust its non-GAAP measure for the adjustment to deferred taxes for the change in tax rates.

Some registrants may also consider adjustments that attempt to depict a "normalized" tax rate between comparable periods to enhance comparability of periods before and after tax reform (i.e., adjustments in which the new tax rate is applied to periods before enactment). However, such non-GAAP measures may be considered misleading and may be deemed an individually tailored accounting principle since they may not reflect different tax strategies, tax assertions, or other actions that a registrant may have taken if the lower tax rate had applied to all periods presented (e.g., increased compensation, increased research and development).

For more information, see [Sections 3.7.2](#) and [4.3](#) of Deloitte's [A Roadmap to Non-GAAP Financial Measures](#).

### B.11.2 Form 8-K Filing Requirements and Considerations

#### FAQ B-42

##### **Will the Act trigger any Form 8-K filing requirements or other Form 8-K considerations?**

For certain taxpayers, there may be a material reduction in DTAs and a corresponding charge to net income as a result of the Act. Registrants have questioned whether this would be considered a material impairment, which would trigger the requirement to file a Form 8-K under Item 2.06. The SEC recently issued [C&DI Question 110.02](#), which clarifies that reduction of a DTA as a result of the rate change would not be considered an impairment. C&DI Question 110.02 also acknowledges that the Act may affect an entity's assessment of whether its DTAs will be realized and notes that if the measurement date approach prescribed by SAB 118 is applied, the entity may still disclose the impairment in its next periodic report in accordance with Item 2.06 of Form 8-K.

Note that notwithstanding the above, a registrant may decide on the basis of its specific facts and circumstances to file a Form 8-K under another item (e.g., Item 8.01) to disclose the Act's material effects.

## B.11.3 Article 11 Pro Forma Financial Information

### FAQ B-43

#### **Can registrants elect to reflect the Act as a material event for historical periods in Article 11 pro forma financial information?**

At the March 13, 2018, CAQ SEC Regulations Committee joint [meeting](#) with the SEC staff, the SEC staff discussed the appropriateness of reflecting the impact of the Act on historical periods (i.e., pre-enactment periods) as a material event in pro forma information presented in accordance with SEC Regulation S-X, Rule 11-01(a)(8). The staff indicated at the meeting that registrants are encouraged to discuss their specific facts and circumstances regarding such pro forma financial presentation with the SEC Division of Corporation Finance, Office of the Chief Accountant. In a subsequent panel discussion at the 2018 Baruch College Financial Reporting Conference in May 2018, a member of the SEC staff indicated that such pro forma adjustments may not be appropriate because, for example, they may not reflect alternative judgments, tax strategies, or other actions that a registrant may have taken if the lower tax rate had applied to historical periods.

## B.11.4 Compensation and Share-Based Payment Awards

### B.11.4.1 Changes to IRC Section 162(m)

IRC Section 162(m) limits the tax deductibility of certain types of compensation paid to the CEO as well as a company's four other highest paid officers (referred to collectively as the "covered employees"). Specifically, only the first \$1 million in compensation, whether cash or stock-based, paid to a covered employee is deductible for tax purposes in a given year. Compensation that is performance-based has not historically been subject to this limitation.

The Act modifies IRC Section 162(m) by (1) expanding which employees are considered covered employees by including the chief financial officer; (2) providing that if an individual is a covered employee for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years; and (3) removing the exceptions for commissions and performance-based compensation. These changes do not apply to compensation stemming from contracts entered into on or before November 2, 2017, unless such contracts were materially modified on or after that date. Compensation agreements entered into and share-based payment awards granted after this date will be subject to the revised terms of IRC Section 162(m).

### FAQ B-44

#### **Do the changes to IRC Section 162(m) affect the accounting for deferred taxes related to share-based payment awards issued to covered employees?**

Yes. The DTA recorded for share-based payment awards granted after November 2, 2017, could be less than what would have been recorded under prior law. For example, since the Act eliminates the exclusion of performance-based compensation, deferred taxes may be recorded only on awards granted after November 2, 2017, to the extent that performance-based compensation will not be limited.

We generally do not expect DTAs related to share-based payment awards that arose on or before November 2, 2017, to be affected by the Act, but companies are encouraged to consult with their accounting and tax advisers if questions arise.

**FAQ B-45****Do the changes to IRC Section 162(m) affect the accounting policy used to account for deferred taxes in cases in which it is expected that some or all compensation paid to an employee will be limited by IRC Section 162(m)?**

No. We believe that there are three approaches commonly applied in practice regarding the accounting for deferred taxes in cases in which compensation is expected to be limited by IRC Section 162(m). These approaches are as follows:

- *Deductible compensation is allocated to cash compensation first* — A DTA would not be recorded for stock-based compensation if cash compensation is expected to exceed the limit.
- *Deductible compensation is allocated to earliest compensation recognized for financial statement purposes* — Because stock-based compensation is typically expensed over a multiple-year vesting period but deductible when fully vested or exercised, and cash-based compensation is generally deductible in the period it is expensed for financial statement purposes, stock-based compensation is generally considered the earliest compensation recognized for financial statement purposes, and a DTA for stock-based compensation would be recorded up to the deductible limit.
- *Limitation is allocated pro rata between stock-based compensation and cash compensation* — A partial DTA may result on the basis of the expected ratio of stock-based compensation to cash compensation.

The choice of which approach to apply is a policy election that should be applied consistently. While the Act modifies IRC Section 162(m), we believe that the above approaches remain acceptable. Accordingly, companies should continue to apply the accounting policy they have previously elected.

**FAQ B-46****If an entity modifies a compensation agreement, must it comply with the Act's updated IRC Section 162(m) limitations?**

It depends. The Act contains explicit wording indicating that material modifications made to a compensation agreement on or after November 2, 2017, will cause the agreement to become subject to the updated requirements of IRC Section 162(m). Judgment may be required in the determination of whether a modification is material. Further, if a modified compensation agreement is related to a share-based payment award, companies will need to consider whether the modification guidance in ASC 718-20 should be applied.

Modifications made before November 2, 2017, may also result in a tax consequence. While modifications made before November 2, 2017, will not cause compensation to be subject to the revised requirements in IRC Section 162(m), the language in IRC Section 162(m) that existed before the Act's revisions indicates that as a result of any modification to a performance-based award, the award will become subject to the legacy IRC Section 162(m) limitations on deductibility.

Companies should be mindful of these potential outcomes when deciding how future compensation agreements will be structured or modified.

**B.11.4.2 Awards With Performance Conditions****FAQ B-47****For share-based payment awards with performance conditions that are based on financial statement metrics, should a probability assessment be performed on the enactment date?**

Yes. Financial statement metrics may change as a result of the Act, which may affect the probability that certain performance conditions will be met. Accordingly, performance conditions that are based on financial statement metrics should be reassessed. For example, compensation cost recognized for a share-based payment award with a performance condition tied to earnings and whose vesting was probable before the enactment date would be reversed if it is no longer probable that the award will vest as of the enactment date (see [FAQ B-4](#)). However, in performing the probability assessment, entities should consider whether an award's existing terms require an adjustment to performance targets as a result of "one-time" or unusual events, which might be the case with tax law changes.

### B.11.4.3 Implications of Individual Statutory Rate Changes

An entity may "net-share settle" its share-based payment awards to meet its statutory tax withholding obligation related to the awards. If the entity has adopted ASU 2016-09, ASC 718 specifies that such provision does not, by itself, result in liability classification for the rewards as long as (1) the entity has a statutory obligation to withhold taxes on the employee's behalf and (2) the amount withheld does not exceed the maximum statutory tax rates in the employee's applicable jurisdiction(s). In circumstances in which the amount withheld exceeds the *maximum* statutory tax rate, ASC 718 requires the entity to classify the awards as liabilities. If the entity has not adopted ASU 2016-09, the amount withheld cannot exceed the *minimum* statutory requirement.

Effective January 1, 2018, the Act lowers individual tax rates. On January 11, 2018, the IRS published updated withholding tables and guidance, including withholding on supplemental income, and instructed entities to use the 2018 withholding tables as soon as possible but not later than February 15, 2018. Before implementing the 2018 withholding tables, an entity is instructed to continue to use the tables and rates in effect before enactment (i.e., the 2017 withholding tables).

#### FAQ B-48

##### **Does the change in individual tax rates affect the statutory tax rates used in an entity's assessment of the amount that can be withheld when share-based payment awards are net-share settled?**

Yes. When an entity net-share settles its share-based payment awards to meet its statutory tax withholding obligation, such withholdings should be decreased to reflect the reduction in tax rates in effect on January 1, 2018 (e.g., from 39.6 percent to 37 percent). Accordingly, entities should implement the updated 2018 withholding tables as soon as possible to reduce, and thereby align with the Act, tax rates for awards that are net-share settled on or after January 1, 2018.

### B.11.5 Certain Hedge Accounting Strategies

#### FAQ B-49

##### **Does the change in tax law affect an entity's hedging strategies?**

If an entity is hedging foreign currency risk on an after-tax basis, as allowed under ASC 815-20-25-3(b)(2)(vi), any change in tax rates applicable to the hedging instrument could disrupt the balance of any related hedging relationship.

For example, assume that Entity ABC's functional currency is the U.S. dollar (USD). Entity ABC has a subsidiary whose functional currency is the euro (EUR), and ABC has a USD/EUR forward contract designated as a hedge of EUR 65 million of its net investment in the foreign subsidiary. The forward contract has a notional amount of EUR 100 million because ABC had a tax rate of 35 percent, and it had designated that it was hedging on an after-tax basis.

Now assume that ABC's tax rate changes to 21 percent as a result of a change in tax law. When the tax law becomes effective, the changes in fair value of the derivative on an after-tax basis will be based on 79 percent of the notional amount of the forward (i.e., EUR 79 million), compared with the designated hedged item, which is a EUR 65 million net investment in a foreign subsidiary. Entity ABC is now overhedged.

An entity should consider how this affects assessments of hedge effectiveness and measurements of ineffectiveness. In addition, it should consider whether it wants to redesignate the existing hedging relationships, rebalance any existing hedges, and designate new hedging relationships.

## B.11.6 Leveraged Leases

### FAQ B-50

#### **What is the Act's effect on the accounting treatment for leveraged leases?**

When a change in income tax rates is enacted, an entity should recalculate leveraged leases from inception and record any differences in current-period earnings. In accordance with ASC 840-30-35-41, the entity would record the effect of the tax rate change on a leveraged lease "in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law."

### FAQ B-51

#### **Is a lessor required to recalculate the effective tax rate in a leveraged lease arrangement on the basis of the revised cash flows that result from the change in corporate tax rates and use that rate to record the tax effects of leveraged lease income allocated to future periods (after tax reform)?**

Yes. Recalculating the effective tax rate in the leveraged lease is consistent with ASC 840-30. Because the income or loss from the arrangement will be taxed or benefited, for U.S. federal income tax purposes, at a 35 percent rate for a portion of the life of the arrangement and a 21 percent rate for the remainder, the effective tax rate in the lease will most likely not equal the lessor's statutory income tax rate. Therefore, the tax effect of pretax leveraged lease income allocated to future periods will most likely not equal pretax leveraged lease income multiplied by the lessor's statutory rate.

## B.11.7 Fair Value and Hypothetical Liquidation at Book Value Considerations

### FAQ B-52

#### **What income tax rate should an entity use when performing fair value measurements as of December 31, 2017?**

When tax rates are an input in a fair value measurement (e.g., when the income approach is used on an after-tax basis), an entity should generally use the same assumption a market participant would use about the income tax rate that will be in effect when the projected cash flows are received. That rate is typically the statutory tax rate unless there is substantial evidence that another tax rate should be used.

### FAQ B-53

#### **Should a company that applies the hypothetical liquidation at book value (HLBV) for an equity method investment or the allocation of earnings to a noncontrolling interest consider the effects of enacted changes in tax rates before the date the enacted changes become effective?**

No. Unlike a fair value measurement, the HLBV method is an approach to allocate earnings on the basis of how an investee (or subsidiary) would allocate current-period earnings to an equity method investor (or noncontrolling interest holder) **if it were to liquidate** at a particular point in time (i.e., as of a balance sheet date). Therefore, if an investee (or subsidiary) were to liquidate as of a balance sheet date before tax reform is effective (e.g., December 31, 2017, for calendar-year-end entities), the tax rates applied in the determination of the liquidation waterfall would not take into account new enacted rates that are not yet effective. Once the enacted rates become effective, a company applying the HLBV method will need to carefully consider the allocation provisions in contracts to determine the impact that those new rates have on the application of HLBV.

#### FAQ B-54

##### **How should a company assess impairment of equity method investments in pass-through entities?**

Some equity method investments are in pass-through entities in which a significant portion of the benefits received by an investor is related to tax credits and other tax benefits (e.g., accelerated pass-through tax losses). In many cases (e.g., pass-through entities that generate solar and wind credits), the equity method investor applies HLBV in recognizing earnings. Although we believe that the impact of tax reform should not be reflected in HLBV before the effective rates affect the contractual waterfall in liquidation (see [FAQ B-53](#)), an equity method investor must consider whether tax reform results in an other-than-temporary impairment (OTTI) under ASC 323. In accordance with [FAQ B-52](#), the future impact of the change in tax rates could result in a change to a market participant's view of the fair value of the investment. An entity should consider all facts and circumstances in performing an analysis of OTTI; however, the expected impact of applying HLBV in future periods is not necessarily an indication of an impairment of the investment.

### **B.11.8 Investments in Qualified Affordable Housing Projects**

Investors in qualified affordable housing projects (QAHPs) also invest in pass-through entities primarily for the tax credits and other tax benefits. If certain criteria are met, the investor may apply the proportional amortization method (PAM) under ASC 323-740, which results in proportional amortization of the investment balance in each period on the basis of the proportion of the total estimated tax benefit allocated to the entity in that period rather than the application of the equity method. The calculation of the proportional amortization frequently includes the total estimated other tax benefits<sup>13</sup> expected to be received by the investor over the life of the investment. The criteria that must be met for an investor to apply PAM must be reevaluated upon the occurrence of either a change in the nature of the investment or a change in the relationship with the investee that could cause the entity to no longer meet the conditions. Given that the Act changes corporate tax rates, the tax benefits to be received by entities holding QAHP investments may be affected.

#### FAQ B-55

##### **Is an investor in a QAHP that accounts for its investment by using the PAM required to reevaluate the conditions for applying PAM as a result of the change in corporate tax rate?**

No. Although a change in tax rates may affect whether the criteria in ASC 323-740-25-1 are met after the initial investment, we do not believe that the change in tax rate represents either a change in the nature of the investment or a change in the relationship with the investee, as those terms are contemplated in ASC 323-740-25-1C. Therefore, an entity is not required to reassess whether it is still appropriate to apply PAM solely because of the change in tax rates.

<sup>13</sup> In accordance with ASC 323-740-35-4, "as a practical expedient, an investor is permitted to amortize the initial cost of the investment in proportion to only the tax credits . . . if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result." If the practical expedient was applied, the change in effective tax rates may not affect the calculation of proportional amortization.

**FAQ B-56****If an investor is not using the practical expedient to amortize its QAHPI investment, how does the change in corporate tax rate affect amortization?**

When the total expected tax benefit (tax credits and other tax benefits received) changes, amortization of the investment must be revised to ensure that cumulative amortization over the life of the investment equals the initial carrying amount (less any residual value). The change in corporate tax rate will generally reduce the benefit of “other” tax benefits (i.e., tax benefits other than credits) to be allocated to a QAHPI investor in the future (i.e., the pass-through losses in the future will now benefit the investor at a 21 percent, instead of a 35 percent, tax rate). If an investor has not elected to use the practical expedient, the proportion of benefits already allocated to the investor will increase in relation to the total expected tax credits and other tax benefits. As a result, we believe that there are two acceptable approaches for adjusting amortization.

Under the first approach, the investor would record a cumulative catch-up adjustment to the carrying amount of the investment on the basis of the amount of tax credits and other tax benefits that have been allocated to the investor in relation to the revised amount of total expected tax benefits. This approach is consistent with the guidance in ASC 323-740, which requires that the initial cost of the investment be amortized in proportion to the tax credits and other benefits that have been allocated to the investor.

Under the second approach, the investor would adjust amortization prospectively. This treatment is consistent with accounting for a change in estimate that does not affect the carrying amount of an asset or liability but alters the subsequent accounting for existing or future assets or liabilities under ASC 250.

An investor should consider whether it has, in effect, made a policy election in prior periods when adjusting amortization to take into account changes in expected tax benefits due to factors other than changes in tax rates. If so, using a different approach to account for the change in tax rate would be a change in accounting principle that would need to be assessed for preferability.

**FAQ B-57****Is an investor required to assess its QAHPI investments for impairment as a result of the change in the corporate tax rate?**

If the investor concludes that the change in corporate tax rate indicates that it is more likely than not that the carrying amount of the investment will not be realized, the investor would be required to assess its QAHPI investments for impairment. This may be the case, for example, if a significant portion of the investor’s yield relied on “other” tax benefits whose value declined as a result of the rate change. We believe that when this assessment is performed, the carrying amount of the investment, after any cumulative catch-up is considered (see FAQ B-56 above), would be compared with the undiscounted amount of the remaining expected tax credits and other tax benefits in the evaluation of whether it is more likely than not the carrying amount will not be realized.

**FAQ B-58****In the measurement of an impairment of a QAHPI investment, should future tax benefits be discounted?**

Yes. As stated in ASC 323-740-35-6, the “impairment loss shall be measured as the amount by which the carrying amount of an investment exceeds its fair value.” Fair value should take into account discounting of the future tax benefits expected to be received.

#### FAQ B-59

##### **If an impairment of a QAHPI investment is recorded, should it be recorded in pretax income (loss) or as a component of income tax expense?**

ASC 323-740 does not specify where in the income statement an impairment charge related to a QAHPI investment should be recorded. Under the proportional amortization method, the amortization of the cost of the investment is netted against the tax benefits received within the income tax expense line. An impairment is a recognition that the unamortized cost of acquiring the benefits exceeds the remaining expected benefits, but it does not change the nature of the initial investment as an investment in tax credits and other tax benefits. Accordingly, we believe that the impairment would be recorded as a component of income tax expense.

## B.11.9 Goodwill Impairment

#### FAQ B-60

##### **What income tax rate should an entity use in testing goodwill for impairment when the testing date is before December 22, 2017?**

Even though goodwill impairment tests are generally performed after the designated goodwill impairment testing date but before the financial statements are issued, an entity should test goodwill for impairment by using facts and circumstances that existed as of the testing date. Therefore, the information used for a test before December 22, 2017, should be limited to information that was available as of that date.

#### FAQ B-61

##### **What impact, if any, does the enactment of the Act have on an entity's assessment of goodwill recoverability?**

Goodwill is tested for impairment annually and between annual tests when an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. While enactment of a new tax law is not one of the examples of events or changes in circumstances listed in ASC 350-20-35-3C, those examples are not all-inclusive. An entity should consider its specific facts and circumstances in determining whether, as a result of enactment of the Act, it might become more likely than not that the fair value of one or more of the entity's reporting units is less than the carrying amount of the reporting unit(s). For example, if a reporting unit includes a significant DTL, enactment of the Act could result in a reduction of the DTL, thereby increasing the carrying value of the reporting unit. However, the enactment of the Act could also result in an increase in the fair value of the reporting unit. An entity should exercise judgment in determining whether enactment of the Act represents a triggering event.

## B.11.10 Foreign Currency Implications of Withholding Tax Liabilities

As discussed in [FAQ B-19](#), [FAQ B-20](#), and [FAQ B-21](#), as a result of the Act, some entities may change their intent to indefinitely reinvest foreign earnings and, in some instances, a liability may need to be recorded for estimated withholding taxes. While foreign withholding taxes are generally considered a liability of the investor rather than the investee (i.e., are attributable to the investor's outside basis difference), such taxes will ultimately be payable to the foreign government in local currency and, provided that the investor and investee have different functional currencies, represent foreign-currency-denominated liabilities of the investor.

**FAQ B-62**

**How should a U.S. parent account for fluctuations in the value of a non-USD-denominated, foreign withholding tax liability related to earnings of a *first-tier* foreign subsidiary (or foreign corporate joint venture that is essentially permanent in duration) (the “*first-tier foreign subsidiary*”) that are not reinvested indefinitely?**

The amount of a non-USD-denominated, foreign withholding tax liability will change as a result of fluctuations in the corresponding exchange rate between the U.S. parent (i.e., the USD) and the applicable local currency of the first-tier foreign subsidiary. Because the U.S. parent is the primary obligor, such a liability is not recorded by the first-tier foreign subsidiary and is therefore not subject to translation. Accordingly, the impact of fluctuations between the reporting currency of the U.S. parent and the functional currency of the first-tier foreign subsidiary should be recorded through continuing operations of the U.S. parent as the related liability is remeasured in each reporting period in accordance with ASC 830-20.

**FAQ B-63**

**How should a *first-tier* foreign subsidiary (or foreign corporate joint venture that is essentially permanent in duration) account for fluctuations in the value of a foreign withholding tax liability related to earnings of a *second-tier* foreign subsidiary (or foreign corporate joint venture that is essentially permanent in duration) (the “*second-tier foreign subsidiary*”) that are not indefinitely reinvested when the *first-tier* foreign subsidiary has the same local and functional currency as that of the *second-tier* foreign subsidiary, which is not the reporting currency?**

Because the first-tier foreign subsidiary and the second-tier foreign subsidiary have the same functional currency, the amount of the withholding tax liability on the functional currency books of the first-tier foreign subsidiary will not change as a result of exchange rate fluctuations. Accordingly, the related liability would not be remeasured in each reporting period, and the first-tier foreign subsidiary would not record transaction gain or loss in accordance with ASC 830-20. However, because the first-tier foreign subsidiary is the primary obligor, such a liability is recorded by the first-tier foreign subsidiary and is therefore subject to translation. Accordingly, the impact of fluctuations between the reporting currency of the U.S. parent and the functional currency of the first-tier foreign subsidiary should be recorded as a CTA through OCI.

**FAQ B-64**

**How should a reporting entity account for fluctuations in the value of a foreign withholding tax liability related to earnings of a *second-tier* foreign subsidiary (or foreign corporate joint venture that is essentially permanent in duration) that are not indefinitely reinvested when the *first-tier* foreign subsidiary has a functional currency that is different from (1) the functional currency of the *second-tier* foreign subsidiary and (2) the reporting currency?**

The amount of a foreign withholding tax liability denominated in the local currency of the second-tier foreign subsidiary will change as a result of fluctuations in the corresponding exchange rate between the applicable local currencies of the first-tier foreign subsidiary and the second-tier foreign subsidiary. Accordingly, the impact of fluctuations between the functional currencies of the first-tier foreign subsidiary and the second-tier foreign subsidiary should be recorded through continuing operations of the first-tier foreign subsidiary as the related liability is remeasured in each reporting period in accordance with ASC 830-20. In addition, because the first-tier foreign subsidiary is the primary obligor, such a liability is recorded by the first-tier foreign subsidiary and is therefore subject to translation. Accordingly, the impact of fluctuations between the reporting currency of the U.S. parent and the functional currency of the first-tier foreign subsidiary should be recorded as a CTA through OCI.

## B.12 Separate-Company Financial Statements

### FAQ B-65

**In applying the separate-return approach to allocate income taxes to the separate financial statements of a member of a U.S. consolidated tax return group, how should a company account for provisions of the Act that are calculated on a consolidated tax return basis (e.g., the deemed repatriation transition tax, GILTI, BEAT)?**

The member should record the tax expense attributable to the various provisions of the Act as if it had not been a member of the U.S. consolidated tax return group. However, depending on the facts and circumstances, it may be appropriate to apply related-party and affiliated group rules that are relevant regardless of whether an entity makes an election to file a consolidated tax return. For more information on the separate-return approach, see [4.49](#).

## B.13 Disclosure Considerations

### FAQ B-66

**What forward-looking disclosures should registrants consider in MD&A about the impact of tax reform?**

Material amounts recorded in the current year related to tax reform would typically be discussed and analyzed as part of a registrant's MD&A. In addition, SEC Regulation S-K, Item 303, requires SEC registrants to disclose in their MD&A any known trends, events, or uncertainties that are reasonably likely to have a material effect on their liquidity, capital resources, or results of operations. Therefore, registrants should consider disclosing in MD&A, to the extent such disclosures are material, the impact of the changes in tax law on future periods in addition to the current period. Such disclosures may include:

- The impact of changes in the effective tax rate on future results of operations.
- The impact of other new provisions (e.g., GILTI, FDII, BEAT) on future results of operations.
- The existence and nature of uncertainties related to those aspects of the Act for which the registrant either (1) recorded provisional amounts or (2) was unable to record a provisional amount because the registrant did not have the necessary information available, prepared, or analyzed to complete its accounting for the change in tax law.
- The implications of paying the required one-time deemed repatriation transition tax on liquidity and capital resources.
- Potential changes in the determination of indefinitely reinvested foreign earnings and the impact of additional cash that may become available for domestic operations.
- The impact that changes in tax rates or other impacts of tax reform could have on contractual agreements, such as debt covenants.

Registrants that provide forward-looking earnings guidance will also need to consider the impact of tax reform on such guidance.

**FAQ B-67****What incremental disclosures are required when an entity adopts a measurement period approach as permitted by SAB 118?**

In addition to the disclosures required by ASC 740, SAB 118 requires companies to disclose “information about the material financial reporting impacts of the Act for which the accounting under [ASC 740 as of the reporting date] is incomplete.” These disclosures include:

- (a) Qualitative disclosures of the income tax effects of the Act for which the accounting is incomplete;
- (b) Disclosures of items reported as provisional amounts;
- (c) Disclosures of existing current or deferred tax amounts for which the income tax effects of the Act have not been completed;
- (d) The reason why the initial accounting is incomplete;
- (e) The additional information that is needed to be obtained, prepared, or analyzed in order to complete the accounting requirements under ASC Topic 740;
- (f) The nature and amount of any measurement period adjustments recognized during the reporting period;
- (g) The effect of measurement period adjustments on the effective tax rate; and
- (h) When the accounting for the income tax effects of the Act has been completed.

We would expect items (a) through (e), as well as item (h), to be included in a company’s disclosures in the first financial statements issued that include the period in which the Act was enacted (e.g., financial statements for the year ended December 31, 2017, for calendar-year companies). Items (f) and (g) will be relevant in subsequent periods to the extent that a company records adjustments during the measurement period, and items (a) through (e) and (h) should be updated in each reporting period until the company has completed its accounting for the income tax effects of the Act.

The examples below illustrate elements that may apply to a particular entity’s compliance with the incremental disclosure requirements of SAB 118. However, the examples are not all-inclusive and do not take into account any other disclosure requirements in ASC 740. See [Chapter 6](#) for additional information regarding disclosures required by ASC 740.

**Examples****[Optional disclosures depending on applicability]**

[Simple description of Tax Act] On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). The Tax Act makes broad and complex changes to the U.S. tax code, including, but not limited to, (1) reducing the U.S. federal corporate tax rate from 35 percent to 21 percent; (2) requiring companies to pay a one-time transition tax on certain unrepatriated earnings of foreign subsidiaries; (3) generally eliminating U.S. federal income taxes on dividends from foreign subsidiaries; (4) requiring a current inclusion in U.S. federal taxable income of certain earnings of controlled foreign corporations; (5) eliminating the corporate alternative minimum tax (AMT) and changing how existing AMT credits can be realized; (6) creating the base erosion anti-abuse tax (BEAT), a new minimum tax; (7) creating a new limitation on deductible interest expense; and (8) changing rules related to uses and limitations of NOL carryforwards created in tax years beginning after December 31, 2017.

[OR]

## FAQ B-67 (continued)

### Examples (continued)

[Simple description of Tax Act applicable to a fiscal year company] On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act makes broad and complex changes to the U.S. tax code that will affect our fiscal year ending September 30, 2018, including, but not limited to, (1) reducing the U.S. federal corporate tax rate, (2) requiring a one-time transition tax on certain unrepatriated earnings of foreign subsidiaries that is payable over eight years, and (3) bonus depreciation that will allow for full expensing of qualified property. The Tax Act reduces the federal corporate tax rate to 21 percent in the fiscal year ending September 30, 2018. Section 15 of the Internal Revenue Code stipulates that our fiscal year ending September 30, 2018, will have a blended corporate tax rate of 24.53 percent, which is based on the applicable tax rates before and after the Tax Act and the number of days in the year.

[OR]

[Detailed description of Tax Act distinguishing elements applicable to 2017 and those applicable to 2018] On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act makes broad and complex changes to the U.S. tax code that will affect 2017, including, but not limited to, (1) requiring a one-time transition tax on certain unrepatriated earnings of foreign subsidiaries that is payable over eight years and (2) bonus depreciation that will allow for full expensing of qualified property.

The Tax Act also establishes new tax laws that will affect 2018, including, but not limited to, (1) reduction of the U.S. federal corporate tax rate; (2) elimination of the corporate alternative minimum tax (AMT); (3) the creation of the base erosion anti-abuse tax (BEAT), a new minimum tax; (4) a general elimination of U.S. federal income taxes on dividends from foreign subsidiaries; (5) a new provision designed to tax global intangible low-taxed income (GILTI), which allows for the possibility of using foreign tax credits (FTCs) and a deduction of up to 50 percent to offset the income tax liability (subject to some limitations); (6) a new limitation on deductible interest expense; (7) the repeal of the domestic production activity deduction; (8) limitations on the deductibility of certain executive compensation; (9) limitations on the use of FTCs to reduce the U.S. income tax liability; and (10) limitations on NOLs generated after December 31, 2017, to 80 percent of taxable income.

[Description of SAB 118] The SEC staff issued SAB 118, which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Act for which the accounting under ASC 740 is complete. To the extent that a company's accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to apply ASC 740 on the basis of the provisions of the tax laws that were in effect immediately before the enactment of the Tax Act.

[Initial recording of impact of Tax Act] In connection with our initial analysis of the impact of the Tax Act, we have recorded a discrete net tax expense [or benefit] of \$XX in the period ending December 31, 2017. This net expense [or benefit] primarily consists of a net expense [or benefit] for the corporate rate reduction of \$XX and a net expense for the transition tax of \$XX. For various reasons that are discussed more fully below, we have not completed our accounting for the income tax effects of certain elements of the Tax Act. If we were able to make reasonable estimates of the effects of elements for which our analysis is not yet complete, we recorded provisional adjustments. If we were not yet able to make reasonable estimates of the impact of certain elements, we have not recorded any adjustments related to those elements and have continued accounting for them in accordance with ASC 740 on the basis of the tax laws in effect before the Tax Act.

**FAQ B-67 (continued)****Examples (continued)**

[Completed elements] Our accounting for the following elements of the Tax Act is complete.

*Reduction of U.S. federal corporate tax rate:* The Act reduces the corporate tax rate to 21 percent, effective January 1, 2018. Consequently, we have recorded a decrease related to DTAs and DTLs of \$XX and \$XX, respectively, with a corresponding net adjustment to deferred income tax expense (or benefit) of \$XX for the year ended December 31, 2017.

[Insert additional elements for items the company may also consider complete.]

[AND/OR]

[Incomplete elements] Our accounting for the following elements of the Tax Act is incomplete. However, we were able to make reasonable estimates of certain effects and, therefore, recorded provisional adjustments as follows:

*Reduction of US federal corporate tax rate:* The Tax Act reduces the corporate tax rate to 21 percent, effective January 1, 2018. For certain of our DTAs and DTLs, we have recorded a provisional decrease of \$XX and \$XX, respectively, with a corresponding net adjustment to deferred income tax expense [or deferred tax benefit] of \$XX for the year ended December 31, 2017. While we are able to make a reasonable estimate of the impact of the reduction in corporate rate, it may be affected by other analyses related to the Tax Act, including, but not limited to, our calculation of deemed repatriation of deferred foreign income and the state tax effect of adjustments made to federal temporary differences.

*Deemed Repatriation Transition Tax:* The deemed repatriation transition tax (Transition Tax) is a tax on previously untaxed accumulated and current earnings and profits (E&P) of certain of our foreign subsidiaries. To determine the amount of the Transition Tax, we must determine, in addition to other factors, the amount of post-1986 E&P of the relevant subsidiaries, as well as the amount of non-U.S. income taxes paid on such earnings. We are able to make a reasonable estimate of the Transition Tax and recorded a provisional Transition Tax obligation of \$XX. However, we are continuing to gather additional information to more precisely compute the amount of the Transition Tax.

*Valuation allowances:* The company must assess whether its valuation allowance analyses are affected by various aspects of the Tax Act (e.g., deemed repatriation of deferred foreign income, GILTI inclusions, new categories of FTCs). Since, as discussed herein, the company has recorded provisional amounts related to certain portions of the Tax Act, any corresponding determination of the need for or change in a valuation allowance is also provisional.

*Cost recovery:* While we have not yet completed all of the computations necessary or completed an inventory of our 2017 expenditures that qualify for immediate expensing, we have recorded a provisional benefit of \$XX based on our current intent to fully expense all qualifying expenditures. This resulted in a decrease of approximately \$XX to our current income tax payable and a corresponding increase in our DTLs of approximately \$XX (after considering the effects of the reduction in income tax rates).

[AND/OR]

## FAQ B-67 (continued)

### Examples (continued)

[Incomplete elements] Our accounting for the following elements of the Tax Act is incomplete, and we were not yet able to make reasonable estimates of the effects. Therefore, no provisional adjustments were recorded.

*Global intangible low taxed income (GILTI):* The Tax Act creates a new requirement that certain income (i.e., GILTI) earned by controlled foreign corporations (CFCs) must be included currently in the gross income of the CFCs' U.S. shareholder. GILTI is the excess of the shareholder's "net CFC tested income" over the net deemed tangible income return, which is currently defined as the excess of (1) 10 percent of the aggregate of the U.S. shareholder's pro rata share of the qualified business asset investment of each CFC with respect to which it is a U.S. shareholder over (2) the amount of certain interest expense taken into account in the determination of net CFC-tested income.

Because of the complexity of the new GILTI tax rules, we are continuing to evaluate this provision of the Tax Act and the application of ASC 740. Under U.S. GAAP, we are allowed to make an accounting policy choice of either (1) treating taxes due on future U.S. inclusions in taxable income related to GILTI as a current-period expense when incurred (the "period cost method") or (2) factoring such amounts into a company's measurement of its deferred taxes (the "deferred method"). We selected the deferred method. Our calculation of the deferred balance with respect to the new GILTI tax rules will depend, in part, on analyzing our global income to determine whether we expect to have future U.S. inclusions in taxable income related to GILTI and, if so, what the impact is expected to be. Because whether we expect to have future U.S. inclusions in taxable income related to GILTI depends on a number of different aspects of our estimated future results of global operations, we are not yet able to reasonably estimate the effect of this provision of the Tax Act. Therefore, we have not made any adjustments related to potential GILTI tax in our financial statements.

[OR]

Because of the complexity of the new GILTI tax rules, we are continuing to evaluate this provision of the Tax Act and the application of ASC 740. Under U.S. GAAP, we are allowed to make an accounting policy choice of either (1) treating taxes due on future U.S. inclusions in taxable income related to GILTI as a current-period expense when incurred (the "period cost method") or (2) factoring such amounts into a company's measurement of its deferred taxes (the "deferred method"). Our selection of an accounting policy with respect to the new GILTI tax rules will depend, in part, on analyzing our global income to determine whether we expect to have future U.S. inclusions in taxable income related to GILTI and, if so, what the impact is expected to be. Because whether we expect to have future U.S. inclusions in taxable income related to GILTI depends on a number of different aspects of our estimated future results of global operations, we are not yet able to reasonably estimate the effect of this provision of the Tax Act. Therefore, we have not made any adjustments related to potential GILTI tax in our financial statements and have not made a policy decision regarding whether to record deferred taxes on GILTI.<sup>14</sup>

*Valuation allowances:* The company must assess whether valuation allowances assessments are affected by various aspects of the Tax Act (e.g., deemed repatriation of deferred foreign income, GILTI inclusions, new categories of FTCs). Since, as discussed herein, the company has recorded no amounts related to certain portions of the Tax Act, any corresponding determination of the need for or change in a valuation allowance has not been completed and no changes to valuation allowances as a result of the Tax Act have been recorded.

<sup>14</sup> See FAQ B-32 for additional information.

## B.14 IFRS Considerations

### FAQ B-68

#### **May an entity that reports under IFRS Standards apply the guidance in SAB 118?**

As indicated in footnote 6 of SAB 118, the SEC will allow a foreign private issuer (FPI) reporting under IFRS Standards to apply the guidance in the SAB when accounting for the effects of the Act.

However, we do not believe that non-FPIs reporting under IFRS Standards may apply the guidance in SAB 118 because SABs are not authoritative guidance under IFRS Standards. Nevertheless, we support the preliminary view of many stakeholders that “SAB 118-like” accounting may be achieved for at least those provisions of the Act for which reliable estimates can be made by applying existing IFRS guidance. For example, although an entity may need to use judgment in accounting for certain aspects of the Act, if a reliable estimate can be made, the entity should recognize such amounts and, if necessary, adjust those estimates over time as more information becomes available and provide accompanying disclosures. It is uncertain at this time, however, whether current IFRS guidance supports accounting similar to that under SAB 118, which permits entities to exclude provisional amounts “for those specific income tax effects for which a reasonable estimate cannot be determined.” In addition, entities should consider providing appropriate disclosures on the basis of their specific situation.

While the answer to this FAQ reflects our views at this time, we understand that IFRS stakeholders are continuing to meet with their regulators, auditing firms, and other oversight bodies to determine whether and, if so, how entities that report under IFRS Standards may navigate the challenges associated with applying existing IFRS guidance to the requirements in the Act. Accordingly, our views are subject to change on the basis of possible additional guidance or further developments in practice.

## B.15 Interim Reporting Considerations

The tax provision for interim periods related to ordinary income (or loss) is computed by using an estimated AETR.

Certain items or events are specifically excluded from the estimated AETR and, therefore, the related tax effects are recognized discretely (i.e., tax effects are excluded from the numerator and underlying pretax book income or expense, if any, is excluded from the denominator).

Items or events excluded from the AETR calculation may include:

- Significant and unusual or infrequently occurring items (see ASC 740-270-30-8).
- Out-of-period adjustments.
- Certain loss jurisdictions (see ASC 740-270-30-36(a)).
- Certain jurisdictions for which an entity is unable to reliably estimate income (or loss) or the related tax (or benefit) (see ASC 740-270-30-36(b)).
- Certain components of pretax income that are not estimable (ASC 740-270-30-17).
- Any item reported net of tax (discontinued operations/OCI/other tax effects in equity).
- Tax effects (excess or deficiency) of exercised or vested share-based payment awards.

#### FAQ B-69

**How should the Act be considered when an entity is estimating its AETR for an interim period after the first annual period after enactment (i.e., the quarter ending March 31, 2018, for calendar-year entities)?**

All provisions of the Act (e.g., BEAT, GILTI, Section 163(j)) related to ordinary income should be considered and estimated as part of an entity's estimated AETR. See [9.01](#) for more information.

#### FAQ B-70

**What if the entity is unable to reliably estimate the current-year impact of a provision of the Act on its AETR?**

An entity that is unable to reliably estimate the current-year impact of a provision of the Act should apply the guidance in ASC 740-270-25-3, under which such an impact would be reported discretely. For more information, see [9.06](#).

#### FAQ B-71

**For Act-related matters for which the accounting was not completed in the period of enactment, how should additional information obtained by an entity during the measurement period be accounted for under SAB 118?**

SAB 118 states:

During the measurement period, an entity may need to reflect adjustments to its provisional amounts upon obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the enactment date that, if known, would have affected the income tax effects initially reported as provisional amounts. Further, an entity may also need to report additional tax effects during the measurement period, based on obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the enactment date that was not initially reported as provisional amounts. . . .

Any provisional amounts or adjustments to provisional amounts included in an entity's financial statements during the measurement period should be included in income from continuing operations as an adjustment to tax expense or benefit in the reporting period the amounts are determined.

Therefore, if, after the period of enactment, an entity obtains information that allows it to finalize, update, or make an initial reasonable estimate of the tax effects of the Act, an adjustment should be recorded to income tax expense/benefit as a discrete item in that reporting period. In other words, the entity should update its accounting for the tax effects of the Act — on the basis of the best information available at the end of each reporting period — for Act-related matters that were not completed in the period of enactment in each reporting period within the measurement period.

**FAQ B-72**

**During the measurement period allowed under SAB 118 (which is not to exceed one year), how should an entity account for interpretive or other guidance issued by a tax authority (e.g., the IRS) that clarifies how certain provisions of the Act should be applied between the balance sheet date and the date financial statements are issued or are available to be issued?**

Under ASC 740, an entity would not normally consider new information that is received after the balance sheet date, but that was not available as of the balance sheet date, as discussed in paragraph B38 of Interpretation 48 (not codified in ASC 740), which states, in part:

[T]he Board decided that recognition and measurement should be based on all information available at the reporting date and that a subsequent change in facts and circumstances should be recognized in the period in which the change occurs. Accordingly, a change in facts subsequent to the reporting date but prior to the issuance of the financial statements should be recognized in the period in which the change in facts occurs.

Given the unique facts and circumstances associated with the Act, however, which result in SAB 118 requiring the recognition of provisional amounts during the measurement period for items that are still open and for which a reasonable estimate can be made, we believe that it would also be acceptable to incorporate such new information into an entity's provisional amounts.

Notwithstanding the aforementioned exception to the normal rule, new information that constitutes a change in tax law would still be reflected in the period in which the new law is enacted.

**FAQ B-73**

**What incremental disclosures does SAB 118 require entities to provide in periods after the enactment period of the Act?**

In addition to the disclosures required by ASC 740, SAB 118 requires entities to disclose "information about the material financial reporting impacts of the Act for which the accounting under [ASC 740 as of the reporting date] is incomplete." See [FAQ B-67](#) for additional discussion and a complete listing of the required disclosures.

While SAB 118 does not explicitly state whether such disclosures pertain to annual financial statements, quarterly financial statements, or both, we note that all registrants were required to provide such disclosures in the period of enactment and, provided that items remain "provisional" or "incomplete" in subsequent filings, we believe that entities will need to refresh their disclosures on a quarterly basis.

Moreover, SEC Regulation S-X, Rule 10-01(a)(5), states:

The interim financial information shall include disclosures either on the face of the financial statements or in accompanying footnotes sufficient so as to make the interim [financial] information presented not misleading. Registrants may presume that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnote disclosure which would substantially duplicate the disclosure contained in the most recent annual report to security holders or latest audited financial statements, such as a statement of significant accounting policies and practices, details of accounts which have not changed significantly in amount or composition since the end of the most recently completed fiscal year, and detailed disclosures prescribed by Rule 4-08 of this Regulation, may be omitted. **However, disclosure shall be provided where events subsequent to the end of the most recent fiscal year have occurred which have a material impact on the registrant.** Disclosures should encompass, for example, significant changes since the end of the most recently completed fiscal year in such items as: accounting principles and practices; estimates inherent in the preparation of financial statements; status of long-term contracts; capitalization including significant new borrowings or modification[s] of existing financing arrangements; and the reporting entity resulting from business combinations or dispositions.

**Notwithstanding the above, where material contingencies exist, disclosure of such matters shall be provided even though a significant change since year end may not have occurred.**

[Emphasis added]

## FAQ B-73 (continued)

Accordingly, we believe the following:

1. Items that were disclosed as complete in a prior Form 10-K (or Form 10-Q) do not need to be repeated in subsequent Form 10-Q filings; however, an item reported as complete in a prior Form 10-Q would generally be repeated in the entity's next Form 10-K filing.
2. Items that were disclosed as provisional or incomplete (Buckets 2 and 3) and, hence, are considered "open" would generally be treated as more akin to "material contingencies." Accordingly, we believe that the relevant SAB 118 disclosures would need to be updated or refreshed (or both) as necessary in follow-on filings for these items until the accounting for such items is completed. In other words, entities should still, at a minimum, continue to denote those items for which the accounting remains provisional or incomplete in future filings, regardless of whether a significant change in the status of such items has occurred since the prior filing date.

The following examples illustrate these concepts:

### Examples

#### **Bucket 2: Items for Which the Accounting Is Provisional**

For elements of the Act that were previously disclosed as being provisional (for which entities were able to make reasonable estimates and recorded provisional adjustments) but that are now determined to be complete without any further adjustment to the provisional amounts previously recorded:

[Our accounting for the following elements of the Act is complete:

*Deemed Repatriation Transition Tax:* The deemed repatriation transition tax (the "Transition Tax") is a tax on certain previously untaxed accumulated and current earnings and profits (E&P) of our foreign subsidiaries. Consequently, we recorded a Transition Tax obligation of \$XX, with a corresponding adjustment to income tax expense of \$XX for the year ended December 31, 2017. No changes have been made to these adjustments, and our accounting for the transition tax is now complete.

*Insert additional elements for items the company may also consider complete.*

*Further, see the disclosure guidelines above for disclosures required in subsequent periods.]*

For elements of the Act that were previously disclosed as being provisional (for which entities were able to make reasonable estimates and recorded provisional adjustments), for which incremental measurement adjustments were recognized during the reporting period, and that are now determined to be complete:

[Our accounting for the following elements of the Act is complete.

*Deemed Repatriation Transition Tax:* The deemed repatriation transition tax (the "Transition Tax") is a tax on certain previously untaxed accumulated and current earnings and profits (E&P) of our foreign subsidiaries. We were able to reasonably estimate the Transition Tax and recorded a provisional Transition Tax obligation of \$XX, with a corresponding adjustment of \$XX to income tax expense for the year ended December 31, 2017. On the basis of revised E&P computations that were completed during the reporting period, we recognized an additional measurement-period adjustment of \$XX to the Transition Tax obligation, with a corresponding adjustment of \$XX to income tax expense during the period. The effect of the measurement-period adjustment on the 2018 effective tax rate was approximately XX percent. The Transition Tax, which has now been determined to be complete, resulted in recording a total Transition Tax obligation of \$XX, with a corresponding adjustment of \$XX to income tax expense.

*Insert additional elements for items the company may also consider complete.*

*Further, see the disclosure guidelines above for disclosures required in subsequent periods.]*

For elements of the Act that were previously disclosed as being provisional (for which entities were able to make reasonable estimates and recorded provisional adjustments) and for which incremental measurement adjustments were recognized during the reporting period but the element is still determined to be provisional:

**FAQ B-73 (continued)****Examples (continued)**

[Our accounting for the following elements of the Act is incomplete. However, we were able to reasonably estimate certain effects and, therefore, recorded provisional adjustments as follows:

*Deemed Repatriation Transition Tax:* The deemed repatriation transition tax (the "Transition Tax") is a tax on certain previously untaxed accumulated and current earnings and profits (E&P) of our foreign subsidiaries. We were able to reasonably estimate the Transition Tax and recorded an initial provisional Transition Tax obligation of \$XX, with a corresponding adjustment of \$XX to income tax expense for the year ended December 31, 2017. On the basis of revised E&P computations that were calculated during the reporting period, we recognized an additional measurement-period adjustment of \$XX to the Transition Tax obligation, with a corresponding adjustment of \$XX to income tax expense during the period. The effect of the measurement-period adjustment on the 2018 effective tax rate was approximately XX percent. A total Transition Tax obligation to date of \$XX has been recorded, with a corresponding adjustment of \$XX to income tax expense. However, we are continuing to gather additional information to more precisely compute the amount of the Transition Tax, and our accounting for this item is not yet complete because [insert reasons why the accounting is not yet complete]. We expect to complete our accounting within the prescribed measurement period.

*Insert additional elements for items the company may also consider provisional.*

*In addition, see the disclosure guidelines above for disclosures required in subsequent periods.]*

For elements of the Act that were previously disclosed as being provisional (for which entities were able to make reasonable estimates and recorded provisional adjustments) and for which no incremental measurement adjustments were recognized during the reporting period and the element is still determined to be provisional:

[Our accounting for the Act is incomplete. As noted at year-end [in the prior quarter], however, we were able to reasonably estimate certain effects and, therefore, recorded provisional adjustments associated with the deemed repatriation transition tax [and *Insert any additional elements for items the company may also consider provisional.*]]

We have not made any additional measurement-period adjustments related to these items during the quarter, because [insert reasons why the accounting is not yet complete]. However, we are continuing to gather additional information to complete our accounting for these items and [expect to complete our accounting within the prescribed measurement period.

*In addition, see the disclosure guidelines above for disclosures required in subsequent periods.]*

**Bucket 3: Items for Which No Estimates Could Be Recorded**

[Our accounting for the Act is incomplete. As noted at year-end [in the prior quarter], we were not yet able to reasonably estimate the effects for GILTI. Therefore, no provisional adjustments were recorded.

Because of the complexity of the new GILTI tax rules, we are continuing to evaluate this provision of the Act and the application of ASC 740. Under U.S. GAAP, we are allowed to make an accounting policy choice of either (1) treating taxes due on future U.S. inclusions in taxable income related to GILTI as a current-period expense when incurred (the "period cost method") or (2) factoring such amounts into a company's measurement of its deferred taxes (the "deferred method"). Our selection of an accounting policy related to the new GILTI tax rules will depend, in part, on analyzing our global income to determine whether we expect to have future U.S. inclusions in taxable income related to GILTI and, if so, what the impact is expected to be. Because whether we expect to have future U.S. inclusions in taxable income related to GILTI depends on a number of different aspects of our estimated future results of global operations, we are not yet able to reasonably estimate the long-term effects of this provision of the Act. Therefore, we have not recorded any potential deferred tax effects related to GILTI in our financial statements and have not made a policy decision regarding whether to record deferred taxes on GILTI or use the period cost method. We have, however, included an estimate of the estimated 2018 current GILTI impact in our AETR for 2018. We expect to complete our accounting within the prescribed measurement period.]

## FAQ B-74

### **What interim disclosures should registrants consider related to the impact of the Act in complying with ASC 740-270 interim disclosure requirements?**

The Act makes broad and complex changes to the U.S. tax code, including, but not limited to, reducing the U.S. federal corporate tax rate from 35 percent to 21 percent. The reduction in the U.S. federal corporate rate may significantly affect the customary relationship between income tax expense and pretax accounting income. ASC 740-270-50-1 states:

Application of the requirements for accounting for income taxes in interim periods may result in a significant variation in the customary relationship between income tax expense and pretax accounting income. The reasons for significant variations in the customary relationship between income tax expense and pretax accounting income shall be disclosed in the interim period financial statements if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

The examples below illustrate an entity's compliance with the interim disclosure requirements of ASC 740-270-50-1 in interim periods following the first annual period after the Act. However, the examples are not all-inclusive and do not take into account any other interim presentation requirements in ASC 740. See [Chapter 9](#) for additional considerations related to interim presentation and disclosures.

#### **Examples**

[Our total income tax expense from continuing operations was \$XX for the three months ended March 31, 2018, compared with \$XX for the same period in 2017. The decrease in income tax expense for the three months ended March 31, 2018, compared with the same period in 2017, was primarily affected by the Act, which reduced the U.S. federal corporate income tax rate from 35 percent to 21 percent effective January 1, 2018. We also recorded an additional tax expense [benefit] of \$XX associated with a measurement-period adjustment in the period related to the Transition Tax obligation of \$XX, and recognized incremental tax expense of \$XX and \$XX for the GILTI and BEAT provisions, respectively, of the Tax Act that were effective for the first time during 2018.]

OR

Our effective income tax rate was XX percent for the three months ended March 31, 2018, compared with XX percent for the same period in 2017. The decrease in the effective tax rates for the three months ended March 31, 2018, compared with the same period in 2017, was primarily affected by the Tax Act, which reduced the U.S. federal corporate income tax rate from 35 percent to 21 percent effective January 1, 2018. We also recorded an additional tax expense [benefit] of \$XX associated with a measurement-period adjustment in the period related to the Transition Tax obligation and recognized incremental tax expense of \$XX and \$XX for the GILTI and BEAT provisions, respectively, of the Tax Act that were effective for the first time during 2018.]

**FAQ B-75**

**Should an entity exclude ordinary losses in foreign subsidiaries from the estimation of its AETR under ASC 740-270-30-36(a) if the entity concludes that it is not more likely than not that the entity will realize the tax benefits of losses in those foreign jurisdictions, but those losses will provide tax benefits for U.S. tax purposes by reducing the entity's GILTI inclusion?**

We believe that there are two acceptable views.

Under one view, both the loss from the foreign subsidiary and the corresponding U.S. tax benefit related to the reduction in the GILTI inclusion would be contemplated in the estimation of the AETR. ASC 740-270-30-36(b) states, in part:

The tax (or benefit) related to ordinary income (or loss) in a jurisdiction may not be limited to tax (or benefit) in that jurisdiction. It might also include tax (or benefit) in another jurisdiction that results from providing taxes on unremitted earnings, foreign tax credits, and so forth.

Accordingly, because there is a benefit in the U.S. jurisdiction, ordinary losses and the related U.S. benefit derived by reduced GILTI inclusion would be included in the overall AETR.

Under the alternative view, however, the U.S. tax benefit related to the reduction in GILTI inclusion would be included in the estimation of the AETR, but the ordinary loss from the foreign subsidiary would not. ASC 740-270-30-36(a) states:

If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with paragraph 740-270-30-30 through 30-33, no tax benefit can be recognized, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). A separate estimated annual effective tax rate shall be computed for that jurisdiction and applied to ordinary income (or loss) in that jurisdiction in accordance with the methodology otherwise required by Subtopic 740-270.

Under this second view, because the guidance in ASC 740-270-30-36 appears to suggest application on a jurisdiction-by-jurisdiction basis, the ordinary loss from the loss jurisdiction and the related tax (or benefit) in that separate jurisdiction would be excluded. However, the U.S. tax benefit related to the reduction in GILTI inclusion would be included in the estimation of the AETR unless the U.S. jurisdiction is also a loss jurisdiction.

## B.16 ASU 2018-02

In February 2018, the FASB issued ASU 2018-02 to address industry concerns related to the application of ASC 740 to certain provisions of the Act. Specifically, some constituents in the banking and insurance industries had expressed concerns about the requirement in ASC 740 that the effect of a change in tax laws or rates on DTAs and DTLs be included in income from continuing operations. That guidance applies even in situations in which the tax effects were initially recognized directly in OCI at the previous rate, resulting in “stranded” amounts in AOCI related to the income tax rate differential.

**FAQ B-76**

**To the extent that deferred tax balances that are attributable to items of pretax comprehensive income or loss other than continuing operations (e.g., discontinued operations, OCI, or items charged or credited directly to equity) are adjusted as discussed in [FAQ B-3](#), what impact, if any, does ASU 2018-02 have on where the adjustment for the effect of the tax rate change is recorded?**

None. The adjustment for the tax effects of changes in tax laws or rates is still allocated to income from continuing operations, even after the issuance of ASU 2018-02. However, the ASU allows an entity to elect a one-time reclassification from AOCI to retained earnings of "stranded" tax effects resulting from the Act. The amount of the reclassification includes (1) the effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, on the date of enactment of the Act related to items remaining in AOCI and (2) other income tax effects of the Act on items remaining in AOCI that an entity elects to reclassify. The effects of the change in the U.S. federal corporate income tax rate on gross valuation allowances that were originally charged to income from continuing operations are not included.

For example, assume that before the enactment date of the Act, an entity recognized a \$1,000 loss in OCI in connection with a derivative used in cash flow hedging activities. No further changes in the fair value of the hedge occur after that date. The forecasted transactions will not occur until after the enactment date. Because there was no tax basis in the derivative, the entity also recognized a \$350 DTA and recorded a corresponding entry to OCI. On the enactment date of the Act, the entity reduced the DTA by \$140 and recognized a corresponding increase in income tax expense, equal to the temporary difference of \$1,000 multiplied by 14 percent. Upon adopting the ASU and electing to make the reclassification, the entity would then recognize a one-time reclassification to move the effect of the rate reduction from AOCI to retained earnings. The entries are summarized in the table below.

	<b>Derivative Liability</b>	<b>AOCI</b>	<b>DTA</b>	<b>Net Income</b>	<b>Retained Earnings</b>
Derivative loss	\$ (1,000)	\$ 1,000			
Related tax effect		(350)	\$ 350		
Reduction in statutory rate			(140)	\$ 140	\$ 140
Reclassification under ASU 2018-02		140			(140)
Final balance	\$ (1,000)	\$ 790	\$ 210		

Note that while the first three entries would have been recorded on or before the enactment date and are not affected by the adoption of the ASU, the reclassification entry would only be recorded upon the adoption of ASU 2018-02 if the entity elects to make the reclassification. The reclassification entry would be recorded directly in the statement of changes in stockholders' equity and is not included in the statement of changes in OCI.

**FAQ B-77****Is the adoption of ASU 2018-02 elective?**

No. All companies are required to adopt ASU 2018-02. However, upon the adoption of the ASU, certain provisions in the ASU are required and others are elective.

For example, a company can *elect* to reclassify the income tax effects of the Act on items in AOCI to retained earnings as described in [FAQ B-76](#) above. Under ASC 220-10-45-12A, if an entity elects to reclassify the income tax effects of the Act, the amount of the reclassification includes:

- a. The effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of enactment of the Tax Cuts and Jobs Act related to items remaining in accumulated other comprehensive income. . . .
- b. Other income tax effects of the Tax Cuts and Jobs Act on items remaining in accumulated other comprehensive income that an entity elects to reclassify, subject to the disclosures in paragraph 220-10-50-2(b).

Accordingly, if a company elects to make a reclassification entry, it would be required to reclassify amounts prescribed in ASC 220-10-45-12A(a) but would not be required to reclassify amounts prescribed in ASC 220-10-45-12A(b).

Regardless of whether an election is made to reclassify income tax effects of the Act, however, all companies are *required* to disclose the following upon adoption of the ASU:

- The company's accounting policy related to releasing income tax effects from AOCI (e.g., the portfolio approach or the security-by-security approach).<sup>15</sup>
- Whether the company has elected to reclassify, to retained earnings in the statement of stockholders' equity, the stranded tax effects in AOCI related to the Act.
- If the company has elected to reclassify to retained earnings the stranded tax effects in AOCI related to the Act, what the reclassification encompasses (whether it only includes the change in the federal corporate tax rate or whether it also includes other changes resulting from the Act that affect AOCI).

The ASU is effective for all entities for fiscal years beginning after December 15, 2018, including interim periods therein. Earlier application is permitted in financial statements that have not yet been issued or made available for issuance. Upon adoption, an entity would apply this guidance to each period in which the effect of the Act (or portion thereof) is recorded and may apply it either (1) retrospectively as of the date of enactment<sup>16</sup> or (2) as of the beginning of the period of adoption.

<sup>15</sup> For more information on the portfolio approach and security-by-security approach, see [7.18](#).

<sup>16</sup> If a registrant elects to apply the guidance **retrospectively** after it files its annual financial statements in its Form 10-K (e.g., if the retrospective adoption is elected in the first quarter of 2018 Form 10-Q filing for a calendar-year entity) and subsequently files a new or amended registration statement that incorporates by reference the interim financial statements that reflect the impact of the adoption, the registrant must consider the need to retrospectively revise its annual financial statements that are incorporated by reference in that new or amended registration statement (i.e., the annual financial statements in its Form 10-K for the year ended December 31, 2017). This requirement does not apply to a registrant that chooses to (1) apply the new guidance as of the beginning of the period of adoption or (2) early adopt the new guidance in its annual financial statements that include the period of enactment (e.g., the annual financial statements in its 2017 Form 10-K for a calendar-year entity).

#### FAQ B-78

**What is an example of “[o]ther income tax effects of the Tax Cuts and Jobs Act” within the meaning of ASC 220-10-45-12A(b) for an entity that has elected to reclassify income tax effects of the Act from AOCI to retained earnings in accordance with ASU 2018-02?**

Items classified as other income tax effects of the Act might include, for example, the effect of certain international tax provisions. In some cases, an entity may not have been indefinitely reinvested in the outside basis difference in its foreign subsidiary and, accordingly, recorded a DTL related to the outside basis difference measured in a manner consistent with laws in effect before the deemed repatriation transition tax. When the DTL was initially recorded, a portion may have been recorded through OCI as the tax effects related to the translation of the underlying assets and liabilities of the foreign subsidiary. Because of tax reform, the measurement of the tax effects related to the outside basis difference may have changed as a result, in whole or in part, of the deemed inclusion of previously untaxed post-1986 foreign E&P, offset by a deduction designed to generally result in an effective U.S. federal income tax rate on such E&P of either 15.5 percent or 8 percent depending on the SFC's aggregate foreign cash position. The remeasurement of the portion of the DTL that remains in AOCI would be an example of other income tax effects of the Act on items remaining in AOCI that an entity may elect to reclassify in accordance with ASC 220-10-45-12A(b).

#### FAQ B-79

**ASC 220-10-50-1 states that an “entity shall disclose a description of the accounting policy for releasing income tax effects from accumulated other comprehensive income.” Are the disclosure requirements under ASC 220-10-50-1 applicable only to stranded taxes, or are they applied more broadly to the tax effect of other items in AOCI?**

The disclosure requirements in ASC 220-10-50-1 are applicable only to stranded taxes. Stranded tax commonly results from changes in valuation allowances or changes in tax laws, tax rates, or tax status. See [7.18](#) for more information about the release of stranded income tax effects from AOCI.

#### FAQ B-80

**If an entity initially adopts ASU 2018-02 by using provisional amounts in accordance with SAB 118, what impact do subsequent changes to those provisional amounts have on the entity’s initial-adoption entries?**

Subsequent changes to provisional amounts will not affect the entity's initial-adoption entries; rather, the entity would need to record additional adjustments to the reclassification in subsequent periods. The FASB acknowledged in paragraph BC23 of ASU 2018-02 that if an entity recorded provisional estimates for an item under SAB 118, and additional information related to facts or circumstances that existed as of the date of enactment is obtained during the measurement period, adjustments to those provisional estimates could result in the recording of the reclassification adjustment contemplated by ASU 2018-02 in multiple reporting periods.

**FAQ B-81****If an entity adopts ASU 2018-02 prospectively in a period *after* the period that includes the enactment date, is the amount of the reclassification adjustment based on the amount that remained at enactment, or is it based on the amount that remains at the time of adoption?**

The amount of the reclassification adjustment is based on the amount that remains at the time of adoption. For example, assume that before enactment, an entity holds an AFS security for which an unrealized loss of \$1,000 has been recorded in AOCI, resulting in a corresponding tax effect of \$350 that is also recorded in AOCI. Upon enactment, the entity records an entry in the amount of \$140 ( $\$1,000 \times (35\% - 21\%)$ ) to reduce the DTA related to the unrealized loss with a corresponding debit to tax expense to reflect the difference between the pre-enactment corporate tax rate of 35 percent and the new corporate tax rate of 21 percent.

In the first quarter of 2018, after the enactment date, the entity sells the AFS security, resulting in the reversal of the remaining \$210 DTA balance and, before application of either the security-by-security approach or portfolio approach, reversal of \$210 of tax benefit recorded in OCI. During the second quarter of 2018 and after the sale of the AFS security, the entity adopts ASU 2018-02 and elects to prospectively reclassify stranded tax effects from AOCI to retained earnings.

If the entity had made an accounting policy election to use the security-by-security approach to account for deferred taxes associated with unrealized gains and losses recorded in OCI, the amount of the reclassification under ASU 2108-02 recorded in the second quarter of 2018 would be \$0 because the entire tax effect associated with the AFS security would have been removed from AOCI when the security was sold.

Alternatively, if the entity had made an accounting policy election to use the portfolio approach to account for deferred taxes associated with unrealized gains and losses recorded in OCI, \$140 would be reclassified from AOCI to retained earnings upon adoption of ASU 2018-02. This is because under the portfolio approach, tax effects associated with an individual security in a portfolio are not removed from AOCI until the disposal of the last security in the portfolio.

**FAQ B-82****How does the existence of a valuation allowance in current or prior periods affect the reclassification under ASU 2018-02 of income tax effects of the Act related to "items remaining in accumulated other comprehensive income" on the date of enactment?**

If a DTA for which the offsetting amount would otherwise be recorded to AOCI requires a valuation allowance at the time it is recorded, there is no net amount recorded in AOCI because the valuation allowance is also recorded as an entry to AOCI. Consequently, upon enactment there would be no stranded tax effect in AOCI related to the item that gave rise to the DTA. The following examples illustrate the impact of valuation allowances on the reclassification of stranded tax effects under ASU 2018-02:

**Examples****Valuation Allowance Recorded Before Tax Effects**

Assume that in year 1, before the enactment date of the Act, an entity with a full valuation allowance against its DTAs recognized a \$100 loss in OCI in connection with an AFS security held as a short-term investment. The entity records a DTA equal to \$35 (the \$100 unrealized loss on the AFS security multiplied by the corporate tax rate of 35 percent). Because the entity has a full valuation allowance against its DTAs, it does not record a net tax benefit in OCI but instead records an increase in the valuation allowance of \$35. The entries for year 1 are as follows:

<b>AFS Security</b>	<b>AOCI</b>	<b>DTA</b>	<b>Valuation Allowance</b>	<b>Retained Earnings</b>	<b>Continuing Operations</b>
Unrealized loss on AFS security	(100)	100	35	(35)	—

**FAQ B-82 (continued)****Examples (continued)**

During year 2, the entity determines that the valuation allowance is no longer needed and releases it through continuing operations by debiting the valuation allowance and crediting tax benefit (i.e., continuing operations) in the amount of \$35. The Act is enacted in year 3, and the entity remeasures its DTA related to the AFS security by using the new lower corporate tax rate of 21 percent to credit the DTA and debit tax expense (i.e., continuing operations) in the amount of \$14 (\$100 unrealized loss on the AFS security multiplied by the difference in tax rates of 14 percent (35 percent minus 21 percent)).

The entity adopts ASU 2018-02 as of January 1 of year 4. The amount remaining in AOCI related to the AFS security as of the date of enactment is \$0. This is because when the tax effects of the changes in value of the AFS security occurred, the entity had a full valuation allowance recorded. Accordingly, no amount is reclassified from AOCI to retained earnings under ASU 2018-02. The entries for years 2, 3, and 4 are as follows:

	<b>AFS Security</b>	<b>AOCI</b>	<b>DTA</b>	<b>Valuation Allowance</b>	<b>Retained Earnings</b>	<b>Continuing Operations</b>
Release of the valuation allowance				35		(35)
Enactment			(14)			14
ASU 2018-02		0			0	
Total (years 1, 2, 3, and 4)	(100)	100	21	0	0	(21)

**Valuation Allowance Recorded After Tax Effects**

Assume the same facts as in the previous example, except that the valuation allowance is not recorded until the beginning of year 2 and is not released before enactment.

In year 1, the entity records the \$35 DTA and corresponding tax benefit in OCI related to the \$100 unrealized loss on the AFS security. The entries for year 1 are as follows:

	<b>AFS Security</b>	<b>AOCI</b>	<b>DTA</b>	<b>Valuation Allowance</b>	<b>Retained Earnings</b>	<b>Continuing Operations</b>
Unrealized loss on AFS security	(100)	100			—	—

In year 2, the entity determines that a full valuation allowance is needed and accordingly credits the valuation allowance in the amount of \$35 with an offsetting entry to tax expense (i.e., the amount is not "backwards traced" to AOCI). In year 3, the Act is enacted, and the entity remeasures its DTA related to the AFS security by using the new lower corporate tax rate of 21 percent to credit the DTA and debit the valuation allowance in the amount of \$14. The entity adopts ASU 2018-02 as of January 1 of year 4. In doing so, it determines that upon enactment, the stranded tax effect related to the AFS security is \$14. This is because although the entity recorded a valuation allowance against the DTA related to the AFS security in year 2, the tax effect related to the AFS security that was recorded in OCI (and thus remained in AOCI as of enactment) was \$35. Consequently, a debit of \$14 is made to AOCI, and a credit of \$14 is made to retained earnings to reclassify the stranded tax effects remaining in AOCI as of enactment. The entries for years 2, 3, and 4 are as follows:

**FAQ B-82 (continued)****Examples (continued)**

	<b>AFS Security</b>	<b>AOCI</b>	<b>DTA</b>	<b>Valuation Allowance</b>	<b>Retained Earnings</b>	<b>Continuing Operations</b>
Full valuation allowance recorded				(35)		35
Enactment			(14)	14		
ASU 2018-02		14			(14)	
Total (years 1, 2, 3, and 4)	<u>(100)</u>	<u>79</u>	<u>21</u>	<u>(21)</u>	<u>(14)</u>	<u>35</u>

**FAQ B-83****Do the adoptions of ASU 2018-02 and ASU 2016-01 affect each other?**

Yes, the adoptions of ASU 2018-02 and ASU 2016-01 affect each other.

ASU 2016-01 requires entities to remeasure equity securities with readily determinable fair values (and those without readily determinable fair values upon the occurrence of certain events) to fair value each period and is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods therein. Upon adoption, an entity is required to record a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. Consequently, entities with equity securities that were classified as AFS before adoption will reclassify amounts from AOCI to retained earnings by means of the cumulative-effect adjustment recorded upon adoption.

As noted previously, ASU 2018-02 allows entities to reclassify certain stranded tax effects related to the Act and is effective for annual periods beginning after December 15, 2018, and interim periods therein, with early adoption permitted. Upon adoption, an entity may elect to reclassify stranded tax effects from AOCI to retained earnings. This reclassification may be performed prospectively (as of the beginning of the period of adoption) or retrospectively (to each period in which the effect of the change in tax rates is recognized).

Because both ASU 2018-02 and ASU 2016-01 may affect amounts previously recorded in AOCI, the impact that the adoption of one ASU has on the adoption of the other will depend on (1) the order in which the ASUs are adopted, (2) the entity's existing policies for releasing stranded tax effects, and (3) the entity's choice of adoption with respect to ASU 2018-02.

For example, if ASU 2016-01 is adopted before ASU 2018-02 and the entity elects to adopt ASU 2018-02 prospectively, certain stranded tax effects may have already been reclassified into retained earnings because the entity's existing policy was to release stranded tax effects by using a security-by-security approach (i.e., those specific effects will not remain in AOCI when ASU 2018-02 is adopted and, accordingly, will not be affected by ASU 2018-02). However, an entity may still elect to reclassify other tax effects of the Act in accordance with ASC 220-10-45-12A(a) (e.g., effect of rate change on deferred tax amounts related to debt securities) or ASC 220-10-45-12A(b) *in addition* to those previously reclassified by means of the cumulative-effect adjustment recorded upon adoption of ASU 2016-01.

Alternatively, if ASU 2018-02 is adopted before ASU 2016-01 (or is adopted after ASU 2016-01, but the entity elects to adopt ASU 2018-02 on a retrospective basis) and the entity has elected to reclassify stranded tax effects from AOCI, the tax effects remaining in AOCI that would be reclassified upon adoption of ASU 2016-01 would generally be limited to the tax effect of the pretax gain or loss on the equity security at the new 21 percent statutory tax rate.

If the two ASUs are adopted simultaneously, companies should decide on which ASU was adopted first since that determination will affect the resulting disclosures.

# Appendix C — Glossary of Terms in the ASC 740 Topic and Subtopics

This appendix includes certain defined terms from the glossaries of ASC 740-10-20 (Chapters 1–6), ASC 740-20-20 (Chapter 7), ASC 740-30-20 (Chapter 8), ASC 740-270-20 (Chapter 9), ASC 718-740-20 (Chapter 10), ASC 805-740-20 (Chapter 11), ASC 830-740-20 (Chapter 12), and ASC 323-740-20 (Chapter 13).

## ASC 740 — Glossary

### **Acquiree**

The business or businesses that the acquirer obtains control of in a business combination. [FAS 141(R), paragraph 3] This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity. [FAS 164, paragraph 3(a)]

### **Acquirer**

The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. [FAS 141(R), paragraph 3]

### **Acquisition by a Not-for-Profit Entity**

A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. [FAS 164, paragraph 3(c)] When applicable guidance in Topic 805 is applied by a not-for-profit entity, the term business combination has the same meaning as this term has for a not-for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

### **Acquisition Date**

The date on which the acquirer obtains control of the acquiree. [FAS 141(R), paragraph 3]

### **Alternative Minimum Tax**

A tax that results from the use of an alternate determination of a corporation's federal income tax liability under provisions of the U.S. Internal Revenue Code.

### **Asset Group**

An asset group is the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. [FAS 144, paragraph 4]

### **Award**

The collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. References to an award also apply to a portion of an award. [FAS 123(R), paragraph 10]

### **Benefit**

See Tax (or Benefit).

## ASC 740 — Glossary (continued)

### **Business**

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. [FAS 141(R), paragraph 3] Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

**Note:** The following definition is Pending Content; see Transition Guidance in paragraph 805-10-65-4.

Paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9 define what is considered a business.

### **Business Combination**

A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. [FAS 141(R), paragraph 3] See also Acquisition by a Not-for-Profit Entity.

### **Carrybacks**

Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period. [FAS 109, paragraph 289]

### **Carryforwards**

Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year. [FAS 109, paragraph 289]

### **Component of an Entity**

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group. [FAS 144, paragraph 41]

### **Conduit Debt Securities**

Certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity. [FAS 126, paragraph 3] Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. [FAS 126, paragraph 3] Further, the conduit bond obligor is responsible for any future financial reporting requirements. [FAS 126, paragraph 3]

### **Consolidated Financial Statements**

The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity. [ARB 51, paragraph B1]

### **Contract**

**Note:** The following definition is Pending Content; see Transition Guidance in 606-10-65-1.

An agreement between two or more parties that creates enforceable rights and obligations. [ASU 2014-09, paragraph 5]

### **Contract Asset**

**Note:** The following definition is Pending Content; see Transition Guidance in 606-10-65-1.

An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance). [ASU 2014-09, paragraph 5]

## ASC 740 — Glossary (continued)

### **Corporate Joint Venture**

A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. [APB 18, paragraph 3] A government may also be a member of the group. [APB 18, paragraph 3] 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. [APB 18, paragraph 3] 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. [APB 18, paragraph 3] Joint venturers thus have an interest or relationship other than as passive investors. [APB 18, paragraph 3] An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. [APB 18, paragraph 3] The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. [APB 18, paragraph 3] A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture. [APB 18, paragraph 3]

### **Current Tax Expense (or Benefit)**

The amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year. [FAS 109, paragraph 289]

### **Customer**

A user or reseller. [SOP 97-2, paragraph 149]

**Note:** The following definition is Pending Content; see Transition Guidance in 606-10-65-1.

A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. [ASU 2014-09, paragraph 9]

### **Deductible Temporary Difference**

Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. See Temporary Difference. [FAS 109, paragraph 289]

### **Deferred Tax Asset**

The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized. [FAS 109, paragraph 289]

### **Deferred Tax Consequences**

The future effects on income taxes as measured by the applicable enacted tax rate and provisions of the enacted tax law resulting from temporary differences and carryforwards at the end of the current year. [FAS 109, paragraph 289]

### **Deferred Tax Expense (or Benefit)**

The change during the year in an entity's deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Income tax expense (or benefit) for the year is allocated among continuing operations, discontinued operations, and items charged or credited directly to shareholders' equity. [FAS 109, paragraph 289]

### **Deferred Tax Liability**

The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law. [FAS 109, paragraph 289]

**ASC 740 — Glossary (continued)****Employee**

An individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service (IRS) Revenue Ruling 87-41. A reporting entity based in a foreign jurisdiction would determine whether an employee-employer relationship exists based on the pertinent laws of that jurisdiction. Accordingly, a grantee meets the definition of an employee if the grantor consistently represents that individual to be an employee under common law. The definition of an employee for payroll tax purposes under the U.S. Internal Revenue Code includes common law employees. Accordingly, a grantor that classifies a grantee potentially subject to U.S. payroll taxes as an employee also must represent that individual as an employee for payroll tax purposes (unless the grantee is a leased employee as described below). A grantee does not meet the definition of an employee solely because the grantor represents that individual as an employee for some, but not all, purposes. For example, a requirement or decision to classify a grantee as an employee for U.S. payroll tax purposes does not, by itself, indicate that the grantee is an employee because the grantee also must be an employee of the grantor under common law.

A leased individual is deemed to be an employee of the lessee if all of the following requirements are met:

- a. The leased individual qualifies as a common law employee of the lessee, and the lessor is contractually required to remit payroll taxes on the compensation paid to the leased individual for the services provided to the lessee.
- b. The lessor and lessee agree in writing to all of the following conditions related to the leased individual:
  1. The lessee has the exclusive right to grant stock compensation to the individual for the employee service to the lessee.
  2. The lessee has a right to hire, fire, and control the activities of the individual. (The lessor also may have that right.)
  3. The lessee has the exclusive right to determine the economic value of the services performed by the individual (including wages and the number of units and value of stock compensation granted).
  4. The individual has the ability to participate in the lessee's employee benefit plans, if any, on the same basis as other comparable employees of the lessee.
  5. The lessee agrees to and remits to the lessor funds sufficient to cover the complete compensation, including all payroll taxes, of the individual on or before a contractually agreed upon date or dates.

A nonemployee director does not satisfy this definition of employee. Nevertheless, nonemployee directors acting in their role as members of a board of directors are treated as employees if those directors were elected by the employer's shareholders or appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to nonemployee directors for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees. [FAS 123(R), paragraph E1]

**Employee Stock Ownership Plan**

An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan. [SOP 93-6, paragraph 2]

**Event**

A happening of consequence to an entity. The term encompasses both transactions and other events affecting an entity. [FAS 109, paragraph 289]

## ASC 740 — Glossary (continued)

### Excess Tax Benefits

The realized tax benefit related to the amount (caused by changes in the fair value of the entity's shares after the measurement date for financial reporting) of deductible compensation cost reported on an employer's tax return for equity instruments in excess of the compensation cost for those instruments recognized for financial reporting purposes. [FAS 123(R), paragraph E1]

**Note:** The following definition is Pending Content; see Transition Guidance in 718-10-65-4.

Glossary term superseded by Accounting Standards Update No. 2016-09

### Exchange Rate

The ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. [FAS 52, paragraph 26]

### Fair Value

The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. [FAS 123(R), paragraph E1]

### Fair Value

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. [FAS 157, paragraph 5]

### Foreign Currency

A currency other than the functional currency of the entity being referred to (for example, the dollar could be a foreign currency for a foreign entity). Composites of currencies, such as the Special Drawing Rights, used to set prices or denominate amounts of loans, and so forth, have the characteristics of foreign currency. [FAS 52, paragraph 162]

### Foreign Entity

An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both:

- a. Prepared in a currency other than the reporting currency of the reporting entity
- b. Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity. [FAS 52, paragraph 162]

### Functional Currency

An entity's functional currency 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. (See paragraphs 830-10-45-2 through 830-10-45-6 and 830-10-55-3 through 830-10-55-7.) [FAS 52, paragraph 162]

### Gains and Losses Included in Comprehensive Income but Excluded from Net Income

Gains and losses included in comprehensive income but excluded from net income include certain changes in fair values of investments in marketable equity securities classified as noncurrent assets, certain changes in fair values of investments in industries having specialized accounting practices for marketable securities, adjustments related to pension liabilities or assets recognized within other comprehensive income, and foreign currency translation adjustments. Future changes to generally accepted accounting principles (GAAP) may change what is included in this category. [FAS 109, paragraph 289]

### Goodwill

An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. [FAS 164, paragraph 3(n)] For ease of reference, this term also includes the immediate charge recognized by not-for-profit entities in accordance with paragraph 958-805-25-29. [FAS 164, paragraph 22, footnote 3]

**ASC 740 — Glossary (continued)****Infrequency of Occurrence**

The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates (see paragraph 225-20-60-3). [APB 30, paragraph 20]

**Income Tax Expense (or Benefit)**

The sum of current tax expense (or benefit) and deferred tax expense (or benefit). [FAS 109, paragraph 289]

**Income Taxes**

Domestic and foreign federal (national), state, and local (including franchise) taxes based on income. [FAS 109, paragraph 289]

**Income Taxes Currently Payable (Refundable)**

See Current Tax Expense (or Benefit). [FAS 109, paragraph 289]

**Intrinsic Value**

The amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of \$20 on a stock whose current market price is \$25 has an intrinsic value of \$5. (A nonvested share may be described as an option on that share with an exercise price of zero. Thus, the fair value of a share is the same as the intrinsic value of such an option on that share.) [FAS 123(R), paragraph E1]

**Investor**

A business entity that holds an investment in voting stock of another entity. [APB 18, paragraph 3]

**Legal Entity**

Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts. [FIN 46(R), paragraph 3]

**Local Currency**

The currency of a particular country being referred to. [FAS 52, paragraph 162]

**Market Participants**

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics: [FAS 157, paragraph 10]

- a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms [ASU 2011-04, paragraph 101]
- b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary [FAS 157, paragraph 10]
- c. They are able to enter into a transaction for the asset or liability [FAS 157, paragraph 10]
- d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so. [FAS 157, paragraph 10]

**Measurement Date**

The date at which the equity share price and other pertinent factors, such as expected volatility, that enter into measurement of the total recognized amount of compensation cost for an award of share-based payment are fixed. [FAS 123(R), paragraph E1]

**Merger of Not-for-Profit Entities**

A transaction or other event in which the governing bodies of two or more not-for-profit entities cede control of those entities to create a new not-for-profit entity. [FAS 164, paragraph 3(q)]

## ASC 740 — Glossary (continued)

### **Noncontrolling Interest**

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest. [ARB 51, paragraph B1]

### **Nonpublic Entity**

An entity that does not meet any of the following criteria:

- a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).
- b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities. [FAS 109, paragraph 289]

### **Not-for-Profit Entity**

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- b. Operating purposes other than to provide goods or services at a profit
- c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- a. All investor-owned entities
- b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans. [FAS 116, paragraph 209]

### **Operating Segment**

A component of a public entity. See Section 280-10-50 for additional guidance on the definition of an operating segment. [FAS 131, paragraph 10]

### **Orderly Transaction**

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). [FAS 157, paragraph 7]

### **Ordinary Income (or Loss)**

Ordinary income (or loss) refers to income (or loss) from continuing operations before income taxes (or benefits) excluding significant unusual or infrequently occurring items. Discontinued operations and cumulative effects of changes in accounting principles are also excluded from this term. The term is not used in the income tax context of ordinary income versus capital gain. [FIN 18, paragraph 5] The meaning of unusual or infrequently occurring items is consistent with their use in the definitions of the terms unusual nature and infrequency of occurrence.

### **Parent**

An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.) [ARB 51, paragraph B1]

**ASC 740 — Glossary (continued)****Public Entity**

An entity that meets any of the following criteria:

- a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).
- b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities. [FAS 109, paragraph 289]

**Related Parties**

Related parties include:

- a. Affiliates of the entity
- b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
- c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- d. Principal owners of the entity and members of their immediate families
- e. Management of the entity and members of their immediate families
- f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
- g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. [FAS 57, paragraph 24]

**Reporting Currency**

The currency in which a reporting entity prepares its financial statements. [FAS 52, paragraph 162]

**Reporting Unit**

The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment (also known as a component). [FAS 142, paragraph F1]

**Revenue**

Revenue earned by an entity from its direct distribution, exploitation, or licensing of a film, before deduction for any of the entity's direct costs of distribution. For markets and territories in which an entity's fully or jointly-owned films are distributed by third parties, revenue is the net amounts payable to the entity by third party distributors. Revenue is reduced by appropriate allowances, estimated returns, price concessions, or similar adjustments, as applicable. [SOP 00-2, paragraph 134]

**Note:** The following definition is Pending Content; see Transition Guidance in 606-10-65-1.

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. [ASU 2014-09, paragraph 9]

## ASC 740 — Glossary (continued)

### Share-Based Payment Arrangements

An arrangement under which either of the following conditions is met:

- a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.
- b. The entity incurs liabilities to suppliers that meet either of the following conditions:
  1. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.)
  2. The awards require or may require settlement by issuance of the entity's shares.

The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity. [FAS 123(R), paragraph E1]

Also called share-based compensation arrangements.

### Share-Based Payment Transactions

A transaction under a share-based payment arrangement, including a transaction in which an entity acquires goods or services because related parties or other holders of economic interests in that entity awards a share-based payment to an employee or other supplier of goods or services for the entity's benefit. [FAS 123(R), paragraph E1] Also called share-based compensation transactions.

### Share Option

A contract that gives the holder the right, but not the obligation, either to purchase (to call) or to sell (to put) a certain number of shares at a predetermined price for a specified period of time. Most share options granted to employees under share-based compensation arrangements are call options, but some may be put options. [FAS 123(R), paragraph E1]

### Special Drawing Rights

Special Drawing Rights on the International Monetary Fund are international reserve assets whose value is based on a basket of key international currencies.

### Subsidiary

An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.) [ARB 51, paragraph B1]

### Tax (or Benefit)

Tax (or benefit) is the total income tax expense (or benefit), including the provision (or benefit) for income taxes both currently payable and deferred. [FIN 18, paragraph 5]

### Tax Consequences

The effects on income taxes—current or deferred—of an event. [FAS 109, paragraph 289]

**ASC 740 — Glossary (continued)****Tax Position**

A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term tax position also encompasses, but is not limited to:

- a. A decision not to file a tax return
- b. An allocation or a shift of income between jurisdictions
- c. The characterization of income or a decision to exclude reporting taxable income in a tax return
- d. A decision to classify a transaction, entity, or other position in a tax return as tax exempt [FIN 48, paragraph 4]
- e. An entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity. [ASU 2009-06, paragraph 2]

**Tax-Planning Strategy**

An action (including elections for tax purposes) that meets certain criteria (see paragraph 740-10-30-19) and that would be implemented to realize a tax benefit for an operating loss or tax credit carryforward before it expires. Tax-planning strategies are considered when assessing the need for and amount of a valuation allowance for deferred tax assets. [FAS 109, paragraph 289]

**Taxable Income**

The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority. [FAS 109, paragraph 289]

**Taxable Temporary Difference**

Temporary differences that result in taxable amounts in future years when the related asset is recovered or the related liability is settled. See Temporary Difference. [FAS 109, paragraph 289]

**Transaction Gain or Loss**

Transaction gains or losses result from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. They represent an increase or decrease in both of the following:

- a. The actual functional currency cash flows realized upon settlement of foreign currency transactions
- b. The expected functional currency cash flows on unsettled foreign currency transactions. [FAS 52, paragraph 162]

**Translation Adjustments**

Translation adjustments result from the process of translating financial statements from the entity's functional currency into the reporting currency. [FAS 52, paragraph 162]

**Unrecognized Tax Benefit**

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. [FIN 48, paragraph 17]

**Unusual Nature**

The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates (see paragraph 225-20-60-3). [APB 30, paragraph 20]

**Valuation Allowance**

The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized. [FAS 109, paragraph 289]

**Variable Interest Entity**

A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10. [FIN 46(R), paragraph 2]

# Appendix D — Sample Disclosures of Income Taxes

The following is adapted and updated from Deloitte's February 2015 *Sample Disclosures: Accounting for Income Taxes*.

## Use of These Sample Disclosures

**The sample disclosures in this document reflect accounting and disclosure requirements outlined in SEC Regulation S-K, SEC Regulation S-X, and ASC 740<sup>1</sup> that are effective as of October 31, 2016. SEC registrants should also consider pronouncements that were issued or effective subsequently that may be applicable to the financial statements, as well as other professional literature such as AICPA audit and accounting guides.**

Portions of certain sample disclosures in this document are based on actual disclosures from public filings. Details that would identify the registrants have been removed, including dollar amounts and specific references to the business.

The sample disclosures are intended to provide general information only. While entities may use them to help assess whether they are compliant with U.S. GAAP and SEC requirements, they are not all-inclusive and additional disclosures may be deemed necessary by entities or their auditors. Further, the sample disclosures are not a substitute for understanding reporting requirements or for the exercise of judgment. Entities are presumed to have a thorough understanding of the requirements and should refer to accounting literature and SEC regulations as necessary.

## New Accounting Standard Updates Not Reflected in This Guidance

On March 30, 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. No new income tax disclosure requirements were added by ASU 2016-09. However, existing disclosures, such as those recommended in the [Deferred Tax Asset Attributable to Excess Stock Option Deductions — Before the Adoption of ASU 2016-09](#) section below, may be affected by the amendments within ASU 2016-09.

On October 24, 2016, the FASB issued ASU 2016-16, which removes the prohibition in ASC 740 against the immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory (i.e., the current accounting for inventory transfers will remain unchanged). No new disclosure requirements were added by ASU 2016-16. However, existing disclosures, such as the effective tax rate reconciliation or the disclosure of the components of DTAs and DTLs, may be affected by the recognition of the tax consequences of intra-entity transfers of assets.

<sup>1</sup> FASB Accounting Standards Codification Topic 740, *Income Taxes*. For titles of other FASB Accounting Standards Codification (ASC) references, see Deloitte's [Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#).

## Management Discussion and Analysis — General

Before the enactment of tax law proposals or changes to existing tax rules, SEC registrants should consider whether the potential changes represent an uncertainty that management reasonably expects could have a material effect on the results of operations, financial position, liquidity, or capital resources. If so, registrants should consider disclosing information about the scope and nature of any potential material effects of the changes.

After the enactment of a new tax law, registrants should consider disclosing, when material, the anticipated current and future impact of the law on their results of operations, financial position, liquidity, and capital resources. In addition, registrants should consider disclosures in the critical accounting estimates section of management's discussion and analysis (MD&A) to the extent that the changes could materially affect existing assumptions used in estimating tax-related balances.

The SEC staff expects registrants to provide early-warning disclosures to help users understand various risks and how these risks potentially affect the financial statements. Examples of such risks include situations in which (1) the registrant may have to repatriate foreign earnings to meet current liquidity demands, resulting in a tax payment that may not be accrued for; (2) the historical effective tax rate is not sustainable and may change materially; (3) the valuation allowance on net deferred tax assets may change materially; and (4) tax positions taken during the preparation of returns may ultimately not be sustained. Early-warning disclosures give investors insight into the underlying assumptions made by management and conditions and risks facing an entity before a material change or decline in performance is reported.

## MD&A — Results of Operations

**SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"**

### Sample Disclosure — Results of Operations

Our effective tax rate for fiscal years 20X3, 20X2, and 20X1 was XX percent, XX percent, and XX percent, respectively. Our tax rate is affected by recurring items, such as tax rates in foreign jurisdictions and the relative amounts of income we earn in those jurisdictions, which we expect to be fairly consistent in the near term. It is also affected by discrete items that may occur in any given year but are not consistent from year to year. In addition to state income taxes, the following items had the most significant impact on the difference between our statutory U.S. federal income tax rate of XX percent and our effective tax rate:

#### 20X3

1. A \$XXX (XX percent) reduction resulting from changes in unrecognized tax benefits for tax positions taken in prior periods, related primarily to favorable developments in an IRS position.

*Note: A detailed explanation of the change and the amount previously recorded as an unrecognized tax benefit would be expected.*

2. A \$XXX (XX percent) increase resulting from multiple unfavorable foreign audit assessments.

*Note: A detailed explanation of the change and the amount previously recorded as an unrecognized tax benefit would be expected.*

3. A \$XXX (XX percent) reduction resulting from rate differences between U.S. and non-U.S. jurisdictions. No U.S. taxes were provided for those undistributed foreign earnings that are indefinitely reinvested outside the United States.

*Note: A discussion of the countries significantly affecting the overall effective rate would be expected.*

4. A \$XXX (XX percent) increase from noncash impairment charges for goodwill that is nondeductible for tax purposes.

**20X2**

1. A \$XXX (XX percent) increase resulting from the resolution of U.S. state audits.
2. A \$XXX (XX percent) increase resulting from a European Commission penalty, which was not tax deductible.
3. A \$XXX (XX percent) reduction resulting from rate differences between U.S. and non-U.S. jurisdictions.

*Note: The notes accompanying the 20X3 items above also apply to 20X2.*

**20X1**

1. A \$XXX (XX percent) reduction resulting from the reversal of previously accrued taxes from an IRS settlement.
2. A \$XXX (XX percent) reduction resulting from rate differences between U.S. and non-U.S. jurisdictions.

*Note: The notes accompanying the 20X3 items above also apply to 20X1.*

*Note: Regulation S-K, Item 303(a)(3)(ii), requires registrants to “[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.” The sample disclosures below present various descriptions registrants might provide under this requirement.*

***Sample Disclosure — Effects in Future Periods of Tax Costs Related to Intra-Entity Sale of Intellectual Property — Before the Adoption of ASU 2016-06***

We recorded deferred charges during the year ended December 31, 20X1, related to the deferral of income tax expense on intra-entity profits that resulted from the sale of our intellectual property rights (including intellectual property acquired during the current year) outside North and South America to our subsidiary in Country X. The deferred charges are included in the “prepaid expenses and other current assets” and “other assets” lines of the consolidated balance sheets in the amounts of \$XXX and \$XXX, respectively. The deferred charges are amortized as a component of income tax expense over the five-year economic life of the intellectual property.

*Note: The tax associated with intra-entity asset transfers should be accounted for under ASC 740-10-25-3(e) and ASC 810-10-45-8. In some cases, these transactions could significantly affect the consolidated financial statements. Entities should discuss the nature of those transactions and their current and future financial statement effects.*

## **Sample Disclosure — Early Warning of Possible Valuation Allowance Recognition in Future Periods**

As of December 31, 20X1, we had approximately \$XX million in net deferred tax assets (DTAs). These DTAs include approximately \$XX million related to net operating loss carryforwards that can be used to offset taxable income in future periods and reduce our income taxes payable in those future periods. Many of these NOL carryforwards will expire if they are not used within certain periods. At this time, we consider it more likely than not that we will have sufficient taxable income in the future that will allow us to realize these DTAs. However, it is possible that some or all of these NOL carryforwards could ultimately expire unused, especially if our component X restructuring initiative is not successful. Therefore, unless we are able to generate sufficient taxable income from our component Y operations, a substantial valuation allowance to reduce our U.S. DTAs may be required, which would materially increase our expenses in the period the allowance is recognized and materially adversely affect our results of operations and statement of financial condition.

## **Sample Disclosure — Early Warning of Possible Valuation Allowance Reversal in Future Periods**

We recorded a valuation allowance against all of our deferred tax assets as of both December 31, 20X2, and December 31, 20X1. We intend to continue maintaining a full valuation allowance on our deferred tax assets until there is sufficient evidence to support the reversal of all or some portion of these allowances. However, given our current earnings and anticipated future earnings, we believe that there is a reasonable possibility that within the next 12 months, sufficient positive evidence may become available to allow us to reach a conclusion that a significant portion of the valuation allowance will no longer be needed. Release of the valuation allowance would result in the recognition of certain deferred tax assets and a decrease to income tax expense for the period the release is recorded. However, the exact timing and amount of the valuation allowance release are subject to change on the basis of the level of profitability that we are able to actually achieve.

*Note: Companies should specify the positive and negative evidence they evaluated, the jurisdiction, and the potential amount of valuation allowance that may be reversed.*

## **Sample Disclosure — Change in Tax Laws Affecting Future Periods**

Changes in tax laws and rates may affect recorded deferred tax assets and liabilities and our effective tax rate in the future. In January 20X4, country X made significant changes to its tax laws, including certain changes that were retroactive to our 20X3 tax year. Because a change in tax law is accounted for in the period of enactment, the retroactive effects cannot be recognized in our 20X3 financial results and instead will be reflected in our 20X4 financial results. We estimate that a benefit of approximately \$XXX will be accounted for as a discrete item in our tax provision for the first quarter of 20X4. In addition, we expect this tax law change to favorably affect our estimated annual effective tax rate for 20X4 by approximately X percentage points as compared to 20X3.

## **MD&A — Critical Accounting Estimates<sup>2</sup>**

### **SEC Interpretation Release Nos. 33-8350, 34-48960, FR-72, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations**

<sup>2</sup> At the 2013 AICPA Conference on Current SEC and PCAOB Developments (the "AICPA Conference"), in remarks related to disclosures about valuation allowances on deferred tax assets, the SEC staff discouraged registrants from providing "boilerplate" information and instead recommended that they discuss registrant-specific factors (e.g., limitations on their ability to use net operating losses and foreign tax credits). The SEC staff also stated that it has asked registrants to disclose the effect of each source of taxable income on their ability to realize a deferred tax asset, including the relative magnitude of each source of taxable income. In addition, the staff recommended that registrants consider disclosing the material negative evidence they evaluated, since such disclosures could provide investors with information about uncertainties related to a registrant's ability to recover a deferred tax asset. For additional information, see Deloitte's December 16, 2013, [Heads Up](#) on the AICPA Conference.

## **Sample Disclosure**

Our income tax expense, deferred tax assets and liabilities, and liabilities for unrecognized tax benefits reflect management's best estimate of current and future taxes to be paid. We are subject to income taxes in the United States and numerous foreign jurisdictions. Significant judgments and estimates are required in the determination of the consolidated income tax expense.

Deferred income taxes arise from temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements, which will result in taxable or deductible amounts in the future. In evaluating our ability to recover our deferred tax assets in the jurisdiction from which they arise, we consider all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax-planning strategies, and results of recent operations. In projecting future taxable income, we begin with historical results adjusted for the results of discontinued operations and incorporate assumptions about the amount of future state, federal, and foreign pretax operating income adjusted for items that do not have tax consequences. The assumptions about future taxable income require the use of significant judgment and are consistent with the plans and estimates we are using to manage the underlying businesses. In evaluating the objective evidence that historical results provide, we consider three years of cumulative operating income (loss).

As of December 31, 20X3, we have federal and state income tax net operating loss (NOL) carryforwards of \$XXX and \$XXX, which will expire on various dates from 20X4 through 20Y8 as follows:

20X4–20X8	\$ XXX
20X9–20Y3	XXX
20Y4–20Y8	<u>XXX</u>
	<u>\$ XXX</u>

We believe that it is more likely than not that the benefit from certain state NOL carryforwards will not be realized. In recognition of this risk, we have provided a valuation allowance of \$XX on the deferred tax assets related to these state NOL carryforwards. If our assumptions change and we determine that we will be able to realize these NOLs, the tax benefits related to any reversal of the valuation allowance on deferred tax assets as of December 31, 20X3, will be accounted for as follows: approximately \$XXX will be recognized as a reduction of income tax expense and \$XXX will be recorded as an increase in equity.

The calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax laws and regulations in a multitude of jurisdictions across our global operations. ASC 740 states that a tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, on the basis of the technical merits.

We (1) record unrecognized tax benefits as liabilities in accordance with ASC 740 and (2) adjust these liabilities when our judgment changes as a result of the evaluation of new information not previously available. Because of the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the unrecognized tax benefit liabilities. These differences will be reflected as increases or decreases to income tax expense in the period in which new information is available.

We believe that it is reasonably possible that an increase of up to \$XX in unrecognized tax benefits related to state exposures may be necessary within the coming year. In addition, we believe that it is reasonably possible that approximately \$XX of our currently remaining unrecognized tax benefits, each

of which are individually insignificant, may be recognized by the end of 20X4 as a result of a lapse of the statute of limitations.

We consider the earnings of certain non-U.S. subsidiaries to be indefinitely invested outside the United States on the basis of estimates that future domestic cash generation will be sufficient to meet future domestic cash needs and our specific plans for reinvestment of those subsidiary earnings. We have not recorded a deferred tax liability related to the U.S. federal and state income taxes and foreign withholding taxes on approximately \$XX of undistributed earnings of foreign subsidiaries indefinitely invested outside the United States. If we decide to repatriate the foreign earnings, we would need to adjust our income tax provision in the period we determined that the earnings will no longer be indefinitely invested outside the United States.

## **MD&A — Liquidity and Capital Resources<sup>3</sup>**

### **SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"**

#### **Sample Disclosure 1**

We earn a significant amount of our operating income outside the United States, which is deemed to be indefinitely reinvested in foreign jurisdictions. As a result, as discussed under Cash and Investments, most of our cash and short-term investments are held by foreign subsidiaries. We currently do not intend or foresee a need to repatriate these funds. We expect existing domestic cash and short-term investments and cash flows from operations to continue to be sufficient to fund our domestic operating activities and cash commitments for investing and financing activities, such as regular quarterly dividends, debt repayment, and capital expenditures, for at least the next 12 months and thereafter for the foreseeable future.

If we should require more capital in the United States than is generated by our domestic operations (e.g., to fund significant discretionary activities such as business acquisitions and share repurchases), we could elect to repatriate future earnings from foreign jurisdictions or raise capital in the United States through debt or equity issuances. These alternatives could result in higher effective tax rates, increased interest expense, or dilution of our earnings. We have borrowed funds domestically and continue to believe we have the ability to do so at reasonable interest rates.

*Note: The SEC staff expects registrants to disclose the amount of cash and short-term investments held by foreign subsidiaries that would not be available to fund domestic operations unless the funds were repatriated. In the sample disclosure above, the registrant had disclosed this information in the Cash and Investments section of its MD&A.*

<sup>3</sup> At the 2011 AICPA Conference, Nili Shah, deputy chief accountant in the SEC's Division of Corporation Finance, and Mark Shannon, associate chief accountant in the SEC's Division of Corporation Finance, discussed certain income tax matters in relation to registrants' significant foreign operations. Ms. Shah indicated that when a registrant with significant amounts of cash and short-term investments overseas has asserted that such amounts are indefinitely reinvested in its foreign operations, the SEC staff would expect the registrant to provide the following disclosures in an MD&A liquidity analysis: (1) the amount of cash and short-term investments held by foreign subsidiaries that is not available to fund domestic operations unless the funds were repatriated; (2) a statement that the company would need to accrue and pay taxes if repatriated; and (3) if true, a statement that the company does not intend to repatriate those funds.

At the 2013 AICPA Conference, the SEC staff also reminded registrants when making the assertion of indefinitely reinvested foreign earnings, companies are required to disclose (1) the amount of the unrecognized deferred tax liability or (2) a statement that estimating an unrecognized tax liability is not practicable. In addition, the staff indicated that it evaluates the indefinite reinvestment assertion in taking into account registrants' potential liquidity needs and the availability of funds in U.S. and foreign jurisdictions.

## **Sample Disclosure 2**

We consider the undistributed earnings of our foreign subsidiaries as of December 31, 20X3, to be indefinitely reinvested and, accordingly, no U.S. income taxes have been provided thereon. As of December 31, 20X3, the amount of cash associated with indefinitely reinvested foreign earnings was approximately \$XX. We have not, nor do we anticipate the need to, repatriate funds to the United States to satisfy domestic liquidity needs arising in the ordinary course of business, including liquidity needs associated with our domestic debt service requirements.

## **MD&A — Contractual Obligations**

**SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"**

## **Sample Disclosure 1**

The table below contains information about our contractual obligations that affect our short- and long-term liquidity and capital needs. The table also includes information about payments due under specified contractual obligations and is aggregated by type of contractual obligation. It includes the maturity profile of our consolidated long-term debt, operating leases, and other long-term liabilities.

	<b>Contractual Obligations (in millions)</b>				
	<b>Total</b>	<b>Less Than 1 Year</b>	<b>1–3 Years</b>	<b>3–5 Years</b>	<b>More Than 5 Years</b>
Long-term debt obligations	\$ XXX	\$ XXX	\$ XXX	\$ XXX	\$ XXX
Interest payments on long-term debt	XXX	XXX	XXX	XXX	XXX
Operating lease obligations	XXX	XXX	XXX	XXX	XXX
Capital lease obligations	XXX	XXX	XXX	XXX	XXX
Unrecognized tax benefits, including interest and penalties	XXX	XXX	XXX	XXX	XXX
Other liabilities reflected on consolidated balance sheet	XXX	XXX	XXX	XXX	XXX
<b>Total</b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>

In the table above, the unrecognized tax benefits, including interest and penalties, are related to temporary differences. The years for which the temporary differences related to the unrecognized tax benefits will reverse have been estimated in the schedule of obligations above. In addition, approximately \$XX of unrecognized tax benefits have been recorded as liabilities, and we are uncertain about whether or, if so, when such amounts may be settled. We also recorded a liability for potential penalties of \$XX and interest of \$XX for the unrecognized tax benefits not included in the table above.

## **Sample Disclosure 2**

The following table presents certain payments due under contractual obligations with minimum firm commitments as of December 31, 20X3:

	<b>Payments Due In (in millions)</b>				
	<b>Total</b>	<b>Less Than 1 Year</b>	<b>1–3 Years</b>	<b>3–5 Years</b>	<b>More Than 5 Years</b>
Operating lease obligations	\$ XXX	\$ XXX	\$ XXX	\$ XXX	\$ XXX
Purchase obligations	XXX	XXX	XXX	XXX	XXX
Other obligations	XXX	XXX	XXX	XXX	XXX
<b>Total</b>	<b><u>XXX</u></b>	<b><u>XXX</u></b>	<b><u>XXX</u></b>	<b><u>XXX</u></b>	<b><u>XXX</u></b>

Our other noncurrent liabilities in the consolidated balance sheet include unrecognized tax benefits and related interest and penalties. As of December 31, 20X3, we had gross unrecognized tax benefits of \$XX and an additional \$XX for interest and penalties classified as noncurrent liabilities. At this time, we are unable to make a reasonably reliable estimate of the timing of payments in individual years in connection with these tax liabilities; therefore, such amounts are not included in the above contractual obligation table.

*Note: Entities may disclose in either a footnote to the table or an “other” column added to the table a liability for unrecognized tax benefits for which reasonable estimates about the timing of payment cannot be made.*

## **Notes to Consolidated Financial Statements**

### **Note A — Summary of Significant Accounting Policies**

#### **Income Taxes**

##### **Sample Disclosure**

We account for income taxes under the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, we determine deferred tax assets and liabilities on the basis of the differences between the financial statement and tax bases of assets and liabilities by using enacted tax rates in effect for the year in which the differences are expected to reverse. 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.

We recognize deferred tax assets to the extent that we believe that these assets are more likely than not to be realized. In making such a determination, we consider all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax-planning strategies, and results of recent operations. If we determine that we would be able to realize our deferred tax assets in the future in excess of their net recorded amount, we would make an adjustment to the deferred tax asset valuation allowance, which would reduce the provision for income taxes.

We record uncertain tax positions in accordance with ASC 740 on the basis of a two-step process in which (1) we determine whether it is more likely than not that the tax positions will be sustained on the basis of the technical merits of the position and (2) for those tax positions that meet the more-likely-than-not recognition threshold, we recognize the largest amount of tax benefit that is more than 50 percent likely to be realized upon ultimate settlement with the related tax authority.

#### **Classification of Interest and Penalties (ASC 740-10-50-19)**

##### ***Sample Disclosure 1***

We recognize interest and penalties related to unrecognized tax benefits on the income tax expense line in the accompanying consolidated statement of operations. Accrued interest and penalties are included on the related tax liability line in the consolidated balance sheet.

##### ***Sample Disclosure 2***

We recognize interest and penalties related to unrecognized tax benefits on the interest expense line and other expense line, respectively, in the accompanying consolidated statement of operations. Accrued interest and penalties are included on the related liability lines in the consolidated balance sheet.

#### **Investment Tax Credit Recognition Policy (ASC 740-10-50-20)**

##### ***Sample Disclosure 1***

We earn investment tax credits from the state of X's economic development program. We use the deferral method of accounting for investment tax credits.

##### ***Sample Disclosure 2***

We use the flow-through method to account for investment tax credits earned on eligible scientific research and development expenditures. Under this method, the investment tax credits are recognized as a reduction to income tax expense in the year they are earned.

### **Note B — Statement of Cash Flows**

#### ***Sample Disclosure***

Supplemental cash flows and noncash investing and financing activities are as follows:

	Years Ended December 31 (in millions)		
	20X3	20X2	20X1
<b>Noncash Investing and Financing Activities:</b>			
Acquisition of property and equipment on account	\$ XXX	\$ XXX	\$ XXX
Acquisition of property and equipment through long-term financing	XXX	XXX	XXX
<b>Supplemental Cash Flow Information:</b>			
Income taxes paid, net of refunds	XXX	XXX	XXX
Interest paid	XXX	XXX	XXX

*Note: Under ASC 230-10-50-2, the supplemental cash flow information for income taxes paid is required when an indirect method is used. Such disclosure can be included in the company's statement of cash flows or in a footnote.*

## **Note C — Acquisitions**

**Financial effects of adjustments that relate to business combinations that occurred in the current or previous reporting periods (ASC 805-10-50-5, *Business Combinations*)**

**Total amount of goodwill that is expected to be deductible for tax purposes (ASC 805-30-50-1(d), *Business Combinations*)**

### ***Sample Disclosure 1***

The preliminary purchase price allocation resulted in goodwill of \$XX million, which is not deductible for income tax purposes. Goodwill consists of the excess of the purchase price over the fair value of the acquired assets and represents the estimated economic value attributable to future operations.

The purchase price allocation is preliminary and subject to revision. At this time, except for the items noted below, we do not expect material changes to the value of the assets acquired or liabilities assumed in conjunction with the transaction. Specifically, the following assets and liabilities are subject to change:

- Intangible customer contracts.
- Payments due from and to related parties.
- Deferred income tax assets and liabilities.

As management receives additional information during the measurement period, these assets and liabilities may be adjusted.

Under the acquisition method of accounting for business combinations, if we identify changes to acquired deferred tax asset valuation allowances or liabilities related to uncertain tax positions during the measurement period, and they are related to new information obtained about facts and circumstances that existed as of the acquisition date, those changes are considered a measurement-period adjustment, and we record the offset to goodwill. We record all other changes to deferred tax asset valuation allowances and liabilities related to uncertain tax positions in current-period income tax expense. This accounting applies to all of our acquisitions, regardless of acquisition date.

### ***Sample Disclosure 2***

Goodwill of \$XX million was assigned to the X and Y segments in the amounts of \$XX million and \$XX million, respectively, and is deductible for tax purposes. The amounts of intangible assets and goodwill have been assigned to the X and Y segments on the basis of the respective profit margins of the acquired customer contracts. The transaction was taxable for income tax purposes, and all assets and liabilities have been recorded at fair value for both book and income tax purposes. Therefore, no deferred taxes have been recorded.

## Note D — Income Taxes

SEC Regulation S-X, Rule 4-08(h), "General Notes to Financial Statements: Income Tax Expense"<sup>4</sup>

### **Sample Disclosure 1**

For financial reporting purposes, income before income taxes includes the following components:

	<b>Years Ended December 31 (in millions)</b>		
	<b>20X3</b>	<b>20X2</b>	<b>20X1</b>
United States	\$ XXX	\$ XXX	\$ XXX
Foreign	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Total</b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>

The expense (benefit) for income taxes consists of:

	<b>Years Ended December 31 (in millions)</b>		
	<b>20X3</b>	<b>20X2</b>	<b>20X1</b>
Current:			
Federal	\$ XXX	\$ XXX	\$ XXX
State	XXX	XXX	XXX
Foreign	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>
Deferred and other:			
Federal	\$ XXX	\$ XXX	\$ XXX
State	XXX	XXX	XXX
Foreign	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>
<b>Total tax expense</b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>

<sup>4</sup> At the 2010 AICPA Conference, Jill Davis, associate chief accountant in the SEC's Division of Corporation Finance, stated that one of the requirements in SEC Regulation S-X, Rule 4-08(h), is to disclose the components of income (loss) before income tax expense (benefit) as either domestic or foreign. Ms. Davis indicated that some registrants' disclosures about these components have been limited in circumstances in which the registrants had a very low income tax expense because a substantial amount of profits were derived from countries with little or no tax. She explained that the disclosures provided should allow an investor to easily determine the effective tax rate for net income attributable to domestic operations and foreign operations and stated that the lack of such disclosure may result in SEC staff comments.

## **Sample Disclosure 2**

For financial reporting purposes, income before income taxes includes the following components:

	<b>Years Ended December 31</b> (in millions)		
	<b>20X3</b>	<b>20X2</b>	<b>20X1</b>
	\$ XXX	\$ XXX	\$ XXX
United States	\$ XXX	\$ XXX	\$ XXX
Foreign	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Total</b>	<b><u>\$ XXX</u></b>	<b><u>\$ XXX</u></b>	<b><u>\$ XXX</u></b>

The provision for income taxes for 20X3, 20X2, and 20X1 consisted of the following:

	<b>Years Ended December 31</b> (in millions)		
	<b>20X3</b>	<b>20X2</b>	<b>20X1</b>
	\$ XXX	\$ XXX	\$ XXX
U.S. Federal:			
Current	\$ XXX	\$ XXX	\$ XXX
Deferred	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>
U.S. State:			
Current	\$ XXX	\$ XXX	\$ XXX
Deferred	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>
Foreign:			
Current	\$ XXX	\$ XXX	\$ XXX
Deferred	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>
<b>Provision for income taxes</b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>

## Components of Income Tax Expense or Benefit (ASC 740-10-50-9)

### Sample Disclosure 1

	Years Ended December 31 (in millions)		
	20X3	20X2	20X1
Current tax expense (benefit)	\$ XXX	\$ XXX	\$ XXX
Deferred tax expense (benefit)	XXX	XXX	XXX
Tax expense (benefit) related to an increase (decrease) in unrecognized tax benefits	XXX	XXX	XXX
Interest expense — gross of related tax effects	XXX	XXX	XXX
Penalties — gross of related tax effects	XXX	XXX	XXX
Tax expense recorded as an increase of paid-in capital	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Total tax expense</b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>

Note: ASC 740-10-50-9 requires disclosure of other items, such as the effects of changes in tax law or in valuation allowances, that may be disclosed elsewhere (i.e., in the reconciliation of the effective tax rate).

### Sample Disclosure 2

	Years Ended December 31 (in millions)		
	20X3	20X2	20X1
Current tax expense (benefit)	\$ XXX	\$ XXX	\$ XXX
Deferred tax expense (benefit)	XXX	XXX	XXX
Other tax expense (benefit)	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Total tax expense</b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>

Note: If presented, the other tax expense (benefit) line in Sample Disclosure 2 would include items affecting the expense that neither meet the definition of a deferred tax item (ASC 740-10-30-4) nor the definition of a current tax item (ASC 740-10-20). If material, the components of the other tax expense (benefit) should be separately described below the table.

## Rate Reconciliation (ASC 740-10-50-12 Through 50-14)

### **Sample Disclosure 1**

Reconciliation between the effective tax rate on income from continuing operations and the statutory tax rate is as follows:

	<b>Years Ended December 31</b> <b>(in millions)</b>		
	<b>20X3</b>	<b>20X2</b>	<b>20X1</b>
Income tax expense (benefit) at federal statutory rate	\$ XXX	\$ XXX	\$ XXX
State and local income taxes net of federal tax benefit	XXX	XXX	XXX
Foreign tax rate differential <sup>5</sup>	XXX	XXX	XXX
Change in valuation allowance	XXX	XXX	XXX
Effect of flow-through entity	XXX	XXX	XXX
Effect of double taxation net of dividend received deduction	XXX	XXX	XXX
Noncontrolling interest	XXX	XXX	XXX
Nondeductible/nontaxable items	XXX	XXX	XXX
Share-based compensation	XXX	XXX	XXX
Tax audit settlements	XXX	XXX	XXX
Other — net	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Income tax expense (benefit)</b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>

Note: SEC Regulation S-X, Rule 4-08(h)(2), indicates that for public entities, the reconciliation should disclose all components of the income tax expense or benefit that comprise 5 percent or more of income tax expense or benefit from continuing operations, determined by using the statutory tax rate. Nonpublic entities are permitted to omit this reconciliation but are required to disclose the nature of significant reconciling items.

<sup>5</sup> At the 2013 AICPA Conference, the SEC staff noted the following issues with registrants' tax rate reconciliation disclosures:

- Labels related to reconciling items were unclear, and disclosures about material reconciling items did not adequately describe the underlying nature of these items.
- For material reconciling items related to foreign tax jurisdictions, registrants did not disclose in MD&A (1) each material foreign jurisdiction and its tax rate and (2) how each jurisdiction affects the amount in the tax rate reconciliation.
- Registrants have inappropriately aggregated material reconciling items. The SEC staff reminded registrants that Regulation S-X requires separate-line-item disclosure for reconciling items whose amount is greater than 5 percent of the amount calculated by multiplying the pretax income by the statutory tax rate.
- Amounts reflected in the tax rate reconciliation were inconsistent with related amounts disclosed elsewhere in a registrant's filing.
- Corrections of errors were inappropriately reflected as changes in estimates.

For additional information, see Deloitte's December 16, 2013, *Heads Up* on the AICPA Conference.

## **Sample Disclosure 2**

The differences between income taxes expected at the U.S. federal statutory income tax rate of 35 percent and the reported income tax (benefit) expense are summarized as follows:

	<b>Years Ended December 31 (in millions)</b>		
	<b>20X3</b>	<b>20X2</b>	<b>20X1</b>
Expected income tax (benefit) expense at federal statutory rate	\$ XXX	\$ XXX	\$ XXX
Valuation allowance for deferred tax assets	XXX	XXX	XXX
Fair value of preferred stock equity conversion feature	XXX	XXX	
Residual tax on foreign earnings	XXX	XXX	XXX
Foreign rate differential <sup>6</sup>	XXX	XXX	XXX
Bargain purchase gain		XXX	
Gain on contingent purchase price reduction	XXX		
Meals and entertainment	XXX	XXX	XXX
Exempt foreign income	XXX	XXX	XXX
Unrecognized tax benefits	XXX	XXX	XXX
State and local income taxes	XXX	XXX	XXX
Dividends received deduction	XXX		
Capitalized transaction costs	XXX	XXX	
Other	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Reported income tax (benefit) expense</b>	<b>\$XXX</b>	<b>\$XXX</b>	<b>\$XXX</b>
<b>Effective tax rate</b>	<b>XX%</b>	<b>XX%</b>	<b>XX%</b>

### **Unrecognized Deferred Tax Liability Related to Investments in Foreign Subsidiaries (ASC 740-30-50-2<sup>7</sup>)**

## **Sample Disclosure 1**

U.S. income tax has not been recognized on the excess of the amount for financial reporting over the tax basis of investments in foreign subsidiaries that is indefinitely reinvested outside the United States. This amount becomes taxable upon a repatriation of assets from the subsidiary or a sale or liquidation of the subsidiary. The amount of such temporary differences totaled \$XXX as of December 31, 20X3. Determination of the amount of any unrecognized deferred income tax liability on this temporary difference is not practicable because of the complexities of the hypothetical calculation.

## **Sample Disclosure 2**

In general, it is our practice and intention to reinvest the earnings of its non-U.S. subsidiaries in those operations. As of December 31, 20X3, we have not made a provision for U.S. or additional foreign withholding taxes on approximately \$XXX of the excess of the amount for financial reporting over the tax basis of investments in foreign subsidiaries that is indefinitely reinvested. Generally, such

<sup>6</sup> See [footnote 4](#).

<sup>7</sup> See [footnote 2](#).

amounts become subject to U.S. taxation upon the remittance of dividends and under certain other circumstances. It is not practicable to estimate the amount of deferred tax liability related to investments in these foreign subsidiaries.

**Components of the Net Deferred Tax Asset or Liability (ASC 740-10-50-2, ASC 740-10-50-6, ASC 740-10-50-8, and ASC 740-10-50-16)**

	<b>December 31 (in millions)</b>	
	<b>20X3</b>	<b>20X2</b>
Receivable allowances	\$ XXX	\$ XXX
Reserves and accruals not currently deductible for tax purposes	XXX	XXX
Share-based compensation	XXX	XXX
Research and development costs	XXX	XXX
NOL and tax credit carryforwards	XXX	XXX
Restructuring and settlement reserves	XXX	XXX
Other	<u>XXX</u>	<u>XXX</u>
Subtotal	<u>\$ XXX</u>	<u>\$ XXX</u>
Less: valuation allowance	<u>XXX</u>	<u>XXX</u>
Total net deferred tax assets	<u><u>\$ XXX</u></u>	<u><u>\$ XXX</u></u>
Inventory valuation and other assets	\$ XXX	\$ XXX
Fixed Assets	XXX	XXX
Other	<u>XXX</u>	<u>XXX</u>
Total deferred tax liabilities	<u>\$ XXX</u>	<u>\$ XXX</u>
Net deferred tax liability	<u>\$ XXX</u>	<u>\$ XXX</u>

**Operating Loss and Tax Credit Carryforwards (ASC 740-10-50-3)**

***Sample Disclosure***

We have income tax NOL carryforwards related to our international operations of approximately \$XXX. We have recorded a deferred tax asset of \$XXX reflecting the benefit of \$XXX in loss carryforwards. Such deferred tax assets expire as follows:

20X4–20X8	\$ XXX
20X9–20Y3	XXX
20Y4–20Y8	<u>XXX</u>
	<u><u>\$ XXX</u></u>

## **Valuation Allowance<sup>8</sup> and Risks and Uncertainties (ASC 275-10-50-8)**

### **Sample Disclosure 1**

Management assesses the available positive and negative evidence to estimate whether sufficient future taxable income will be generated to permit use of the existing deferred tax assets. A significant piece of objective negative evidence evaluated was the cumulative loss incurred over the three-year period ended December 31, 20X3. Such objective evidence limits the ability to consider other subjective evidence, such as our projections for future growth.

On the basis of this evaluation, as of December 31, 20X3, a valuation allowance of \$XXX has been recorded to recognize only the portion of the deferred tax asset that is more likely than not to be realized. The amount of the deferred tax asset considered realizable, however, could be adjusted if estimates of future taxable income during the carryforward period are reduced or increased or if objective negative evidence in the form of cumulative losses is no longer present and additional weight is given to subjective evidence such as our projections for growth.

### **Sample Disclosure 2**

We have federal and state income tax NOL carryforwards of \$XXX and \$XXX, which will expire on various dates in the next 15 years as follows:

20X4–20X8	\$ XXX
20X9–20Y3	XXX
20Y4–20Y8	<u>XXX</u>
	<b><u>\$ XXX</u></b>

We believe that it is more likely than not that the benefit from certain state NOL carryforwards will not be realized. In recognition of this risk, we have provided a valuation allowance of \$XXX on the deferred tax assets related to these state NOL carryforwards. If or when recognized, the tax benefits related to any reversal of the valuation allowance on deferred tax assets as of December 31, 20X3, will be accounted for as follows: approximately \$XXX will be recognized as a reduction of income tax expense and \$XXX will be recorded as an increase in equity.

The federal, state, and foreign NOL carryforwards in the income tax returns filed included unrecognized tax benefits. The deferred tax assets recognized for those NOLs are presented net of these unrecognized tax benefits.

Because of the change of ownership provisions of the Tax Reform Act of 1986, use of a portion of our domestic NOL and tax credit carryforwards may be limited in future periods. Further, a portion of the carryforwards may expire before being applied to reduce future income tax liabilities.

<sup>8</sup> At the 2011 AICPA Conference, Mark Shannon advised that entities must consider all available evidence, both positive and negative, in determining whether a valuation allowance is needed to reduce a deferred tax asset to an amount that is more likely than not to be realized. Mr. Shannon said that some registrants are placing less weight on recent losses when weighing the positive and negative evidence because they view the current economic downturn as an aberration, as given in an example in ASC 740-10-30-22. He stated that while each company's facts and circumstances could differ, in general it would be difficult to conclude the economic downturn is an aberration. He also reminded participants that overcoming such negative evidence would require significant objective positive evidence. At the 2012 AICPA Conference, Mr. Shannon reiterated these comments. He also emphasized the importance of evidence that is objectively verifiable and noted that it carries more weight than evidence that is not.

## Valuation Allowance Reversal<sup>9</sup>

### ***Sample Disclosure***

As of December 31, 20X3, our deferred tax assets were primarily the result of U.S. NOL, capital loss, and tax credit carryforwards. A valuation allowance of \$XXX and \$XXX was recorded against our gross deferred tax asset balance as of December 31, 20X3, and December 31, 20X2, respectively. For the years ended December 31, 20X3, and December 31, 20X2, we recorded a net valuation allowance release of \$XXX (comprising a full-year valuation release of \$XXX related to the X segment, partially offset by an increase to the valuation allowance of \$XXX related to the Y segment) and \$XXX, respectively, on the basis of management's reassessment of the amount of its deferred tax assets that are more likely than not to be realized.

As of each reporting date, management considers new evidence, both positive and negative, that could affect its view of the future realization of deferred tax assets. As of December 31, 20X3, in part because in the current year we achieved three years of cumulative pretax income in the U.S. federal tax jurisdiction, management determined that there is sufficient positive evidence to conclude that it is more likely than not that additional deferred taxes of \$XXX are realizable. It therefore reduced the valuation allowance accordingly.

As of December 31, 20X3, and December 31, 20X2, we have NOL carryforwards of \$XXX and \$XXX, respectively, which, if unused, will expire in years 20Y6 through 20Z2. We have capital loss carryforwards totaling \$XXX and \$XXX as of December 31, 20X3, and December 31, 20X2, respectively, which, if unused, will expire in years 20X4 through 20X8. In addition, as of December 31, 20X3, and December 31, 20X2, we have qualified affordable housing tax credit carryforwards totaling \$XXX and \$XXX, respectively, which, if unused, will expire in years 20X8 through 20Z3, and alternative minimum tax credits of \$XXX and \$XXX, respectively, that may be carried forward indefinitely. Certain tax attributes are subject to an annual limitation as a result of the acquisition of our Subsidiary A, which constitutes a change of ownership as defined under IRC Section 382.

## **Deferred Tax Asset Attributable to Excess Stock Option Deductions — Before the Adoption of ASU 2016-09**

### ***Sample Disclosure 1***

As a result of certain realization requirements of ASC 718, the table of deferred tax assets and liabilities does not include certain deferred tax assets as of December 31, 20X3, and December 31, 20X2, that arose directly from (or the use of which was postponed by) tax deductions related to equity compensation that are greater than the compensation recognized for financial reporting. Equity will be increased by \$XXX if and when such deferred tax assets are ultimately realized. We use ASC 740 ordering when determining when excess tax benefits have been realized.

<sup>9</sup> At the 2012 AICPA Conference, Mark Shannon noted that registrants who have returned to profitability may be considering whether they should reverse a previously recognized valuation allowance. He indicated that factors to consider in making this determination include (1) the magnitude and duration of past losses and (2) the magnitude and duration of current profitability as well as changes in the factors that drove losses in the past and those currently driving profitability. Nili Shah further noted that registrants should assess the sustainability of current profits as well as their track record of accurately forecasting future financial results. She pointed out that registrants' disclosures should include a discussion of the factors or reasons that led to a reversal of a valuation allowance that effectively answers the question "why now." Such disclosures would include a comprehensive analysis of all available positive and negative evidence and how the entity weighed each piece of evidence in its assessment. She also reminded registrants that the same disclosures would be expected when there is significant negative evidence and a registrant concludes that a valuation allowance is necessary.

## **Sample Disclosure 2**

As a result of certain realization requirements of ASC 718, the table of deferred tax assets and liabilities does not include certain deferred tax assets as of December 31, 20X3, and December 31, 20X2, that arose directly from tax deductions related to equity compensation greater than compensation recognized for financial reporting. Equity will be increased by \$XXX if and when such deferred tax assets are ultimately realized. We use tax law ordering when determining when excess tax benefits have been realized.

*Note: As of the date of adoption of FASB Statement No. 123(R), Share-Based Payment (now codified in ASC 718), an entity that previously recognized a deferred tax asset for excess tax benefits before its realization was required to discontinue that practice prospectively. As a result, some entities may continue to have deferred tax assets for an NOL carryforward that includes such excess tax benefits until the NOL carryforward is either used or expires. In this case, it may not be appropriate to reverse any related valuation allowance recorded in the same year the related deferred tax asset was first recorded, even if the facts and circumstances indicate that it is more likely than not that the deferred tax asset will be realized. These entities should modify the above samples accordingly.*

*Entities are required to present in the consolidated statements of cash flows the impact of the tax benefit of any realized excess tax deduction in accordance with ASC 230-10-45-14(e). The excess tax benefit is separate from taxes paid and is reported as a component of cash inflows from financing activities. The excess tax benefit should be determined on a gross basis (i.e., not netted with tax deficiencies related to share-based payment awards). Operating cash outflows are increased by the same amount, resulting in including in operating cash flows the income taxes that the entity would have paid had it not been for the excess tax benefit.*

## **Tax Holidays (SEC Accounting Bulletin Topic 11.C, "Tax Holidays")**

### **Sample Disclosure**

We operate under tax holidays in other countries, which are effective through December 31, 20X3, and may be extended if certain additional requirements are satisfied. The tax holidays are conditional upon our meeting certain employment and investment thresholds. The impact of these tax holidays decreased foreign taxes by \$XXX, \$XXX, and \$XXX for 20X3, 20X2, and 20X1, respectively. The benefit of the tax holidays on net income per share (diluted) was \$.XX, \$.XX, and \$.XX for 20X3, 20X2, and 20X1, respectively.

## **Tabular Reconciliation of Unrecognized Tax Benefits (ASC 740-10-50-15A(a))**

*Note: This tabular reconciliation disclosure is not required for nonpublic entities.*

## **Sample Disclosure 1**

The following is a tabular reconciliation of the total amounts of unrecognized tax benefits:

	<b>20X3</b>	<b>20X2 (in millions)</b>	<b>20X1</b>
<b>Unrecognized tax benefits — January 1</b>	<b>\$XXX</b>	<b>\$XXX</b>	<b>\$XXX</b>
Gross increases — tax positions in prior period	XXX	XXX	XXX
Gross decreases — tax positions in prior period	XXX	XXX	XXX
Gross increases — tax positions in current period	XXX	XXX	XXX
Settlement	XXX	XXX	XXX
Lapse of statute of limitations	XXX	XXX	XXX
<b>Unrecognized tax benefits — December 31</b>	<b>\$XXX</b>	<b>\$XXX</b>	<b>\$XXX</b>

## **Sample Disclosure 2**

*Note: The table on the next page illustrates a selection of reconciling items that may be reported separately or aggregated on the basis of the specific facts and circumstances. The list is not intended to be all-inclusive. If reported separately, the descriptions should be appropriately titled so that the user of the financial statements will understand the nature of the reconciling item being reported.*

	<b>20X3</b>	<b>20X2 (in millions)</b>	<b>20X1</b>
<b>Unrecognized tax benefits — January 1</b>	<b>\$XXX</b>	<b>\$XXX</b>	<b>\$XXX</b>
Current year — increase	XXX	XXX	XXX
Prior year — increase	XXX	XXX	XXX
Claims	XXX	XXX	XXX
Prior year — decrease	XXX	XXX	XXX
Accrual to return changes	XXX	XXX	XXX
Settlements	XXX	XXX	XXX
Statute expiration	XXX	XXX	XXX
Current year acquisitions	XXX	XXX	XXX
Divestitures	XXX	XXX	XXX
Currency	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Unrecognized tax benefits — December 31</b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>	<b><u>\$XXX</u></b>

**UTBs that, if recognized, would affect the effective tax rate (ASC 740-10-50-15A(b))**

*Note: This disclosure is not required for nonpublic entities.*

Included in the balance of unrecognized tax benefits as of December 31, 20X3; December 31, 20X2; and December 31, 20X1, are \$XXX, \$XXX, and \$XXX, respectively, of tax benefits that, if recognized, would affect the effective tax rate. Also included in the balance of unrecognized tax benefits as of December 31, 20X3; December 31, 20X2; and December 31, 20X1, are \$XXX, \$XXX, and \$XXX, respectively, of tax benefits that, if recognized, would result in adjustments to other tax accounts, primarily deferred taxes.

**The total amounts of interest and penalties recognized in the Statement of Operations and the total amounts of interest and penalties recognized in the Statements of Financial Position (ASC 740-10-50-15(c))**

We recognize interest accrued related to unrecognized tax benefits and penalties as income tax expense. Related to the unrecognized tax benefits noted above, we accrued penalties of \$XX and interest of \$XX during 20X3 and in total, as of December 31, 20X3, and recognized a liability for penalties of \$XX and interest of \$XX. During 20X2, we accrued penalties of \$XX and interest of \$XX and in total, as of December 31, 20X2, had recognized a liability for penalties of \$XX and interest of \$XX. During 20X1, we accrued penalties of \$XX and interest of \$XX.

**Tax positions for which it is reasonably possible that the total amounts of UTBs that will significantly increase or decrease within 12 months of the reporting date (ASC 740-10-50-15(d))**

We believe that it is reasonably possible that a decrease of up to \$XX in unrecognized tax benefits related to state exposures may be necessary within the coming year. In addition, we believe that it is reasonably possible that approximately \$XX of current other remaining unrecognized tax benefits, each of which are individually insignificant, may be recognized by the end of 20X4 as a result of a lapse of the statute of limitations. As of December 31, 20X2, we believed that it was reasonably possible that a decrease of up to \$XX in unrecognized tax benefits related to state tax exposures would have occurred during the year ended December 31, 20X3. During the year ended December 31, 20X3, unrecognized tax benefits related to those state exposures actually decreased by \$XX as illustrated in the table above.

**A description of tax years that remain subject to examination by major tax jurisdictions (ASC 740-10-50-15(e))**

We are subject to taxation in the United States and various states and foreign jurisdictions. As of December 31, 20X3, tax years for 20X0, 20X1, and 20X2 are subject to examination by the tax authorities. With few exceptions, as of December 31, 20X3, we are no longer subject to U.S. federal, state, local, or foreign examinations by tax authorities for years before 20X0. Tax year 20W9 was open as of December 31, 20X2.

**Subsequent Events Disclosure (ASC 855-10-50-2)**

***Sample Disclosure***

In January 20X4, we received notice of a tax incentive award of \$XX that will allow us to monetize approximately \$XX of state research and development tax credits. In exchange for this award, we pledged to hire more employees and maintain the additional headcount through at least December 31, 20X8. Failure to do so could result in our being required to repay some or all of these incentives.

*Note: Disclosure of a nonrecognized subsequent event is required only when the financial statements would be considered misleading without such disclosure.*

## Schedule II — Valuation and Qualifying Accounts

The following schedule and accompanying footnote are reproduced from SEC Regulation S-X, Rule 12-09:

Column A — Description <sup>1</sup>	Column B — Balance at beginning of period	Column C — Additions		Column D — Deductions — describe	Column E — Balance at end of period
		(1) — Charged to costs and expenses	(2) — Charged to other accounts — describe		

<sup>1</sup> List, by major classes, all valuation and qualifying accounts and reserves not included in specific schedules. Identify each class of valuation and qualifying accounts and reserves by descriptive title. Group (a) those valuation and qualifying accounts that are deducted in the balance sheet from the assets to which they apply and (b) those reserves which support the balance sheet caption, Reserves. Valuation and qualifying accounts and reserves as to which the additions, deductions, and balances were not individually significant may be grouped in one total and in such a case the information called for under columns C and D need not be given.

*Note: A liability for unrecognized tax benefits is not a valuation or qualifying account, whereas a valuation allowance on a deferred tax asset is a valuation account.*

## Interim Disclosures

### Variations in customary income tax expense relationships (ASC 740-270-50-1)

#### Sample Disclosure 1

Our effective tax rate (ETR) from continuing operations was XX percent and XX percent for the quarter and nine months ended September 30, 20X2, respectively, and XX percent and XX percent for the quarter and nine months ended September 30, 20X1, respectively. The following items caused the quarterly or year-to-date ETR to be significantly different from our historical annual ETR:

- During the third quarter and nine months ended September 30, 20X2, we recorded an income tax benefit of approximately \$XX million as a result of a favorable settlement of uncertain tax positions in jurisdiction X, which reduced the ETR by XX percent and XX percent respectively.
- During the nine months ended September 30, 20X1, we recorded an income tax benefit of approximately \$XX million related to an increase in tax rates in country X enacted in the third quarter, which increased the ETR by XX percent.

#### Sample Disclosure 2

When calculating the annual estimated effective income tax rate for the three months ended March 31, 20X1, we were subject to a loss limitation rule because the year-to-date ordinary loss exceeded the full-year expected ordinary loss. The tax benefit for that year-to-date ordinary loss was limited to the amount that would be recognized if the year-to-date ordinary loss were the anticipated ordinary loss for the full year.

### ***Sample Disclosure 3***

We have historically calculated the provision for income taxes during interim reporting periods by applying an estimate of the annual effective tax rate for the full fiscal year to "ordinary" income or loss (pretax income or loss excluding unusual or infrequently occurring discrete items) for the reporting period. We have used a discrete effective tax rate method to calculate taxes for the fiscal three- and six-month periods ended June 30, 20X2. We determined that since small changes in estimated "ordinary" income would result in significant changes in the estimated annual effective tax rate, the historical method would not provide a reliable estimate for the fiscal three- and six-month periods ended June 30, 20X2.

### ***Separate Company Financial Statements***

**Entities with separately issued financial statements that are members of a consolidated tax return (ASC 740-10-50-17(b))**

### ***Sample Disclosure***

Our company is included in the consolidated tax return of Parent P. We calculate the provision for income taxes by using a "separate return" method. Under this method, we are assumed to file a separate return with the tax authority, thereby reporting our taxable income or loss and paying the applicable tax to or receiving the appropriate refund from P. Our current provision is the amount of tax payable or refundable on the basis of a hypothetical, current-year separate return. We provide deferred taxes on temporary differences and on any carryforwards that we could claim on our hypothetical return and assess the need for a valuation allowance on the basis of our projected separate return results.

Any difference between the tax provision (or benefit) allocated to us under the separate return method and payments to be made to (or received from) P for tax expense are treated as either dividends or capital contributions. Accordingly, the amount by which our tax liability under the separate return method exceeds the amount of tax liability ultimately settled as a result of using incremental expenses of P is periodically settled as a capital contribution from P to us.

# Appendix E — Sample SEC Comments: Income Taxes

The SEC staff's comments about income taxes continue to focus on (1) the potential tax and liquidity ramifications related to the repatriation of foreign earnings, (2) valuation allowances, and (3) disclosures related to the income tax rate.

Further, the staff continues to ask registrants to provide early-warning disclosures to help financial statement users understand these items and how they potentially affect the financial statements. For additional information about early-warning disclosures, see Section 3.1.5 of Deloitte's *A Roadmap to SEC Comment Letter Considerations, Including Industry Insights*.

Registrants can also expect to receive comments pertaining to both (1) tax effects of significant or unusual transactions that occurred during the period and (2) noncompliance with disclosure requirements (e.g., omission of required disclosures).

At recent AICPA Conferences, the staff stated that boilerplate language should be avoided with respect to income tax disclosures within MD&A and that approaches more conducive to effective disclosure would include:

- Using the income tax rate reconciliation as a starting point and describing the details of the material items.
- Discussing significant foreign jurisdictions, including statutory rates, effective rates, and the current and future impact of reconciling items.
- Providing meaningful disclosures about known trends and uncertainties, including expectations regarding the countries where registrants operate.

## Repatriation of Foreign Earnings and Liquidity Ramifications

In accordance with ASC 740, when the earnings of a foreign subsidiary are indefinitely reinvested, registrants should disclose the nature and amount of the temporary difference for which no DTL has been recognized as well as the changes in circumstances that could render the temporary difference taxable. In addition, registrants should disclose either (1) the amount of the unrecorded DTL related to that temporary difference or (2) a statement that determining that liability is not practicable.

Registrants may need to repatriate cash from foreign subsidiaries. ASC 740-30-25-19 states that "[i]f circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity, [the parent entity] shall accrue as an expense of the current period income taxes attributable to that remittance."

The SEC staff continues to (1) ask for additional information when registrants claim that it is not practicable to determine the amount of unrecognized DTL and (2) request that registrants expand disclosures in MD&A about their indefinitely reinvested foreign earnings. In addition, the staff has indicated that it evaluates such an assertion by taking into account registrants' potential liquidity needs and the availability of funds in U.S. and foreign jurisdictions. Recently, the staff has focused on situations in which registrants have repatriated a portion of their foreign earnings but continue to assert that the remaining earnings are considered to be indefinitely invested.

Disclosures in an MD&A liquidity analysis should include:

- The amount of cash and short-term investments held by foreign subsidiaries that would not be available to fund domestic operations unless the funds were repatriated.
- A statement that the company would need to accrue and pay taxes if the funds are repatriated.
- If true, a statement that the company does not intend to repatriate those funds.

## **Valuation Allowances**

ASC 740-10-30-5(e) requires entities to reduce DTAs by "a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the [DTAs] will not be realized. The valuation allowance shall be sufficient to reduce the [DTA] to the amount that is more likely than not to be realized." ASC 740-10-30-16 through 30-23 provide additional guidance. In light of this guidance, the SEC staff has commented when registrants' filings indicate that no valuation allowance has been recorded or when it seems that the valuation allowance recorded is insufficient. More recently, the staff has asked registrants about reversals of, or other changes in, their valuation allowances.

The staff has reminded registrants that in assessing the realizability of DTAs, they should consider cumulative losses in recent years to be significant negative evidence and that to avoid recognizing a valuation allowance, they would need to overcome such evidence with significant objective and verifiable positive evidence.

The SEC staff has indicated that factors for registrants to consider in determining whether they should reverse a previously recognized valuation allowance would include:

- The magnitude and duration of past losses.
- The magnitude and duration of current profitability.
- Changes in the above two factors that drove losses in the past and those currently driving profitability.

Further, the staff has noted that registrants should bear in mind that the goal of the assessment is to determine whether sufficient positive evidence outweighs existing negative evidence. The staff has emphasized the importance of evidence that is objectively verifiable and has noted that such evidence carries more weight than evidence that is not. In addition, registrants should (1) assess the sustainability of profits in jurisdictions in which an entity was previously in a cumulative loss position and (2) consider their track record of accurately forecasting future financial results. Doubts about the sustainability of profitability in a period of economic uncertainty may give rise to evidence that would carry less weight in a valuation allowance assessment. Likewise, a registrant's poor track record of accurately forecasting future results would also result in future profit projections that may be very uncertain and should carry less weight in the overall assessment.

The SEC staff has also pointed out that registrants' disclosures should include a discussion of the specific factors or reasons that led to a reversal of a valuation allowance to effectively answer the question "Why now?" Such disclosures would include a comprehensive analysis of all available positive and negative evidence and how the registrant weighed each piece of evidence in its assessment. In addition, the SEC staff has reminded registrants that the same disclosures would be expected when there is significant negative evidence and a registrant concludes that a valuation allowance is necessary.

## **Income Tax Rate (Including Rate Reconciliation and Effective Tax Rate)**

Registrants often pay income taxes in multiple jurisdictions other than the domestic federal jurisdiction (e.g., domestic state and local jurisdictions, foreign federal and foreign local or provincial jurisdictions), and the applicable income tax rates vary in each jurisdiction and therefore affect the registrant's effective tax rate. Further, tax laws often differ from financial accounting standards; therefore, permanent differences can arise between pretax income for financial reporting purposes and taxable income. Although such differences are not uncommon, the SEC staff often requests that registrants provide greater transparency into the underlying reasons for differences between the federal statutory rate and the registrant's effective tax rate. The staff may also request additional details about events that give rise to a significant change in a registrant's effective tax rate as compared with prior periods.

One of the tax rate-related disclosure requirements that have received increased scrutiny in recent years is the obligation to provide a rate reconciliation. In accordance with ASC 740 and SEC Regulation S-X, Rule 4-08(h)(2), registrants must disclose a reconciliation that uses percentages or dollar amounts of income tax expense or benefit attributable to continuing operations with the amount that would have resulted from applying domestic federal statutory tax rates (the regular rate, not the alternative minimum tax rate) to pretax income from continuing operations.

Further, registrants should disclose the estimated amount and the nature of each significant reconciling item. ASC 740-10-50 does not define "significant." However, SEC Regulation S-X, Rule 4-08(h), states that public entities should disclose (on an individual basis) all reconciling items that constitute 5 percent or more of the computed amount (i.e., income before tax multiplied by the applicable domestic federal statutory tax rate). Reconciling items may be aggregated in the disclosure if they are individually less than 5 percent of the computed amount.

The SEC staff has noted the following issues related to registrants' tax rate reconciliation disclosures:

- Labels related to reconciling items were unclear, and disclosures about material reconciling items did not adequately describe the underlying nature of these items.
- For material reconciling items related to foreign tax jurisdictions, registrants did not disclose in MD&A (1) each material foreign jurisdiction and its tax rate and (2) how each jurisdiction affects the amount in the tax rate reconciliation.
- Registrants have inappropriately aggregated material reconciling items that are greater than 5 percent of the amount they calculated by multiplying the pretax income by the statutory tax rate.
- Amounts reflected in the tax rate reconciliation were inconsistent with related amounts disclosed elsewhere in a registrant's filing.
- Corrections of errors were inappropriately reflected as changes in estimates.

Further, in recent speeches, the staff has remarked that in the tax rate reconciliation, registrants continue to use boilerplate language that does not describe the components shown, and that explaining both why certain events occurred that affected the effective tax rate and how those events will affect the tax rate going forward would provide more meaningful information to investors. The staff also noted that when the “foreign rate differential” and other components of the tax rate reconciliation are not easily understood or transparent, registrants might consider preparing the tax rate reconciliation on a disaggregated basis (e.g., by country) in a tabular format.

## **Transaction-Specific Disclosures**

ASC 740-10-50-14 requires all entities to “disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented.” In accordance with this requirement, the SEC staff has reminded registrants that it is looking for disclosures that help the reader understand the company’s big-picture tax situation. That includes helping the reader understand the tax effects of any significant or unusual events that took place during the period. Such events may include significant restructuring activities or acquisitions and divestitures. When disclosing information about these transactions, registrants should provide detailed descriptions of the events and clear explanations of how they affected income taxes during the period and may affect income taxes in future periods. Registrants with such transactions should consider disclosing the following:

- Whether temporary or permanent differences were created as a result of the transactions.
- Accounting impact of the temporary or permanent differences created.
- The expected impact of the transactions on the effective tax rate in future periods.
- The actual or expected impact on the registrants’ assertions related to indefinitely reinvested foreign earnings, if the transactions involved foreign entities.
- The actual or expected impact on the registrants’ conclusions with respect to the realizability of DTAs.

## **Noncompliance With Disclosure Requirements**

Registrants can expect to receive comments from the SEC staff when (1) required disclosures have been omitted, (2) registrants do not fully comply with the various disclosure requirements, and (3) amounts and descriptions of events are inconsistent with disclosures elsewhere in the report. Registrants should carefully review the numerous disclosures required by U.S. GAAP and the SEC to ensure that disclosures in the footnotes and in MD&A are complete and accurate. Recent comments have raised the following issues:

- Omission of required disclosures. For example:
  - Income from operations before income tax expense for each country in which the registrant operates and the nominal tax rates in those countries.
  - Expiration dates of operating loss carryforwards.
- Limited or missing description of the income tax effects of an accounting change or error, including amounts and classification within the financial statements.
- Limited or missing description of the income tax effects of the adoption of an accounting standard.
- Limited or missing description of the income tax effects of tax elections, tax receivable agreements, and tax holidays.
- Use of inappropriate non-GAAP measures related to income taxes.

- Unclear line-item descriptions in the financial statements or in disclosures (e.g., generic titles in the rate reconciliation).
- Amounts in disclosures that do not reconcile to amounts presented in the financial statements or disclosed elsewhere in the report.
- Limited discussion in MD&A of matters related to income taxes.

\*\*\*\*\*

Included below are extracts of a sampling of SEC staff comments on various income-tax-related topics, including a registrant's assessment of the realizability of DTAs, undistributed earnings of foreign subsidiaries, foreign tax rate, uncertain tax positions, and disclosures. These extracts have been reproduced from comments published on the SEC's Web site that were issued in recent years. In many cases, the staff's comments are focused on the MD&A instead of or in addition to the financial statement disclosures. Dollar amounts and information identifying registrants or their businesses have been redacted from the comments.

The comments are organized by topic, as follows:

<b>Topic</b>	<b>Example Comments</b>	<b>Topic</b>	<b>Example Comments</b>
Deferred Taxes	3	Rate Reconciliation — Foreign Rate Differential	15
Disclosures	8	Undistributed Earnings of Foreign Subsidiaries	14
Intraperiod Tax Allocation	2	Unrecognized Tax Benefits	7
Non-GAAP Measures	16	Valuation Allowance	20
Rate Reconciliation — General	18	Other	12

## Examples of SEC Comments

### Deferred Taxes

#### Examples of SEC Comments

- We note your reclassification of prior year deferred tax liabilities. We also note you do business in the U.S., a number of state jurisdictions and a number of foreign jurisdictions. Please tell us why you changed the classification and whether the reclassification results in the offset of deferred income tax liabilities and assets attributable to different tax jurisdictions. Refer to ASC 740-10-45-6.
- [W]e note from the table on page [X] that you have recorded a disproportionately small deferred tax asset of \$[X] million for this [tax receivable agreement] liability. Please tell us how you determined this \$[X] million deferred tax asset.
- We . . . note from page [X] the Energy efficiency deferred tax asset. Please clarify what this deferred tax asset represents. Since this item is nearly half of your gross deferred tax assets, please disclose how you expect to realize this amount and how long you believe it will take. Discuss any limitations on such realization, including expiration dates, regulatory actions, etc.

## Disclosures

### Examples of SEC Comments

- We note that you have foreign operating loss carryforwards of \$[X] million. Please revise your future filings to disclose the expiration date(s) of your operating loss carryforwards. Refer to ASC 740-10-50-3(a).
- We note that you have net operating loss carryforwards with expiration dates ranging from one year to an indefinite period. Please revise to provide additional detail regarding the expiration dates for these net operating loss carryforwards. Refer to FASB ASC 740-10-50-3.
- Please tell us the amount of income before income tax expense for domestic versus foreign operations for each period presented, and tell us why you do not provide this disclosure as required by [R]ule 4-08(h) of Regulation S-X.
- We note from your disclosure in Note [X] that about [X]% of your income tax expense for the year ended August 31, 2015 is related to foreign income. Please revise to disclose the components of income before income tax expense as either domestic or foreign. See Rule 4-08(h) of Regulation S-X.
- Please revise future filings to disclose the components of income (loss) before income tax expense (benefit) as either domestic or foreign in accordance with Rule 4-08(h)(1)(i) of Regulation S-X.
- We note the significant changes between comparable periods in the earnings (loss) before income taxes from certain income tax jurisdictions. In future filings, please discuss and quantify the individually significant items that caused the period-to-period changes. Please provide draft disclosure to be included in future filings.
- You attribute the tax benefit you record in 2013 and 2014 to net operating loss and tax credit carryforwards for [Company A] which offset the deferred tax liability recorded in connection with its acquisition. In the last paragraph on page [X] you indicate that the benefit relates only to U.S. state net operating loss carryforwards. Please revise your disclosure to clarify whether the benefit relates to both net operating loss and tax credit carryforwards. In addition, separately tell us why no apparent benefit is recorded for U.S. federal income taxes and reference for us the authoritative literature you rely upon to support your accounting.
- We note that you provide the amount of income tax expense (benefit) for some components of comprehensive income but not all. For instance, you do not appear to provide this information for unrealized losses on available for sale securities or for the reclassification adjustments. Please tell us how you considered the guidance in ASC 220-10-45-12 with regards to these disclosures.

## Intraperiod Tax Allocation

### Examples of SEC Comments

- We note your deferred tax asset for discontinued operations increased significantly in fiscal year 2015. Please explain to us, and disclose in future filings, what the deferred tax asset in discontinued operations specifically relates to and the reasons why it increased in fiscal year 2015. Please also explain to us: why the offset for this increase is not recorded in discontinued operations and how you determined that realization of this asset is more likely than not.
- We note that you entered into a Tax Receivable Agreement (TRA) with your pre-IPO shareholders as part of the September 30, 2015 Reorganization. Tell us your consideration of ASC 740-20-45-11g and why you accounted for your TRA obligations as a period expense in the year ended December 31, 2015 rather than equity.

## Non-GAAP Measures

### Examples of SEC Comments

- Please revise Tables 2, 2a and 2b to separately quantify:
  - The tax effect of pre-tax non-GAAP adjustments and explain any significant differences from your statutory or effective tax rates;
  - The resolution of uncertain tax positions and explain how they were resolved; and
  - The change in deferred taxes and explain why they changed.

Also, tell us why the tax effect recorded in your non-GAAP performance measure for the nine months ended September 30, 2015 in Tables 2 and 2b is [X]% of the pre-tax adjustments and the impact in the comparable period of 2014 is negative [X]%. These amounts are substantially different from the statutory tax rates in [country A] and the U.S. and your consolidated effective tax rate. Please see Question 102.11 of the Compliance & Disclosure Interpretations associated with Non-GAAP Financial Measures.
- In your earnings release you indicate that you believe your presentation of non-GAAP net income provides investors with a more meaningful understanding of your ongoing and projected operating performance. When a measure is a performance measure, Question 102.11 of the updated Compliance and Disclosure Interpretations issued on May 17, 2016 requires inclusion of both current and deferred income tax expense. Since you believe it is important to investors to understand the cash taxes you actually pay, we would not object to separate disclosure of such amounts. Please revise your future press releases accordingly.
- We note your GAAP effective tax rate for the years ended 2015, 2014 and 2013 was [X]%, [X]% and [X]%, respectively, and your non-GAAP effective tax rate for those years was [X]%, [X]% and [X]%, respectively. Please explain to us how you calculate the income tax effects of your non-GAAP adjustments. See Question 102.11 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016.
- Please revise future earnings releases to separate the tax impact attributable to the repatriation of the [Country A] subsidiary's earnings from the business separation costs. See Question 102.11 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016.
- Please explain how you calculated the income tax effects of your non-GAAP adjustments in your next earnings release. Also, tell us why the tax rate for the total pre-tax adjustments from continuing operations attributable to [Company A] is [X]% for the nine-month period ended June 30, 2016, excluding repatriation. See Question 102.11 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016.
- Please revise your reconciliation of Earnings after Tax Non-GAAP to begin with net income rather than a measure that is not on the face of your consolidated income statements and does not include income taxes. See Question 103.02 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016.
- We note that the adjustments to arrive at adjusted earnings are presented "net of tax." Please present the income tax effects of your non-GAAP adjustments as a separate adjustment and explain how you calculated the income tax effects related to these adjustments in your next earnings release. See Question 102.11 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016.
- Footnote [X] to your non-GAAP table indicates that you calculate the income tax impact of your non-GAAP adjustments "using the statutory tax rates in effect during the period." Given that you operate in several different countries and that the effective tax rate applied to your non-GAAP adjustments varies significantly from year to year, this description does not appear sufficiently detailed to allow an investor to understand the effective tax rate applied to the non-GAAP adjustments in any one year. Please revise future filings to better explain this matter. In doing so, please consider disclosing each material non-GAAP adjustment's country of origin and the statutory tax rate of such country.

## Non-GAAP Measures (continued)

### Examples of SEC Comments

- We note that the adjustments to your non-GAAP net income on page [X] appear to have been made on a gross basis without any corresponding adjustment for the current income tax effects even though your reconciliation begins with an after-tax GAAP amount. That presentation is inconsistent with Question 102.11 of our Compliance and Disclosure Interpretations on Non-GAAP Financial Measures updated on May 17, 2016. Please review this guidance when preparing your future filings.
- We note that each individual adjustment included in non-GAAP net income is presented net of tax rather than showing the income tax impact as a separate line, and it is unclear how the tax effect was calculated. Therefore, your disclosures may be inconsistent with Question 102.11 of the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please review this guidance when preparing your next filing that includes such non-GAAP disclosures.
- We note that you present the income tax effects of your non-GAAP adjustments as "Income tax expense, as adjusted" without providing the reconciliation required by Item 10(e)(1)(i)(B) of Regulation S-K or clearly explaining how it was calculated, which is inconsistent with Question 102.11 of the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please review this guidance when preparing your next earnings release.
- In your reconciliation of non-GAAP net income, you adjust tax expense to the non-GAAP cash tax rate. Please address the following:

The non-GAAP cash income tax determined by subtracting your adjustment from your GAAP income tax does not appear to be the same amount as reported on page [X] of your December 31, 2015 Form 10-K. Please explain to us the basis for the adjustment and how it is calculated. Also, please consider the updated guidance in Question 102.11 of the non-GAAP C&DIs in your future earnings releases to clearly explain your non-GAAP tax adjustments.

If you consider your measure of non-GAAP net income to be a performance measure, please also note that the use of a cash income tax rate may be inconsistent with the updated guidance in Question 102.11 of the non-GAAP C&DIs.

- We note that you have provided a reconciliation of your effective tax rate to your operating tax rate, a non-GAAP financial measure. Please identify the nature of the unusual or infrequent items, items related to uncertain tax positions and other discrete items in each period. We also note that this presentation may be inconsistent with the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please review this guidance when preparing your future filings.
- You believe that the non-GAAP financial measures adjusted EPS, Total Segment EBIT, operating tax rate and adjusted EBITDA assist your investors in evaluating the changes in your results and the Company's performance. We also note that you believe that Total Segment EBIT provides useful supplemental information for your investors as it is an important indicator of the Company's operations strength and performance. Please revise your disclosure in future filings to provide adequately detailed information specific to your circumstances as to why each of these non-GAAP measures are useful to investors. Refer to Item 10(e)(1)(i)(C) of Regulation S-K.
- Please explain the nature of the discrete tax-related certain items.
- We note here and elsewhere in your exchange act filings, you present Non-GAAP financial measures that you identify as "Adjusted net income", "Adjusted diluted earnings per share", and "Adjusted net margin" that add-back income tax expense in their determinations. Please explain to us why you add-back income tax expense in your calculations of these Non-GAAP financial measures, including what information you are trying to convey to investors and why you believe these measures are useful.

## Rate Reconciliation — General

### Examples of SEC Comments

- We note that there have been significant changes in your effective tax rate in recent periods. Specifically, the effective rate was [X]% for 2014, [X]% for 2015, and [X]% for the nine months ended October 2, 2016. There appear to be multiple factors contributing to these fluctuations which include foreign losses in [Country X] with no tax benefits, tax benefits on the repatriation of foreign earnings, additional tax expense related to an underaccrual and tax expense on a settlement with [foreign] tax authorities. Please address the following:
  - In your discussion of the effective tax rate, please quantify the extent to which each significant factor contributed to the fluctuation in the effective tax rate from period to period;
  - Please help us better understand the nature of the additional expense recorded related to the underaccrual of tax expense and in a settlement with [foreign] authorities, including what periods the underaccrual and settlement relate to and the extent to which these factors impact the effective tax rate; and
  - Please help us better understand why you are generating tax benefits rather than incurring tax expense on the repatriation of foreign earnings pursuant to ASC 740.
- Please tell us your applicable U.S. federal statutory tax rate in the fiscal years 2014 and 2013 and how you considered the requirements to disclose a reconciliation applying your domestic federal statutory tax rate to pretax income from continuing operations. See ASC 740-10-50-12. To the extent you continue to believe the use of a [X]% effective tax rate is appropriate tell us the basis for your conclusion including the accounting guidance you relied upon.
- Please expand your discussion and analysis of the fiscal year 2015 effective tax rate as compared to the fiscal year 2014 effective tax rate to quantify each material factor. Please also provide a discussion of the specific global tax planning initiatives.
- [W]e note that in your reconciliation between the federal statutory rate and the effective income tax rate disclosed in Note [X], foreign and state income taxes are combined in one line item. Please note that if either of these items (foreign income taxes or state income taxes) affects the statutory tax rate by more than 5% (either positively or negatively) they should be separately presented on the reconciliation.
- We note that you provide a reconciliation of your tax expense using the federal statutory rate of the United States on page [X]. We also note that you are incorporated in [Country A]. Please explain to us why you believe the U.S. tax rate is the appropriate rate for purposes of providing the disclosure required by FASB ASC 740-10-50-12.
- We note from page [X] that Energy efficiency preferences has had an increasingly downward impact on your effective tax rate, causing it to go from [X]% in 2012, to [X]% in 2013, to ([X])% in 2014. The disclosure on page [X] regarding the effects of investment tax credits, production tax credits, and deductions permitted under Section 179D of the Code does not enable a reader to sufficiently understand why these items had those specific effects on the effective tax rate from year to year. Please explain. Since this item has a material impact on the tax provision/benefit and therefore net income, please tell us and disclose whether this apparent trend is expected to continue and to what extent. Refer to Item 303(a)(3)(ii) of Regulation S-K. In this regard, you did not state what the expected impact would be for 2015. Further, if the impact of these Energy efficiency preferences are recurring, the MD&A disclosures in the March 31, 2015 and June 30, 2015 Forms 10-Q do not explain why the estimated annual effective tax rates applied for the 2015 periods are so much higher compared to the 2014 periods. Please address.
- We note in the “Taxes on income reconciliation” schedule on page [X], significant amounts attributed to “Non-deductible expenses and other permanent differences” and “Increase in uncertain position, net”, are key reasons for your recording of a \$[X] million tax expense provision for fiscal 2014 despite having incurred an \$[X] million pretax loss. Please tell us what consideration you gave to providing further quantitative breakdowns of each of these line items as well as qualitative discussions of the nature of separate items included in each. Refer to Rule 4-08(h)(2) of Regulation S-X and ASC 740-10-50-14.

## Rate Reconciliation — General (continued)

### Examples of SEC Comments

- You disclose that your estimated effective tax rate decreased from [X]% in 2013 to [X]% in 2014 as a result of a net tax benefit of approximately \$[X] million due to the resolution of uncertain tax positions. Considering the impact of the net tax benefit to your current year effective tax rate and income tax expense, please expand your discussion to describe the nature of the tax benefit, including the additional reduction in your net operating loss carryforwards.
  - You disclose on page [X] that the effective tax rate for fiscal 2014 was impacted by an increase in the company's uncertain tax positions. However, we note from the rate reconciliation on page [X] that your effective tax rate was also impacted by the effect of non-U.S. operations and prior year true-ups. Please explain further what is included in the "prior year true-up" line item. Also, tell us your consideration to discuss the impact of these items on your effective tax rate in your results of operations discussion. For example, to the extent that any specific foreign jurisdictions had a significant impact on your effective tax rate, please disclose this information and include a discussion of how potential changes in such countries' operations may impact your results of operations. Refer to Item 303(a)(3) of Regulation S-K and Section III.B of SEC Release 33-8350.
  - We note your abbreviated discussion and analysis of income tax benefit/(expense) for fiscal years 2014 and 2013 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 the discussion should address the following items:
    - the impact of state taxes increased from [X]% to over [X]%,
    - the impact of differing tax rates increased from [X]% to [X]%,
    - the impact of non-deductible expenses increased from [X]% to [X]%,
    - the impact of US taxes on foreign earnings changed from [X]% to ([X]%),
- Also, please explain how you calculated the impact of valuation allowance changes to be [X]% and explain in detail the [X]% impact of uncertain tax positions and the potential impact of this item on future tax provisions. Material items that are not expected to recur should be highlighted in your disclosure. The disclosure should fully explain why your effective tax rate changed from [X]% in 2013 to [X]% in 2014. Please refer to Item 303(a)(3) of Regulation S-K and Section 501.12 of the Financial Reporting Codification for guidance.
- We note a line item called "Certain expenses capitalized on books and deducted in tax return" in your effective income tax rate reconciliation on page [X]. Please tell us what this line item represents and, in doing so, clarify why it appears a temporary difference has been included in your rate reconciliation.
  - You disclose that your effective tax rate for 2014 was [X]% compared to [X]% for 2013, primarily due to the reduction in the [state A] income tax rate. You further disclose that you estimate your 2015 effective tax rate to be comparable to the 2013 rate. Please provide us a proposed disclosure to be included in future filings to describe the reduction in the [state A] income tax rate in 2014 that resulted in your [X]% effective tax rate for this period
  - We note the line item in your rate reconciliation titled "Adjustment to reserves in prior years," as well as footnote (1) where you disclose that it relates to the effects of reconciling income tax amounts in your consolidated financial statements to your tax returns and reductions to NOLs from previous acquisitions. Please tell us more about these adjustments and quantify the significant components of the aggregate adjustment. With respect to your reconciliation of amounts in your GAAP financial statement to your tax returns, please tell us why each of the significant changes were necessary, and whether the changes were due to new information that became available subsequent to the reporting date of your previously issued financial statements. With respect to the reductions to NOLs from previous acquisitions, please tell us what drove these reductions, what information you used in making that determination and when the information became available to you. Please be detailed in your response and cite relevant U.S. GAAP to support your explanations.

## Rate Reconciliation — General (continued)

### Examples of SEC Comments

- Please help us understand the nature of the changes in the effective tax rate from [X] percent for 2013 to ([X]) percent for 2014. In this regard, please:
  - Explain to us why the foreign tax credit line item of the components of U.S. tax impact of foreign operations increased significantly relative to the dividends received from foreign subsidiaries line item in 2014.
  - Provide us your computation of the [X]% impact of the valuation allowance change in the 2014 effective tax rate reconciliation and explain why it does not appear to be reasonable in relation to the change in the valuation allowance.
  - Provide us your computation of the [X]% impact of unrecognized tax benefits in the 2014 effective tax rate reconciliation and explain why it does not appear to be reasonable in relation to the activity in the reconciliation of the beginning and ending amount of liabilities associated with uncertain tax benefits for 2014.
- [You state] that the non-assessable non-operating items relate to related party inter-company interest income. Please tell us whether this transaction was between wholly-owned subsidiaries of the company and, therefore, was eliminated in the consolidation process. If so, please tell us why you believe the effective tax rate should be adjusted for this item. In addition, please revise your disclosures to explain what non-assessable, non-operating items relate to as described in your response.
 

You state that significant permanent differences, which included “non-assessable non-operating items,” materially impacted your effective tax rate in fiscal 2015. Please explain further the nature of these items and tell us your consideration for disclosing this information.

We also note that taxes in foreign jurisdictions with a tax rate different from [home country] significantly impacted your effective rate. To the extent that any specific foreign jurisdictions had a significant impact on your effective tax rate, please disclose this information and include a discussion of how potential changes in such countries’ operations may impact your results of operations. Refer to Item 303(a)(3) of Regulation S-K and Section III.B of SEC Release 33-8350.
- Please disclose a reconciliation of the applicable tax rate in accordance with paragraph 81(c) of IAS 12.
- We note that your effective tax rate significantly increased for fiscal year 2014. Please expand your disclosures for each of the factors disclosed contributing to the increase in the effective tax rate to provide investors with additional insight of the nature of the factors. For example, it is unclear why there was a tax increase related to investments in subsidiaries, associates and joint ventures. Please refer to Item 5 of Form 20-F and Section 501.12.b. of the Financial Reporting Codification for guidance.
- Please explain further why your effective tax rate increased from [X]% in fiscal 2013 to [X]% in fiscal 2014, resulting in an increase in your total income tax expenses of nearly [X]%. To the extent these changes are attributable to changing tax incentives, please clarify. In addition, tell us your consideration to provide enhanced disclosures to better explain the factors that contribute to any significant fluctuations in your effective tax rate. We refer you to Item 5.A of Form 20-F and Section III.B of SEC Release No. 33-8350.

## Rate Reconciliation — Foreign Rate Differential

### Examples of SEC Comments

- Please provide us with a breakdown of the tax differential and non-deductible expense line items included in the effective tax rate reconciliation and tell us what consideration you gave to Rule 4-08(h)(2) of Regulation S-X to provide a further quantitative breakdown of such amounts. Also, considering the significant changes in the effective tax rate, please tell us what consideration you gave to providing an expanded discussion of the factors that impacted your tax provision. In this regard, we note the disclosures on page [X] only address the impact for the change in the valuation allowance and not the changes in the line items noted herein. Refer to Item 5.D of Form 20-F and Section III.D of SEC Release No. 33-6835.
- We note from your income tax and segment disclosures in Notes [X] and [X], on pages [X] and [X] respectively, what appear to be disproportionate relationships among domestic and foreign revenues, pre-tax income (losses) and related provisions both within and across the three years presented. For example, the relationship of your non-U.S. revenues to non-U.S. pre-tax loss and related foreign tax provision appears to require expanded MD&A disclosures as to how your mix of geographic revenues and related income tax planning has historically impacted or is reasonably likely to impact future results of operations and financial position. Please explain the material components of foreign effective income tax rates and their importance in understanding U.S. and non-U.S. contributions to your results of operations. Tell us how you would consider revision to MD&A to explain the foregoing issues in future filings.
- We see that during 2015, you implemented tax planning initiatives related to non-U.S. subsidiaries which resulted in U.S. foreign tax credits of \$[X] million including the amounts related to [country A]. Please describe to us in greater detail the specific tax planning initiatives you implemented, clarify for us why these initiatives resulted in both foreign tax credits and additional U.S. income taxes, and identify for us any tax jurisdictions, other than [country A], which represent a significant portion of the amount recognized in 2015. Tell us the periods over which you expect the foreign tax credits will be available and, if possible, quantify their impact on your future results.
- Please clarify whether the "foreign rate differential" caption contains any items other than the difference between the U.S. and foreign statutory tax rates. For example, tell us whether this line reflects any changes in foreign valuation allowances, changes in foreign uncertain tax positions, changes in foreign tax rates or nondeductible items, etc. Also, include in your response quantification of the impact.
- We note that your income tax benefit increased significantly in fiscal year 2015. Your disclosures indicate that the change was due to the "increased income tax benefit arising from acquisitions," however the details of the acquisition tax benefits are not disclosed. Please explain to us the nature of the acquisition tax benefits, quantify the impact and tell us in which line item they are reflected in your rate reconciliation on page [X]. As part of your response, please tell us what consideration was given to providing more detailed disclosure of what the acquisition tax benefits represent.
- Please explain to us what is included in the "foreign repatriation" line item in your rate reconciliation table. Also, please tell us the amount repatriated for each of the last three fiscal years, clarify how the additional tax upon repatriation is reflected in the reconciliation table and explain the impact of foreign tax credits, if any, on your effective tax rate upon repatriation.
- We refer you to page [X] and note that your effective tax rate was significantly affected by lower rates on your non-U.S. operations in each year presented. It appears as though separately discussing the foreign effective income tax rates is important information necessary to understanding your results of operations. Accordingly, please discuss in greater detail the impact on your effective income tax rates and obligations of having proportionally higher earnings in countries where you have lower statutory tax rates. You should consider explaining the relationship between the foreign and domestic effective tax rates in greater detail. Please refer to Item 303(a)(3)(i) of Regulation S-K and Section III.B of SEC Release 33-8350.

## Rate Reconciliation — Foreign Rate Differential (continued)

### Examples of SEC Comments

- We note the significant effect of zero tax rate in [country A] in your income tax rate reconciliation and were unable to find any discussion of your operations in [country A] and how they resulted in such a material decrease in your effective tax rate. In sufficient detail please tell us about your income generating activities in [country A] and why you have no tax liability associated with the related income. Tell us about reviews that have been conducted by the various tax authorities and the related risks associated with your tax position.
- We note that the net effects of foreign rate differential and credits line item of the effective tax rate reconciliation significantly increased to a reduction of [X]% for fiscal year 2015 as compared to a reduction of [X]% and [X]% for fiscal years 2014 and 2013, respectively. Please expand footnote (1) to the table to (i) quantify the significant foreign tax credits generated, (ii) clarify whether these foreign tax credits resulted in the recognition of a deferred tax asset and, if so, quantify the amount, and (iii) disclose the facts and circumstances that generated the foreign tax credits. Please also disclose the percentage of pre-tax earnings generated in foreign jurisdictions with tax rates lower than the U.S. federal income tax rate [for] all periods presented.
- We note your disclosure that foreign jurisdictions in which you operate had profitability which require you to provide for income tax. We also note that your tax reconciliation on page [X] includes significant adjustments for both the foreign tax rate differential and amortizable tax goodwill. In future filings please expand your disclosure to address clearly the significant adjustments included in your tax reconciliation, including the statutory tax rates and tax expense from your foreign operations in the [country A] and [country B]. To the extent there are any known uncertainties or trends that could impact your income taxes in future periods, please also address these in your disclosure. Refer to Item 303(a) of Regulation S-K. Please provide draft disclosure in your response.
- Based on your income tax footnote disclosures, it appears that there is a significant disparity in the effective tax rates of your domestic and international operations. In this regard, we also note that although your foreign earnings before taxes declined from \$[X] million in 2014 to \$[X] million in 2015, the tax differential on foreign earnings increased from \$([X] million) in 2014 to \$([X] million) in 2015. Please revise your discussion herein or in Management's Discussion and Analysis to address why your tax differential on foreign earnings increased disproportionately to your decrease in pre-tax foreign earnings. We note your disclosure on page [X] which discusses the reasons for the decline in your effective tax rate, including the \$[X] million tax benefit related to the 2015 Inter-company Debt Refinancing. However, based on the reconciliation you have presented on page [X], it appears that this discussion should be expanded. If a particular country contributes disproportionately to your income based on significantly lower tax rates, explain the impact such tax structures had on your results. If changes in the geographical mix of income were a significant driver of changes in your effective tax rate, please disclose the facts and circumstances leading to the changes in the geographical mix of income and whether you expect these changes to continue. Refer to Item 303(a)(3)(i) of Regulation S-K and Section III.B of SEC Release No. 33-8350.
- We note from the effective tax rate reconciliation on page [X] the net tax benefit of \$[X] million on undistributed foreign earnings, presumably from your [country A] subsidiary as mentioned on page [X]. Please explain how a change to the assertion that the earnings from your [country A] subsidiary are permanently reinvested could result in such a benefit or deferred tax asset, rather than an expense or deferred tax liability. Please also address how your statement on page [X] that taxes on undistributed foreign earnings is not required since such earnings are deemed to be permanently reinvested continues to be appropriate.
- We note that your tax reconciliation on page [X] includes significant foreign tax rate differential adjustments that affected your effective tax rates. Please tell us and expand your disclosure in MD&A in future filings by providing additional details regarding the composition of the foreign tax rate differentials. In this regard, please specify which of your foreign jurisdictions had a more significant impact on your foreign tax rate differential for each period presented, the statutory tax rates in these jurisdictions and how they contributed to the change in your overall effective tax rate.

## Rate Reconciliation — Foreign Rate Differential (continued)

### Examples of SEC Comments

- We note your statement that a higher proportion of operating income was from international operations during fiscal year 2015 as compared to fiscal year 2014, which had a greater positive impact on the effective tax rate for fiscal year 2015. However, your presentation on page [X] indicates that your foreign operations reported a loss for fiscal year 2015 versus income for fiscal year 2014. Please expand your disclosure to clarify your discussion of the impact the tax differential on foreign earnings had on your effective tax rate to address this potential inconsistency.
- We note that for the year ended June 30, 2015, your non-US income is approximately [X]% of your consolidated income before income taxes and loss in equity interests. However, these non-US jurisdictions make up only about [X]% of your consolidated income tax expense. We also note that they reduce the effective income tax rate by [X]%. In light of the fact that foreign income before income taxes has increased significantly over the past few years and appears to materially impact your effective tax rate, please tell us your primary foreign jurisdictions, the effective tax rates in those jurisdictions, and the amount of pre-tax profit in those jurisdictions.

## Undistributed Earnings of Foreign Subsidiaries

### Examples of SEC Comments

- During the quarter ended October 2, 2016, you determined that a portion of your foreign earnings were not [indefinitely] reinvested within the meaning of ASC 740-30-25-17. You estimated that approximately \$[X] million would be repatriated to the U.S. in the fourth quarter of 2016. Please help us better understand the facts and circumstances which led to your determination that these funds should be repatriated and correspondingly the amount to repatriate. As of December 31, 2015, undistributed earnings of foreign subsidiaries amounted to \$[X] million and were considered to be indefinitely reinvested and accordingly no provision for U.S. federal and state income taxes was recorded. Upon your planned repatriation of the approximately \$[X] million, please tell us how you were able to conclude that the remainder of your undistributed earnings of foreign subsidiaries should continue to be considered to be indefinitely reinvested pursuant to ASC 740-30-25-17. Please address your specific plans for reinvestment for these undistributed earnings that demonstrate remittance of the earnings would be postponed indefinitely.
- Please revise to disclose the amount of undistributed foreign earnings, if any, for which you have not provided any U.S. income tax. In addition, please revise to disclose the amount of the unrecognized deferred tax liability related to undistributed earnings or include a statement that such determination is not practicable. We refer you to ASC 740-30-50-2b and 50-2c.
- Disclosure in your filing states that you intend to reinvest the earnings of subsidiaries outside of [country A]. Please provide us with an explanation for your statement that determining the amount of the unrecognized deferred tax liability for undistributed foreign earnings is not practicable. Also, please revise your disclosure to describe the types of events that would cause temporary differences for which a deferred tax liability has not been recognized to become taxable. Refer to FASB ASC 740-30-50-2.
- You state on page [X] that it is your intention to permanently reinvest the undistributed earnings associated with your foreign subsidiaries; however, your tax rate reconciliation on page [X] reflects a foreign repatriation benefit for each period presented. In addition, you appear to have repatriated earnings in each of the last five fiscal years. Therefore, please clarify your policy regarding foreign earnings, and tell us whether your assertion that foreign earnings are indefinitely reinvested relates to all or only a portion of total foreign earnings. If the former is true, please explain to us how you evaluated the criteria for the exception to recognition of a deferred tax liability in accordance with ASC 740-30-25-17 and 18. If the latter is true, please tell us how you determine which earnings to repatriate and tell us the impact on your effective tax rate and income tax expense recorded during the period.

## Undistributed Earnings of Foreign Subsidiaries (continued)

### Examples of SEC Comments

- Please tell us the amount of undistributed earnings of foreign subsidiaries that are considered to be indefinitely reinvested, the deferred tax liability for unrepatriated foreign earnings; and how you complied with the disclosure requirements of ASC 740-30-50-2.
- Please disclose the cumulative amount of each type of temporary differences for which a deferred tax liability has not been recognized, pursuant to ASC 740-30-50-2.b.
- If significant to an understanding of your liquidity, please disclose the amount of cash, cash equivalents and short-term investments held by foreign subsidiaries. Additionally, to the extent material, please describe any significant amounts that may not be available for U.S. operations related to cash, cash equivalents and short-term investments held by foreign subsidiaries where you consider earnings to be permanently reinvested. Also, address the potential tax implications of repatriation.
- We note from disclosures on pages [X] and [X] that a significant portion of your income before income taxes is derived from foreign sources and that undistributed earnings held overseas could result in additional U.S. taxable income of \$[X] billion. We also note that at June 28, 2015 you only held cash and cash equivalents of approximately \$[X] million. In future filings, please revise this discussion to disclose the amount of cash and cash equivalents as well as liquid investments held by foreign subsidiaries at the date of each balance sheet presented and quantify any amounts that would not be available for use in the United States without incurring U.S taxes. Please further provide a discussion of any known trends, demands or uncertainties relating to your liquidity as a result of your policies of permanently reinvesting earnings outside the United States. Refer to Item 303(a)(1) of Regulation S-K.
- The majority of your cash and cash equivalents are held by foreign subsidiaries and most of these funds are considered permanently reinvested outside the U.S. You repatriated \$[X] million of cash during fiscal 2015 and \$[X] million during the first quarter of fiscal 2016 in the form of cash dividends. You note that these were part of your total planned dividends for these periods. In this regard, please address the following:

Please help us understand how you determine the amount of your total planned dividends for each year versus those amounts that will be considered to be permanently reinvested;

Please tell us whether you previously considered the foreign earnings that were repatriated during fiscal 2015 or fiscal 2016 to be permanently reinvested. If so, please tell us at what point you determined that they would not be; and

Please tell us how you concluded that the remaining \$[X] million should be considered to be permanently reinvested in light of your repatriation of amounts in previous years.

Refer to paragraph ASC 740-30-25-17.

- Please tell us the amount of undistributed earnings of foreign subsidiaries that are considered to be indefinitely reinvested, the deferred tax liability for unrepatriated foreign earnings; and how you complied with the disclosure requirements of ASC 740-30-50-2.

Since your foreign operations are significant, please tell us and:

Disclose the amount of cash, cash equivalents and short-term investments held by your foreign subsidiaries as compared to your total amount of cash, cash equivalents and short-term investments as of year-end;

Quantify the amount of cash held in foreign countries where the funds are not readily convertible into other foreign currencies, including U.S. dollars. Please also explain the implications of any such restrictions upon your liquidity;

Discuss the fact that if the foreign cash and cash equivalents are needed for your operations in the U.S., you would be required to accrue and pay U.S. taxes to repatriate these funds; and

Disclose if it is your intent is to permanently reinvest these foreign amounts outside the U.S. and whether your current plans demonstrate a need to repatriate the foreign amounts to fund your U.S. operations including debt repayment.

Please refer to Item 303(a)(1) of Regulation S-K, SEC Release 33-8350 Section IV and Financial Reporting Codification 501.03.a.

## Undistributed Earnings of Foreign Subsidiaries (continued)

### Examples of SEC Comments

- We note from your tax rate reconciliation schedule on page [X], that you repatriated foreign earnings in 2012, 2013, and 2014. On page [X], you disclose that in 2012, you assessed your forecasted cash needs and the overall financial position of your foreign subsidiaries and determined that a portion of previously permanently reinvested earnings would no longer be reinvested overseas. Please tell us about the circumstances that caused you to change your assertion in each period and about your application of FAS ASC 740-30-25-17, including the evidence you had to support your original assertion.
- We reference your response to comment [X] in our prior comment letter dated [X], 2014 in which you agreed to disclose in future filings the cumulative amount of undistributed earnings of your foreign subsidiaries for which no U.S. income taxes have been provided as required by FASB ASC 740-30-50-2. Please tell us why you did not include this disclosure in your Form 10-K for the fiscal year ended March 31, 2015.
- We note from your disclosure that you repatriated \$[X] million of foreign earnings in 2014. We also note that you have repatriated foreign earnings since 2009 and currently plan to repatriate additional amounts from your [country A] subsidiary. Further, we note that the undistributed earnings of your foreign subsidiaries are considered permanently reinvested. Tell us the underlying reasons for your repatriation of foreign earnings and in light of your repatriation of earnings since 2009, how you are able to conclude that your undistributed earnings are permanently reinvested. If you believe that any of your foreign earnings continue to be permanently reinvested, indicate the specific countries in which these earnings are located. Finally disclose the unrecognized deferred income tax liability pursuant to ASC 740-30-50-2.
- We note that continuing operations in the United States have generated losses before income taxes for the past three years and that the cumulative amount of earnings upon which U.S. income tax has not been provided is approximately \$[X] million. Please disclose whether or not there have been repatriations during the periods presented in your financial statements, and if so, describe the nature, amounts, timing and special circumstances surrounding these repatriations. To the extent that you do not intend to repatriate foreign earnings, state this assertion in your disclosure.

Please tell us how you evaluated the criteria for the exception to recognition of a deferred tax liability in accordance with ASC 740-30-25-17 and 18 for undistributed earnings that are intended to be indefinitely reinvested. Describe the type of evidence that sufficiently demonstrates that remittance of earnings will be postponed indefinitely.

- We note that your headquarters are in [country A], that a significant portion of your income before income taxes is derived from foreign sources and that as of the 2015 year-end more than \$[X] million of your undistributed earnings were permanently reinvested outside the United States. Further, although we note that at October 3, 2015 you held cash and cash equivalents of approximately \$[X] million, representing approximately [X] percent of your total assets, in your February [X], 2016 earnings call you indicated that your cash position is extremely limited in the U.S. and remains a major constraint, such that you are considering adding a credit facility to help buffer the limited cash balance. Please address the following in your future filings:

Disclose the amount of cash, cash equivalents and liquid investments held by foreign subsidiaries at each balance sheet date and quantify any amounts that would not be available for use without potentially incurring U.S taxes.

Provide a discussion of any known trends, demands or uncertainties relating to your liquidity as a result of your policies of permanently reinvesting earnings outside the U.S. Discuss any strategies you have in place to access cash held overseas. Refer to Item 303(a)(1) of Regulation S-K and Section IV of SEC Release 33-8350.

Please describe to us in greater detail the business structure reorganization of your foreign subsidiaries that resulted in a change in your permanent reinvestment assertion outside the United States. Please explain to us how you applied the guidance in ASC 740-30-25-17 that resulted in your recording a \$[X] million tax benefit.

## Unrecognized Tax Benefits

### Examples of SEC Comments

- Please clarify the nature of the \$[X] million reconciling item relating to "integration of acquired technologies." Considering the significance of this item to your income taxes, please tell us what consideration was given to providing additional disclosure surrounding the line item. Further, we note your disclosure on page [X] that in the third quarter of fiscal 2015, the company reached final settlement with the Examination Division of the IRS on the integration of acquired technologies for fiscal 2015. Please tell us if this exposure was considered in your unrecognized tax benefits and indicate the factors you considered in making this determination. Tell us how you expect the integration of acquired technologies to impact your effective tax rate in the future and what consideration you gave to disclosing these factors, including any uncertainties with respect to the positions you have taken.
- Please revise to disclose the total amount of unrecognized tax benefits that, if recognized, would affect your effective tax rate. Refer to FASB ASC 740-10-50-15A.
- [E]xplain the nature of and basis for the \$[X] million of additions for tax positions taken in fiscal 2015 presented in your gross unrecognized tax benefit reconciliation in Note [X], page [X].
- Further explain the facts and circumstances leading to the increase in your uncertain tax benefits and the amendment to your tax returns for 2006 to 2013. Tell us what consideration you gave to providing a more comprehensive explanation for these significant variances in the customary relationship between income tax expense and earnings before income taxes. Refer to ASC 740-270-50-1. In addition, in your MD&A discussion, tell us what consideration you gave to explaining and quantifying any related trends, events or uncertainties that are reasonably expected to have a material impact on your liquidity, capital resources and/or results of operations, including your expectations of the impact on your annual effective tax rate. Refer to Item 303(a) of Regulation S-K and Section III.B.3 of SEC Release 34-48960.
- We note that the \$[X] million increase in unrecognized tax benefits related to prior year tax positions. In accordance with ASC 740-10-50-15A.b., please disclose the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. Also, since you expect a decrease of \$[X] million for unrecognized tax benefits over the next twelve months, please provide the disclosures required by ASC 740-10-50-15[d].
- We note your disclosure in Note [X] that in 2014 you recognized a significant income tax benefit from a reduction in uncertain tax positions. We also note from your disclosure on page [X] that this reduction related to: 1) \$[X] million of gross reductions for tax positions taken during the prior year; 2) \$[X] million of reductions from settlements with taxing authorities; and 3) \$[X] million of reductions from lapse of applicable statutes of limitation. Please explain to us the nature of each of these amounts and tell us why you believe it is appropriate to recognize these reductions to your income tax expense during fiscal 2014.
- We note from your tax rate reconciliation that in 2014 you recognized a \$[X] million tax benefit and a \$[X] million tax expense in connection with uncertain tax positions and an IRS audit resolution, respectively. In addition, you reduced your net operating loss carryforwards by approximately \$[X] million for a loss resulting from the past dissolution of a subsidiary. Please address the following:
  - Clarify if the amounts in the reconciliation (i.e. \$[X] million benefit and \$[X] million expense) represent two discrete tax matters.
  - Tell us how the \$[X] million reduction in net operating loss carryforwards is reflected in the change in your deferred tax asset net operating losses from \$[X] at December 31, 2013 to \$[X] at December 31, 2014 (refer to page [X]). Please advise and revise to clarify, as necessary.
- We note from your table at the top of page [X] that you recognized in 2014 the entire unrecognized tax benefits (\$[X]) from the prior year. We also note from your disclosure on page [X] in your 2013 Form 10-K that you determined it was reasonably possible that your unrecognized tax benefits may increase or decrease in 2014; however, you could not estimate the range of such possible changes. Please explain the facts and circumstances surrounding the uncertainties and explain why an estimate of the range could not be made. Refer to ASC 740-10-50-15.

## Valuation Allowance

### Examples of SEC Comments

- [We] note that cumulative losses are one of the most objectively verifiable forms of negative evidence that may make it difficult to support an assertion that realization of deferred tax assets is more likely than not. Please provide us a more comprehensive analysis that supports your conclusion that realization of your deferred tax assets at December 31, 2015 is more likely than not. Please ensure your analysis specifically addresses the following:
  - Tell us the amount of the taxable loss in your 2015 tax return and explain any material differences between that amount and the estimated loss included in your response;
  - Provide us an evaluation of your reliance on each of the four sources of taxable income identified in your response;
  - More fully explain to us the specific nature of each "extraordinary item" included in your response and how you determined they are not likely to occur in future periods; and
  - Provide us an objectively verifiable estimate of the future income required to fully realize your deferred tax assets.
- We note from your disclosure that cumulative profitable quarters and projected future pretax income are sources of positive evidence that led you to conclude that it is more likely than not you will realize your deferred tax asset. However, we note you recorded pre-tax operating losses in fiscal 2015, 2013 and during the nine months ended September 30, 2016. As it appears that pre-tax cumulative operating losses in recent years exist, please explain to us why you believe it was appropriate to reverse your entire deferred tax asset in fiscal 2015. As part of your response, please provide us with your analysis of the positive and negative evidence considered in determining the likelihood that your deferred tax assets will be realized, including the weight given to each positive and/or negative factor and the extent each factor is objectively verifiable. Additionally, please include the significant assumptions used in your future pretax income projections and why you believe they are reasonable and appropriate.
- With respect to the \$[X] million release of the valuation allowance previously held against a deferred tax asset related to tax losses carried forward in [Country X], please provide us with your analysis of all available evidence considered, both positive and negative, and how this evidence was weighted in determining that a partial release of this valuation allowance was warranted during the fourth quarter of 2016.
- We note your disclosures that your deferred tax assets are reduced by a valuation allowance when it is more likely than not that a portion of a deferred tax asset would not be realized. We further note that based on your Note [X], your valuation allowance increased significantly from \$[X] million as of September 30, 2014, to \$[X] million as of September 30, 2015, driven primarily by an increase related to a valuation allowance of \$[X] million that was recorded in relation to the [Company A] acquisition. Please expand your disclosures to specifically describe the nature of the underlying deferred tax assets that had a corresponding valuation allowance recorded. Additionally, please expand your disclosures to specifically highlight the positive and negative evidence you considered in arriving at the conclusion that it is more likely than not that \$[X] million of acquired deferred tax assets would not be realized. To the extent applicable, please highlight any material jurisdictions you operate in that impacted your determination and total valuation allowance recorded. Please refer to Item 303 of Regulation S-K and Section 501.14 of the Financial Reporting Codification for guidance.
- We see that you reversed a valuation allowance of \$[X] million related to the forecasted future utilization of NOL's at a [country A] subsidiary. Please provide us an analysis of the material positive and negative factors that you considered when arriving at your conclusion about the realizability of the deferred tax assets. Refer to ASC 740-10-30-16 through 25. As a related matter, please tell us why you did not include a discussion of the judgments and assumptions that resulted in the reversal of the valuation allowance within critical accounting policies on page [X].

## Valuation Allowance (continued)

### Examples of SEC Comments

- Your narrative disclosure indicates that there is a \$[X] million valuation allowance attributed to \$[X] million in state net operating loss carryforwards, however, there is no corresponding valuation allowance reflected in the tabular presentation of the significant components of your deferred tax assets and liabilities as of January 3, 2015. Please clarify whether or not your valuation allowance is included in your table as an offset and if not, why not. If so, please separately reflect the valuation allowance in order to present the total of all deferred assets. See ASC 740-10-50-2. Please also address this comment as it relates to your fiscal year 2013 presentation.
- You indicate that you evaluated the deferred tax assets and determined that the net assets will be realized through future years' taxable income. However, we note that you have generated losses before income taxes over the past three years and for the nine months ended September 30, 2015. Please tell us and revise your disclosure in future filings to provide a more detailed explanation as to how you determined it is more likely than not that you will realize total deferred tax assets. Please ensure your disclosure addresses each of the following points, as appropriate:

Please discuss the nature of the positive and negative evidence that you considered, how that evidence was weighted, and how that evidence led you to determine it was not appropriate to record a valuation allowance on the remaining deferred income tax assets. You should consider discussing the significant estimates and assumptions used in your analysis. Please discuss how you determined the amount of the valuation allowance to record;

Please disclose the amount of pre-tax income that needs to be generated to realize the deferred tax assets. Include an explanation of the anticipated future trends included in your projections of future taxable income. Confirm to us that the anticipated future trends included in your assessment of the realizability of your deferred tax assets are the same anticipated future trends used in estimating the fair value of your reporting units for purposes of testing goodwill for impairment and any other assessment of your tangible and intangible assets for impairment;

Please disclose the nature of your tax planning strategies, how each strategy supports the realization of deferred tax assets, the amount of the shortfall that each strategy covers, and any uncertainties, risks, or assumptions related to these tax- planning strategies; and

To the extent you are relying on the reversal of any deferred tax liabilities in your assessment of the realizability of your deferred tax assets, please disclose this fact. Also clarify, if true, that the deferred tax liabilities you are relying on in your assessment will reverse in the same period and jurisdiction and are of the same character as the temporary differences giving rise to the deferred tax assets.

Refer to ASC 740-10-30-16 through 25 and Section 501.14 of the Financial Reporting Codification for guidance.

- We note that you released \$[X] million of your deferred tax valuation allowance in fiscal 2014 due to income forecasted to be realized in 2015 in connection with certain tax planning actions expected to be completed in 2015. We also note you recorded a further reduction of \$[X] million in the third quarter of 2015 due to revised forecasted income from your 2014 analysis as a result of proposed IRS regulations. Please provide us with your analysis of the positive and negative evidence considered by management in reaching the conclusion to release these portions of the valuation allowance. Your response should include an explanation of the nature of the tax planning actions and the proposed IRS regulations and your consideration to disclose such information in MD&A. Please refer to ASC 740-10-30, ASC 740-10-50-9-h, and Item 303(a)(3) of Regulation S- K for guidance.
- We note that you do not have a deferred tax valuation allowance for the full net deferred tax assets in the periods presented. We further note that you had losses before taxes of (\$[X]) million in 2014 and (\$[X]) million in 2015 and goodwill impairment of \$[X] million in 2014. Please tell us in detail and revise future filings to explain why your deferred tax assets will more likely than not be realized. Specifically discuss the key facts and circumstances including the nature of the positive and negative evidence you considered in making your determination. Refer to guidance starting at ASC 740-10-30-16.

## Valuation Allowance (continued)

### Examples of SEC Comments

- During your March 31, 2015 quarterly earnings call held April [X], 2015, your CFO stated that based on your forecasted profitability in the United States you may release all or a portion of your \$[X] billion domestic tax valuation allowance by the end of 2015. We note that for the quarter ended March 31, 2015, you decreased your deferred tax asset valuation allowance by \$[X] million ([X]% of pre-tax income). Please expand the discussion in MD&A to analyze the factors you considered in evaluating your total deferred tax assets, including the following, as appropriate:

Address specific benchmarks or targets that would support your decision to release your valuation allowance back into income in future periods.

Include an explanation of the anticipated future trends included in your projections of future taxable income.

Disclose the amount of pre-tax income you need to generate to realize the deferred tax assets.

Describe any changes in your tax planning strategies that you believe will enable you to realize certain portions of the deferred tax asset along with the changes in facts and circumstances that prompted you to develop these new tax planning strategies.

Refer to Sections 501.02 and 501.14 of the Financial Reporting Codification and paragraphs 17-23 of ASC 740-10-30 for guidance.

- We note your disclosure on page [X] that part of the positive evidence you considered in evaluating your valuation allowance as of September 30, 2015 was your ten quarters of cumulative income from continuing operations. However, we note that in reviewing your filings that you only generated income from continuing operations before taxes in three of the last ten quarters. Please clarify for us your statement "ten quarters of cumulative income from continuing operations." In addition, please disclose the amount of pre-tax income required to realize the deferred tax assets in future periods.
- Given the significant nature of the reversal of your allowance for deferred tax assets in 2014 and your recent return to pre-tax loss in the six months ending June 30, 2015, please revise your filing to include a risk factor which discusses how and why changes in your deferred tax asset valuation allowance may impact your financial statements.
- We note that in 2014, the Group re-recognized a deferred tax asset of EUR [X] million in the consolidated statement of financial position based on recent profitability and the latest forecasts of future financial performance. Please tell us in more detail about the basis for your conclusion that it is probable that the entity will be able to re-establish a pattern of sufficient tax profitability in [country A] and [country B] to utilize the cumulative losses, foreign tax credits and other temporary differences. In your response, please tell us how you considered the criteria in IAS 12.24 and IAS 34-36. Further expand MD&A to disclose in further detail the nature of the evidence that support your conclusion that the deferred tax asset of EUR [X] million should be recognized.
- Please revise your filing to disclose any reasonably likely factors that may cause an adjustment to your deferred tax asset valuation allowance in the near term. For example, we note your disclosure on page [X] of a tax planning strategy that would result in an immediate reversal of temporary differences associated with the excess of book basis over tax basis for certain investments, but the timing and magnitude of this tax planning strategy is unclear. Refer to Section V of SEC Release No. 33-8350.
- We note that you recorded a significant decrease in your deferred tax valuation allowance resulting in a \$[X] million decrease in the provision for income taxes for the year ended January 3, 2015. Your disclosures indicate that you attributed the release of the valuation allowance to the anticipated timing of deferred tax asset and liability reversal in future periods as well as projections of future taxable income in the U.S. associated with the acquisition of [Company A]. Please provide an analysis of the material positive and negative factors that you considered when arriving at your conclusion about the realizability of your deferred tax assets. Specifically, please also address your consideration and weighting that you placed on the historical results of [Company A] in arriving at your conclusions. In this regard, we note that the financial statement of [Company A] included in your Form 8-K filed on February [X], 2015 indicate that [Company A] has generated consecutive years of net losses prior to its acquisition. Refer to ASC 740-10-30-16 through 25 and ASC 805-740-30-3.

## Valuation Allowance (continued)

### Examples of SEC Comments

- We note from page [X] that your forecast for [Company A] shows you will have taxable profits over the long-term and will therefore utilize the deferred tax assets associated with net operating loss carryforwards. Given your recent history of losses, please provide us with your analysis as to why you believe recognition of such deferred tax assets continues to be appropriate under IAS 12, paragraphs 35 through 37. Your response should clearly explain your net operating loss carryforwards for each entity . . . and your analysis of the realization for each. We may have further comment upon receipt of your response.
- Please explain to us and revise future filings to disclose your basis for determining a tax valuation allowance is required.
- We note your foreign tax credits had the largest impact on the effective tax rate in 2014. Please tell us and disclose the nature of the “operational change of [your] business terms” that gave rise to the elimination of the related valuation allowance.
- We note your disclosure on page [X] that you recorded a \$[X] million release to your deferred tax asset valuation allowance. To the extent that this release materially impacted your results of operations, please tell us what consideration was given to disclosing the specific circumstances that lead to such release and the circumstances that could reasonably cause you to adjust your valuation allowance in the future. Income Taxes, page [X].
- We note your disclosure stating that due to the trend of your operating results over the last few quarters, you do not presently have sufficient positive evidence to overcome the significant negative evidence of having twelve consecutive quarters of cumulative losses in your [country A] and [country B] jurisdictions at June 30, 2015. Therefore, you recognized a valuation allowance with respect to your [country A] and [country B] net deferred income tax assets in the amount of \$[X] million. Given the impact of the valuation allowance on your results of operations, please address the following comments:

Tell us the specific positive evidence you considered in concluding that at December 31, 2014 and March 31, 2015 it was more likely than not that these deferred tax assets were recoverable, including how your positive evidence overcame “several consecutive quarters of losses.” In this regard, we note that these several consecutive quarters of losses ultimately resulted in you having twelve consecutive quarters of cumulative losses in both your [country A] and [country B] jurisdictions.

Tell us the amount of losses your [country A] and [country B] jurisdictions generated for each of the three years ended December 31, 2014 as well as the quarters ended March 31 and June 30, 2015. Please also tell us the amount of income these jurisdictions were required to generate at the end of each of the foregoing periods in order to fully realize their respective deferred tax assets. To the extent available, provide us with any projections and/or budgets that you looked to as positive indicators and address any assumptions that were not ultimately attained.

## Valuation Allowance (continued)

### Examples of SEC Comments

Tell us how you concluded that as of December 31, 2014 and March 31, 2015 there was not a material uncertainty regarding the recoverability of these deferred tax assets such that you determined that specific disclosure of your apparent operating losses in your [country A] and [country B] jurisdictions were required in accordance with FRC Sections 501.12.b and 501.15.a.4. In this regard, we note that in your Form 10-K for the year ended December 31, 2013 and 2014, you disclose that, "... prior to the complete utilization of these carryforwards, if we generate operating losses in our [country A] and [country B] operations for an extended period of time, it is possible we might conclude the benefit of the carryforwards would no longer meet the more-likely-than-not recognition criteria, at which point we would be required to recognize a valuation allowance against some or all of the then-remaining tax benefit associated with the carryforwards." Please tell us your consideration of including additional disclosures given the apparent negative results in your [country A] and [country B] jurisdictions. In this regard, there is a concern that given the lack of additional information, readers may have assumed that there were no additional negative indicators that management considered in its determination of the recoverability of these deferred tax assets as of December 31, 2014. Specifically address how you determined that the apparent recurring operating losses in [country A] and [country B] were not a known trend or uncertainty that you could have reasonably expected to have a material impact on your income. In this regard, we note that the Instruction 3 to Item 303(a) of Regulation S-K states that MD&A "shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."

## Other

### Examples of SEC Comments

- We note that the decrease in your income tax expense in the first quarter of 2017 was primarily attributable to a tax benefit resulting from the restructuring of certain foreign entities. Please describe for us, in detail, the nature of the restructuring and explain how this resulted in a decrease in your income tax expense. In addition, tell us the impact you expect the restructuring will have on your full year effective tax rate and what consideration you gave to disclosing the potential impact. We refer you to ASC 740-10-50-14.
- Upon your divestiture of [X] business, you recorded [an \$X] million pre-tax loss and [an \$X] million after-tax gain. Please help us better understand the impact of income taxes on this transaction pursuant to ASC 740 and correspondingly how this resulted in the recording of an after-tax gain in light of the pre-tax loss.
- You disclose . . . that you received a tax holiday related to your new operating facility in [Country X]. To the extent material, please disclose the aggregate dollar and per share effects. Refer to Staff Accounting Bulletin Topic 11.C for guidance.
- [A]s prescribed in the Instructions to paragraph 303(a) of Regulation S-K, [MD&A] shall focus on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. It is the staff's view that your revised disclosure, even if read in conjunction with the financial statement footnote that you cite, does not appear to address whether the significant decline in your income taxes, and the underlying reasons therefore, are indicative of expected results. Separately, your disclosure does not appear to have quantified the impact of each main driver causing the decline in your income taxes. Expand your disclosure to address these items. See Item 303(a)(3) of Regulation S-K and the guidance in Sections 501.04, 501.12.b.3 and 501.12.b.14 of the Financial Reporting Codification.
- Please tell us the amount of undistributed earnings on your foreign subsidiaries for each period presented. Explain to us why the amount of undistributed earnings on your foreign subsidiaries is immaterial in light of the significant amounts of income from foreign subsidiaries in each period as well as the fact that a majority of your cash and cash equivalents are held in bank accounts outside the U.S.

## Other (continued)

### Examples of SEC Comments

- We note your disclosure on page [X] that you classified within fiscal 2014 discontinued operations "the U.S. income tax benefit related to the excess tax basis in the common shares of [Company A] that we should recover as a worthless stock deduction in 2014." We also note your disclosure on page [X] that the \$[X] million deferred tax asset related to the impaired investment in a foreign subsidiary was recovered as a worthless stock deduction during 2014. Please address the following comments related to your tax treatment for these items:

Citing authoritative accounting guidance, where applicable, explain in sufficient detail how you accounted and the related timing for this worthless stock deduction during the periods presented. To assist our understanding, provide us with the related journal entries you recorded.

Tell us why you did not record the tax benefit of this deduction in an earlier period, such as the fourth quarter of 2013 when you announced your intentions to cease [country A] operations, as opposed to 2014.

You disclose on page [X] that the income tax benefit related to this deduction was \$[X] million. Please explain the difference between this amount and the benefit to your deferred income taxes of \$[X] million discussed on page [X] and the deferred tax asset of \$[X] million on page [X].

- Please show us how to reconcile deferred tax expense to the amount of deferred income taxes disclosed in the consolidated statements of cash flows.
- We note that the tax benefit from stock based compensation is presented as an adjustment to reconcile net earnings to net cash provided by operating activities. Please explain to us how you account for and present excess income tax benefits in the consolidated statements of stockholders' equity and cash flows. In addition, please explain to us why your accounting and presentation of excess tax benefits and tax deficiencies comply with ASC 718-740-35-3 through ASC 718-740-35-9 and ASC 718-740-45-2 through ASC 718-740-45-4.
- We note your presentation of the change in the foreign currency translation adjustment includes the related tax benefit. Please describe for us the transactions and circumstances that resulted in recognizing a tax benefit related to the foreign currency translation adjustment. Refer to ASC 220-10-45-16 and ASC 830-30-40-1.
- You disclose that you recorded an income tax benefit during the three months ended March 31, 2015 as a result of using the actual year-to-date earnings instead of the estimated annual effective tax rate. Please tell us how your accounting for the income tax benefit is in accordance with ASC 740-270-30. Please also tell us your estimated annual ordinary income and your forecasted annual effective tax rate for 2015 and the key assumptions underlying these estimates.
- You disclose that the reorganization process is expected to be complete by December 2015 and that it will result in a lower percentage of pre-tax income being subject to U.S. federal statutory tax rate. In your second quarter earnings call, management indicates that the transition period related to the reorganization could be for as long as [X] years and that during the transitional period you expect additional taxes of \$[X] million on an annual basis. Also noted in this call are management comments that you are assuming an effective tax rate of up to [X]% for 2015 as a result of the transitional fluctuations. Please describe for us the reorganization that is expected to be completed by December 2015. Describe for us the nature of the transactions expected to be undertaken during the transition period, the reasons why the transitional period could last up to [X] years, and why there will be annual additional non-cash tax expense during the transitional period.
- You state on page [X] that you are currently analyzing whether a change of control occurred in the year ended December 31, 2012, that negatively impacts your gross deferred tax assets. Please tell us what event is the basis for this analysis and when you expect to determine its tax impact, if any.

For a discussion of SEC comment letters on topics other than accounting for income taxes, see Deloitte's *A Roadmap to SEC Comment Letter Considerations, Including Industry Insights*.

# Appendix F — Differences Between U.S. GAAP and IFRS Standards

Under U.S. GAAP, ASC 740 is the primary source of guidance on accounting for income taxes.

Under IFRS Standards,<sup>1</sup> IAS 12 is the primary source of guidance on accounting for income taxes.

In general, the income tax accounting frameworks under both U.S. GAAP and IFRS Standards contain the same basic principle concerning the basis of DTAs and DTLs: the recognition of temporary differences between the carrying amount of assets and liabilities in the financial statements and their basis for income tax reporting purposes.

The table below summarizes the key differences between U.S. GAAP and IFRS Standards in the accounting for income taxes and is followed by a detailed explanation of each difference.<sup>2</sup>

Subject	U.S. GAAP	IFRS Standards
Classification of DTAs and DTLs	<p><b>Before the adoption of ASU 2015-17:</b></p> <p>Classification is split between current and noncurrent components on the basis of either (1) the underlying asset or liability or (2) the expected reversal of items not related to an asset or liability.</p> <p><b>After the adoption of ASU 2015-17:</b></p> <p>The difference between U.S. GAAP and IFRS Standards is eliminated. All DTAs and DTLs are classified as noncurrent.</p>	There is no split between current and noncurrent. All DTAs and DTLs are classified as noncurrent.
Recognition of DTAs	DTAs are recognized in full and then reduced by a valuation allowance if it is more likely than not that some or all of the DTAs will not be recognized.	No valuation allowance concerning DTAs, which are recognized only if it is probable (more likely than not) that they will be used.
Tax rate for measuring DTAs and DTLs	Enacted tax rates are used.	Enacted or “substantively” enacted tax rates are used.

<sup>1</sup> The IASB issued *IFRS for SMEs* in July 2009. *IFRS for SMEs* is a stand-alone standard and does not require preparers of private entity financial statements to cross-refer to full IFRS Standards. *Section 29* of *IFRS for SMEs* is the primary source of guidance on accounting for income taxes for entities applying *IFRS for SMEs*. This appendix does not address the differences between Section 29 and IAS 12 and, therefore, the accounting for income tax differences that might exist between U.S. GAAP and *IFRS for SMEs*.

<sup>2</sup> Differences are based on comparison of authoritative literature under U.S. GAAP and IFRS Standards and do not necessarily include interpretations of such literature.

(Table continued)

<b>Subject</b>	<b>U.S. GAAP</b>	<b>IFRS Standards</b>
Uncertain tax positions	ASC 740 prescribes a two-step recognition and measurement approach to determining the amount of tax benefit to recognize in the financial statements. The first step is recognition: The entity determines whether it is more likely than not that a tax position will be sustained upon examination. The second step is measurement: The entity measures a tax position that reaches the more-likely-than-not recognition threshold to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely to be realized upon settlement.	<p>IFRIC Interpretation 23 was issued by the International Accounting Standards Board (IASB®) in June 2017 and is effective for annual periods beginning on or after January 1, 2019, with earlier application permitted. The standard clarified how uncertainty over income tax treatment should be recognized and measured under IAS 12.</p> <p><b>Before the adoption of IFRIC Interpretation 23:</b></p> <p>IAS 12 does not specifically address the accounting for tax uncertainties. The recognition and measurement provisions of IAS 37 are relevant because an uncertain tax position may give rise to a liability of uncertain timing and amount. Recognition is based on whether it is probable that an outflow of economic resources will occur. "Probable" is defined as "more likely than not." Measurement is based on the entity's best estimate of the amount of the tax benefit.</p> <p><b>After the adoption of IFRIC Interpretation 23:</b></p> <p>If an entity concludes that it is probable that the taxing authority will accept an uncertain tax treatment, recognition and measurement are consistent with the positions as taken in the tax filings. If the entity concludes that it is not probable that the taxing authority will accept the tax treatment as filed, the entity is required to reflect the uncertainty by using (1) the most likely amount or (2) the expected value. "Probable" is defined as "more likely than not."</p>

(Table continued)

<b>Subject</b>	<b>U.S. GAAP</b>	<b>IFRS Standards</b>
Tax consequences of intra-entity sales	<p><b>Before the adoption of ASU 2016-16:</b></p> <p>Tax expense from intra-entity sales is deferred until the related asset is sold or disposed of, and no deferred taxes are recognized for the purchaser's change in tax basis.</p> <p><b>After the adoption of ASU 2016-16:</b></p> <p>Tax expense from intra-entity transfers, other than transfers of inventory, is recognized in the seller's jurisdiction, and deferred taxes are recognized in the buyer's jurisdiction for the difference between the basis of the transferred asset for financial reporting purposes and that for income tax reporting purposes at the buyer's tax rate. Tax effects of intra-entity transfers of inventory continue to be deferred. See "Before the adoption of ASU 2016-16" above.</p>	Tax expense from intra-entity transfers is recognized in the seller's jurisdiction, and deferred taxes are recognized in the buyer's jurisdiction for the difference between the basis of the transferred asset for financial reporting purposes and that for income tax reporting purposes at the buyer's tax rate.
Deferred taxes on foreign nonmonetary assets/liabilities when the functional currency is not the local currency and the remeasurement is based on historical exchange rates.	No deferred tax is recognized on basis differences resulting from changes in exchange rates and the indexing of basis for income tax reporting purposes.	Deferred tax is recognized on the basis differences resulting from changes in exchange rates and the indexing of basis for income tax reporting purposes.
Other exceptions to the basic principle that deferred tax is recognized for all temporary differences	<p>(1) Leveraged lease (commencing before the adoption of ASU 2016-02) exemption — no deferred tax is recognized under ASC 740. See ASC 840-30 for information about the tax consequences of leveraged leases.</p> <p>ASC 842 does not include guidance on leveraged leases. Entities are not permitted to account for any new or subsequently amended lease arrangements as leveraged leases after the effective date of ASC 842.</p> <p>(2) No "initial recognition" exception under U.S. GAAP.</p>	<p>(1) No similar exception under IFRS Standards because they do not address leverage leases.</p> <p>(2) "Initial recognition" exemption — deferred tax is not recognized for taxable or deductible temporary differences that arise from the initial recognition of an asset or liability in a transaction that (a) is not a business combination and (b) at the time of the transaction does not affect accounting profit or taxable profit. Changes in this unrecognized DTA or DTL are not subsequently recognized.</p>

(Table continued)

<b>Subject</b>	<b>U.S. GAAP</b>	<b>IFRS Standards</b>
Special deductions (special deductions provide tax benefits under specific tax jurisdictions for unique industries or governmental purposes)	Special-deduction tax benefits should not be anticipated by offsetting a DTL. Instead, such tax benefits should be recognized for financial reporting purposes no earlier than the year in which they are available to reduce taxable income on the entity's tax returns. In addition, the future tax effects of special deductions may nevertheless affect (1) the average graduated tax rate to be used in measuring DTAs and DTLs when graduated tax rates are a significant factor and (2) the need for a valuation allowance for DTAs.	No similar guidance in IAS 12.
Share-based compensation	<p><b>Before the adoption of ASU 2016-09:</b></p> <p>For awards that ordinarily give rise to a tax deduction, deferred taxes are computed on the basis of compensation expense recognized for financial reporting purposes. Excess tax benefits are recorded as an increase to APIC when realized (i.e., when taxes payable is reduced). Deficiencies resulting in write-off of DTAs, net of valuation allowance, are recognized in equity or the income statement, depending on availability of excess benefits in the APIC pool.</p> <p><b>After the adoption of ASU 2016-09:</b></p> <p>For awards that ordinarily give rise to a tax deduction, deferred taxes are computed on the basis of compensation expense recognized for financial reporting purposes. Tax benefits in excess of or less than the related DTA are recognized in the income statement when realized for income tax reporting purposes. ASU 2016-09 eliminated the concept of the "APIC pool."</p>	For awards that will give rise to a tax deduction in a later accounting period, deferred taxes are computed on the basis of the hypothetical tax deduction for the share-based payment in every period under the applicable tax law (i.e., intrinsic value). Recognition of deferred taxes could be through either profit or loss or equity.
Subsequent changes in deferred taxes that were originally charged or credited to equity (backward tracing)	<p>Backward tracing is generally prohibited. Subsequent changes to deferred taxes originally charged or credited to equity (e.g., because of a change in tax rate) are generally allocated to continuing operations, not to equity.</p> <p>Note that this appendix does not include the guidance of ASU 2018-02, which allows a one-time reclassification from AOCI to retained earnings of "stranded" tax effects related to the change in tax rate as a result of U.S. tax reform, commonly known as the Tax Cuts and Jobs Act.</p>	As with the initial treatment, IAS 12 requires that the resulting change in deferred taxes also be charged or credited back directly to equity.

(Table continued)

Subject	U.S. GAAP	IFRS Standards
Reconciliation of actual and expected tax rate	<p>Required for public companies only; expected tax expense is computed by applying the domestic federal statutory rates to pretax income from continuing operations.</p> <p>Nonpublic companies must disclose the reconciling nature of the reconciling items but are not required to provide the amounts.</p>	Required for all entities applying IFRS Standards; expected tax expense is computed by applying the applicable tax rate(s) to accounting profit, disclosing also the basis on which any applicable tax rate is computed.
Undistributed earnings on foreign subsidiaries	<p>No deferred tax is recognized on undistributed earnings of foreign subsidiaries and corporate joint ventures (that are essentially permanent in duration) if such earnings can be demonstrated to be indefinitely reinvested.</p> <p>Note that according to paragraph 64 of ASU 2015-10, “[t]his exception to recognizing deferred taxes is not applicable for partnerships (or other pass-through entities).”</p>	<p>Deferred tax is recognized on the undistributed earnings of any form of investee (foreign or domestic, subsidiaries, branches, associates, and interests in joint arrangements) unless (1) the parent is able to control the timing of the temporary difference's reversal and (2) it is probable that the temporary difference will not reverse in the foreseeable future.</p> <p>Note that there is no similar prohibition on applying the exception to partnerships.</p>
Interim reporting and tax rate	<p>The forecasted tax rate is generally computed at an entity level on the basis of the forecasted ordinary income/(loss) and associated tax expense for the entire reporting group and combined into one overall forecasted annual effective tax rate.</p> <p>Year-to-date (YTD) tax expense is typically calculated by multiplying the group's YTD pretax income by the group's forecasted annual effective tax rate.</p>	<p>Each jurisdiction computes its projected rate, and that rate must be applied in each jurisdiction to the actual YTD income.</p> <p>The interim-period tax charge is the sum of each entity's interim tax charge. If such a sum is not practicable, a weighted average of all group rates may be used if it is a reasonable approximation of the effect of using more specific rates.</p>

## F.1 Classification of DTAs and DTLs

### ***Before the Adoption of ASU 2015-17***

Under U.S. GAAP, ASC 740-10-45-4 states, “Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting.” In addition, if the deferred tax is unrelated to an asset or liability (e.g., an operating loss carryforward), the classification on the balance sheet should be based on the expected reversal of the underlying temporary difference.

### ***After the Adoption of ASU 2015-17***

ASU 2015-17, which requires entities to present DTAs and DTLs as noncurrent in a classified balance sheet, eliminates the difference between U.S. GAAP and IFRS Standards. The ASU is effective for public entities in fiscal years beginning after December 15, 2016, and in interim periods therein. For nonpublic entities, the new guidance will apply in annual periods beginning after December 15, 2017, and in

interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for all entities for interim or annual financial statements that have not been issued. In addition, entities are permitted to apply the amendments either prospectively or retrospectively.

Under IFRS Standards, paragraph 56 of IAS 1 states, "When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position, it shall not classify deferred tax assets (liabilities) as current assets (liabilities)." Therefore, on the balance sheet (i.e., the balance sheet showing current and noncurrent assets and liabilities), all DTAs and DTLs are classified as noncurrent.

## **F.2 Recognition of DTAs**

Under U.S. GAAP, ASC 740-10-30-5(e) states that DTAs are recognized in full and then reduced "by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized." The valuation allowance will "reduce the deferred tax asset to the [net] amount that is more likely than not to be realized."

Under IFRS Standards, DTAs are recognized only to the extent that realizing them is probable (akin to U.S. GAAP's more-likely-than-not threshold). Therefore, there is no need for a DTA valuation allowance.

## **F.3 Tax Rate for Measuring DTAs and DTLs**

Under U.S. GAAP, DTLs (assets) are measured at the enacted tax rates only. ASC 740-10-10-3 states that "the objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized."

Under IFRS Standards, DTLs (assets) should be measured at the tax rates that are expected to apply when the liability is settled or the asset is realized, on the basis of tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Paragraph 48 of IAS 12 states, in part:

Current and deferred tax assets and liabilities are usually measured using the tax rates (and tax laws) that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).

## **F.4 Uncertain Tax Positions**

Under U.S. GAAP, an entity cannot recognize a tax benefit in its financial statements unless it concludes that it is "more likely than not" that the benefit will be sustained on audit by the taxing authority solely on the basis of the technical merits of the associated tax position. In making this determination, an entity must assume that the position will be (1) examined by a taxing authority that has full knowledge of all relevant information and (2) resolved in the court of last resort. If the recognition threshold is not reached, no benefit can be recognized, even when the entity believes that some amount of benefit will ultimately be realized.

If the recognition threshold is reached, the tax benefit recognized is measured at the largest amount of the tax benefit that, in the entity's judgment, is more than 50 percent likely to be realized. The analysis should be based on the amount the taxpayer would ultimately accept in a negotiated settlement with the taxing authority. To compute the amount that is more than 50 percent likely to be realized, an entity must perform a cumulative-probability assessment of the possible outcome(s). Assigning probabilities

in measuring a recognized tax position requires a high degree of judgment and should be based on all relevant facts, circumstances, and information.

### ***Before the Adoption of IFRIC Interpretation 23***

No formal guidance existed concerning uncertain tax positions. Since IAS 12 did not specifically address accounting uncertainties, the recognition and measurement criteria of IAS 37 was considered relevant because an uncertain tax position may give rise to a liability of uncertain timing and amount. Under IAS 37, recognition is based on whether it is probable that an outflow of economic resources will occur. "Probable" is defined as "more likely than not." Measurement is based on the entity's best estimate of the amount of the tax benefit.

### ***After the Adoption of IFRIC Interpretation 23***

Entities should no longer analogize to IAS 37. Paragraphs 9 and 10 of IFRIC Interpretation 23 state:

An entity shall consider whether it is probable that a taxation authority will accept an uncertain tax treatment.

If an entity concludes it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.

The entity assesses whether it is probable that a taxing authority will accept an uncertain tax treatment. The assessment is based on the tax position as filed on the tax return and therefore must include consideration of both the technical merits of the position and the amount included on the return. While IFRIC Interpretation 23 is silent on the definition of "probable," the word is defined in IAS 37 as "more likely than not."

Paragraph 11 of IFRIC Interpretation 23 states:

If an entity concludes it is not probable that the taxation authority will accept an uncertain tax treatment, the entity shall reflect the effect of uncertainty in determining the related taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates. An entity shall reflect the effect of uncertainty for each uncertain tax treatment by using either of the following methods, depending on which method the entity expects to better predict the resolution of the uncertainty:

- a. the most likely amount — the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value.
- b. the expected value — the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.

The determination of whether to use the most likely amount method or the expected value method is not an accounting policy decision but is based on facts and circumstances.

In general, although the principles of IFRIC Interpretation 23 are similar to those in ASC 740 and IAS 37, the methods introduced by IFRIC Interpretation 23 to reflect uncertainty may create measurement differences in comparison with the cumulative probability assessment requirement under U.S. GAAP. Other differences between IFRIC Interpretation 23 and ASC 740 may include recognition of interest and penalties, classification, presentation, and disclosure related to uncertainty in income taxes.

### Example F-1

Assume that an entity takes a deduction of \$1,000 that is not a timing item (resulting in a \$250 reduction in the income tax payable on the basis of a tax rate of 25 percent) on its tax return.

Under ASC 740, the entity concludes solely on the basis of the technical merits of the tax position that it is more likely than not that the position will be sustained if the taxpayer takes the dispute to the court of last resort. Under IAS 37, the entity concludes that loss is probable upon examination by and settlement with the taxing authority. Under IFRIC Interpretation 23, the entity concludes that it is not probable that the taxing authority will accept the tax treatment used in the tax return. This conclusion includes consideration of how the taxing authority will evaluate both the technical merits of the position and the amount shown on the return.

The entity estimates the probabilities of the possible tax benefit amounts that may be sustained upon examination by the taxing authority as indicated in the table below.

Possible Estimated Outcome (a)	Individual Probability of Occurring (b)	Cumulative Probability of Occurring (c)	Estimate of Expected Value (d) = (a) × (b)
\$ 250	22%	22%	\$ 55
200	30%	52%	60
150	20%	72%	30
100	20%	92%	20
0	8%	100%	0
			<u>\$ 165</u>

Under ASC 740, the entity would measure the associated tax benefit at the largest amount of benefit that is more than 50 percent likely to be realized upon settlement. Therefore, the entity should recognize a tax benefit of \$200 because this represents the largest benefit with a cumulative probability of more than 50 percent. Accordingly, the entity should record a \$50 income tax liability.

Under IAS 37, an income tax liability is required because the entity has determined that loss is probable upon examination by and settlement with the taxing authority. IAS 37 does not provide explicit guidance on which of the many acceptable methods the entity should use in determining the best estimate of the liability to recognize. One such method is a weighted-average method (i.e., the expected value method), which would result in an income tax liability of \$85 in accordance with the example above since the weighted average of all possible outcomes is a benefit of \$165.

Under IFRIC Interpretation 23, the entity must recognize the effect of uncertainty because it is not probable that the full deduction taken on its tax return will be accepted by the taxing authority. To measure the required liability, the entity should select the measurement method that best predicts the resolution of uncertainty. By applying the most likely amount method, the entity would initially calculate a \$50 income tax liability on the basis of a \$200 benefit with a 30 percent likelihood. However, the entity would observe that there was a range of possible outcomes that were neither binary nor concentrated on one value. Consequently, the entity would conclude that the expected value method, which results in recognition of an \$85 income tax liability on the basis of a \$165 sustained benefit, would best predict the resolution of uncertainty in view of the facts and circumstances surrounding this tax position.

## F.5 Tax Consequences of Intra-Entity Sales

### ***Before the Adoption of ASU 2016-16***

Under U.S. GAAP, when accounting for the tax consequences of intra-entity sales between different tax jurisdictions, an entity should eliminate intra-entity profit on the internal transaction. The FASB has concluded that an entity's income statement should not reflect a tax consequence for intra-entity sales that are eliminated in consolidation. The current tax paid or payable from the sale (of inventory or other assets) is deferred upon consolidation (as a prepaid income tax) and is not recorded until the inventory or other asset is sold to an unrelated party. In addition, under U.S. GAAP, the buyer is prohibited from recognizing a temporary difference between the book carrying amount and the asset's tax base.

### ***After the Adoption of ASU 2016-16***

ASU 2016-16, which removes the prohibition in ASC 740 against the immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory (i.e., the current accounting for inventory transfers will remain unchanged), eliminates the differences between U.S. GAAP and IFRS Standards on intra-entity sales of assets other than inventory. The ASU did not add any new disclosure requirements.

Under IFRS Standards, the deferred tax effect must be recognized on consolidation for intra-entity sales. For example, an intra-entity sale creates a temporary difference between the book carrying amount of the asset and its tax base. When intra-entity entities operate in different tax jurisdictions, are subject to different tax rates, or both, the rate used is that at which the temporary difference is expected to reverse, which generally is that of the buyer's tax jurisdiction. If the buyer's tax rate is different from the seller's tax rate, the deferred tax recognized may not entirely offset the taxes payable from the sale in consolidation.

## F.6 Deferred Taxes on Foreign Nonmonetary Assets/Liabilities When the Functional Currency Is Not the Local Currency and the Remeasurement Is Based on Historical Exchange Rates

Under U.S. GAAP, ASC 740 prohibits recognition of deferred tax consequences for differences that arise from changes in exchange rates or indexing for tax purposes for those foreign subsidiaries that are required to use historical rates to remeasure nonmonetary assets and liabilities from the local currency into the functional currency. Although this basis difference technically meets the definition of a temporary difference under ASC 740, the FASB has concluded that to account for it as a temporary difference is to effectively recognize deferred taxes on exchange gains and losses that are not recognized in the income statement under ASC 830.

Under IFRS Standards, deferred taxes are recognized. Paragraph 41 of IAS 12 states:

The non-monetary assets and liabilities of an entity are measured in its functional currency (see IAS 21). If the entity's taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or (subject to paragraph 24) asset. The resulting deferred tax is charged or credited to profit or loss (see paragraph 58).

## F.7 Other Exceptions to the Basic Principle That Deferred Tax Is Recognized for All Temporary Differences

### F.7.1 Leveraged Leases — Commencing Before the Adoption of ASU 2016-02

Under U.S. GAAP, an exemption is made in applying the basic principles of ASC 740 for leveraged leases. Under ASC 840-30, the tax consequences of leveraged leases are incorporated directly into the lease accounting measurements; therefore, no temporary differences are recognized.

ASC 842 does not include guidance on leveraged leases. Entities are not permitted to account for any new lease arrangements as leveraged leases after the effective date of ASC 842, which eliminates the difference between U.S. GAAP and IFRS Standards on leveraged leases.

IFRS Standards do not include a concept of leveraged leases.

### F.7.2 Initial Recognition

Under IFRS Standards, deferred tax is not provided on temporary differences that arise from the initial recognition of an asset or liability in a transaction that (1) is not a business combination and (2) does not affect accounting profit or taxable profit. In addition, changes in this unrecognized DTA or DTL are not subsequently recognized. For example, in some tax jurisdictions, certain assets may not be deductible for tax purposes. That is, an asset's book basis is greater than its tax basis of zero. In this situation, even though the difference between the asset's book basis and tax basis represents an initial temporary difference, IFRS Standards do not permit the recognition of the deferred taxes on the basis of the "initial recognition" exemption. IFRS Standards state that the recognition of deferred tax in this case would simply gross up the balance sheet and make the financial statements less "transparent."

Unlike IFRS Standards, U.S. GAAP do not contain an "initial recognition" exemption.

## F.8 Special Deductions

Under U.S. GAAP, tax benefits of special deductions for financial reporting purposes are recognized no earlier than the year in which they are available to reduce taxable income on the tax return. Although anticipation of future special deductions in the measurement of deferred liabilities is not permitted, the future tax effects of special deductions may nevertheless affect (1) the average graduated tax rate used for measuring DTAs and DTLs when graduated tax rates are a significant factor and (2) the need for a valuation allowance for DTAs. In those circumstances, implicit recognition is unavoidable because those special deductions are one of the determinants of future taxable income, and future taxable income is used to determine the average graduated tax rate and may affect the need for a valuation allowance.

There is no guidance on "special deductions" under IFRS Standards.

## F.9 Share-Based Compensation

### *Before the Adoption of ASU 2016-09*

Under U.S. GAAP, the deferred tax recorded on share-based compensation is computed on the basis of the expense recognized in the financial statements for awards that ordinarily give rise to a tax deduction. Therefore, changes in an entity's share price do not affect the DTA recorded on the entity's financial statements.

All excess tax benefits (e.g., tax deduction on the award is in excess of cumulative compensation for financial reporting) are recognized in APIC when realized (when taxes payable is reduced), and tax deficiencies (e.g., tax deduction on the award is less than cumulative compensation for financial reporting) are recognized either in the income tax provision or in APIC to the extent that there is a sufficient "APIC pool" related to previously recognized excess tax benefits.

### ***After the Adoption of ASU 2016-09***

Under ASU 2016-09, an entity recognizes all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement. This change eliminates the notion of the APIC pool.

Under IFRS Standards, the deferred tax is computed on the basis of the expected tax deduction for the share-based payments in every period under the applicable tax law (i.e., intrinsic value). Therefore, changes in share price do affect the DTA at period-end and result in adjustments to the DTA. If the amount of the estimated future tax deduction for awards exceeds the amount of the tax effect of the related cumulative compensation expense for financial reporting purposes, a portion of the tax deduction is deemed to relate to an equity item. The excess of the associated deferred tax is therefore recognized directly in equity. If the tax deduction received is less than the compensation expense or if no tax deduction is anticipated (e.g., because the share price has declined), the DTA is reversed to profit or loss or equity, or both, as appropriate, depending on how the deferred tax benefit was originally recorded.

### **F.10 Subsequent Changes in Deferred Taxes That Were Originally Charged or Credited to Equity (Backward Tracing)**

Under U.S. GAAP, subsequent-period changes in deferred tax items that were originally charged or credited to shareholders' equity or comprehensive income are allocated to the income tax provision related to continuing operations and not directly charged or credited to shareholders' equity or to other comprehensive income. For example, the effect of a change in the subsequent tax rate on recorded deferred tax would be charged or credited to the current income tax provision of continuing operations even if such a tax effect was originally recorded in shareholders' equity. (Note that there are limited exceptions to the above in ASC 740-10-45-20 and ASC 740-20-45-11(c)-11(f).)

This appendix does not include the guidance of ASU 2018-02, which allows a one-time reclassification from AOCI to retained earnings of "stranded" tax effects related to the change in tax rate as a result of U.S. tax reform, commonly known as the Tax Cuts and Jobs Act.

Under IFRS Standards, however, subsequent-period changes in deferred taxes that were originally charged or credited to shareholders' equity are also allocated to shareholders' equity. Paragraph 61A of IAS 12 states, "Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss." For example, a deferred tax item originally recognized by a charge or credit to shareholders' equity may change either from changes in assessments of recovery of DTAs or from changes in tax rates, laws, or other measurement attributes. In a manner consistent with the original treatment, IFRS Standards require that the resulting subsequent change in deferred taxes be charged or credited directly to equity as well.

## F.11 Reconciliation of Actual and Expected Tax Rate

Under U.S. GAAP, all public entities must disclose a reconciliation by using percentages or dollars between (1) the reported amount of income tax expense attributable to continuing operations and (2) the amount of income tax expense that would have resulted from applying domestic federal statutory rates to pretax income from continuing operations. The amount and nature of each significant reconciling item should be disclosed as well. For nonpublic entities, a numerical reconciliation is not required; however, the nature of all significant reconciling items between (1) and (2) above should be disclosed.

Under IFRS Standards, paragraph 81(c) of IAS 12 states that all entities must disclose a numerical reconciliation in either or both of the following forms:

1. The reported "tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s) disclosing also the basis on which [any] applicable tax [rate is] computed."
2. "The average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed."

## F.12 Undistributed Earnings on Investments

Under U.S. GAAP, a deferred tax is generally required on undistributed earnings arising after 1992 that relate to a domestic subsidiary or a domestic joint venture. However, no deferred tax is recognized on the undistributed profits of an investment in a foreign subsidiary or foreign corporate joint venture (that is permanent in duration) if such earnings can be demonstrated to be indefinitely reinvested. In accordance with paragraph 64 of ASU 2015-10, "[t]his exception to recognizing deferred taxes is not applicable for partnerships (or other pass-through entities)."

IFRS Standards require recognition of a deferred tax for all undistributed earnings associated with any form of investee except to the extent that (1) the parent is able to control the timing of the reversal of the temporary difference and (2) it is probable that the temporary difference will not reverse in the foreseeable future. Under IFRS Standards, however, there is no distinction between domestic and foreign investments.

## F.13 Interim Reporting and Tax Rate

Under U.S. GAAP, an entity must estimate its ordinary income and the related tax expense or benefit for the full fiscal year (total of expected current and deferred provisions) to calculate its estimated annualized effective tax rate. Ordinary income or loss is income from continuing operations less significant unusual or infrequently occurring items. Certain other exceptions may apply that remove ordinary income/(loss) from the computation. Amounts and related tax effects, if any, excluded from the overall forecasted effective tax rate are generally accounted for either discretely or through a separate forecasted tax rate.

Under IFRS Standards, a separate estimated average annual effective income tax rate is determined for each taxing jurisdiction and applied individually to the interim-period pretax income of each jurisdiction. The interim-period tax charge is the sum of each entity's interim tax charge. IAS 12 does not address interim tax reporting. Paragraphs B12 through B22 of IAS 34 provide examples of the application of the recognition and measurement principles of IAS 34 to interim income tax expense.

# Appendix G — Titles of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

## AICPA Technical Practice Aid

*Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*

## AICPA Statement of Position

SOP 00-2, *Accounting by Producers or Distributors of Films*

SOP 97-2, *Software Revenue Recognition*

SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*

SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*

SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*

## FASB Accounting Standards Codification (ASC) Topics

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 220, *Comprehensive Income*

ASC 225, *Income Statement*

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 272, *Limited Liability Entities*

ASC 275, *Risks and Uncertainties*

ASC 320, *Investments — Debt and Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 325, *Investments — Other*

ASC 350, *Intangibles — Goodwill and Other*  
ASC 360, *Property, Plant, and Equipment*  
ASC 405, *Liabilities*  
ASC 420, *Exit or Disposal Cost Obligations*  
ASC 450, *Contingencies*  
ASC 460, *Guarantees*  
ASC 470, *Debt*  
ASC 505, *Equity*  
ASC 606, *Revenue From Contracts With Customers*  
ASC 715, *Compensation — Retirement Benefits*  
ASC 718, *Compensation — Stock Compensation*  
ASC 740, *Income Taxes*  
ASC 805, *Business Combinations*  
ASC 810, *Consolidation*  
ASC 815, *Derivatives and Hedging*  
ASC 820, *Fair Value Measurement*  
ASC 825, *Financial Instruments*  
ASC 830, *Foreign Currency Matters*  
ASC 835, *Interest*  
ASC 840, *Leases*  
ASC 842, *Leases*  
ASC 855, *Subsequent Events*  
ASC 852, *Reorganizations*  
ASC 942, *Financial Services — Depository and Lending*  
ASC 946, *Financial Services — Investment Companies*  
ASC 970, *Real Estate — General*  
ASC 980, *Regulated Operations*

## **FASB Accounting Standards Updates (ASUs)**

ASU 2018-02, *Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*

ASU 2017-15, *Codification Improvements to Topic 995, U.S. Steamship Entities: Elimination of Topic 995*

ASU 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*

ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

ASU 2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*

ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*

ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*

ASU 2014-17, *Business Combinations (Topic 805): Pushdown Accounting* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-15, *Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern*

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2014-08, *Presentation of Financial Statements (Topic 205): and Property, Plant, and Equipment (Topic 360)*

ASU 2014-01, *Investments (Topic 323)*

## **FASB Statements (Pre-Codification Literature)**

No. 164, *Not-for-Profit Entities: Mergers and Acquisitions* — Including an amendment of FASB Statement

No. 157, *Fair Value Measurements*

No. 142, *Goodwill and Other Intangible Assets*

No. 141(R), *Business Combinations*

No. 141, *Business Combinations*

No. 123(R), *Share-Based Payment*

No. 123, *Share-Based Payment*

No. 109, *Accounting for Income Taxes*

No. 96, *Accounting for Income Taxes*

No. 37, *Balance Sheet Classification of Deferred Income Taxes* — an amendment of APB Opinion No. 11

## **FASB Interpretations (Pre-Codification Literature)**

No. 48, *Accounting for Uncertainty in Income Taxes* — an interpretation of FASB Statement No. 109

No. 46(R), *Consolidation of Variable Interest Entities* — an interpretation of ARB No. 51

No. 30, *Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets* — an interpretation of APB Opinion No. 29

No. 18, *Accounting for Income Taxes in Interim Periods* — an interpretation of APB Opinion No. 28

## **FASB Staff Positions (Pre-Codification Literature)**

FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards"

FAS 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision Within the American Jobs Act of 2004"

FAS 109-1, "Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004"

FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"

FIN 48-1, "Definition of Settlement in FASB Interpretation No. 48"

## **FASB Accounting Principles Board (APB) Opinions**

APB 2, *Accounting for the "Investment Credit"*

APB 4, *Accounting for the "Investment Credit"*

APB 10, *Omnibus Opinion — 1966 Consolidated Financial Statements Poolings of Interest — Restatement of Financial Statements Tax Allocation Accounts — Discounting Offsetting Securities Against Taxes Payable Convertible Debt and Debt Issued With Stock Warrants Liquidation Preference of Preferred Stock Installment Method of Accounting*

APB 18, *The Equity Method of Accounting for Investments in Common Stock*

APB 21, *Interest on Receivables and Payables*

APB 23, *Accounting for Income Taxes — Special Areas*

APB 25, *Accounting for Stock Issued to Employees*

APB 28, *Interim Financial Reporting*

APB 30, *Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*

## **FASB Technical Bulletin**

FTB 79-09, *Accounting in Interim Periods for Changes in Income Tax Rates*

## **FASB Staff Q&As**

Topic 740, No. 1, *Whether Private Companies and Not-for-Profit Entities Can Apply SAB 118*

Topic 740, No. 2, *Whether to Discount the Tax Liability on the Deemed Repatriation*

Topic 740, No. 3, *Whether to Discount Alternative Minimum Tax Credits That Become Refundable*

Topic 740, No. 4, *Accounting for the Base Erosion Anti-Abuse Tax*

Topic 740, No. 5, *Accounting for Global Intangible Low-Taxed Income*

## **EITF Issues (Pre-Codification Literature)**

06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards"

05-8, "Income Tax Consequences of Issuing Convertible Debt With a Beneficial Conversion Feature"

98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations"

95-20, "Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments"

95-13, "Classification of Debt Issue Costs in the Statement of Cash Flows"

95-10, "Accounting for Tax Credits Related to Dividend Payments in Accordance With FASB Statement No. 109"

95-9, "Accounting for Tax Effects of Dividends in France in Accordance With FASB Statement No. 109"

94-10, "Accounting by a Company for the Income Tax Effects of Transactions among or With Its Shareholders Under FASB Statement No. 109"

94-1, "Accounting for Tax Benefits Resulting From Investments in Affordable Housing Projects"

93-17, "Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation"

93-16, "Application of FASB Statement No. 109 to Basis Differences Within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23"

93-13, "Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income From Continuing Operations"

93-9, "Application of FASB Statement No. 109 in Foreign Financial Statements Restated for General Price-Level Changes"

93-7, "Uncertainties Related to Income Taxes in a Purchase Business Combination"

92-8, "Accounting for the Income Tax Effects Under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary"

91-8, "Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax"

88-4, "Classification of Payment Made to IRS to Retain Fiscal Year"

87-8, "Tax Reform Act of 1986: Issues Related to the Alternative Minimum Tax"

86-43, "Effect of a Change in Tax Law or Rates on Leveraged Leases"

86-9, "IRC Section 338 and Push-Down Accounting"

D-32, "Intraperiod Tax Allocation of the Tax Effect of Pretax Income From Continuing Operations"

D-31, "Temporary Differences Related to LIFO Inventory and Tax-to-Tax Differences"

D-30, "Adjustment Due to Effect of a Change in Tax Laws or Rates"

## **SEC Accounting Series Release (ASR)**

No. 280, "General Revision of Regulation S-X: Income or Loss Applicable to Common Stock"

No. 149, "Improved Disclosure of Income Tax Expense"

## **SEC Staff Accounting Bulletins (SABs)**

Topic 1.B, "Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity"

Topic 1.C, "Tax Holidays"

Topic 1.M, "Materiality"

Topic 1.N, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements"

Topic 5.A, "Expenses of Offering"

Topic 6.I, "Accounting Series Release 149 — Improved Disclosure of Income Tax Expense (Adopted November 28, 1973 and Modified by ASR 280 Adopted on September 2, 1980)"

Topic 11.C, "Tax Holidays"

SEC Staff Accounting Bulletin No. 118

## **SEC Regulation S-K**

Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

## **SEC Regulation S-X**

Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

Rule 4-08, "General Notes to Financial Statements"

Rule 5-02, "Balance Sheets"

Rule 5-03, "Income Statements"

Article 10, "Interim Financial Statements"

Rule 10-01, "Interim Financial Statements"

Article 11, "Pro Forma Financial Information"

Rule 11-01, "Presentation Requirements"

Rule 11-02, "Preparation Requirements"

## **SEC Financial Reporting Manual**

Topic 3, "Pro Forma Financial Information"

## **SEC Form 8-K**

Item 2.06, "Material Impairments"

Item 8.01, "Other Events"

## **Internal Revenue Code (IRC)**

IRC Section 15, "Effect of Changes"

IRC Section 78, "Dividends Received From Certain Foreign Corporations by Domestic Corporations Choosing Foreign Tax Credit"

IRC Section 83, "Property Transferred in Connection With Performance of Services"

- IRC Section 103, "Interest on State and Local Bonds"
- IRC Section 162, "Trade or Business Expenses"
- IRC Section 162(m), "Certain Excessive Employee Remuneration"
- IRC Section 165, "Losses"
- IRC Section 171, "Amortizable Bond Premium"
- IRC Section 199, "Income Attributable to Domestic Production Activities"
- IRC Section 265, "Expenses and Interest Relating to Tax-Exempt Income"
- IRC Section 271, "Debts Owed by Political Parties, Etc."
- IRC Section 274, "Disallowance of Certain Entertainment, etc., Expenses"
- IRC Section 275, 'Certain Taxes"
- IRC Section 338, 'Certain Stock Purchases Treated as Asset Acquisitions"
- IRC Section 382, 'Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change"
- IRC Section 383, "Special Limitations on Certain Excess Credits, Etc."
- IRC Section 421, "General Rules"
- IRC Section 422, "Incentive Stock Options"
- IRC Section 423, "Employee Stock Purchase Plans"
- IRC Section 424, "Definitions and Special Rules"
- IRC Section 481, "Adjustments Required by Changes in Method of Accounting"
- IRC Section 585, "Reserves for Losses on Loans of Banks"
- IRC Section 704, "Partner's Distributive Share"
- IRC Section 806, "Small Life Insurance Company Deduction"
- IRC Section 833, "Treatment of Blue Cross and Blue Shield Organizations, Etc."
- IRC Section 931, "Income From Sources Within Guam, American Samoa, or the Northern Mariana Islands"
- IRC Section 965, "Temporary Dividends Received Deduction"
- IRC Section 1016, "Adjustments to Basis"
- IRC Section 1502, "Regulations"

## **International Standards**

- IAS 12, *Income Taxes*
- IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*
- IAS 34, *Interim Financial Reporting*
- IAS 35, *Discontinuing Operations* (superseded by IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*)
- IAS 36, *Impairment of Assets*

# Appendix H — Abbreviations

Abbreviation	Description	Abbreviation	Description
<b>AC</b>	acquiring company	<b>DTA</b>	deferred tax asset
<b>AETR</b>	annual effective tax rate	<b>DTL</b>	deferred tax liability
<b>AFS</b>	available for sale	<b>E&amp;P</b>	earnings and profits
<b>AGUB</b>	adjusted grossed-up basis	<b>EBITDA</b>	earnings before income taxes, depreciation, and amortization
<b>AICPA</b>	American Institute of CPAs	<b>ED</b>	exposure draft
<b>AMT</b>	alternative minimum tax	<b>EITF</b>	FASB's Emerging Issues Task Force
<b>AMTI</b>	alternative minimum taxable income	<b>EPS</b>	earnings per share
<b>AOCI</b>	accumulated other comprehensive income	<b>ESOP</b>	employee stock ownership plan
<b>APB</b>	FASB Accounting Principles Board	<b>ESPP</b>	employee stock purchase plan
<b>APIC</b>	additional paid-in capital	<b>ETR</b>	effective tax rate
<b>ASC</b>	FASB Accounting Standards Codification	<b>EUR</b>	euro
<b>ASR</b>	SEC Accounting Series Release	<b>FAQ</b>	frequently asked question
<b>ASU</b>	FASB Accounting Standards Update	<b>FAS</b>	FASB Statement of Financial Accounting Standard
<b>BEAT</b>	base erosion anti-abuse tax	<b>FASB</b>	Financial Accounting Standards Board
<b>CAD</b>	Canadian dollar	<b>FBB</b>	final book basis
<b>C&amp;DI</b>	SEC Compliance and Disclosure Interpretation	<b>FC</b>	foreign currency
<b>CEO</b>	chief executive officer	<b>FCC</b>	Federal Communications Commission
<b>CFC</b>	controlled foreign corporation	<b>FCT</b>	foreign currency transaction
<b>CGT</b>	capital gains tax	<b>FDII</b>	foreign-derived intangible income
<b>CNIT</b>	corporate net income tax	<b>FIFO</b>	first in, first out
<b>CPP</b>	cash purchase price	<b>FIN</b>	FASB Interpretation
<b>CTA</b>	cumulative translation adjustment	<b>FRM</b>	SEC Financial Reporting Manual
<b>CU</b>	currency unit	<b>FSP</b>	FASB Staff Position
<b>DRD</b>	dividends received deduction		

Abbreviation	Description	Abbreviation	Description
<b>FTB</b>	FASB Technical Bulletin	<b>OCI</b>	other comprehensive income
<b>FTC</b>	foreign tax credit	<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>GAAP</b>	generally accepted accounting principles	<b>OTTI</b>	other-than-temporary impairment
<b>GILTI</b>	global intangible low-taxed income	<b>P&amp;L</b>	profit and loss
<b>GP</b>	general partner	<b>PAM</b>	proportional amortization method
<b>GRT</b>	gross receipts tax	<b>PCAOB</b>	Public Company Accounting Oversight Board
<b>GW</b>	goodwill	<b>PP&amp;E</b>	property, plant, and equipment
<b>HLBV</b>	hypothetical liquidation at book value	<b>PTI</b>	percentage of taxable income
<b>HTM</b>	held to maturity	<b>QAHP</b>	qualified affordable housing project
<b>IAS</b>	International Accounting Standard	<b>QAHPI</b>	qualified affordable housing project investment
<b>IASB</b>	International Accounting Standards Board	<b>Q&amp;A</b>	question and answer
<b>IFRIC</b>	IFRS Interpretations Committee	<b>QBAI</b>	qualified business asset investment
<b>IFRS</b>	International Financial Reporting Standard	<b>REIT</b>	real estate investment trust
<b>IPO</b>	initial public offering	<b>R&amp;D</b>	research and development
<b>IRC</b>	Internal Revenue Code	<b>RIC</b>	regulated investment company
<b>IRS</b>	Internal Revenue Service	<b>SAB</b>	SEC Staff Accounting Bulletin
<b>ISO</b>	incentive stock option	<b>SEC</b>	U.S. Securities and Exchange Commission
<b>LC</b>	local currency	<b>SFC</b>	specified foreign corporation
<b>LICTI</b>	life insurance company taxable income	<b>SIC</b>	Standing Interpretations Committee
<b>LIFO</b>	last in, first out	<b>SOP</b>	AICPA Statement of Position
<b>LLC</b>	limited liability company	<b>TC</b>	target company
<b>MD&amp;A</b>	Management's Discussion and Analysis	<b>TMT</b>	tentative minimum tax
<b>MLTN</b>	more likely than not	<b>TTB</b>	total tax benefit
<b>MPA</b>	modified prospective application	<b>USD</b>	U.S. dollar
<b>NFP</b>	not-for-profit entity	<b>UTB</b>	unrecognized tax benefit
<b>NOL</b>	net operating loss	<b>UTP</b>	uncertain tax position
<b>NQSO</b>	nonstatutory option	<b>VIE</b>	variable interest entity