



A Roadmap to Accounting for Income Taxes

2016

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Preface

To our friends and clients:

We're pleased to present the 2016 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 740¹ and IFRSs² (in [Appendix G](#)). 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 October 31, 2016. 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, examples related to some of the guidance included in the previous edition have been added or substantively revised, 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 2015 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.

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).

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

Sincerely,

Deloitte & Touche LLP

¹ For the full titles of standards, topics, and regulations, see [Appendix B](#).

² For the full forms of acronyms, see [Appendix C](#).

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Executive Summary

The following is a brief summary of the Roadmap's 13 chapters and 7 appendixes, which includes guidance that has been amended or added to this 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. Updates include the clarification of guidance related to the accounting for taxes assessed on dividend payors contained in 2.03.
- [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. Updates to this chapter include the following added and amended guidance:
 - 3.20 — Considerations of Tax Positions by Tax-Exempt or Pass-Through Entities (amended).
 - 3.20A — Unrecognized Tax Benefits and Spin-Off Transactions (added).
 - 3.51A — Accounting for Foreign Branch Operations (added).
 - 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 (added).
 - 3.54A — Tax Effects of a "Check-the-Box" Election (added).
- [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. Updates to this chapter include the following added and amended guidance:
 - 4.04 — Measuring Deferred Taxes for Indefinite-Lived Intangible Assets When Different Tax Rates May Apply (amended).
 - 4.20 — Applicability of Pushdown Accounting to Income Taxes (amended).
 - 4.27 — Using the Reversal of a DTL for an Indefinite-Lived Asset as a Source of Taxable Income (amended).
 - 4.28A — Assessing Realization of a Deferred Tax Asset for Regular Tax Net Operating Loss Carryforwards When an Entity Anticipates Paying AMT Perpetually (added).
 - 4.49 — Acceptable Methods of Allocating Tax to Separate Financial Statements (amended).

- o 4.52A — Accounting for Income Taxes in the Balance Sheet of Separate Financial Statements: Deferred Tax Assets Related to Tax Attributes (added).
- 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 E, which contains comprehensive disclosure examples (discussed below). Updates to Chapters 5 and 6 include the following added and amended guidance:
 - o 5.03 — Recognition of Changes in Indemnification Assets Under a Tax Indemnification Arrangement (amended).
 - o 5.05 — Accounting for the Tax Effects of a Change in Tax Accounting Method (amended).
 - o 5.08 — Interaction of Unrecognized Tax Benefits and Tax Attributes (amended).
 - o 6.07A — Appropriate Federal Statutory Rate for Use in the Rate Reconciliation of a Foreign Reporting Entity (added).
 - o 6.07B — Computing the “Foreign Rate Differential” in the Rate Reconciliation (added).
 - o 6.11 — Disclosure of Unrecognized Tax Benefits That Could Significantly Change Within 12 Months of the Reporting Date (amended).
 - o 6.26 — Disclosures Required in the Separate Financial Statements of a Member of a Consolidated Tax Return (amended).
 - o 6.26A — Disclosure Requirements When Abbreviated Financial Statements Are Presented in a Public Filing (amended and renumbered from 4.58).
 - o 6.27A — Disclosure of the Components of Income (or Loss) Before Income Tax Expense (or Benefit) as Either Foreign or Domestic — Branches and Intraentity Transactions (added).
 - o Non-GAAP Measures — Treatment of Tax Adjustments (added).
- 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 and amended guidance:
 - o 7.06 — Intraperiod Tax Allocation: Exceptions to the General Rule (amended).
 - o 7.06A — Application of ASC 740-20-45-7 to Amounts Credited Directly to APIC (added).
 - o 7.06B — Application of ASC 740-20-45-7 to Foreign Currency Exchange Gains (added).
- 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. Updates to this chapter include the following added and amended guidance:
 - o 8.03A — Outside Basis Difference in a Foreign Subsidiary — Subpart F Income (added).
 - o 8.03B — Outside Basis Difference in a Foreign Subsidiary — “Deferred” Subpart F Income (added).
 - o 8.14 — Deferred Tax Consequences of an Investment in a More-Than-50-Percent-Owned Subsidiary (amended).
- 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, 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. Updates to this chapter include the following added and amended guidance:

- 10.05 — “Recharge Payments” Made by Foreign Subsidiaries (amended).
- ASU 2016-09 FAQs (added).
- **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 added and amended guidance:
 - 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 (added).
 - 11.12 — Tax Consequences of Business Combinations Achieved in Stages: Remeasurement of the Original Investment (amended).
 - 11.23A — Settlement of Share-Based Payment Awards Held by the Acquiree’s Employees (added).
 - 11.34 — Tax Effects of Goodwill Remaining in a Reporting Unit Upon Disposal of a Subsidiary That Was Previously Integrated Into the Reporting Unit (amended).
- **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. Updates to this chapter include clarification within 12.02 of guidance related to the accounting for deferred taxes related to nonmonetary assets and liabilities when the functional currency is not the local currency:
 - 12.02 — Accounting for Deferred Taxes Related to Nonmonetary Assets and Liabilities When the Functional Currency Is Not the Local Currency (amended).
- **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. Updates to this chapter include the following added guidance:
 - 13.02A — Determining Whether an Investor Has the Ability to Exercise Significant Influence Over an Entity That Invests in Qualified Affordable Housing Projects (added).
- **Appendix A** — Contains implementation guidance and illustrations from ASC 740.
- **Appendix B** — Glossary containing the full titles of topics, standards, and regulations used in the Roadmap.
- **Appendix C** — Glossary containing the full forms of abbreviations used throughout the Roadmap.
- **Appendix D** — Contains excerpts from the ASC 740 glossary of terms that are important to the accounting for income taxes.
- **Appendix E** — Includes comprehensive disclosure examples.
- **Appendix F** — Comprises a sample of recent SEC comments on income tax matters, which may be particularly useful for SEC registrants.
- **Appendix G** — A comprehensive discussion of the income tax accounting guidance under IFRSs.

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. Intrapariod 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.

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]

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]

05-10 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]

ASC 740-10

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]

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:

- The amount of taxes that will be payable or refundable in future years inclusive of reversing temporary differences and carryforwards
- 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 740-10-1, 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 "intraproduct tax allocation" (see [Chapter 7, "Intraproduct 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.

New in the 2016 Edition:

The guidance on accounting for taxes assessed on dividend payors contained within 2.03 has been clarified.

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]

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.

ASC 740-10 (continued)

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>\$ 77,000</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>\$ 11,250</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.

2.04 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, 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 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 an 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.

Company A should not apply the provisions of ASC 740 to the subsidiary's previously taken tax position after the sale of the subsidiary because Z filed a separate tax return, and 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 and 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), since recognition of the indemnification liability would adjust the seller's gain or loss on sale:

Gain/loss on sale	54	
DTA	36	
Indemnification liability		90

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.

New in the 2016 Edition:

The following new guidance has been added to Chapter 3:

- 3.20A — Unrecognized Tax Benefits and Spin-Off Transactions.
- 3.51A — Accounting for Foreign Branch Operations.
- 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.
- 3.54A — Tax Effects of a "Check-the-Box" Election.

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.

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

ASC 740-10 (continued)

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

- 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.

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), 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 and the ASC master glossary both define 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 or the ASC master glossary. As used in ASC 740, the term signifies a legal entity that is subject to tax and consolidated by the reporting entity. The definition in ASC 810 includes partnerships and trusts; however, those entities may not be subject to tax because their earnings pass directly to the owners of the partnership (subject to any assessment for uncertainty). See [8.06](#) for further discussion of pass-through entities.

[Appendix D, “Glossary of Terms in the ASC 740 Topic and Subtopics,”](#) includes the definition of a corporate joint venture from the Codification.

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.

	20X1	20X2	20X3	20X4
Activity in Book — Bad-Debt Reserve				
Beginning balance	\$ 500	\$ 500	\$ 300	\$ 600
Loan loss provision	100	100	400	300
Charge-offs	<u>(100)</u>	<u>(300)</u>	<u>(100)</u>	<u>(320)</u>
	<u>\$ 500</u>	<u>\$ 300</u>	<u>\$ 600</u>	<u>\$ 580</u>
Activity in Tax — Bad-Debt Reserve				
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		<u>240</u>		<u>260</u>
Ending balance	<u>\$ 910</u>	<u>\$ 850</u>	<u>\$ 910</u>	<u>\$ 850</u>
Current Tax Liability				
Pretax accounting income before loan loss provision	\$ 2,000	\$ 2,000	\$ 2,000	\$ 3,000
Tax bad-debt deduction	<u>(160)</u>	<u>(240)</u>	<u>(160)</u>	<u>(260)</u>
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>

Deferred tax amounts are shown below.

	20X0	20X1	20X2	20X3	20X4
Deferred Tax Balance					
Deductible temporary difference*	\$ 500	\$ 500	\$ 300	\$ 600	\$ 580
Taxable temporary difference**		<u>(60)</u>		<u>(60)</u>	
Net temporary difference	<u>\$ 500</u>	<u>\$ 440</u>	<u>\$ 300</u>	<u>\$ 540</u>	<u>\$ 580</u>
DTA — net	<u>\$ 200</u>	<u>\$ 176</u>	<u>\$ 120</u>	<u>\$ 216</u>	<u>\$ 232</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).

	20X1	20X2	20X3	20X4
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)
	<u>760</u>	<u>760</u>	<u>640</u>	<u>1,080</u>
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 annual effective tax rate (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."

3.16 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.

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:

- It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.
- 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.
- Each tax position shall be evaluated without consideration of the possibility of offset or aggregation with other positions. [FIN 48, paragraph 7]

ASC 740-10 (continued)

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.

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.

ASC 740-10 (continued)

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]

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.¹

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

¹ 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).

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., a net operating loss or 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 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.

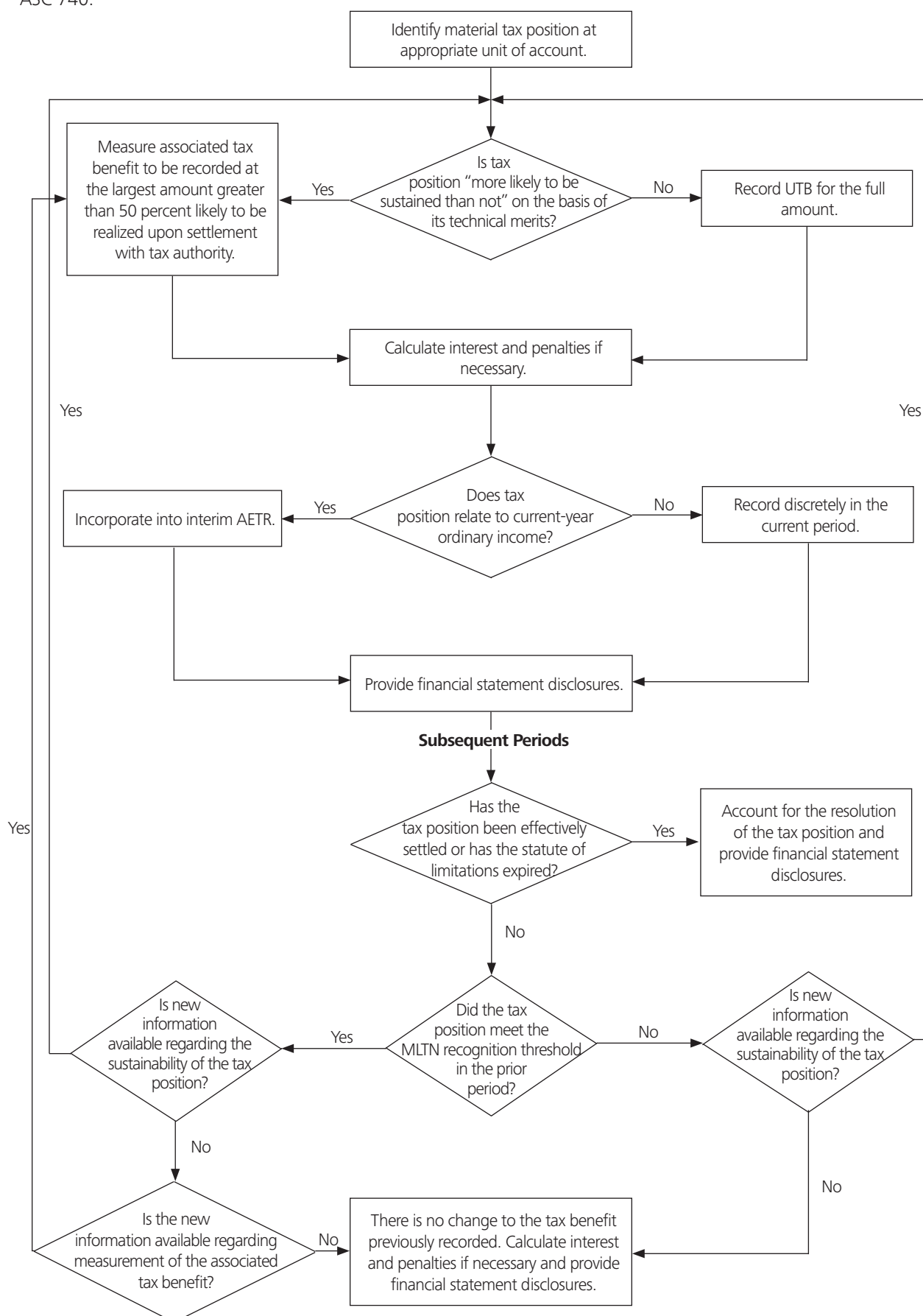
The following table summarizes the different assumptions an entity uses when applying steps 1 and 2:

Step 1 — Recognition	Step 2 — Measurement
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

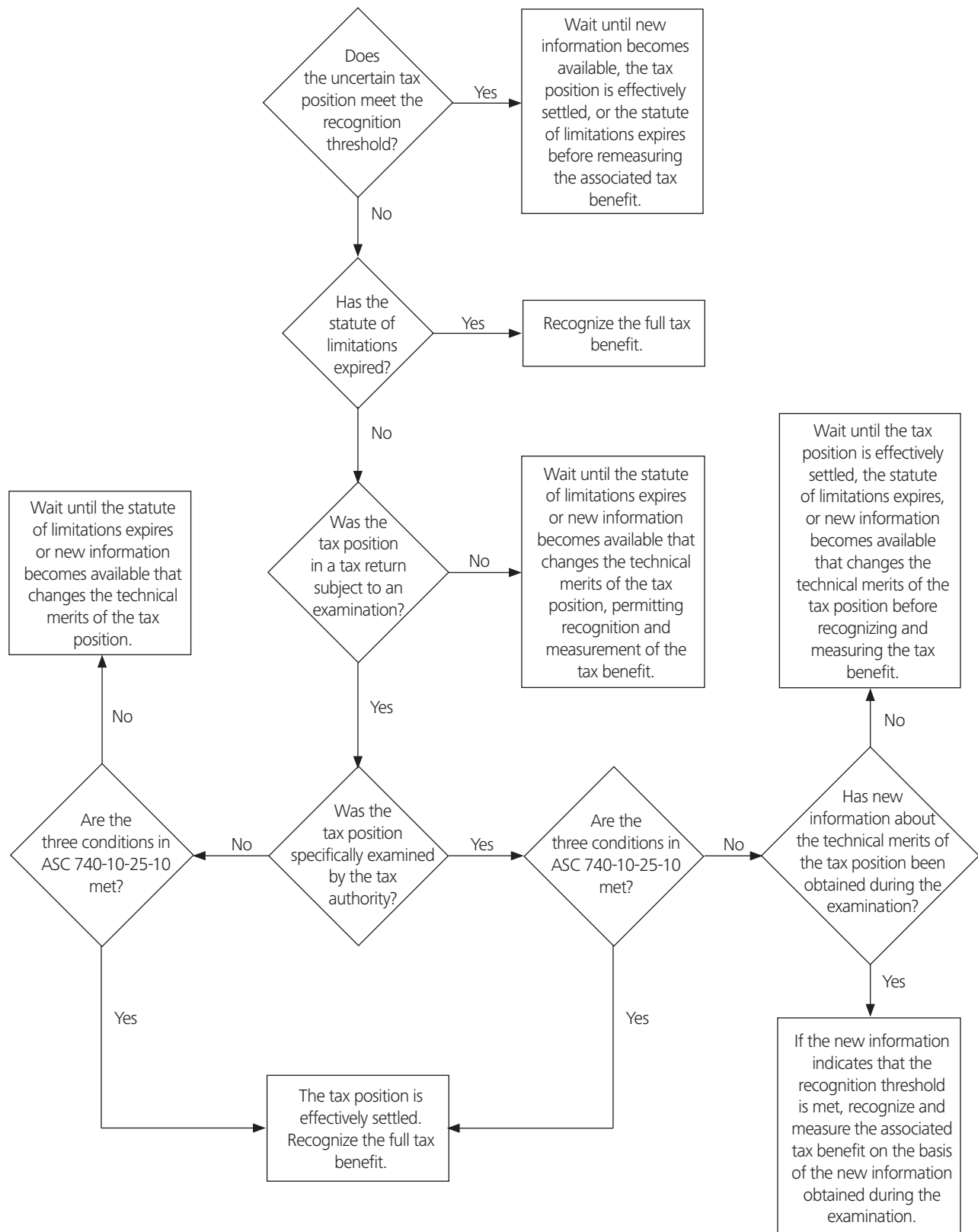
Once determined, the unit of account for a tax position should be the same for each position and similar positions from period to period unless changes in facts and circumstances indicate that a different unit of account is appropriate.

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:

- 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."

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:

	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:

	Tax			
	Ordinary Income	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	1,000	300	—	300
	<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 SEC Staff Accounting Bulletin 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.
- 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]

ASC 740-10 (continued)

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.
- 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]

ASC 740-10 (continued)

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]

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]

ASC 740-10 (continued)

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]

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, 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).

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.

Example 3-20 (continued)

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 post-acquisition 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.

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:

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

^(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) Before adoption of ASU 2015-07.

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. For financial reporting purposes, B defers the income recognition 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. The accounting method change results in the following adjustments to the income tax accounts:

Debit (Credit)	Before	Impact of Form 3115	After
DTA — advance payments	\$ 200	\$ (200)	\$ —
Current tax payable		200	200

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

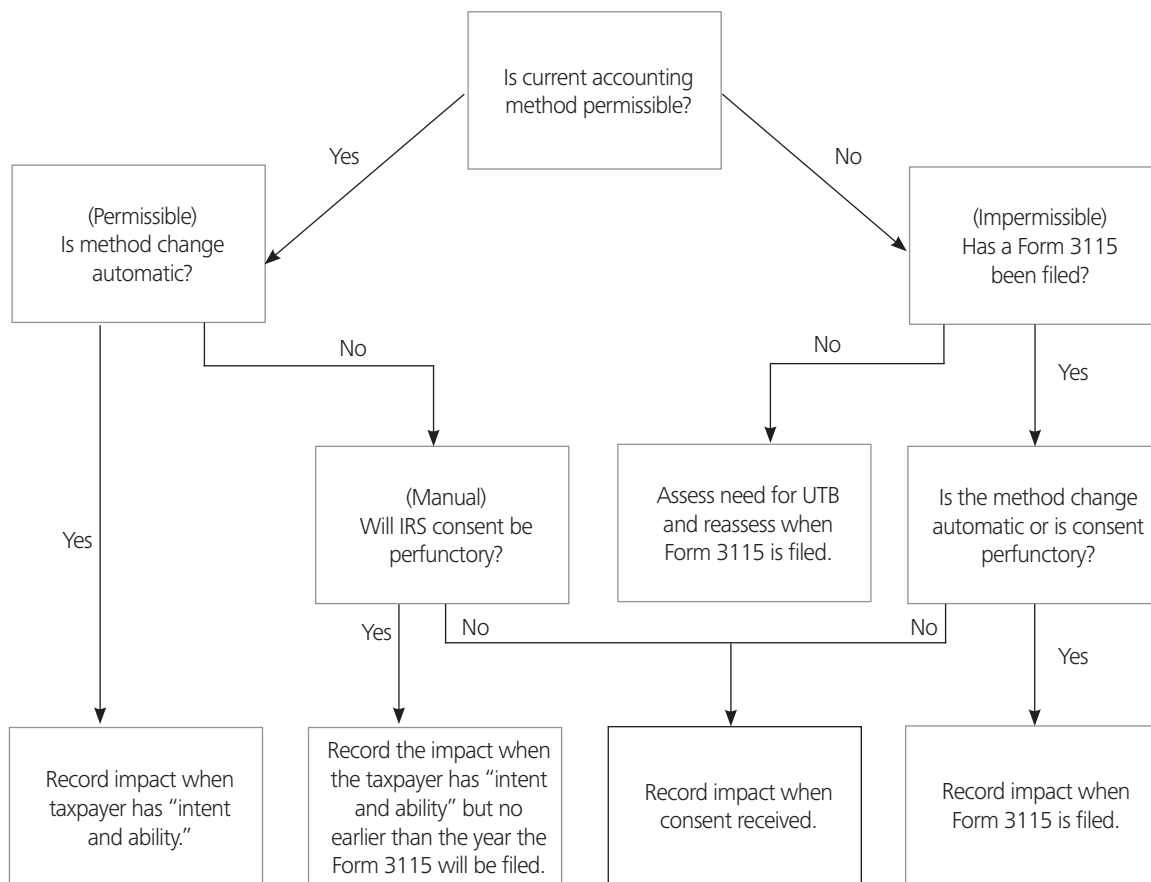
Generally, the impact of a manual change in a federal income tax accounting method from one permissible method to another permissible method should be recognized when the entity has filed a Form 3115 and has received the affirmative written consent of the IRS. However, if consent of the IRS is considered 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:

	Foreign Branch	U.S. State
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.

Example 3-22A (continued)

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

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

U.S. Temporary Difference	Beginning of Year	Calendar Year	End of Year
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		Debit	Credit
DTL		1,500	
CTA			1,500
Journal Entry: View B		Debit	Credit
DTL		1,500	
Transaction gain or 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]

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)).
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)).

(Table continued)

Accounting Description	Treatment	Tax Treatment
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 entity² may separately elect its tax classification, or tax status,

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

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 liabilities 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 liabilities 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 liability) 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 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).³

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).

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

Example 3-23B (continued)

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 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.

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 earnings and profits 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 earnings and profits, 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.⁴ 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.⁵

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.

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 National 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.

⁴ 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.

⁵ 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 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, **actions and elections that are expected to be implemented** 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).

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	\$ 1,000	\$ 1,000
Income tax expense		
Current	340	400
Deferred	—	30
Total	340	430
Net income	\$ 660	\$ 570
ETR	34%	43%

Example 3-25 (continued)

Balance Sheet (Select Accounts)	December 31	
	20X2	20X3
DTL	\$ 170	\$ 200
Equity CTA	500	500
Deferred tax thereon	(170)	(170)
Net balance	\$ 330	\$ 330

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:

- 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.
- 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.
- 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.

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>
Total tax provision	\$	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.

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.

New in the 2016 Edition:

The following new guidance has been added to Chapter 4:

- [4.28A — Assessing Realization of a Deferred Tax Asset for Regular Tax Net Operating Loss Carryforwards When an Entity Anticipates Paying AMT Perpetually.](#)
- [4.52A — Accounting for Income Taxes in the Balance Sheet of Separate Financial Statements: Deferred Tax Assets Related to Tax Attributes.](#)

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.

ASC 740-10 (continued)

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]

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:

- 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.
- Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (see paragraph 740-10-30-8).
- Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate.
- Measure deferred tax assets for each type of tax credit carryforward.
- 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.¹

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.

¹ For ease of illustration, currency differences are ignored.

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]

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]

ASC 740-10 (continued)

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 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 capital gains tax 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%

- 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:

	Future Years		
	20X2	20X3	20X4
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>\$ 400,000</u>	<u>\$ 100,000</u>	<u>\$ 50,000</u>
Tax based on graduated tax rates:			
(\$50,000 × 15%)	7,500	7,500	7,500
(\$25,000 × 25%)	6,250	6,250	
(\$25,000 × 34%)	8,500	8,500	
(\$235,000 × 39%)	91,650		
(over \$335,000 × 34%)	<u>22,100</u>		
(b) Estimated tax	<u>\$ 136,000</u>	<u>\$ 22,250</u>	<u>\$ 7,500</u>
(c) Applicable tax rate (b ÷ a)	34%	22.3%	15%
Deferred income tax (\$10,000 × c)	<u>\$ 3,400</u>	<u>\$ 2,230</u>	<u>\$ 1,500</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.

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:

	DTA (DTL)
Taxable temporary difference (\$1,000 × 34%)	\$ (340)
Deductible temporary difference (\$250 × 34%)	85
AMT credit carryforward	<u>100</u>
Net DTL before management’s assessment of the need for a valuation allowance	<u><u>\$ (155)</u></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**.

Example 4-7 (continued)

Case 3

Assume the same facts as in Cases 1 and 2, except:

- The entity's DTAs and DTLs are computed as follows:

	DTA (DTL)
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.

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%

Example 4-8 (continued)

- 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 $[(1+2) \times 60\%]$	<u>(780,000)</u>	<u>(240,000)</u>	<u>—</u>
4. Expected future taxable income (loss)	<u>\$ 520,000</u>	<u>\$ 160,000</u>	<u>\$ (100,000)</u>
5. Expected future tax liability*	<u>\$ 176,800</u>	<u>\$ 45,650</u>	<u>\$ —</u>
6. Applicable tax rate $(5 \div 4)^{**}$	34%	28.5%	15%
7. DTL (2×6)	<u>\$ 102,000</u>	<u>\$ 85,500</u>	<u>\$ 45,000</u>

* 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:

- 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.
- If there is a basis difference, whether it is temporary and thus must be recognized under ASC 740.
- 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><u>10,750</u></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:

- The amount of taxes that will be payable or refundable in future years inclusive of reversing temporary differences and carryforwards
- 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
Pretax income (loss)	100	(100)	(100)	100	100
Taxable income before NOL carryforward	100	(100)	(100)	100	100
NOL carryforward*	N/A	N/A	N/A	(100)	(100)
Taxable income	100	(100)	(100)	—	—
Statutory tax rate	10%	10%	10%	10%	10%
Total current tax computed on income (greater of capital or income)	10	8	8	8	8
Capital tax	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:

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)
Net operating loss carryforward	—	€ 10,000	€ 10,000	€ 2,500 [a]

Example 4-11A (continued)

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:

- Future reversals of existing taxable temporary differences
- Future taxable income exclusive of reversing temporary differences and carryforwards
- Taxable income in prior carryback year(s) if carryback is permitted under the tax law
- Tax-planning strategies (see paragraph 740-10-30-19) that would, if necessary, be implemented to, for example:
 - Accelerate taxable amounts to utilize expiring carryforwards
 - Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
 - 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]

ASC 740-10 (continued)

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]

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, infrequent, or extraordinary item) is an aberration rather than a continuing condition. [FAS 109, paragraph 24]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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 securities from earnings and report them as a net amount in OCI. ASC 320-10-35-18 requires that an entity assess 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, 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 only records 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.

Under U.S. GAAP, 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 4.29 for additional discussion on 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.

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].”

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 a 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.” 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 paragraph 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.

Office Buildings in the United Kingdom

For tax purposes, certain office buildings and other real estate cannot be depreciated under U.K. tax law. In addition, the tax basis of such property is 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, and the use of capital losses is limited to offsetting capital gains. 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 for which a DTA is recognized under ASC 740.

Because the inflation rate in the United Kingdom is moderate, the U.K. pound is the functional currency for most U.K. operations and, in accordance with ASC 740-10-25-20(g), the deferred tax consequences of indexing for tax purposes will be included in the consolidated financial statements of entities with U.K. operations that own real property subject to indexing. The reversal of the temporary difference between the indexed adjusted tax basis and the net book value of the property for financial reporting purposes should be assumed to occur during the year in which the building is expected to be sold or abandoned.

ASC 740-10-30-18 indicates that “realization of the tax benefit of an existing deductible temporary difference . . . ultimately depends on the existence of sufficient taxable income of the appropriate character.” Further, this paragraph lists “four possible sources of taxable income [that] may be available under the tax law,” which an entity should consider in determining whether realization is more likely than not. In addition, 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 that will result in taxable or deductible amounts . . . when the reported amount of the asset or liability is recovered or settled, respectively.” Therefore, an entity with operations in the United Kingdom should consider all sources of taxable income available in that jurisdiction when assessing whether realization of the resulting deductible temporary difference is more likely than not.

Such an entity should also consider that it would not be appropriate to provide a valuation allowance on the basis of the assumption that little or no tax would ultimately be paid on the eventual sale of the property. Because the indexed tax basis of the property will be included in the determination of the gain or loss on the sale, the realization of the difference between the book basis and the tax basis of the property would almost always be deemed more likely than not. If the entity does not provide a valuation allowance in this situation, the effective tax rate in the year of sale is somewhat normalized because the tax consequences of the reduction of the DTA from the sale are offset by the gain that would be reported for financial reporting purposes but not for tax purposes.

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 of 1986 (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-contract 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 permanently 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 FTCs 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:

Example 4-15 (continued)

Future Years	(Originating) Reversing Amount
20X2	\$ (60)
20X3	44
20X4	90
20X5	90
20X6	<u>(14)</u>
	<u>\$ 150</u>

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:

Future Years	(Originating) Reversing Amount
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 Net Operating Loss 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.

Example 4-15A (continued)

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:

	Regular Tax		AMT	
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 × 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 AMTI × 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.

	Regular Tax		AMT	
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		1,000 A	
NOL deduction	<u>(500)</u>		<u>0</u>	
Taxable income	100 B		1,000 B	
Tax rate	<u>35% C</u>		<u>20% C</u>	
Taxes payable with NOL carryforward (B × C)	\$ 35		\$ 200	
Taxes payable without NOL carryforward (A × C)	\$ 210		\$ 200	

Example 4-15B (continued)

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 ($\600×35 percent). However, because of the NOL carryforwards, the entity would not have any current tax payable from the regular tax system but rather would have to pay \$200 of minimum tax ($\$1,000 \text{ AMTI} \times 20$ percent). Accordingly, the 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 \text{ percent}) - \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.

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 liabilities 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>

Example 4-19 (continued)

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.
- 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 × 40%)	<u>400</u>
Total valuation allowance	<u>\$ (600)</u>
DTA (\$9,000 × 40%)	\$ 3,600
Less: valuation allowance	<u>(600)</u>
Net DTA	<u>\$ 3,000</u>

Example 4-20 (continued)

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,² 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.³

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 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.

² IRC Section 275(a)(4)(A) and Treas. Reg. Section 1.901-1(h)(2).

³ Treas. Reg. Section 301.6511(d)-3.

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 income \times 25% 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 $(\$300 \text{ distribution} \times 35\% \text{ tax rate})$.

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 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 permanent differences.⁴ 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.

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.

⁴ While adjustments would typically be made for permanent items such as nondeductible goodwill impairments and meals and entertainment, 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.

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 such circumstances, 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.

However, the fact that a going-concern explanatory paragraph is not included 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.

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.

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 income⁵ 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 losses⁶ 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:

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**:

⁵ For more information on developing estimates of future income, see 4.40 and 4.41.

⁶ 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 (continued)

	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>

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:

- 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
- 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
- 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 pre-acquisition NOL carryforwards. Company L's existing contracts will produce sufficient taxable income to enable use of the loss carryforwards.

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 4-35⁷ 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.

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.

⁷ Note that similar examples may not result in a similar conclusion. An entity must use judgment in determining whether a valuation allowance is necessary.

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:

	Amount
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	25
	<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.
- 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			Three Year Total
	20X4	20X3	20X2	
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>

Example 4-37 (continued)

- 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, extraordinary items, 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]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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 SEC Staff Accounting Bulletin 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:

Description	Separate-Return Approach			Sum of Separate- Return Tax Expense	Consolidated	
	P (Stand-Alone)	S1	S2		P	Difference
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			Sum of Separate- Return Tax Expense	Consolidated	
	P	S1	S2		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)	<u>\$ 120</u>	<u>\$ (40)</u>	<u>\$ 160</u>	<u>\$ 240</u>	<u>\$ 240</u>	<u>\$ 0</u>

* 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:

	Parent		S1		S2		
	Amount	Relative Percentage	Amount	Relative Percentage	Amount	Relative Percentage	Total
Pretax income (loss)	\$ 300	53%	\$ (100)	(17)%	\$ 400	67%	\$ 600
Permanent items	<u>\$ 100</u>		<u>\$ 50</u>		<u>\$ (200)</u>		<u>\$ (50)</u>
Pretax income (loss) adjusted for permanent items	\$ 400	73%	\$ (50)	(9)%	\$ 200	36%	\$ 550
Tax rate	40%		40%		40%		<u>40%</u>
Consolidated tax							<u><u>\$ 220</u></u>

Example 4-39A (continued)

On the basis of the assumptions above, the group members would record the following tax expense in accordance with the allocation method chosen:

	Parent		S1		S2		
	Tax Allocated	Relative Percentage	Tax Allocated	Relative Percentage	Tax Allocated	Relative Percentage	Total
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

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 225-10-599-3 (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.

A separate reporting entity generally should not present hypothetical DTAs, along with any required valuation allowance, in the balance sheet of its separate financial statements. Generally, two approaches exist,⁸ 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 additional paid-in capital.

⁸ If the separate-return method has been modified for realizability, an entity would be required to apply the first approach because once the parent has used the tax attribute, realization of the tax attribute in the separate financial statements has occurred in a manner consistent with the initial conclusion about the recognition of the attribute in the separate financial statements (i.e., it cannot be realized again).

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.

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.

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	[5 million NOL carryforward × 40% tax rate]
Deferred tax benefit		2 million

If it elects not to record the hypothetical DTA, it would record the following entries:

NOL DTA	2 million	
Deferred tax benefit		2 million
Retained earnings	2 million	
NOL DTA		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	
Paid-in capital		400

To record the income tax consequences of generating \$1,000 of income during 20X1, on the basis of a tax rate of 40 percent.

Journal Entry — Consolidated Group Member S2

Retained earnings*	400	
Income tax benefit from loss on continuing operations		400

To record the income tax consequences of incurring a \$1,000 loss during 20X1, on the basis of a tax rate of 40 percent.

* If S2 did not have retained earnings, the allocation would create a DTA. However, if S2 left the group, no NOL would be allocated to S2.

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 stand-alone 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 basis⁹), 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.¹⁰ 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 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)¹¹ 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

⁹ 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.

¹⁰ See 4.49 for guidance on acceptable methods of allocating income taxes to members of a group.

¹¹ A separate allocation to individual divisions that operated within a single legal entity is not required.

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 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.

4.58 *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 disregarded entity (i.e., a corporation) or can be disregarded as an entity separate from its owner.¹² 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

¹² While the entity is disregarded for federal income tax purposes, it continues to be regarded as an entity for all other purposes.

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.

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 $(\$200 \times 40 \text{ percent})$ 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)

	20X7	20X8	20X9	20Y0	20Y1	Totals
EBITDA	\$ 1,200	\$ 1,200	\$ 1,200	\$ 1,200	\$ 1,200	\$ 6,000
Depreciation	(200)	(200)	(200)	(200)	(200)	(1,000)
Interest	—	—	—	—	—	—
NIBT	<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>
Tax income	<u>\$ 200</u>	<u>\$ 1,200</u>	<u>\$ 1,200</u>	<u>\$ 1,200</u>	<u>\$ 1,200</u>	<u>\$ 5,000</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>
Net income	<u>\$ 600</u>	<u>\$ 600</u>	<u>\$ 600</u>	<u>\$ 600</u>	<u>\$ 600</u>	<u>\$ 3,000</u>
ETR:	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)	—
Journal Entries	20X7	20X8	20X9	20Y0	20Y1	
Current tax provision	\$ 80	\$ 480	\$ 480	\$ 480	\$ 480	
Cash or current tax liability	(80)	(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	
Cash or increase in current tax liability	—	(80)	(80)	(80)	(80)	
Cash or reduction in current tax liability	—	80	80	80	80	
ASC 740 provision	—	(80)	(80)	(80)	(80)	
Long-term UTB liability	—	80	80	80	—	
Current UTB liability	—	(80)	(80)	(80)	—	
	20X7	20X8	20X9	20Y0	20Y1	
Supplemental cash flow statement disclosure						
Income taxes paid	\$ 80	\$ 480	\$ 480	\$ 480	\$ 480	
UTBs						
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>	

Example 4-42 (continued)

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.

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]

ASC 740-10 (continued)

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]

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.¹ 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 deduction × 35% 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.

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.

¹ 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.

Example 5-1²

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 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.

² 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.

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		<u>(100,000)</u>			
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	<u>160,000</u>	<u>(15,000)</u>
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	<u>240,000</u>	<u>(20,000)</u>
Total	<u>\$ 400,000</u>	<u>\$ (35,000)</u>

* 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 a net operating loss 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	52.50	26.25	—	—
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]

ASC 740-10 (continued)

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]

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]

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 E, “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.

New in the 2016 Edition:

The following new guidance has been added to Chapter 6:

- [6.07A — Appropriate Federal Statutory Rate for Use in the Rate Reconciliation of a Foreign Reporting Entity.](#)
- [6.07B — Computing the “Foreign Rate Differential” in the Rate Reconciliation.](#)
- [6.27A — Disclosure of the Components of Income \(or Loss\) Before Income Tax Expense \(or Benefit\) as Either Foreign or Domestic — Branches and Intraentity Transactions.](#)
- [Non-GAAP Measures — Treatment of Tax Adjustments.](#)

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 revaluations of the deferred tax balances are not identified separately from revaluations 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.

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.¹ 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.

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.

¹ This would apply to (or **include**) a tax inversion.

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]

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, net operating losses, 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]

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]

ASC 740-10 — SEC Materials (continued)

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]

6. Securities Gains and Losses

Question: If the tax on the securities gains and losses of banks and insurance companies varies by more than 5% from the applicable statutory Federal income tax rate, should a reconciliation to the statutory rate be provided?

[SAB Topic 6.I, paragraph 6 Q]

Interpretive Response: Yes. [SAB Topic 6.I, paragraph 6 Q 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]

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.

(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>UWV</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 2016 Edition:

The following new guidance has been added to Chapter 7:

- 7.06A — Application of ASC 740-20-45-7 to Amounts Credited Directly to APIC.
- 7.06B — Application of ASC 740-20-45-7 to Foreign Currency Exchange Gains.

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:

- Continuing operations
- Discontinued operations
- Extraordinary items
- Other comprehensive income
- Items charged or credited directly to shareholders’ equity. [FAS 109, paragraph 35]

Pending Content (Transition Guidance: ASC 225-20-65-1)

45-2 Income tax expense or benefit for the year shall be allocated among:

- Continuing operations
- Discontinued operations [FAS 109, paragraph 35]
- Subparagraph superseded by Accounting Standards Update No. 2015-01
- Other comprehensive income
- Items charged or credited directly to shareholders’ equity. [FAS 109, paragraph 35]

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]

ASC 740-20 (continued)

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 Intraproduct 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 intraproduct tax allocation.

7.02 Intraproduct Tax Allocation: Application Level

ASC 740-20 does not explicitly state how the intraproduct 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 intraproduct 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, extraordinary items, discontinued operations, 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-32, paragraph 11] Application of this modification makes it appropriate to consider an extraordinary gain in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [FAS 109, paragraph 140]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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]

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:

- 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)
- Changes in tax laws or rates (see paragraph 740-10-35-4)
- Changes in tax status (see paragraphs 740-10-25-32 and 740-10-40-6)
- 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:

- 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)
- Changes in tax laws or rates (see paragraph 740-10-35-4)
- Changes in tax status (see paragraphs 740-10-25-32 and 740-10-40-6)
- 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:

	Without Loss From Discontinued Operations	With Loss From Discontinued Operations (in Accordance With the Tax Return)	Difference
Income from continuing operations	\$ 3,000	\$ 2,000	
Section 199 special deduction	(270)	(180)	
Taxable income	<u>2,730</u>	<u>1,820</u>	
Tax rate	40%	40%	
Income tax per component	<u>\$ 1,092</u>	<u>\$ 728</u>	<u>\$ (364)*</u>
Tax provision — continuing operations	\$ 1,092		
Tax provision — discontinued operations	(364)		
Total income tax expense	<u>\$ 728</u>		

* 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	36
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.¹
 3. "Dividends that are paid on unallocated shares held by an employee stock ownership plan and that are charged to retained earnings."²
 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.

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.

¹ 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.

² See footnote 1.

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 Intraproduct 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 intraproduct 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 net operating loss 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)
Other comprehensive income	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 net operating loss 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 “intraperson 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 intraperson 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 Intraperson 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 Intraproduct 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.

Intraproduct 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	<u>(400)</u>	<u>(160)*</u>
Net income	(100)	140
Capital gain (AFS securities)	600	600
Tax expense	<u>0</u>	<u>(240)</u>
OCI (net of tax)	<u>600</u>	<u>360</u>
Total comprehensive income	<u>\$ 500</u>	<u>\$ 500</u>

* $(1,000 \times 40\%) - (600 \times 40\%)$.

7.09 Intraproduct 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 intraproduct 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 intraproduct 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 intraproduct 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, 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 Intraproduct 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 allocated³ 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.

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.

³ 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.

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 differences⁴) 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 differences⁵) 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 difference⁶). 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.

⁴ See 3.04 for the meaning of "inside" and "outside" basis differences.

⁵ See footnote 2.

⁶ See footnote 2.

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.

Deferred taxes associated with the stock of the component being sold (the outside basis difference⁷) 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 differences⁸) 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 differences⁹) 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.

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 . . . ordinarily are 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.

⁷ See footnote 2.

⁸ See footnote 2.

⁹ See footnote 2.

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]

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]

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]

ASC 740-20 (continued)

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 740-20 (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

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

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.

7.22 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 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.

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.

New in the 2016 Edition:

The following new guidance has been added to Chapter 8:

- 8.03A — Outside Basis Difference in a Foreign Subsidiary — Subpart F Income.
- 8.03B — Outside Basis Difference in a Foreign Subsidiary — “Deferred” Subpart F Income.

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.

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]

ASC 740-30 (continued)

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]

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:

Investment	DTA Considerations	DTL Considerations
<ul style="list-style-type: none"> • Domestic subsidiary • Domestic 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.”	<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"> • 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. • 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.
<ul style="list-style-type: none"> • 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).

(Table continued)

Investment	DTA Considerations	DTL Considerations
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 earnings and profits 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 earnings and profits 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 earnings and profits, but will become includible 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 earnings and profits (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)	<u>250</u>
U.S. taxable income recognized	360
U.S. tax rate	<u>35%</u>
U.S. tax liability before FTC	(126)
FTC	<u>250</u>
Excess FTC	<u>\$ 124</u>

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.

Upon consolidation of a VIE, an entity must apply the income tax accounting guidance in ASC 740. Specifically, the entity will need to determine the temporary differences that exist as of the date the entity consolidates the VIE. The entity must consider the accounting for 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. ASC 740-30-20 defines a subsidiary as an “entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a [VIE] that is consolidated by a primary beneficiary.)” See 8.01 for a discussion of foreign versus domestic subsidiaries.

When determining whether an exception to recording an outside basis difference may apply to a VIE, an entity should consider whether it has the ability to make the assertions necessary to apply the exception. The table below summarizes the exceptions for recording a DTA or DTL on outside basis differences and considerations for entities that consolidate a VIE.

Note that the activities to control whether an exception to recording a DTL is met may not be the same activities that most significantly affect the VIE’s economic performance under ASC 810-10-25-38A. Provided that the entity controls these activities and that the other criteria for the exception are met, a primary beneficiary of a VIE may apply the outside basis exceptions. However, meeting some of these exceptions may be challenging. When determining which party has the power to control decisions regarding the distribution of earnings, an entity should consider how the VIE is controlled (i.e., through contract or governing documents rather than voting interests) and the other parties to the arrangement.

Investment	Exception to Recording a DTA	Exception to Recording a DTL	Additional Considerations for a Primary Beneficiary of a VIE
Foreign VIE for which the reporting entity is the primary beneficiary	A DTA is not recorded for the tax basis over the financial reporting basis of the temporary difference in the investment unless the temporary difference will reverse in the foreseeable future.	A DTL is recorded for the financial reporting basis over the tax basis of the temporary difference of an investment in an entity that is essentially permanent in duration unless the entity has invested or will invest the undistributed earnings indefinitely.	When determining whether deferred taxes should be recorded on the outside basis difference, entities should consider whether they control the ability to distribute earnings of the foreign VIE.
Domestic VIE for which the reporting entity is the primary beneficiary and undistributed earnings arose in fiscal years beginning after December 15, 1992	A DTA is not recorded for the tax basis over the financial reporting basis of the temporary difference in the investment unless the temporary difference will reverse in the foreseeable future.	A DTL is recorded for the financial reporting basis over the tax basis of the temporary difference ¹ unless the investment can be recovered in a tax-free manner without significant cost and the entity expects to use this means of recovery.	<ul style="list-style-type: none"> When determining whether a DTA should be recorded, entities should consider whether they can assert that the temporary difference will reverse in the foreseeable future. When determining whether a DTL should be recorded, entities should consider whether they can recover the investment in a tax-free manner without significant cost and whether they expect to use this means of recovery.

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

¹ Note that ASC 740-30-25-7 refers to “an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary.” Often a VIE will not be controlled through voting rights and, therefore, a reporting entity will need to use judgment to resolve whether this exception in ASC 740 (1) applies when the entity has the power to direct the most significant activities of the VIE and (2) determines that the entity can recover its investment in the VIE in a tax-free manner.

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."

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 $[(\$100,000 + (\$50,000 \times 90\%)) \times 40\%]$	<u>(58,000)</u>
Consolidated net income	92,000
Less: net income attributable to noncontrolling interests (\$50,000 \times 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 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.

Company	Original Carrying Amount	Original Ownership Interest	Carrying Amount 1/1/20Y0	Ownership Interest 1/1/20Y0
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>

Example 8-10 (continued)

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 million selling price – (\$70 million tax basis × 12.5% portion sold)] × 40% 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 million selling price – (\$80 million book basis × 12.5% portion sold)] × 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 million book basis – \$70 million tax basis) × 12.5% portion sold] × 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.

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.

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]

ASC 740-30 (continued)

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 paragraph 205-20-45-1 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]

Pending Content (Transition Guidance: ASC 205-20-65-1)

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]

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 accrual of those income taxes shall not be accounted for as an extraordinary item. 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.

ASC 740-30 (continued)

Pending Content (Transition Guidance: ASC 225-20-65-1)

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 subsidiary² 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 the indefinite reversal exception to recognition of DTLs for undistributed earnings of a domestic subsidiary generated in fiscal years beginning 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 (see 8.16).

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. Since a deductible outside basis difference in a subsidiary generally reverses only upon sale or taxable liquidation of the subsidiary (i.e., it is not expected to reverse in the normal course of business), 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.

² See 3.02 for a discussion of the definition of “subsidiary.”

At the point the criteria in ASC 360-10-45-9 through 45-11 for a measurement date have been met, 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

ASC 740-30-25-5(a) does not allow the indefinite reversal exception to recognition of DTLs for undistributed earnings of a domestic subsidiary and a domestic corporate joint venture. Rather, under this paragraph, investors owning more than 50 percent of the voting capital must record a DTL unless the tax law provides a means by which the investment can be recovered tax-free. ASC 740-30-25-5(b) requires recognition of a DTL for the tax consequences of an excess of the amount for financial reporting purposes over the tax basis of a 50-percent-or-less-owned investee (i.e., accounted for as an equity method investment under ASC 323), because the investor does not have majority voting power and cannot control dividend distributions, like-kind distributions, taxable liquidations, and other events and transactions that may have tax consequences for the investor.

Sometimes an investor may own more than 50 percent of the voting capital of an investee but the minority investor may possess certain participatory rights that, under ASC 810-10-25-2 through 25-14, would prevent the majority investor from controlling the investee. In this situation, neither the majority investor nor the minority investor would control the investee under ASC 810 and the majority investor would be precluded from consolidating the investee. Instead, the majority investor would account for the investee as an equity method investment in accordance with ASC 323.

When an investor (1) owns more than 50 percent of the voting capital of a domestic entity and (2) accounts for that entity under the equity method (i.e., is precluded from consolidation) because it does not control the entity, the recognition of a DTL for the excess of the amount for financial statement purposes over the tax basis is a matter of judgment. The investor must assess the tax consequences to determine whether such an excess is a taxable temporary difference, as defined in ASC 740-30-25-7.

ASC 740-30-25-7 states that an outside basis difference “is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the entity expects that it will ultimately use that means.” Therefore, in the scenario described above, the investor may continue to avoid recognizing deferred taxes for outside basis differences if it can demonstrate that these differences will not result in taxable amounts in future years. Otherwise, the investor would be required to recognize a DTL in accordance with ASC 740-30-25-5(a).

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 the need for a valuation allowance for a DTA related to deductible temporary differences and other DTAs, future taxable income related to taxable temporary differences for which a DTL has not been recognized under the indefinite reversal criterion of ASC 740-30-25-17 should not be considered a source of taxable income. In addition, 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 (in accordance with ASC 740-30-25-13). Those sources of taxable income should not be used to support a conclusion that a valuation allowance is not necessary because a DTL has not been recognized on the related taxable temporary differences on the basis that the differences will not reverse in the foreseeable future. Example 8-13 illustrates this concept.

Example 8-13

Assume that Entity X, a U.S. domestic parent entity, has two foreign subsidiaries, FS1 and FS2. The amount for financial reporting and the tax basis of X's investment in FS1 are \$2,000 and \$3,000, respectively, on December 31, 20X1 (i.e., X has a deductible outside basis difference related to its investment in FS1). The amount for financial reporting and the tax basis of X's investment in FS2 are \$10,000 and \$8,000, respectively, on December 31, 20X1 (i.e., X has a taxable outside basis difference related to its investment in FS2).

Entity X has recorded a DTA related to its investment in FS1, having concluded that it is apparent that the \$1,000 deductible outside basis difference will reverse in the foreseeable future. However, X has not recorded a DTL related to its investment in FS2 because it has asserted that the indefinite reinvestment criteria have been met for the \$2,000 taxable temporary difference, which is attributable to undistributed earnings. Furthermore, FS2 has not previously remitted earnings.

Ordinarily, an existing taxable temporary difference (e.g., from the undistributed earnings of FS2) 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 FS2, and FS2 has not remitted earnings in the past; therefore, X cannot consider those earnings in determining whether it is more likely than not that the DTA representing the tax benefit of the \$1,000 deductible temporary difference on FS1 is realizable. In addition, X cannot assume that the \$1,000 deductible temporary difference existing at the close of 20X1 will be eliminated through additional future earnings of FS1 or other foreign subsidiaries of X (such as FS2) if (1) a DTL has not been recognized for the tax consequences of undistributed earnings of those foreign entities and (2) the foreign entities have not remitted earnings in the past.

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 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).

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; income tax expense for such undistributed earnings shall not be accounted for as an extraordinary item. 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; such adjustment of income tax expense shall not be accounted for as an extraordinary item. [APB 23, paragraph 12]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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; income tax expense for such undistributed earnings shall not be accounted for as an extraordinary item. 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; such adjustment of income tax expense shall not be accounted for as an extraordinary item. [APB 23, paragraph 12]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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; the accrual of those income taxes shall not be accounted for as an extraordinary item. [APB 23, paragraph 13]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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.

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 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
- The cumulative amount of each type of temporary difference
- 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]
- 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.

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, discontinued operations, and extraordinary items (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.

ASC 740-270 (continued)

Pending Content (Transition Guidance: ASC 225-20-65-1)

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.

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.

ASC 740-270 (continued)

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, infrequently occurring, or extraordinary 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 225-20-65-1)

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, infrequently occurring, or extraordinary losses.

Pending Content (Transition Guidance: ASC 225-20-65-1)

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, discontinued operations, or an extraordinary item. [FIN 18, paragraph 18] See Subtopic 740-20 for the requirements to allocate total income tax expense (or benefit).

Pending Content (Transition Guidance: ASC 225-20-65-1)

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
Pretax income	\$ 55,000	\$ 60,000	\$ 60,000
Nondeductible expenses	10,000	15,000	15,000
Deductible temporary difference:			
Restructuring accrual	<u>10,000</u>	<u>25,000</u>	<u>(25,000)</u>
Taxable income	<u>\$ 75,000</u>	<u>\$ 100,000</u>	<u>\$ 50,000</u>

Example 9-1 (continued)

Solution

Estimated AETR — 20X1

Pretax income		\$ 60,000
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)		30.8%

* 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:

Income Statement (Select Accounts)	20X1 Q1
Pretax income	\$ 55,000
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	30.8%

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.

Debits (Credits)	Balance Sheet		Income Statement Provision
	Current Taxes	Deferred Taxes	
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 Intraproduct 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 intraproduct 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	40%
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)	

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	Tax Receivable (Payable)
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>\$ (400,000)</u>		<u>\$ 120,000</u>	<u>\$ 300,000</u>		<u>\$ (120,000)</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).

Example 9-4 (continued)

Alternative 2

Quarter	Continuing Operations			Discontinued Operations			Balance Sheet
	Income/ (Loss)	AETR	Tax	Income/ (Loss)	AETR	Tax	Tax Receivable (Payable)
First	\$ (100,000)		\$ 120,000	\$ 300,000	40%	\$ (120,000)	\$ —
Second	(100,000)						—
Third	(100,000)						—
Fourth	(100,000)						—
	<u>\$ (400,000)</u>		<u>\$ 120,000</u>	<u>\$ 300,000</u>		<u>\$ (120,000)</u>	<u>\$ —</u>

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	Tax Receivable (Payable)
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	(100,000)	30%	30,000			(30,000)	—
	<u>\$ (400,000)</u>		<u>\$ 120,000</u>	<u>\$ 300,000</u>		<u>\$ (120,000)</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 Ordinary Income Cannot Be Reliably Estimated

Generally, an entity can reliably estimate ordinary income (or loss). If an entity cannot reliably estimate part of its ordinary income (or loss), the tax expense (or benefit) related to the individual item would be reported separately in the interim period in which the item occurs. In cases in which the AETR is highly sensitive to estimates of total ordinary income (or loss) levels, the best estimate of the AETR may be the actual year-to-date rate as of the interim period. Common examples include (1) nominal profits and significant permanent differences or tax credits compared with ordinary income such that minor fluctuations in these estimates could result in significant fluctuations of the entity's AETR and (2) recognition of significant foreign exchange gains and losses. The determination of what constitutes a "reliable estimate" is a matter of professional judgment.

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 Intraproduct 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 reclass 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 reclass 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†	400	400	400	400	1,600
Reduction in valuation allowance as a result of reduction in gross DTAs‡	(400)	(400)	(400)	(400)	(1,600)
Reduction in valuation allowance as a result of changes in judgement over the future years§	—	(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.

† 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.

‡ 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.

§ 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.

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>\$ 1,500</u>
Estimated ETR ($\$1,500 \div \$2,500$)	<u>60%</u>
Income earned in the first quarter of 20X2	<u>\$ 2,000</u>
Income tax expense for the first quarter of 20X2	<u>\$ 1,200</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

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	(800)
Estimated taxable income	7,200
Tax rate	35%
Current tax expense	2,520
Deferred tax expense	280
Estimated annual tax provision	\$ 2,800
Estimated AETR	35%

Estimated Change in DTA

	Gross	Tax Rate	DTA
1/1/20X2	\$ 1,000	35%	\$ 350
12/31/20X2	200	35%	70
Change	\$ 800		\$ 280

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	35%	35%	5%	40%	40%
DTA	\$ 350	\$ (35)	\$ 45	\$ (280)	\$ 80

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	<u>(800)</u>
Estimated taxable income	7,200
Tax rate	<u>40%</u>
Current tax expense	2,880
Deferred tax expense	<u>315*</u>
Estimated annual tax provision	<u>\$ 3,195</u>
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	<u>35%</u>	<u>35%</u>	<u>5%</u>	<u>40%</u>	<u>40%</u>
DTA (DTL)	<u>\$ 105</u>	<u>\$ 70</u>	<u>\$ 25</u>	<u>\$ (240)</u>	<u>\$ (40)</u>

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	<u>35.0%</u>	<u>39.9%</u>	<u>39.9%</u>	<u>39.9%</u>
Tax (cumulative)	700	1,598	2,396	3,195
Discrete tax (cumulative)	<u>—</u>	<u>(70)*</u>	<u>(70)</u>	<u>(70)</u>
Total income tax (cumulative)	\$ 700	\$ 1,528	\$ 2,326	\$ 3,125
Previously recorded	<u>\$ —</u>	<u>\$ 700</u>	<u>\$ 1,528</u>	<u>\$ 2,326</u>
Tax expense for quarter	<u>\$ 700</u>	<u>\$ 828</u>	<u>\$ 798</u>	<u>\$ 799</u>
ETR	35.0%	41.4%	39.9%	39.9%

Quarterly OCI Changes

	Q1	Q2	Q3	Q4
OCI (pretax)	\$ (300)	\$ 200	\$ 200	\$ 300
Tax	<u>105</u>	<u>(75)**</u>	<u>(80)</u>	<u>(120)</u>
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.¹¹

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.

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>\$ 80,000</u>					<u>\$ 40,000</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>\$ (15,000)</u>					<u>\$ (5,000)</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.

¹ 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 (continued)

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	—	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>\$ 65,000</u>				<u>\$ 35,000</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 extraordinary items that will be separately reported or 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]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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 extraordinary items that will be separately reported or reported net of their related tax effect also shall be excluded from the estimated annual effective tax rate calculation. This description of significant unusual or extraordinary items includes unusual items, infrequently occurring items, discontinued operations, and extraordinary items.

Pending Content (Transition Guidance: ASC 225-20-65-1)

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.

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).

ASC 740-270 (continued)

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.

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.

ASC 740-270 (continued)

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.

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.

ASC 740-270 (continued)

- 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.

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.

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.

ASC 740-270 (continued)

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		XXX
Total tax provision	\$	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:

- 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.
- 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)				
	A	B	C	Total	Combined — Excluding C	Year to Date — Excluding C	AETR	Year to Date	Less Previously Reported	Reporting Period
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	10,000
Third quarter	20,000	10,000	(10,000)	20,000	30,000	90,000	33%	30,000	20,000	10,000
Fourth quarter	20,000	10,000	—	30,000	30,000	120,000	33%	40,000	30,000	10,000
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%

Example 9-13 (continued)

Quarterly tax computations are as follows:

Reporting Period	Ordinary Income (Loss)				Year to Date	Tax Expense (Benefit)			
	A	B	C	Total		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	<u>80,000</u>	<u>40,000</u>	<u>(20,000)</u>	<u>100,000</u>					<u>39,000</u>

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, discontinued operations, and extraordinary items for the year-to-date period. [FIN 18, paragraph 16]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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 Extraordinary items and 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 such 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, infrequently occurring, or extraordinary 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.

Pending Content (Transition Guidance: ASC 225-20-65-1)

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, extraordinary items, discontinued operations, and so forth. That requirement also pertains to reporting the tax benefit of an operating loss carryforward in interim periods. [FIN 18, paragraph 20]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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. The tax benefits of interim losses accounted for in this manner would not be reported as extraordinary items in the results of operations of the interim period. [APB 28, paragraph 20]

Pending Content (Transition Guidance: ASC 225-20-65-1)

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 component before the date on which the criteria in paragraph 360-10-45-9 are met. The term discontinued component refers to the disposal of a component of an entity. [FIN 18, paragraph 19]

Pending Content (Transition Guidance: ASC 205-20-65-1)

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 component, prior to the interim period in which the date on which the criteria in paragraph 360-10-45-9 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 component 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), based on 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 component 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 component. [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.

ASC 740-270 (continued)

Pending Content (Transition Guidance: ASC 205-20-65-1)

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.

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. 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. The guidance in this chapter is applicable for entities who have not adopted the new guidance. 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.

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]

ASC 718-740 (continued)

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]

Pending Content (Transition Guidance: ASC 718-40-65-1)

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]

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.

ASC 718-740 (continued)

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 capital gains tax 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

Some share-based payment awards (e.g., ISOs or awards granted under a qualified ESPP) are not tax-deductible to the grantor unless a disqualifying disposition occurs. Therefore, when compensation cost related to such awards is recorded, no DTA is recognized, and, accordingly, no corresponding tax benefit is recorded in the income statement.

A company should not record a tax benefit in the income statement for non-tax-deductible awards (e.g., ISOs) that are expected to be subject to disqualifying dispositions. ASC 718-740-25-3 explains that the tax effects of an event (e.g., a disqualifying disposition) that gives rise to a tax deduction for awards that ordinarily do not result in tax deductions should not be accounted for **until** the event 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. If the tax deduction exceeds the cumulative compensation cost recorded, a tax benefit would be recorded in the income statement on the basis of the compensation cost of that award recorded in the financial statements. The tax benefit of any excess of the amount of the deduction taken over the cumulative compensation cost recorded

would be recorded in APIC and included in the employer's "APIC pool" when realized. See 10.18 for a discussion of the APIC pool and the accounting for income tax effects of share-based payment awards.

If the tax deduction is less than the cumulative compensation cost recorded in the financial statements, the tax benefit to be recorded should be based on the actual tax deduction resulting from the disqualifying disposition of the award. Therefore, when a disqualifying disposition occurs, the amount of the tax benefit recorded in the income statement is based on the lesser of the (1) actual deduction taken and (2) cumulative compensation cost recorded in the financial statements.

Example 10-1

A company grants an 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 and related tax benefit are 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 \$40 in the income statement and an increase to APIC (which would also serve to increase its APIC pool) of \$8 $[(\$120 \text{ deduction taken in the tax return} - \$100 \text{ grant-date fair-value-based measure}) \times 40\% \text{ tax rate}]$.

Example 10-2

A company grants an 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 tax benefit or DTA is recorded because the award does not result in a tax deduction to the company.

Assume a disqualifying disposition occurs and results in the company's taking a deduction of \$80 in its tax return. 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.

The FASB Statement 123(R) Resource Group discussed this scenario at its July 21, 2005, meeting and agreed that the direct tax effects of share-based compensation awards should be accounted for under the ASC 718 income tax accounting model.¹ 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.

¹ 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

On January 1, 20X1, U.S. Parent (USP) grants two nonqualified options: one option to a U.S. employee and one option to an employee of USP's wholly owned foreign subsidiary, FS. Each option has an exercise price of \$40 and a grant date fair value of \$30. The options vest after the employees provide one year of service from the date of the grant. Both employees exercise the options on July 1, 20X2, when the share price is \$110. The U.S. federal tax rate is 40 percent, and the tax rate in FS's tax jurisdiction is 30 percent. Note that USP has asserted that the earnings of FS are indefinitely reinvested. Assume that there has been no movement in the foreign exchange rates during the year.

The following journal entries illustrate the accounting for this example:

Journal Entries: To Recognize Stock Compensation Expense and Associated Deferred Tax Asset and Benefit Over Vesting Period (January 1, 20X1 – December 31, 20X1)

USP

Stock compensation expense	30	
Investment in FS	30	
APIC		60

FS

Stock compensation expense	30	
APIC		30

To record the compensation expense, USP records an increase in its investment in FS related to the option that was granted to an employee of FS, and FS records a corresponding equity entry in its books. Upon consolidation, USP would consolidate FS's stock compensation expense, and the investment in FS and FS APIC would be eliminated. Note that this entry does not affect the outside financial reporting basis of USP's investment in FS because the stock compensation expense recognized by FS will be closed out in retained earnings.

USP

DTA	12	
Deferred tax expense		12

FS

DTA**	9	
Deferred tax expense		9

To record the associated tax effects for the stock compensation recognized over the vesting period.

Journal Entries: Upon the Exercise of the Options (July 1, 20X2)

USP

Cash	80	
APIC		80

To record the cash received from option holders upon exercise of the USP option and FS option.

Example 10-2A (continued)

USP

Deferred tax expense	12	
DTA		12
Income taxes payable	28	
Investment in FS	12	
APIC*		28
Current tax expense		12

FS

Deferred tax expense	9	
DTA**		9
Income taxes payable**	21	
APIC*		12
Current tax expense		9

To record the income tax effects of the options upon exercise, including USP entry to record FS's excess tax benefit through its investment and APIC accounts. Upon consolidation, the investment in FS and the FS APIC would be eliminated.

USP

Intra-entity receivable	70	
Investment in FS (nontaxable)*		70

FS

APIC	70	
Intra-entity payable **		70

To record an intra-entity receivable/payable for the amount of cash that USP will be reimbursed by FS because of the exercise of the option.

Journal Entries: Settlement of Recharge Agreement (After July 1, 20X2)

USP

Cash	70	
Intra-entity receivable		70

FS

Intra-entity payable	70	
Cash**		70

To record the settlement of the recharge between USP and FS.

* Before the adoption of ASU 2016-09 the credit to recognize any excess tax benefit will be recorded to APIC. After the adoption of ASU 2016-09, the credit will be recorded to current tax expense.

** To the extent that USP has not asserted that FS's earnings are indefinitely reinvested, these amounts would have an impact on the tax effects on the outside basis difference to be accounted for under ASC 740-30.

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.

Cost-sharing agreements affect the U.S. company's accounting for the income tax effects of share-based compensation. 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 ($\$100$ [book compensation expense] \times 70% [percentage not subject to reimbursement] \times 40% [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 ($\150 [intrinsic value when the option is exercised] \times 70% [percentage not reimbursed] \times 40%). Accordingly, \$14 ($\$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 ($\100 [book compensation expense] \times 30% [percentage reimbursed] \times 40%). If the stock-based charge under [ASC 718] is considered a deductible temporary difference, a deferred tax asset also should be recorded in 2006 for the financial statement expense, in the amount of \$40 ($\100 [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.

10.07 Interaction Between ASC 740 and ASC 718-740-25-10

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 share-based 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). Since a deduction does not 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 capital gains tax 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, since the employee made the Section 83(b) election and the predecessor company already received a deduction upon the vesting of the original award, the company 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 a Net Operating Loss Carryforward Acquired in a Business Combination

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 a 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

Under U.S. GAAP, the appropriate accounting treatment for income taxes related to share-based compensation is that 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

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 DTAs 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

Example 10-4 (continued)

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]

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

ASC 718-740 (continued)

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.

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 718-20-55-71); 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. [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

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

As noted above, 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 in assessing whether a valuation allowance is needed. 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 only be able to record a valuation allowance against the DTA 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

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.

² 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

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 deduction¹ 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.

Journal Entry: Upon Exercise of Options (Assuming Sufficient APIC Pool Credits)

Deferred tax expense	320	
APIC	80	
DTA		400
To reverse the DTA and record the tax benefit deficiency in APIC (\$320 – \$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.

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 award was, in substance, a separate award) or (2) a straight-line basis over the total requisite service period for the entire award.

An entity’s policy decision about the recognition of compensation cost for a share-based payment award with only service conditions that have a graded vesting schedule affects the recognition of the DTA for that award. 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 share-based compensation cost (i.e., compensation cost could be recognized on a straight-line basis over the total requisite service period for the entire award but the tax effects must be recognized on an accelerated basis). 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.

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:

Number of Options	Grant Date	Exercise Price (per Option)	Grant-Date Fair-Value-Based Measure (per Option)	Compensation Cost Recorded
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 share-based compensation is \$360 $[(\$200 + \$300 + \$400) \times 40\% \text{ tax rate}]$. 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 $[(\$20 \text{ fair value on date of exercise} - \$13 \text{ exercise price}) \times 75 \text{ options exercised}]$. 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 $(\$525 \times 40\%)$.		
Deferred tax expense	90	
DTA		90
To reverse the DTA $(\$225 \times 40\%)$.		
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.		

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

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.

10.17 Change in Tax Rates

For enacted changes in a tax rate affected by the deferred taxes related to temporary differences arising from tax-deductible share-based payment awards, a DTA is 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")

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

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

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.		
Income tax expense	600	
APIC	1,000	
DTA		1,600
To reverse the tax effects of unexercised options.		

10.21 Combining Employee and Nonemployee APIC Pools

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

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 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 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

Under ASC 718, 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 may 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

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.

10.25 Recording Tax Benefits of Awards Granted Before the Adoption of Statement 123(R)

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

As described in 10.25, for awards granted before, but 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 (1) whether the entity has elected to use the simplified method of calculating its APIC pool, as described in FSP FAS 123(R)-3, and, if so, (2) 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).

Example 10-14 (continued)

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	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.		
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 shares that were vested before adoption, 75 percent of shares vested before adoption and 25 percent after adoption (\$900 = \$3,000 × 40% tax rate × 75%).)

The shortfall is \$100, which is recorded as income tax expense (\$400 initial DTA – \$300 (\$3,000 × 25% × 40% tax rate)) or ((\$400 deferred tax expense + \$900 current tax expense) – \$1,200 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

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

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

ASC 718-740 (continued)

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

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.

Pending Content (Transition Guidance: ASC 718-40-65-1)

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

ASC 718-740 (continued)

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.

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

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. Upon adoption, the following guidance would no longer be relevant as all DTAs would be classified as noncurrent. For more information on the ASU, including effective dates and transition requirements, see [Chapter 5](#).

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.

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.

10.31 ESOP: Income Tax Accounting Example

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, the accounting treatment described in ASC 718-740-45-5 and 45-6 unfairly penalizes the income statement by limiting the tax benefit recorded.

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 — \$40.

Fair value of shares when 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.

Journal Entries

Unearned ESOP shares	40	
Shareholders' equity		40
[Setup ESOP shares]		
Compensation expense	50	
Unearned ESOP shares		40
APIC		10
[ESOP shares released]		
Tax benefit	16	
Tax provision		16
[Record tax entries for above transaction]		

Some suggest that the credit to the tax provision should be \$20, which equates to the compensation expense times the ETR. Under this approach, the remaining \$4 debit would be charged to APIC. An ESOP sponsor should not account for tax aspects of its ESOP shares in this manner. Rather, such a sponsor must strictly adhere to the guidance in ASC 718-740-45-5 and 45-6 and not debit APIC for the tax effects of the ESOP in excess of previous credits to APIC related to the cost of committed shares that exceed the fair value of shares committed to be released.

10.32 Tax Benefit of ESOP Dividends

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).

In accordance with ASC 718-40-25-9, S would not recognize its loan to the ESOP, and related interest income, in the financial statements. Further, under ASC 718-40-25-16, dividends on unallocated shares would not be recorded as dividends for financial reporting purposes (i.e., not recorded in retained earnings). Company S, however, 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.

The guidance does not directly specify the appropriate accounting 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.

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

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.

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-based measure) × 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

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

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

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).³

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

Entities must present, in the statement of cash flows, the impact of the tax benefit of any realized excess tax deduction. (See 10.19 for a discussion of the realization of excess tax benefits.) 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). (See 10.39 for a discussion of including tax benefit deficiencies in the statement of cash flows.) 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.

Example 10-20

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 DTA, 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.

Also, assume that in the year of exercise, A has taxable income in the amount of \$21,000 (before the impact of the \$12,000 share-based compensation deduction is taken into account) or \$9,000 of taxable income after the share-based 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.

³ 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.

10.39 Presentation in the Statement of Cash Flows of Tax Benefit Deficiencies of Share-Based Payment Awards

Tax benefit deficiencies (tax shortfalls) do not reduce the amount of realized excess tax benefits presented as cash inflows from financing activities. 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 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.
- 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 a net operating loss 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 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.

New in the 2016 Edition:

The following new guidance has been added to Chapter 11:

- 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.
- 11.23A — Settlement of Share-Based Payment Awards Held by the Acquiree's Employees.

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.

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]

ASC 805-740 (continued)

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:

- Modify the intra-entity tax allocation agreement so that taxes are allocated to the acquired entity on the preacquisition tax basis
- Credit the tax benefit from the tax basis step-up to the acquired entity's additional paid-in capital when realized
- 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.

11.03 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:

Identifiable Assets	TC’s Stock	S1	S2
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:

AC

Investment in TC	1,000	
Cash		1,000

Example 11-1 (continued)

To record TC's investment in S1 and S2:

TC

Investment in S1	750	
Investment in S2	250	
Equity		1,000

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

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

Example 11-3 (continued)

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 for the reason discussed in the preceding paragraph (related to excess tax over financial reporting basis in a subsidiary).

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 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 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 in a **taxable** business combination).

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.

The following illustrates the book and tax bases of the assets:

	Book Basis	New Tax Basis
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 million – \$7.5 million) × 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 million – \$20 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:

	Book Basis	New Tax Basis
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 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 million – \$7.5 million) × 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 (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 costs are incurred in a period before the acquisition date of a business combination and those costs are not immediately deductible for tax purposes, the acquirer will need to assess whether that difference is a temporary difference that will result in the recognition of a DTA. To determine the expected tax consequences of the acquisition-related costs, the acquirer may use either of the following two approaches.¹

Approach 1

If the acquisition-related costs would result in a future tax deduction if the business combination did not occur, a deductible temporary difference exists and a DTA should be recorded when the expense is recognized for financial reporting purposes. Example 11-7 illustrates how this approach would be applied. Upon consummation of the business combination, the acquirer would need to reassess the DTA to determine whether recognition continues to be appropriate (i.e., whether the business combination is taxable or nontaxable). If recognition is no longer appropriate, the DTA should be reversed to the income statement.

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 the recording of the DTA. Examples 11-7 and 11-8 illustrate how this approach would be applied. In Example 11-7, it is assumed that a taxable business combination would generally result in an entity's recording a DTA. In Example 11-8, it is assumed that a nontaxable business combination would not result in an entity's recording of the DTA because of the exception in ASC 740-30-25-9. 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).

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 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.

¹ The approach an entity selects is an accounting policy election that, like all such elections, 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 tax 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 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

* $\$200$ (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.

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

Example 11-9 (continued)

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

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.

The following table illustrates AC's investment in TC:

	Book Basis	New Tax Basis
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:

	Book Basis	Tax Basis
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.

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		<u>45,000,000</u>

* $(\$4,000,000 + \$400,000 \text{ DTL}) - \$400,000 \text{ DTA}$.

** DTL recognized for the taxable temporary difference in the land acquired $(\$5,000,000 - \$4,000,000) \times 40\%$.

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.

11.20 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.

Example 11-15 (continued)

On Acquisition Date:

1. Preliminary calculation of goodwill components:

	Book	Tax
Component 1 goodwill	\$ 800	\$ 800
Component 2 goodwill	—	200
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:

	Year 1	Year 2	Year 3
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>

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.

	January 1, 20X9	End of Year 1	End of Year 2	End of Year 3
Financial reporting basis — goodwill	<u>\$ 667</u>	<u>\$ 667</u>	<u>\$ 667</u>	<u>\$ 667</u>
Tax basis — component 1 goodwill	667	334	—	—
Tax basis — component 2 goodwill	<u>333</u>	<u>166</u>	<u>—</u>	<u>—</u>
Total tax basis in goodwill	<u>1,000</u>	<u>500</u>	<u>—</u>	<u>—</u>
Temporary difference — component 1 goodwill	<u>—</u>	<u>333</u>	<u>667</u>	<u>667</u>
Temporary difference — component 2 goodwill	<u>333</u>	<u>167</u>	<u>—</u>	<u>—</u>
DTL — component 1 goodwill	<u>—</u>	<u>133</u>	<u>267</u>	<u>267</u>
DTA — component 2 goodwill	<u>\$ 133</u>	<u>\$ 67*</u>	<u>\$ —</u>	<u>\$ —</u>
Deferred income tax expense		<u>\$ 200</u>	<u>\$ 200</u>	<u>\$ —</u>
Current income tax benefit		<u>\$ (200)</u>	<u>\$ (200)</u>	

* 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).

Example 11-15 (continued)

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:

	Year 1	Year 2	Year 3
Book income (pretax)	\$ 10,000	\$ 11,000	\$ 12,000
Tax amortization			
Current	3,800	4,200	4,800
Deferred	<u>200</u>	<u>200</u>	<u>—</u>
Total income tax expense	<u>4,000</u>	<u>4,400</u>	<u>4,800</u>
Net income	<u>\$ 6,000</u>	<u>\$ 6,600</u>	<u>\$ 7,200</u>

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).

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 ($\$160,000 \times 40\%$).

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 [$\$1,000,000 - (\$1,000,000/\$1,600,000 \times \$160,000)$] and the DTA associated with component 2 goodwill would be reduced by \$40,000 [$(\$1,000,000/\$1,600,000 \times \$160,000) \times 40\%$]. Component 1 goodwill would be reduced to \$540,000 [$\$600,000 - (\$600,000/\$1,600,000 \times \$160,000)$], which would create a DTL of \$24,000 [$(\$600,000/\$1,600,000 \times \$160,000) \times 40\%$] 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

Statement 141(R) (codified in ASC 805) amended paragraph 262 of 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 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:

	20X8	20X9	2X10	2X11
Income before amortization of goodwill	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000
Tax amortization of goodwill	<u>400</u>	<u>400</u>	<u>—</u>	<u>—</u>
Taxable income	<u>600</u>	<u>600</u>	<u>1,000</u>	<u>1,000</u>
Income tax payable	<u>\$ 240</u>	<u>\$ 240</u>	<u>\$ 400</u>	<u>\$ 400</u>

As of the combination date, goodwill is separated into two components as follows:

	Reported Amount	Tax Basis
First component	\$ 600	\$ 600
Second component	<u>—</u>	<u>200</u>
Total goodwill	<u>\$ 600</u>	<u>\$ 800</u>

Example 11-17 (continued)

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)

TTB = \$40 + (0.40 × TTB)

TTB = \$67

Goodwill for financial reporting purposes for years 20X8–2X11 is:

	20X8	20X9	2X10	2X11
Balance at beginning of year	\$ 600	\$ 533	\$ 466	\$ 466
TTB allocated to reduce goodwill	<u>67</u>	<u>67</u>	<u>—</u>	<u>—</u>
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:

	20X8	20X9	2X10	2X11
Reported goodwill at end of year	\$ 533	\$ 466	\$ 466	\$ 466
Tax basis of goodwill (first component)	<u>300</u>	<u>—</u>	<u>—</u>	<u>—</u>
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	<u>—</u>	<u>93</u>	<u>186</u>	<u>186</u>
Deferred tax expense for the year	<u>\$ 93</u>	<u>\$ 93</u>	<u>\$ —</u>	<u>\$ —</u>

Income for financial reporting for years 20X8–2X11 is:

	20X8	20X9	2X10	2X11
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	<u>67</u>	<u>67</u>	<u>—</u>	<u>—</u>
Income tax expense	<u>400</u>	<u>400</u>	<u>400</u>	<u>400</u>
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

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](#) 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.

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 measure² 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 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.

Examples 11-18 and 11-19, 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 Statement 141(R).

² 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.

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).

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 × 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	
DTA		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 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 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).

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 ($\$100 \times [4 \text{ years} \div 5 \text{ years}]$) 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	
DTA		40
APIC		14

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 a 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

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](#) 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 measure³ 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.

For share-based payment awards exchanged in a business combination that do not ordinarily result in a tax deduction, there are two currently acceptable approaches to accounting for the tax benefits received from an employee's disqualifying disposition.

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.

Examples 11-20 and 11-21, 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 Statement 141(R).

³ See footnote 2.

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 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).

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 ($\$100 \times [4 \text{ years} \div 5 \text{ years}]$) 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, 20X1. 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 ($\$135 \times 40\%$ 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.

Example 11-20 (continued)

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 Example 11-20, Approach 1. Under Approach 2, the June 30 and December 31, 20X1, journal entries will be the same as those under Approach 1.

As in Example 11-20, Approach 1, 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: 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:

- The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree (see Subtopic 805-20)
- 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)
- 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))
- 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]

ASC 805-740 (continued)

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 million × 40%), with an offsetting entry to deferred tax expense.

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>

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:

$$\text{DTA} = (0.40 / (1 - 0.40)) \times \$150,000$$

$$\text{DTA} = \$100,000$$

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 × 40%.

Example 11-25 (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 and a deferred tax benefit of \$280,000 (\$700,000 × 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 × 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. When testing goodwill for impairment, an entity may perform the two-step goodwill impairment test when it (1) qualitatively determines that the fair value of a reporting unit is more likely than not less than its 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

- 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.

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.

Taxable Versus Nontaxable Assumption in Step 1

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 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:

- Whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value
- The feasibility of the assumed structure
- 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:

- Whether the reporting unit could be sold in a nontaxable transaction
- 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.

Assigning Deferred Taxes to 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 NOL and tax credit carryforwards to a reporting unit, an entity should consider the following guidance from ASC 350-20-35-39 and 35-40:

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.

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 DTLs assigned to each reporting unit.

Tax Basis in Step 2

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 (see *Taxable Versus Nontaxable Assumption in Step 1* above). 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.

11.33 Determining the Deferred Tax Effects of a Goodwill Impairment

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 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. Questions have arisen about how an entity should account for the deferred tax effects of a partial goodwill impairment when the reporting unit subject to the impairment is (1) made up of multiple legal entities operating in different tax jurisdictions and (2) the goodwill balance of that reporting unit consists of 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.

Example 11-27 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.

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

	Component 1 Goodwill	Component 2 Goodwill	Tax Basis	Total Book Basis
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

	Component 1 Goodwill	Component 2 Goodwill	Tax Basis	Total Book Basis
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 $[(\$1,000,000 - \$900,000) \times 30\%]$ related to the taxable temporary difference of its component 1 goodwill.
- Entity Z has a DTL of \$160,000 $[(\$4,000,000 - \$3,600,000) \times 40\%]$ 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 $[(\$1,500,000/\$6,000,000) \times \$2,000,000]$ of the impairment is allocated to Y and \$1,500,000 $[(\$4,500,000/\$6,000,000) \times \$2,000,000]$ 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.

Legal Entity Y

	Component 1 Goodwill	Component 2 Goodwill	Tax Basis	Book Basis
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>500,000</u>
December 31, 20X9	<u>\$ 666,667</u>	<u>\$ 333,333</u>	\$ 900,000	<u>\$ 1,000,000</u>

* $(\$1,000,000 \div \$1,500,000) \times \$500,000$.

** $(\$500,000 \div \$1,500,000) \times \$500,000$.

Example 11-27 (continued)

Legal Entity Z

	Component 1 Goodwill	Component 2 Goodwill	Tax Basis	Book Basis
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

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, \$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 also 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 Company P uses this method to determine the deferred tax consequences of deconsolidating only a portion 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 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 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 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](#) 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.

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 \times 75% awards expected to vest \times 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.

Example 11-28 (continued)

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 $[(\$800 \text{ acquisition-date fair-value-based measure allocated to consideration transferred} \times 20\% \text{ revised awards expected to vest}) - \$600 \text{ amount previously recognized as consideration transferred}]$ 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 $[(\$200 \text{ acquisition-date fair-value-based measure allocated to postcombination service} \times 20\% \text{ revised awards expected to vest} \times 75\% \text{ services rendered}) - \$75 \text{ compensation cost previously recognized}]$.

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 $[(\$200 \text{ acquisition-date fair-value-based measure allocated to postcombination service} \times 20\% \text{ awards expected to vest} \times 100\% \text{ services rendered}) - \$30 \text{ compensation cost previously recognized}]$ 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]

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 acquiring entity's DTAs that existed as of the acquisition 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 11.02 and ASC 805-740-30-3).	Generally, record as an adjustment to income tax expense (see ASC 805-740-35-3).
Valuation allowance on the acquired entity's DTAs that existed as of the acquisition 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 ASC 805-30-25-2 through 25-4. All other changes should generally be recorded as an adjustment to income tax expense (see ASC 805-740-45-2).	Generally, record as an adjustment to income tax expense (see ASC 805-740-45-2).

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

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.

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]

ASC 830-740 (continued)

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

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

Example 12-1A (continued)

The difference between the LC-denominated hypothetical sales proceeds and the tax basis meets the definition of a temporary difference. However, because ASC 740-10-25-25-3(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):

	Book	Tax	Temporary Difference	DTA (DTL)
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 DTE 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:

	LC	Exchange Rate	Functional Currency	Transaction Gain
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
DTE at weighted-average rate	(15,000)	1.35	(11,111)	
DTE 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,¹ 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."

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).

¹ See ASC 830-10-45-11 through 45-13 for guidance on determining whether an economy is considered highly inflationary.

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.²

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 a net operating loss carryforward).

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):

	Tax Basis	Book Basis	Temporary Difference	DTA / (DTL)
Basis on January 1, 20X5	1,000,000	1,000,000	—	—
20X5 Depreciation expense	<u>250,000</u>	<u>250,000</u>	—	—
	750,000	750,000	—	—
20X5 Indexing	<u>112,500</u>	—	<u>112,500</u>	<u>45,000</u>
Basis on December 31, 20X5	<u><u>862,500</u></u>	<u><u>750,000</u></u>	<u><u>112,500</u></u>	<u><u>45,000</u></u>

On December 31, 20X5, A would recognize a DTA of 45,000 LC (temporary difference of 112,500 LC × 40% tax rate). Because the local currency is A's functional currency, A measures the DTA as the difference between the book basis and the tax basis after taking into account the effects of indexing. In the example above, the DTA recognized is solely related to the increase in the tax basis of the equipment that resulted from indexing in 20X5 (i.e., there is no difference in the foreign currency book and tax basis of the equipment, excluding the effects of indexing). 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 CTA account within OCI.

² 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 (continued)

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):

	Tax Basis		Book Basis	Temporary Difference	DTA / (DTL)
	Not Recognized Under ASC 740	Recognized Under ASC 740			
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 × 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.

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 LC × 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).³ 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		Book Basis	Temporary Difference	DTA / (DTL)
	Not Recognized Under ASC 740	Recognized Under ASC 740			
Basis on January 1, 20X7	86,250	575,000	500,000	75,000	30,000
20X7 Depreciation expense	43,125	287,500	250,000	37,500	(15,000)
	43,125	287,500	250,000	37,500	15,000
20X7 Indexing	49,594	—	—	N/A	N/A
Basis on December 31, 20X7	92,719	287,500	250,000	37,500	15,000

³ 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).

Example 12-2 (continued)

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 20X6.⁴ 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.

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.

Local-Currency-Denominated Monetary Assets and Liabilities

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.

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,

⁴ 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.

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 ÷ 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 ÷ 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 ($\text{USD } 100 \text{ million} \times 1.25$).

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 ($[\text{CAD } 125 \text{ million} - \text{CAD } 133 \text{ million}] \times 30\%$). 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.

New in the 2016 Edition:

The following new guidance has been added to Chapter 13:

- [13.02A — Determining Whether an Investor Has the Ability to Exercise Significant Influence Over an Entity That Invests in Qualified Affordable Housing Projects](#) [Determining Whether an Investor Has the Ability to Exercise Significant Influence Over an Entity That Invests in Qualified Affordable Housing Projects](#).

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]

ASC 323-740 (continued)

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

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]

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]

ASC 323-740 (continued)

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]

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:

- The initial investment balance less any expected residual value of the investment, multiplied by
- 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]

ASC 323-740 (continued)

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]

34-4 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]

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

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]

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 323-740-599-2 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:¹

- 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.

¹ 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."

While an investment in a QAHP 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 [QAHP] 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 QAHP 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 QAHP entity, it is reasonable to conclude, on the basis of the EITF's stated objective, that an investor in a QAHP entity 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 (QAHPs) 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 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 QAHP 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 QAHP. Because the scope of ASC 323-740 is limited to QAHPs, it is unclear whether a QAHP that generates other credits in addition to QAHP

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 QAHP 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 QAHP 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 QAHP 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 QAHP 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 QAHP 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 QAHP, 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 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 QAHPs. 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	Total Credits & Other Tax Benefit	Less: Amortization	Net Benefit	Deductible Temporary Difference	Deferred Tax Asset	Deferred Tax Benefit (Expense)	Net Benefit (Expense)			
1	\$ 200,000	\$ 15,636	\$ 184,364	\$ 200,000	\$ 8,000	\$ 192,000	\$ 14,000	\$ 3,200	\$ 17,200	\$ 15,636	\$ 1,564	\$ 7,636	\$ 3,055	\$ 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	4,618			
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	4,618			
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	4,618			
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	4,618			
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	4,618			
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	4,618			
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	4,618			
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	4,618			
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	4,618			
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)	(1,745)			
12	40,727	2,909	37,818	112,000	8,000	104,000	-	3,200	3,200	2,909	291	66,182	26,473	(2,036)	(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)	(1,745)			
14	34,909	2,909	32,000	96,000	8,000	88,000	-	3,200	3,200	2,909	291	56,000	22,400	(2,036)	(1,745)			
15	32,000	2,909	29,091	88,000	8,000	80,000	-	3,200	3,200	2,909	291	50,909	20,364	(2,036)	(1,745)			
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)	(1,745)			
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)	(1,745)			
18	23,273	2,909	20,364	64,000	8,000	56,000	-	3,200	3,200	2,909	291	35,636	14,255	(2,036)	(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	(2,036)	(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)	(1,745)			
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)	(1,745)			
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)	(1,745)			
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)	(1,745)			
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)	(1,745)			
25	2,909	2,909	-	8,000	8,000	-	-	3,200	3,200	2,909	291	-	-	(2,036)	(1,745)			
							\$ 140,000	\$ 80,000	\$ 320,000	\$ 200,000	\$ 20,000				\$ 20,000			

- A =Beginning book basis each year, representing initial \$200,000 investment in year 1 and prior-year ending balance in Column C for remaining years
B =Initial investment of \$200,000 × 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 I)
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-year 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 L × 40% tax rate
N =Change in deferred tax asset in Column M for the year.
O =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	Amortization	Ending	Beginning	Depreciation	Ending	Tax credits	Other tax benefit	Total Credits		Less: Amortization	Net Benefit (Expense)	Temporary Difference	Deferred Tax		Net Benefit (Expense)
									Tax Benefit	Other				Deferred Tax Asset	Deferred Tax Liability	
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	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	3,200	-	-	112,000	44,800	(3,200)	-	
12	-	-	-	112,000	8,000	104,000	-	3,200	3,200	-	-	104,000	41,600	(3,200)	-	
13	-	-	-	104,000	8,000	96,000	-	3,200	3,200	-	-	96,000	38,400	(3,200)	-	
14	-	-	-	96,000	8,000	88,000	-	3,200	3,200	-	-	88,000	35,200	(3,200)	-	
15	-	-	-	88,000	8,000	80,000	-	3,200	3,200	-	-	80,000	32,000	(3,200)	-	
16	-	-	-	80,000	8,000	72,000	-	3,200	3,200	-	-	72,000	28,800	(3,200)	-	
17	-	-	-	72,000	8,000	64,000	-	3,200	3,200	-	-	64,000	25,600	(3,200)	-	
18	-	-	-	64,000	8,000	56,000	-	3,200	3,200	-	-	56,000	22,400	(3,200)	-	
19	-	-	-	56,000	8,000	48,000	-	3,200	3,200	-	-	48,000	19,200	(3,200)	-	
20	-	-	-	48,000	8,000	40,000	-	3,200	3,200	-	-	40,000	16,000	(3,200)	-	
21	-	-	-	40,000	8,000	32,000	-	3,200	3,200	-	-	32,000	12,800	(3,200)	-	
22	-	-	-	32,000	8,000	24,000	-	3,200	3,200	-	-	24,000	9,600	(3,200)	-	
23	-	-	-	24,000	8,000	16,000	-	3,200	3,200	-	-	16,000	6,400	(3,200)	-	
24	-	-	-	16,000	8,000	8,000	-	3,200	3,200	-	-	8,000	3,200	(3,200)	-	
25	-	-	-	8,000	8,000	-	-	3,200	3,200	-	-	-	-	(3,200)	-	
	\$ 200,000				\$ 200,000		\$ 140,000	\$ 80,000	\$ 220,000	\$ 200,000	\$ 20,000	\$ 20,000	\$ -	\$ -	\$ 20,000	

- A = Beginning book basis each year, representing initial \$200,000 investment in year 1 and prior-year 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-year 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 L × 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

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

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.

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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.

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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]

Pending Content

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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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.

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 an extraordinary loss 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 an extraordinary gain if it offsets the current or deferred tax consequences of that extraordinary 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 an extraordinary gain 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)

Pending Content

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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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]

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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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 FAS 106-2, 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 FAS 106-2, 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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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]

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

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

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

55-78 THIS PENDING CONTENT PARAGRAPH TO BE ROLLED OFF AT SAME TIME AS THE ONE BELOW! 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]

Pending Content

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.

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]

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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.

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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.

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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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:

- The \$1,500 of taxable temporary differences and \$900 of future taxable income exclusive of reversing temporary differences
- \$2,400 of future taxable income exclusive of reversing temporary differences
- \$2,400 of taxable income in the current or prior years by loss carryback to those years
- \$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]

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:

- At the end of the current year (Year 3), an entity's only temporary differences are deductible temporary differences in the amount of \$900.
- Pretax financial income, taxable income, and taxes paid for each of Years 1-3 are all positive, but relatively negligible, amounts.
- 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>

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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.

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:

- 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
- 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:

- Enacted tax rates are 30 percent for Years 1–3 and 40 percent for Year 4 and thereafter.
- 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:

- The entity recognizes a \$360 (\$900 at 40 percent) deferred tax asset to be realized by offsetting taxable income in future years.
- 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]

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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.

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:

- Expected taxable income (excluding the qualified production activities deduction and net operating loss carryforwards) for 2005: \$21,000
- Expected qualified production activities income for 2005: \$50,000
- Net operating loss carryforwards at December 31, 2004, which expire in 2005: \$20,000
- Expected W-2 wages for 2005: \$10,000
- Assumed statutory income tax rate: 35%
- 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 ^(a)	<u>20,000</u>
Expected taxable income (after deducting the net operating loss carryforwards)	<u>\$ 1,000</u>
Qualified production activities deduction	<u><u>\$ 30</u></u>

- ^(a) 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><u>\$ 970</u></u>

[FSP FAS 109-1, paragraph Appendix A]

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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:

- The enacted tax rate is 40 percent for all years.
- An operating loss occurs in Year 5.
- 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.
- Financial income, taxable income, and taxes currently payable or refundable are as follows.

	Year 1	Years 2-4	Year 5	Year 6	Year 7
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>

- 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.

	Year 1	Years 2-4	Year 5	Year 6	Year 7
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.

	Year 1	Years 2-4	Year 5	Year 6	Year 7
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.

	Year 1	Years 2–4	Year 5	Year 6	Year 7
Deferred tax expense (benefit):					
Increase in deferred tax liability	\$ 320	\$ 880	\$ 320	\$ 280	\$ 240
(Increase) decrease in net deferred tax asset	<u>—</u>	<u>—</u>	<u>(1,520)</u>	<u>(280)</u>	<u>1,800</u>
	320	880	(1,200)	—	2,040
Currently payable (refundable)	<u>480</u>	<u>1,120</u>	<u>(1,120)</u>	<u>—</u>	<u>760</u>
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]

55-157 Financial and taxable income in this Example are as follows.

	Financial Income	Taxable Income
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		<u>2,500</u>
Taxable income before loss carryforward		2,500
Loss carryforward from Year 1		<u>(4,000)</u>
Taxable income		<u>\$ —</u>

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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. A \$900 operating loss carryforward expires at the end of next year.
- b. 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.
- c. 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.
- d. There is a qualifying tax-planning strategy to accelerate the future reversal of all \$1,200 of taxable temporary differences to next year.
- e. Estimated legal and other expenses to implement that tax-planning strategy are \$150.
- f. The enacted tax rate is 40 percent for all years.

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>\$ 90</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.

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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.

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))	100	50	100	50	50
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.

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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:

- The amount paid is less than the tax basis of the asset (Case A).
- The amount paid is more than the tax basis of the asset (Case B).
- The transaction results in a deferred credit (Case C).
- A deferred credit is created by a financial asset (Case D).
- [Subparagraph Not Used]
- 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):

$$\text{FBB} - [\text{Tax Rate} \times (\text{FBB} - \text{Tax Basis})] = \text{CPP}$$

Equation B (determine the amount assigned to the deferred tax asset):

$$(\text{Tax Basis} - \text{FBB}) \times \text{Tax Rate} = \text{DTA}$$

55-174 In this Case, the following variables are known:

- Tax Basis = \$150
- Tax Rate = 35 percent
- CPP = \$100.

55-175 The unknown variables (FBB and DTA) are solved as follows:

$$\text{Equation A: FBB} = \$73$$

$$\text{Equation B: DTA} = \$27.$$

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.

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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]

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:

- Tax Basis = \$200
- Tax Rate = 35 percent
- CPP = \$50.

55-187 The unknown variables (FBB and DTA) are solved as follows:

$$\text{Equation A: FBB} = \$31. \text{ However, because the FBB cannot be less than zero, the FBB is recorded at zero.}$$

$$\text{Equation B: DTA} = \$70.$$

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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.

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

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

55-206 Paragraph superseded by Accounting Standards Update No. 2015-17

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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

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

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

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>\$ 12,500,000</u>
Accumulated deferred tax liability related to unremitted earnings	<u>\$ 1,250,000</u>

[FAS 37, paragraph 23]

Pending Content

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

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

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:

- The gross method (Case A)
- The net method (Case B)
- The statutory tax rate reconciliation method (Case C).

55-213 Cases A, B, and C share the following assumptions:

- 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.
- Pretax financial income from continuing operations is \$5,000.
- Income tax expense from continuing operations is \$1,500.
- Effective tax rate is 30%.
- 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.

	Current	Deferred
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.

	20X7	20X6	20X5
	(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]

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]

ASC 740-10 — Implementation Guidance and Illustrations (continued)

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:

- Entity N's characterization of its activities as related or unrelated to its exempt purpose
- Entity N's allocation of revenue between activities that relate to its exempt purpose and those that are allocated to unrelated business income
- 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]

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]

ASC 740-20 — Implementation Guidance and Illustrations

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:

- Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years
- Changes in tax laws or rates
- Changes in tax status
- 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:

- Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years
- Changes in tax laws or rates
- Changes in tax status
- 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.

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.

Temporary Differences	Future Years			Total
	Year 2	Year 3	Year 4	
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.

ASC 740-20 — Implementation Guidance and Illustrations (continued)

Temporary Differences	Future Years		
	Year 3	Year 4	Total
Discontinued operations	\$ 700	\$ —	\$ 700
Continuing operations	<u>(200)</u>	<u>(100)</u>	<u>(300)</u>
	<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)	<u>(80)</u>
Deferred tax benefit for Year 2	<u>\$ (30)</u>

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)	<u>(150)</u>
Deferred tax expense for Year 2	<u>\$ 130</u>

55-7 Total tax expense and tax expense allocated to continuing and discontinued operations for Year 2 are determined as follows.

	Discontinued Operations	Continuing Operations	Total
Pretax reported income	\$ 200	\$ 50	\$ 250
Originating and reversing temporary differences, net	<u>(200)</u>	<u>100</u>	<u>(100)</u>
Taxable income	<u>\$ —</u>	<u>\$ 150</u>	<u>\$ 150</u>
Current tax expense (40 percent)	\$ —	\$ 60	\$ 60
Deferred tax expense (benefit) as determined above	<u>130</u>	<u>(30)</u>	<u>100</u>
Income tax expense	<u>\$ 130</u>	<u>\$ 30</u>	<u>\$ 160</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).

ASC 740-20 — Implementation Guidance and Illustrations (continued)

Case A: Loss from Continuing Operations with an Extraordinary Gain

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 an extraordinary gain 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).

Pending Content

55-10 Editor's Note: The content of paragraph 740-20-55-10 will change upon transition, together with a change in its heading noted below.

Case A: Loss from Continuing Operations with a Gain on Discontinued Operations

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 extraordinary gain 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>\$ 270</u>

Pending Content

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>\$ 270</u>

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 extraordinary gain is the difference between \$120 of total tax expense and the \$150 tax benefit from continuing operations. [FAS 109, paragraph 274]

Pending Content

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.

ASC 740-20 — Implementation Guidance and Illustrations (continued)

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 an extraordinary gain.
- 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.

Pending Content

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.

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		(330)	(210)
Tax expense allocated to the extraordinary gain			<u>\$ 160</u>

Pending Content

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		(330)	(210)
Tax expense allocated to the extraordinary gain			<u>\$ 160</u>

55-17 Absent the extraordinary gain 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 extraordinary gain does not change that allocation. [FAS 109, paragraph 275]

Pending Content

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.

	Foreign Currency	Exchange Rate	Dollars
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.

	Net Investment	Deferred Tax Liability
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]

ASC 740-270 — Implementation Guidance and Illustrations

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]

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.

Ordinary Income				Tax		
Reporting Period	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	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.

Ordinary Income (Loss)			Estimated Annual Effective Tax Rate	Tax (or Benefit)		
Reporting Period	Reporting Period	Year-to-Date		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.

Ordinary Income (Loss)			Estimated Annual Effective Tax Rate	Tax (or Benefit)		
Reporting Period	Reporting Period	Year-to-Date		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]

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.

Ordinary Income (Loss)			Estimated Annual Effective Tax Rate	Tax (or Benefit)		
Reporting Period	Reporting Period	Year-to-Date		Year-to-Date	Less Previously Provided	Reporting Period
First quarter	\$ (20,000)	\$ (20,000)	— ^(a)	\$ —	\$ —	\$ —
Second quarter	10,000	(10,000)	— ^(a)	—	—	—
Third quarter	15,000	5,000	40%	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>

^(a) 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]

ASC 740-270 — Implementation Guidance and Illustrations (continued)

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.

	Estimated, End of			Actual Fiscal Year
	First Quarter	Second Quarter	Third Quarter	
Estimated ordinary income for the fiscal year	\$ 100,000	\$ 80,000	\$ 80,000	\$ 100,000
Tax at 50% statutory rate	\$ 50,000	\$ 40,000	\$ 40,000	\$ 50,000
Less anticipated credits	(5,000)	(5,000)	(10,000)	(10,000)
Net tax to be provided	\$ 45,000	\$ 35,000	\$ 30,000	\$ 40,000
Estimated annual effective tax rate	45%	43.75%	37.5%	40%

55-10 Quarterly tax computations are as follows.

Reporting Period	Ordinary Income (Loss)		Estimated Annual Effective Tax Rate	Tax		
	Reporting Period	Year-to-Date		Year-to-Date	Less Previously Provided	Reporting Period
First quarter	\$ 25,000	\$ 25,000	45%	\$ 11,250	\$ —	\$ 11,250
Second quarter	5,000	30,000	43.75%	13,125	11,250	1,875
Third quarter	25,000	55,000	37.5%	20,625	13,125	7,500
Fourth quarter	45,000	100,000	40%	40,000	20,625	19,375
Fiscal year	\$ 100,000					\$ 40,000

[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	(10,000)
Net tax benefit	\$ (60,000)
Estimated annual effective tax rate (\$60,000 ÷ \$100,000)	60%

[FIN 18, paragraph 49]

ASC 740-270 — Implementation Guidance and Illustrations (continued)

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]

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:

- Ordinary losses in all interim periods (Case A1)
- 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.

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)	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>\$ (100,000)</u>					<u>\$ (60,000)</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.

Reporting Period	Ordinary Income (Loss)		Estimated Annual Effective Tax Rate	Tax (or Benefit)			Reporting Period
	Reporting Period	Year-to-Date		Year-to-Date		Less Previously Provided	
				Computed	Limited to		
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) ^(a)	(36,000)	(44,000)
Fourth quarter	<u>40,000</u>	(100,000)	60%	(60,000)		(80,000)	<u>20,000</u>
Fiscal year	<u>\$ (100,000)</u>						<u>\$ (60,000)</u>

^(a) 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]

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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:

- Ordinary losses in all interim periods (Case C1)
- 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>	(100,000)	20%	(20,000)	(12,000)	<u>(8,000)</u>
Fiscal year	<u>\$ (100,000)</u>					<u>\$ (20,000)</u>

[FIN 18, paragraph 53]

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)			Tax (or Benefit)			
	Ordinary Income (Loss)	Year-to-Date	Estimated Annual Effective Tax Rate	Year-to-Date		Less Previously Provided	Reporting Period
				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>\$ (100,000)</u>						<u>\$ (20,000)</u>

[FIN 18, paragraph 54]

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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	<u>\$ 100,000</u>
The tax benefit to be recognized is the lesser of:	
Tax effect of the loss carryforward (\$100,000 at 50% statutory rate)	<u>\$ 50,000</u>
Amount of the net deferred tax liabilities that would otherwise have been settled during the carry-forward period	<u>\$ 24,000</u>
Estimated annual effective tax rate (\$24,000 ÷ \$100,000)	<u>24%</u>

[FIN 18, paragraph 55]

55-22 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)	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>	(100,000)	24%	(24,000)	(14,400)	<u>(9,600)</u>
Fiscal year	<u>\$ (100,000)</u>					<u>\$ (24,000)</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, Infrequently Occurring, or Extraordinary Items

55-24 The following Cases illustrate accounting for income taxes applicable to unusual, infrequently occurring, or extraordinary 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).

Pending Content

55-24 Editor's Note: The content of paragraph 740-270-55-24 will change upon transition, together with a change in its heading noted below.

Example 3: Accounting for Income Taxes Applicable to Unusual or Infrequently Occurring Items

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).

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55-25 Cases A and B illustrate the computation of the tax (or benefit) applicable to unusual, infrequently occurring, or extraordinary 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, infrequently occurring, or extraordinary 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, infrequently occurring, or extraordinary items is illustrated in Example 7 (see paragraph 740-270-55-52). [FIN 18, paragraph 56]

Pending Content

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]

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, infrequently occurring, or extraordinary 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.

Reporting Period	Ordinary Income	Unusual, Infrequently Occurring, or Extraordinary Loss	Tax (or Benefit) Applicable to	
			Ordinary Income	Unusual, Infrequently Occurring, or Extraordinary Loss
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>16,000</u>	
Fiscal year	<u>\$ 100,000</u>	<u>\$ (50,000)</u>	<u>\$ 40,000</u>	<u>\$ (25,000)</u>

Pending Content

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.

Reporting Period	Ordinary Income	Unusual or Infrequently Occurring	Tax (or Benefit) Applicable to	
			Ordinary Income	Unusual or Infrequently Occurring
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>16,000</u>	
Fiscal year	<u>\$ 100,000</u>	<u>\$ (50,000)</u>	<u>\$ 40,000</u>	<u>\$ (25,000)</u>

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55-27 Note that changes in assumptions would not change the timing of the recognition of the tax benefit applicable to the unusual, infrequently occurring, or extraordinary item as long as realization is more likely than not. [FIN 18, paragraph 57]

Pending Content

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]

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, infrequently occurring, or extraordinary 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, infrequently occurring, or extraordinary 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. [FIN 18, paragraph 58]

Assumptions and Reporting Period	Ordinary Income (Loss)	Unusual, Infrequently Occurring, or Extraordinary Loss	Tax (or Benefit) Applicable to				
			Ordinary Income (Loss)	Unusual, Infrequently Occurring, or Extraordinary 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>16,000</u>	40,000	(25,000)	(24,000)	<u>(1,000)</u>
Fiscal year	<u>\$ 100,000</u>	<u>\$ (50,000)</u>	<u>\$ 40,000</u>				<u>\$ (25,000)</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>16,000</u>	40,000	(25,000)	(24,000)	<u>(1,000)</u>
Fiscal year	<u>\$ 100,000</u>	<u>\$ (50,000)</u>	<u>\$ 40,000</u>				<u>\$ (25,000)</u>

FIN 18, paragraph 58

Pending Content

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.

			Tax (or Benefit) Applicable to				
			Ordinary Income (Loss)		Unusual or Infrequently Occurring Loss		
Assumptions and Reporting Period	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>16,000</u>	40,000	(25,000)	(24,000)	<u>(1,000)</u>
Fiscal year	<u>\$ 100,000</u>	<u>\$ (50,000)</u>	<u>\$ 40,000</u>				<u>\$ (25,000)</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>16,000</u>	40,000	(25,000)	(24,000)	<u>(1,000)</u>
Fiscal year	<u>\$ 100,000</u>	<u>\$ (50,000)</u>	<u>\$ 40,000</u>				<u>\$ (25,000)</u>

FIN 18, paragraph 58

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	<u>\$ 100,000</u>
Tax at 50% statutory rate	\$ 50,000
Less anticipated credit	<u>(10,000)</u>
Net tax to be provided	<u>\$ 40,000</u>
Estimated annual effective tax rate	<u>40%</u>

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55-30 Quarterly tax computations for the first two quarters are as follows.

Reporting Period	Ordinary Loss		Estimated Annual Effective Tax Rate	Tax		
	Reporting Period	Year-to-Date		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 ^(a)	—	—
Fiscal year	<u>\$ 160,000</u>	<u>\$ (25,000)</u>	<u>\$ (55,000)</u>

^(a) Estimated.

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.

Reporting Period	Ordinary Loss		Estimated Annual Effective Tax Rate	Tax		
	Reporting Period	Year-to-Date		Year-to-Date	Less Previously Provided	Reporting Period
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>\$ 160,000</u>					<u>\$ 72,000</u>

[FIN 18, paragraph 62]

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55-34 Tax benefit applicable to Division X for the first two quarters is computed as follows.

Reporting Period	Tax Applicable to Ordinary Loss		Tax Benefit Applicable to Division X (A–B)
	Previously Reporting (A)	Recomputed (Above) (B)	
First quarter	\$ 8,000	\$ 11,250	\$ (3,250)
Second quarter	10,000	15,750	(5,750)
			<u>\$ (9,000)</u>

FIN 18, paragraph 62

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.

	Loss From Operations Division X	Provision for Loss on Disposal
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)	(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	<u>72,000</u>	<u>72,000</u>
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.

Reporting Period	Pretax Income (Loss)			Tax (or Benefit) Applicable to		
	Continuing Operations	Operations of Division X	Provisions for Loss on Disposal	Continuing Operations	Operations of Division X	Provisions for Loss on Disposal
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]

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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:

- Ordinary income in all jurisdictions (Case A)
- Ordinary loss in a jurisdiction; realization of the tax benefit not more likely than not (Case B)
- 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 extraordinary 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.

Pending Content

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>\$ 100,000</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>\$ 38,000</u>

Overall estimated annual effective tax rate (\$38,000 ÷ \$100,000)	<u>38%</u>
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55-40 Quarterly tax computations are as follows.

Reporting Period	Ordinary Income				Tax			
	United States	Country A	Total	Year-to-Date	Overall Estimated Annual Effective Tax Rate	Year-to-Date	Less Previously Reported	Reporting Period
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>\$ 60,000</u>	<u>\$40,000</u>	<u>\$ 100,000</u>					<u>\$ 38,000</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.

Reporting Period	Ordinary Income (or Loss)					Tax (or Benefit)		
	United States	Country A	Combined Excluding Country B	Country B	Total	Combined Excluding Country B	Country B	Total
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>\$ 60,000</u>	<u>\$ 40,000</u>	<u>\$ 100,000</u>	<u>\$ (40,000)</u>	<u>\$ 60,000</u>	<u>\$ 38,000</u>	<u>\$ —</u>	<u>\$ 38,000</u>

[FIN 18, paragraph 66]

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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
First quarter	FC	10,000	FC 4,000	\$ 12,500	\$ 3,000
Second quarter		5,000	2,000	8,750	1,500
Third quarter		30,000	12,000	27,500	9,000
Fourth quarter		<u>15,000</u>	<u>6,000</u>	<u>16,250</u>	<u>4,500</u>
Fiscal year	FC	<u>60,000</u>	FC <u>24,000</u>	<u>\$ 65,000</u>	<u>\$ 18,000</u>

55-43 Quarterly tax provisions are as follows.

Reporting Period	Ordinary Income					Tax		
	United States	Country A	Combined Excluding Country C	Country C	Total	Combined Excluding Country C	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	<u>35,000</u>	<u>5,000</u>	<u>40,000</u>	<u>16,250</u>	<u>56,250</u>	<u>15,200</u>	<u>4,500</u>	<u>19,700</u>
Fiscal year	<u>\$ 60,000</u>	<u>\$40,000</u>	<u>\$100,000</u>	<u>\$ 65,000</u>	<u>\$165,000</u>	<u>\$ 38,000</u>	<u>\$18,000</u>	<u>\$ 56,000</u>

[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:

- Legislation effective in a future interim period (Case A)
- 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 ÷ \$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 ÷ \$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]

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]

ASC 740-270 — Implementation Guidance and Illustrations (continued)

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.

Net sales ^(a)		\$	XXXX	
Other Income ^(a)			XXX	
			<u>XXXX</u>	
Costs and Expenses				
Cost of sales ^(a)	\$	XXXX		
Selling, general and administrative expenses ^(a)		XXXX		
Interest expenses ^(a)		XXX		
Other deductions ^(a)		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 ^(b)				XXXX
Provision for income taxes (benefit) ^(b)				<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		
				<u>XXXX</u>
Income (loss) before extraordinary items				XXXX
Extraordinary items (less applicable income of \$XXXX)				<u>XXXX</u>
Net income (loss)				<u>\$ XXXX</u>

^(a) Components of ordinary income (loss).

^(b) Consists of the total income taxes (or benefit) applicable to ordinary income, unusual items, and infrequently occurring items.

[FIN 18, paragraph 71]

ASC 740-270 — Implementation Guidance and Illustrations (continued)

Pending Content

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 ^(a)		\$	XXXX	
Other Income ^(a)			XXX	
			<u>XXXX</u>	
Costs and Expenses				
Cost of sales ^(a)	\$	XXXX		
Selling, general and administrative expenses ^(a)		XXXX		
Interest expenses ^(a)		XXX		
Other deductions ^(a)		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 ^(b)				XXXX
Provision for income taxes (benefit) ^(b)				<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		
				<u>XXXX</u>
Income (loss) before extraordinary items				XXXX
Extraordinary items (less applicable income of \$XXXX)				<u>XXXX</u>
Net income (loss)				<u>\$ XXXX</u>

^(a) Components of ordinary income (loss).

^(b) 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:

- The enacted tax rate is 40 percent for all future years, and amortization of goodwill is not deductible for tax purposes.
- A wholly owned entity is acquired for \$20,000, and the entity has no leveraged leases.
- 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.

ASC 805-740 — Implementation Guidance and Illustrations (continued)

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:

- The enacted tax rate is 40 percent for all future years.
- The purchase price is \$20,000, and the assigned value of the net assets acquired is also \$20,000.
- 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.
- 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)

- 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.

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.

	Year 3	Year 4
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.

	Year 3	Year 4
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]

ASC 805-740 — Implementation Guidance and Illustrations (continued)

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.

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>\$ 20,000</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 FC. 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.

	19X2		19X3
Financial reporting basis	CFC 350	× 1.5	CFC 525
Tax basis	CFC 100	× 1.25	CFC 125
Temporary difference	CFC 250		CFC 400
Tax rate	× .40		× .40
Deferred tax liability, end of year	CFC 100		CFC 160
Deferred tax liability (restarted), beginning of year	CFC 100	× 1.5	CFC 150
Deferred tax expense			CFC 10

[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 demonstrates the application of the cost, equity, and effective yield methods of accounting for a limited partnership investment in a qualified affordable housing project. [EITF 94-01, paragraph Exhibit 94-1A]

Pending Content

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.

Date of investment	January 1, 19X1
Purchase price of investment	\$ 100,000

Pending Content

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 8 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 and book loss will be equal to depreciation expense. The cumulative book loss recognized by the investor under the equity method of accounting is limited to the \$100,000 investment.
- i. Deferred taxes are provided for the difference between the book and tax bases of the investment. Deferred taxes are provided for losses in excess of the at-risk investment.
- j. The investor will maintain the investment for 15 years (so there will be no recapture of tax credits).
- k. The investor expects that the estimated residual value of the investment will be zero.
- l. Under the effective yield method, a letter of credit or similar guarantee exists to qualify the investment for the use of the effective yield method. [EITF 94-1, Exhibit 94-1A]

Pending Content

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 The investor's cash flow analysis follows.

Year	Purchase of Investment (1)	Tax Depreciation (2)	Tax Credit (3)	Taxes Saved (4)	Cash Saved (Spent)
1	\$ 100,000				\$ (100,000)
2		\$ 7,273	\$ 16,000	\$ 18,909	18,909
3		7,273	16,000	18,909	18,909
4		7,273	16,000	18,909	18,909
5		7,273	16,000	18,909	18,909
6		7,273	16,000	18,909	18,909
7		7,273	16,000	18,909	18,909
8		7,273	16,000	18,909	18,909
9		7,273	16,000	18,909	18,909
10		7,273	16,000	18,909	18,909
11		7,273		2,909	2,909
12		7,273		2,909	2,909
13		7,273		2,909	2,909
14		7,273		2,909	2,909
15		<u>7,273</u>	<u> </u>	<u>2,909</u>	<u>2,909</u>
Total		<u>\$ 109,095</u>	<u>\$ 160,000</u>	<u>\$ 203,635</u>	<u>\$ 103,635</u>

(1) Assumed investment for a 5 percent limited partnership interest in the project.

(2) Depreciation (on \$200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.

(3) 8 percent tax credit on \$200,000 tax basis of the underlying assets.

(4) (Column [2] × 40% tax rate) + Column (3).

ASC 323-740 — Implementation Guidance and Illustrations (continued)

Pending Content

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 × (total tax benefits received during the year in Column (6) / 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) × 40% tax rate.
- (6) Column (3) + Column (5).
- (7) Column (6) – Column (2).

ASC 323-740 — Implementation Guidance and Illustrations (continued)

55-6 A summary of the net income effect of the cost, equity, and effective yield methods follows. This summary is based on the detailed analyses of the cost method with amortization, the equity method, and the effective yield method, which appear after the following summary.

Summary of Net Income Impact

Year	Cost Method			Equity Method			Effective Yield Method		
	Income (Loss) Continuing Operations	Income Tax Expense (Benefit)	Net Income	Income (Loss) Continuing Operations	Income Tax Expense (Benefit)	Net Income	Income (Loss) Continuing Operations	Income Tax Expense (Benefit)	Net Income
1	\$ (10,000)	\$ (20,000)	\$ 10,000	\$ (7,273)	\$ (18,909)	\$ 11,636		\$ (12,164)	\$ 12,164
2	(10,000)	(20,000)	10,000	(7,273)	(18,909)	11,636		(11,795)	11,795
3	(10,000)	(20,000)	10,000	(7,273)	(18,909)	11,636		(11,392)	11,392
4	(10,000)	(20,000)	10,000	(7,273)	(18,909)	11,636		(10,949)	10,949
5	(10,000)	(20,000)	10,000	(7,273)	(18,909)	11,636		(10,464)	10,464
6	(10,000)	(20,000)	10,000	(7,273)	(18,909)	11,636		(9,932)	9,932
7	(10,000)	(20,000)	10,000	(7,273)	(18,909)	11,636		(9,349)	9,349
8	(10,000)	(20,000)	10,000	(7,273)	(18,909)	11,636		(8,710)	8,710
9	(10,000)	(20,000)	10,000	(25,816)	(26,327)	511		(8,009)	8,009
10	(10,000)	(20,000)	10,000	(16,000)	(22,401)	6,401		(7,236)	7,236
11									
12									
13									
14									
15									
Total	<u>\$ (100,000)</u>	<u>\$ (200,000)</u>	<u>\$ 100,000</u>	<u>\$ (100,000)</u>	<u>\$ (200,000)</u>	<u>\$ 100,000</u>	<u>\$ —</u>	<u>\$ (100,000)</u>	<u>\$ 100,000</u>

[EITF 94-01, paragraph Exhibit 94-1A]

Pending Content

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	Net Investment (1)	Amortization of Investment (2)	Tax Depreciation (3)	Tax Credit (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
1	\$ 90,000	\$ 10,000	\$ 7,273	\$ 16,000	\$ 18,909	\$ 1,091	\$ 10,000
2	80,000	10,000	7,273	16,000	18,909	1,091	10,000
3	70,000	10,000	7,273	16,000	18,909	1,091	10,000
4	60,000	10,000	7,273	16,000	18,909	1,091	10,000
5	50,000	10,000	7,273	16,000	18,909	1,091	10,000
6	40,000	10,000	7,273	16,000	18,909	1,091	10,000
7	30,000	10,000	7,273	16,000	18,909	1,091	10,000
8	20,000	10,000	7,273	16,000	18,909	1,091	10,000
9	10,000	10,000	7,273	16,000	18,909	1,091	10,000
10		10,000	7,273	16,000	18,909	1,091	10,000
11			7,273		2,909	(2,909)	
12			7,273		2,909	(2,909)	
13			7,273		2,909	(2,909)	
14			7,273		2,909	(2,909)	
15			7,273		2,909	(2,909)	
Total		<u>\$ 100,000</u>	<u>\$ 109,095</u>	<u>\$ 160,000</u>	<u>\$ 203,635</u>	<u>\$ (3,635)</u>	<u>\$ 100,000</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.
- (4) 8 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).

ASC 323-740 — Implementation Guidance and Illustrations (continued)

Pending Content

55-7 A detailed analysis of the cost method with amortization follows.

Year	Net Investment (1)	Amortization of Investment (2)	Tax Depreciation (3)	Tax Credit (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
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	\$ 16,000	\$ 18,909		\$ 11,636
2	85,454	7,273	7,273	16,000	18,909		11,636
3	78,181	7,273	7,273	16,000	18,909		11,636
4	70,908	7,273	7,273	16,000	18,909		11,636
5	63,635	7,273	7,273	16,000	18,909		11,636
6	56,362	7,273	7,273	16,000	18,909		11,636
7	49,089	7,273	7,273	16,000	18,909		11,636
8	41,816	7,273	7,273	16,000	18,909		11,636
9 ^(a)	16,000	25,816	7,273	16,000	18,909	\$ 7,418	511
10		16,000	7,273	16,000	18,909	3,492	6,401
11			7,273		2,909	(2,909)	
12			7,273		2,909	(2,909)	
13			7,273		2,909	(2,909)	
14			7,273		2,909	(2,909)	
15			7,273		2,909	(2,909)	
Total		<u>\$ 100,000</u>	<u>\$ 109,095</u>	<u>\$ 160,000</u>	<u>\$ 203,635</u>	<u>\$ (3,635)</u>	<u>\$ 100,000</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 (*) below)

(3) Depreciation (on \$200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.

(4) 8 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).

ASC 323-740 — Implementation Guidance and Illustrations (continued)

Pending Content

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 ^(a)	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 ^(a) 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).

ASC 323-740 — Implementation Guidance and Illustrations (continued)

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 A detailed analysis of the effective yield method follows.

Year	Net Investment (1)	Tax Credit (2)	Amortization of Investment (3)	Tax Depreciation (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
1	\$ 93,607	\$ 16,000	\$ 6,393	\$ 7,273	\$ 12,516	\$ (352)	\$ 12,164
2	86,599	16,000	7,008	7,273	11,901	(106)	11,795
3	78,918	16,000	7,681	7,273	11,228	163	11,391
4	70,499	16,000	8,419	7,273	10,490	458	10,948
5	61,272	16,000	9,227	7,273	9,682	782	10,464
6	51,158	16,000	10,114	7,273	8,795	1,136	9,931
7	40,073	16,000	11,085	7,273	7,824	1,525	9,349
8	27,923	16,000	12,150	7,273	6,759	1,951	8,710
9	14,605	16,000	13,318	7,273	5,591	2,418	8,009
10		16,000	14,605	7,273	4,304	2,935	7,239
11				7,273	2,909	(2,909)	
12				7,273	2,909	(2,909)	
13				7,273	2,909	(2,909)	
14				7,273	2,909	(2,909)	
15				7,273	2,909	(2,909)	
Total		<u>\$ 160,000</u>	<u>\$ 100,000</u>	<u>\$ 109,095</u>	<u>\$ 103,635</u>	<u>\$ (3,635)</u>	<u>\$ 100,000</u>
Internal rate of return based on tax credits only						<u>9.61%</u>	

(1) End-of-year investment for a 5 percent limited partnership interest in the project net of amortization in Column (3).

(2) 8 percent tax credit on \$200,000 tax basis of the underlying assets.

(3) Column (2) – (beginning investment × 9.61%).

(4) Depreciation (on \$200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.

(5) Column (2) – Column (3) + (Column [4] × 40% tax rate).

(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 [3] – Column [4]) × 40% tax rate.

(7) Column (5) + Column (6).

[EITF 94-1, paragraph Exhibit 94-1A]

Pending Content

55-10 Paragraph superseded by Accounting Standards Update No. 2014-01

Appendix B — Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

AICPA Literature

AICPA Statement on Auditing Standards, AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

AICPA Statement of Position (SOP) 93-6, *Employers' Accounting for Employee Stock Ownership Plans*

FASB ASC References

For titles of *FASB Accounting Standards Codification* references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#)."

FASB Accounting Standards Updates and Other FASB Literature

See the FASB's Web site for the titles of:

- [Accounting Standards Updates](#).
- [Proposed Accounting Standards Updates](#) (exposure drafts and public comment documents).
- [Pre-Codification literature](#) (Statements, Staff Positions, EITF Issues, and Topics).
- [Concepts Statements](#).

PCAOB Literature

AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*

SEC Division of Corporation Finance FRM

Topic 3, "Pro Forma Financial Information"

- Section 3410, "Sub-Chapter S Corporations and Partnerships"
- Section 3270, "Tax Effects"

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 11-02, “Preparation Requirements”

Rule 12-09, “Valuation and Qualifying Accounts”

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.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”

Topic 11.C, “Tax Holidays”

International Standards

See Deloitte’s [IAS Plus Web site](#) for the titles of:

- International Financial Reporting Standards.
- International Accounting Standards.
- Exposure documents.

Appendix C — Abbreviations

Abbreviation	Description
AC	acquiring company
AETR	annual effective tax rate
AFS	available for sale
AGUB	adjusted grossed-up basis
AICPA	American Institute of CPAs
AMT	alternative minimum tax
AMTI	alternative minimum taxable income
AOCI	accumulated other comprehensive income
APB	Accounting Principles Board
APIC	additional paid-in capital
ASC	FASB Accounting Standards Codification
ASR	SEC Accounting Series Release
ASU	FASB Accounting Standards Update
CAD	Canadian dollar
C&DI	SEC Compliance and Disclosure Interpretation
CFC	controlled foreign corporation
CGT	capital gains tax
CNIT	corporate net income tax
CPP	cash purchase price
CTA	cumulative translation adjustment
CU	currency unit
DTA	deferred tax asset
DTE	deferred tax expense
DTL	deferred tax liability

Abbreviation	Description
E&P	earnings and profits
EBITDA	earnings before income taxes, depreciation, and amortization
ED	exposure draft
EITF	FASB's Emerging Issues Task Force
EPS	earnings per share
ESOP	employee stock ownership plan
ESPP	employee stock purchase plan
ETR	effective tax rate
FAQ	frequently asked question
FAS	FASB Statement of Financial Accounting Standard
FASB	Financial Accounting Standards Board
FBB	final book basis
FC	foreign currency
FCC	Federal Communications Commission
FCT	foreign currency transaction
FIFO	first in, first out
FIN	FASB Interpretation
FRM	SEC Financial Reporting Manual
FSP	FASB Staff Position
FTB	FASB Technical Bulletin
FTC	foreign tax credit
GAAP	generally accepted accounting principles
GP	general partner
GRT	gross receipts tax

Abbreviation	Description	Abbreviation	Description
GW	goodwill	OTTI	other-than-temporary impairment
HTM	held to maturity	P&L	profit and loss
IAS	International Accounting Standard	PCAOB	Public Company Accounting Oversight Board
IASB	International Accounting Standards Board	PP&E	property, plant, and equipment
IFRIC	IFRS Interpretations Committee	PTI	percentage of taxable income
IFRS	International Financial Reporting Standard	QAHP	qualified affordable housing project
IPO	initial public offering	QAHPI	qualified affordable housing project investment
IRC	Internal Revenue Code	Q&A	question and answer
IRS	Internal Revenue Service	REIT	real estate investment trust
ISO	incentive stock option	R&D	research and development
LC	local currency	RIC	regulated investment company
LICTI	life insurance company taxable income	SAB	SEC Staff Accounting Bulletin
LIFO	last in, first out	SEC	U.S. Securities and Exchange Commission
LLC	limited liability company	SIC	Standing Interpretations Committee
MD&A	Management's Discussion and Analysis	SOP	AICPA Statement of Position
MLTN	more likely than not	TC	target company
MPA	modified prospective application	TMT	tentative minimum tax
NFP	not-for-profit entity	TSA	tax-sharing arrangement
NIBT	net income before tax	TTB	total tax benefit
NOL	net operating loss	USD	U.S. dollar
NQSO	nonstatutory option	UTB	unrecognized tax benefit
NSO	see NQSO	UTP	uncertain tax position
OCI	other comprehensive income	VIE	variable interest entity
OECD	Organisation for Economic Co-operation and Development		

Appendix D — 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).

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.

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.

ASC 740 — Glossary (continued)

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]

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]

ASC 740 — Glossary (continued)

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, extraordinary items, and items charged or credited directly to shareholders' equity. [FAS 109, paragraph 289]

Note: The following definition is Pending Content; see Transition Guidance in 225-20-65-1.

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]

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]

ASC 740 — Glossary (continued)

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]

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]

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]

ASC 740 — Glossary (continued)

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]

- 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]
- 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]
- They are able to enter into a transaction for the asset or liability [FAS 157, paragraph 10]
- 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)]

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:

- 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).
- 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).
- Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities. [FAS 109, paragraph 289]

ASC 740 — Glossary (continued)

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]

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]

ASC 740 — Glossary (continued)

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]

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]

Temporary Difference

A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites eight examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 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. [FAS 109, paragraph 289]

Note: The following definition is Pending Content; see Transition Guidance in 740-10-65-5.

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 examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 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. [FAS 109, paragraph 289]

Tentative Minimum Tax

An intermediate calculation used in the determination of a corporation's federal income tax liability under the alternative minimum tax system in the United States. See Alternative Minimum Tax.

Time Value

The portion of the fair value of an option that exceeds its intrinsic value. For example, a call option with an exercise price of \$20 on a stock whose current market price is \$25 has intrinsic value of \$5. If the fair value of that option is \$7, the time value of the option is \$2 (\$7 – \$5). [FAS 123(R), paragraph E1]

ASC 740 — Glossary (continued)

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 E — 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 740¹ 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.

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

¹ 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."

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 Estimates²

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*

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

² 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.

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 Resources³

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.

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.

³ 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.

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.

Contractual Obligations					
	Total	Less Than 1 Year	1–3 Years	3–5 Years	More Than 5 Years
	(in millions)				
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
Total	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>

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:

Payments Due In					
	Total	Less Than 1 Year	1–3 Years	3–5 Years	More Than 5 Years
	(in millions)				
Operating lease obligations	\$ XXX	\$ XXX	\$ XXX	\$ XXX	\$ XXX
Purchase obligations	XXX	XXX	XXX	XXX	XXX
Other obligations	XXX	XXX	XXX	XXX	XXX
Total	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>

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		
	20X3	20X2	20X1
	(in millions)		
Noncash Investing and Financing Activities:			
Acquisition of property and equipment on account	\$ XXX	\$ XXX	\$ XXX
Acquisition of property and equipment through long-term financing	XXX	XXX	XXX
Supplemental Cash Flow Information:			
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”⁴

Sample Disclosure 1

For financial reporting purposes, income before income taxes includes the following components:

	Years Ended December 31		
	20X3	20X2	20X1
	(in millions)		
United States	\$ XXX	\$ XXX	\$ XXX
Foreign	XXX	XXX	XXX
Total	\$ XXX	\$ XXX	\$ XXX

The expense (benefit) for income taxes consists of:

	Years Ended December 31		
	20X3	20X2	20X1
	(in millions)		
Current:			
Federal	\$ XXX	\$ XXX	\$ XXX
State	XXX	XXX	XXX
Foreign	XXX	XXX	XXX
	\$ XXX	\$ XXX	\$ XXX
Deferred and other:			
Federal	\$ XXX	\$ XXX	\$ XXX
State	XXX	XXX	XXX
Foreign	XXX	XXX	XXX
	\$ XXX	\$ XXX	\$ XXX
Total tax expense	\$ XXX	\$ XXX	\$ XXX

Sample Disclosure 2

For financial reporting purposes, income before income taxes includes the following components:

	Years Ended December 31		
	20X3	20X2	20X1
	(in millions)		
United States	\$ XXX	\$ XXX	\$ XXX
Foreign	XXX	XXX	XXX
Total	\$ XXX	\$ XXX	\$ XXX

⁴ 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.

The provision for income taxes for 20X3, 20X2, and 20X1 consisted of the following:

	Years Ended December 31		
	20X3	20X2	20X1
	(in millions)		
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>
Provision for income taxes	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>

Components of Income Tax Expense or Benefit (ASC 740-10-50-9)

Sample Disclosure 1

	Years Ended December 31		
	20X3	20X2	20X1
	(in millions)		
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>
Total tax expense	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>

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		
	20X3	20X2	20X1
	(in millions)		
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>
Total tax expense	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>

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:

	Years Ended December 31		
	20X3	20X2	20X1
	(in millions)		
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 ⁵	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>
Income tax expense (benefit)	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>

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.

⁵ 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:

	Years Ended December 31		
	20X3	20X2	20X1
	(in millions)		
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 ⁶	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	XXX	XXX	XXX
Reported income tax (benefit) expense	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>
Effective tax rate	XX%	XX%	XX%

Unrecognized Deferred Tax Liability Related to Investments in Foreign Subsidiaries (ASC 740-30-50-2⁷)

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 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.

⁶ See footnote 4.

⁷ See footnote 2.

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)

	December 31	
	20X3	20X2
	(in millions)	
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>\$ XXX</u>	<u>\$ XXX</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	\$ XXX	\$ XXX

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>\$ XXX</u>

Valuation Allowance⁸ 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

⁸ 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.

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>
	<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 \$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.

Valuation Allowance Reversal⁹

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.

⁹ 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.

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.

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:

	20X3	20X2	20X1
		(in millions)	
Unrecognized tax benefits — January 1	\$ XXX	\$ XXX	\$ XXX
Gross increases — tax positions in prior period	XXX	XXX	XXX
Gross decreases — tax positions in prior period	XXX	XXX	
Gross increases — tax positions in current period	XXX	XXX	XXX
Settlement	XXX	XXX	XXX
Lapse of statute of limitations	XXX	XXX	XXX
Unrecognized tax benefits — December 31	\$ XXX	\$ XXX	\$ XXX

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.

	20X3	20X2	20X1
		(in millions)	
Unrecognized tax benefits — January 1	\$ XXX	\$ XXX	\$ XXX
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	XXX	XXX	XXX
Unrecognized tax benefits — December 31	<u>\$ XXX</u>	<u>\$ XXX</u>	<u>\$ XXX</u>

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 ¹	Column C — Additions		Column D — Deductions — describe	Column E — Balance at end of period
	Column B — Balance at beginning of period	(1) — Charged to costs and expenses	(2) — Charged to other accounts — describe	
¹ 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 F — 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, (3) rate reconciliation, and (4) unrecognized tax benefits.

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 the "Management's Discussion and Analysis" section of Deloitte's *SEC Comment Letters — Including Industry Insights — What "Edgar" Told Us (Ninth Edition)* and its recently issued *SEC Comment Letters — Statistics According to "Edgar": Supplement to the Ninth Edition*.

At the 2015 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff reemphasized the need for registrants to improve disclosures and increase transparency related to (1) the potential tax and liquidity ramifications of cash held outside the United States and (2) the tax rate reconciliation. Specifically, the staff noted that in situations in which a registrant has asserted that its foreign earnings are indefinitely reinvested but also has significant amounts of cash located in foreign jurisdictions that would be subject to tax if such amounts were repatriated, the staff has requested disclosure of the amount of cash that is held in those foreign jurisdictions.

The staff also remarked that in the tax rate reconciliation, registrants continue to use boilerplate language that is not especially helpful in describing 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.

Another issue under recent SEC scrutiny is the increased use of non-GAAP measures (see the [Non-GAAP Measures — Treatment of Tax Adjustments](#) section in Chapter 6), particularly with respect to income taxes, as evidenced by several recent speeches highlighting the inappropriate use of non-GAAP measures that do not contemplate the tax effects of the adjustments made to the GAAP 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. Question 102.11 of the SEC staff's Compliance and Disclosure Interpretations (C&DIs) on non-GAAP measures 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. Given the recent scrutiny of non-GAAP measures, registrants can expect to receive comments from the staff if such disclosures are not in accordance with the established C&DIs.

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.

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, 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.

Unrecognized Tax Benefits

Under ASC 740-10-25-6, entities cannot recognize a tax benefit related to a tax position unless it is "more likely than not" that tax authorities will sustain the tax position solely on technical merits. The tax benefit recognized is measured as the largest amount of the tax benefit that is more than 50 percent likely to be realized. The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured under ASC 740-10 is referred to as an "unrecognized tax benefit." Generally, if the unrecognized tax benefit would be settled by offsetting it with an available loss or tax credit carryforward in the same jurisdiction, it should be netted against the related DTA. Otherwise, the amount of the unrecognized tax benefit is presented as a liability in the statement of financial position.

The SEC staff has commented when registrants omit disclosures required under ASC 740-10-50-15 and 50-15A about unrecognized tax benefits, which include a tabular reconciliation of such benefits.

In addition, the SEC staff may ask registrants about their conclusions regarding disclosures about reasonably possible changes in unrecognized tax benefits. Because the guidance on the acceptable level of aggregation of information for these disclosures is not prescriptive and permits judgment, the SEC staff evaluates a registrant's level of disclosure on a case-by-case basis.

Examples of what registrants should disclose under ASC 740-10-50-15(d) include:

- Information related to scheduled expiration of the tax position's statute of limitations. A registrant should disclose this information if (1) the statute of limitations is scheduled to expire within 12 months of the financial statement's date and (2) management believes it is reasonably possible that the statute's expiration will cause the total amounts of unrecognized tax benefits to significantly increase or decrease.
- Significant unrecognized tax benefits for tax positions that the registrant believes will be effectively settled within 12 months in accordance with ASC 740-10-25-9.

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 the second half of 2015 and in 2016. 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:

Topic	Example Comments	Topic	Example Comments
Deferred Taxes	3	Rate Reconciliation — Foreign Rate Differential	14
Disclosures	8	Undistributed Earnings of Foreign Subsidiaries	12
Intraperiod Tax Allocation	2	Unrecognized Tax Benefits	7
Non-GAAP Measures	16	Valuation Allowance	17
Rate Reconciliation — General	17	Other	7

Examples of SEC Comments

Deferred Taxes

- 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

- 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

- 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

- 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.
- 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

- 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.
- 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.
- 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

- 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.
- 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.
- 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

- 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.
- 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.

- 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

- 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

- 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].
- 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.
- 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.
- 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.

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

- 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 *SEC Comment Letters — Including Industry Insights — What "Edgar" Told Us (Ninth Edition)* and its recently issued *SEC Comment Letters — Statistics According to "Edgar": Supplement to the Ninth Edition*.

Appendix G — Accounting for Income Taxes Under IFRSs

The following is an excerpt from the 2016 iGAAP Book, Chapter A13, *Income Taxes*. Requirements drawn from official IASB material are shown in unshaded text. Interpretative material supplementing the IASB guidance is highlighted by gray shading.

1 Introduction

1.1 Overview of IAS 12

IAS 12 *Income Taxes* follows a ‘comprehensive balance sheet method’ of accounting for income taxes, which recognises both the current tax consequences of transactions and events and the future tax consequences of the future recovery or settlement of the carrying amount of an entity’s assets and liabilities. Differences between the carrying amount and tax base of assets and liabilities, and carried forward tax losses and credits, are recognised, with limited exceptions, as deferred tax liabilities or deferred tax assets, with the latter also being subject to a ‘probable taxable profits’ test.

1.2 Amendments to IAS 12 since the last edition of this manual

None. IAS 12 was most recently amended in May 2014.

2 Scope

2.1 Income taxes – definition

IAS 12 deals with accounting for income taxes. The Standard defines income taxes as including “all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, that are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity”. [IAS 12:2]

The determination as to whether a tax is an ‘income tax’ is a matter requiring careful judgement based on the specific facts and circumstances. Factors to consider in making this determination include, but are not limited to, whether:

- the ‘starting point’ for determining the taxable amount is based on taxable profits rather than another metric (e.g. units of production);
- the tax is based on a ‘taxable profit’ notion, implying a net rather than a gross amount;
- the tax is based on actual income and expenses rather than a notional amount (e.g. on a tonnage capacity);
- the legal description or characteristics of the tax imply that the tax is calculated based on taxable profits; and
- there is any withholding related to the tax.

The IFRIC (now the IFRS Interpretations Committee) referred to this topic in the March 2006 *IFRIC Update*. The IFRIC noted that the definition of taxable profit implies that not all taxes are in the scope of IAS 12, and that the requirement to disclose an explanation of the relationship between the tax expense and the accounting profit implies that taxable profit need not be the same as accounting profit.

Taxes that are unlikely to meet the definition of an income tax include:

- sales taxes (because they are transactional taxes based on sales value rather than on taxable profits);
- production-based taxes (see example 2.5A); and
- ‘tonnage’ taxes (see 2.3).

Care should be exercised in respect of taxes imposed in different jurisdictions that are referred to by common titles but for which the detailed application varies significantly between jurisdictions (such as ‘petroleum revenue taxes’ – see example 2.5B). The determination as to whether such taxes are income taxes should be made on a case-by-case basis.

2.2 Levies

IFRIC 21 *Levies* provides guidance on when to recognise a liability for a ‘levy’ imposed by a government; a levy is defined as “an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (ie laws and/or regulations), other than:

- (a) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of IAS 12); and
- (b) fines or other penalties that are imposed for breaches of the legislation”.

Therefore, any levy imposed by a government should be assessed to determine if it meets the definition of an income tax (see 2.1). If it does, it should be accounted for in accordance with IAS 12 rather than in accordance with IFRIC 21.

Section 9.4 of chapter A12 provides a detailed description of the requirements of IFRIC 21.

2.3 Tonnage tax

In some jurisdictions, shipping entities can choose to be taxed by means of a ‘tonnage tax’ instead of under general corporate income tax regulations. Tonnage tax may be paid on the basis of tonnage transported, tonnage capacity or a notional profit.

The IFRIC (now the IFRS Interpretations Committee) have considered tonnage taxes, as reported in the May 2009 *IFRIC Update*. The IFRIC noted that taxes based on tonnage transported or tonnage capacity are based on a gross rather than a net amount, and taxes on notional income are not based on the entity’s actual income and expenses. Such taxes should not be considered income taxes in accordance with IAS 12 and should not be presented as part of tax expense in the statement of comprehensive income. However, the IFRIC also noted that an entity subject to tonnage tax might present additional subtotals in the statement of comprehensive income if that presentation is relevant to an understanding of its financial performance.

2.4 Interest and penalties

In many jurisdictions, interest and penalties are assessed on underpayments or late payments of income tax. In some circumstances, interest and penalties arise because the tax amount payable could not be agreed with the tax authority until significantly after the due date. Alternatively, interest and penalties may arise because the entity has made a deliberate choice not to make the appropriate tax payments before the due date.

When there is no significant uncertainty with respect to the overall amount of income tax payable and an entity deliberately delays payment of the amount, the resulting interest and penalties can be clearly distinguished from the assessed income tax. Accordingly, in such circumstances, the interest and penalties should not be presented as income tax in the financial statements, but should be separately presented on the basis of their nature (i.e. either as a finance cost (interest) or operating expense (penalties)).

However, in circumstances such as those described in 3.3.3.1 when there is significant uncertainty regarding the amount of income tax to be paid, an entity may in the course of its discussions with the tax authorities delay making payment for the full amount of tax possibly payable (to avoid, for example, prejudicing a future appeal against the amount claimed as due by the tax authorities) and, by so doing, risk incurring interest and penalties. In such circumstances, possible interest and penalties can be seen as being part of the overall uncertain tax position and, as such, an accounting policy of presenting them as part of tax expense (income) is acceptable.

2.5 Hybrid taxes

Entities are sometimes subject to a tax that has different components. It is necessary to exercise careful judgement when determining whether each of the components meets the definition of an income tax under IAS 12.

Example 2.5A

Tax comprising both production- and profit-based components

Company A is subject to a tax made up of two discrete components – a production-based component and a profit-based component. The production-based component is a fixed minimum amount per tonne of product sold. The total tax, however, may exceed the fixed minimum per tonne depending on the entity's profitability.

The production-based component of the tax should not be considered an income tax because it is based on the weight of product sold rather than taxable profits; it is, therefore, outside the scope of IAS 12. On the other hand, any amounts due as a result of the profit-based component should be considered an income tax and within the scope of IAS 12.

The production-based component of the tax may be reported within either 'cost of goods sold' or 'operating expenses', though the former is preferable. In either case, the presentation should reflect the substance of the entity's operations and should be consistently applied.

Example 2.5B

Petroleum revenue tax

In many jurisdictions, taxes are imposed on 'petroleum revenue'; these taxes are generally designed to ensure that the tax authority benefits from 'super profits' generated by entities in certain resource sectors.

Petroleum revenue taxes vary from jurisdiction to jurisdiction, but they are generally determined based on revenue from extraction activities reduced by specified items of deductible expenditure. The deductions are often limited to items relating to the extraction activities, but may also include other amounts such as administration expenses and deductions based on assets held in the industry.

In addition, the amount of petroleum revenue tax paid will often itself be deductible when computing the entity's 'general' income tax liability.

The key characteristic that defines an income tax is that it is based on a measure of taxable profit. Whether a petroleum revenue tax in a particular jurisdiction is considered to be an income tax will depend on the rules in that specific jurisdiction and whether the basis for the tax is judged to be closer to a measure of revenue or a measure of net profit.

The fact that the 'taxable profit' for the purposes of the petroleum revenue tax differs from 'taxable profit' for the purpose of a jurisdiction's general income tax regime (e.g. because it relates to only part of the operations or because different deductions or allowances are available) is not in itself relevant because the basis for the petroleum revenue tax may still be considered to be a measure of net profit (albeit a different measure than that used as the basis for general income tax).

If the petroleum revenue tax is allowed as a deduction when computing the entity's general income tax liability, this does not preclude the petroleum revenue tax from being considered an income tax for the purposes of IAS 12. The reference in IAS 12:2 to 'all' domestic taxes indicates that there may be more than one form of income tax in a particular jurisdiction.

2.6 Investment tax credits

IAS 12:4 states that the Standard does not deal with methods of accounting for government grants or 'investment tax credits'. IAS 12 does not provide a definition for 'investment tax credits', which is a term used in many tax jurisdictions to describe a wide range of tax arrangements. Accordingly, in practice, the first step in accounting for an 'investment tax credit' is to determine whether it is within the scope of IAS 12. Even if a tax benefit is referred to by a tax authority as an investment tax credit, it is important to consider the substance to determine whether the tax benefit is outside the scope of IAS 12. A tax credit (outside the scope of IAS 12) provides a reduction to taxes payable and can be distinguished from a tax deduction (within the scope of IAS 12) which is factored into the determination of taxable income.

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (see chapter A36) has a broad scope exemption, not just for investment tax credits, but also for "government assistance that is provided for an entity in the form of benefits that are available in determining taxable income or are determined or limited on the basis of income tax liability".

When a tax credit is determined to be an investment tax credit (and, consequently, outside the scope of IAS 12 and IAS 20), it is a matter of judgement under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to determine the most appropriate accounting treatment. It may be appropriate to analogue to IAS 12 or IAS 20. Generally, if an approach similar to IAS 12 is adopted, a credit will be recognised in profit or loss, and the related asset in the statement of financial position, when the entity satisfies the criteria to receive the credit. If the substance of the arrangement is considered to be closer to a government grant, and an IAS 20 approach is adopted, the credit will be recognised in profit or loss over the periods necessary to match the benefit of the credit with the costs for which it is intended to compensate.

2.7 Refundable tax credits

In some jurisdictions, tax credits may arise that have either or both of the following characteristics.

- The credit may be utilised to obtain a cash payment, rather than solely to reduce income tax payable in the year in which the credit is generated or to reduce income tax payable over a number of years. Therefore, the benefit is not dependent entirely on the entity having a future or past income tax liability against which the credit can be utilised (e.g. an entity may receive a full or partial cash payment despite being in a tax loss position).
- The credit may be utilised to receive a refund of a combination of income taxes and other non-income taxes paid during the year. For example, the tax credit may be offset first against income tax payable for the year, then against some other taxes (e.g. payroll taxes) incurred in the year, with any unused credit carried forward to subsequent years.

Such credits are often referred to as 'refundable' tax credits.

Whether refundable tax credits come within the scope of IAS 12 depends on the specific terms of the particular tax credits under consideration. The most appropriate accounting treatment for such refundable tax credits will be a matter of judgement to be determined under IAS 8. It will be necessary to look carefully at the substance of the particular credit, including the requirements that must be met in order to generate the credit and how the credit will be realised in practice. IAS 12 and IAS 20 are likely to provide the most appropriate references for the purpose of determining an appropriate accounting policy. For example, if the credit can be used to generate a cash payment and realisation is not dependent on any past or future income tax liability, then it may be reasonable to conclude that the credit is in the nature of a government grant and is not within the scope of IAS 12.

2.8 Additional tax deductions

Example 2.8

Additional tax deductions

Entity A will receive an additional tax deduction if it invests in more than 25 per cent of an investee abroad and it meets a number of specified conditions. The deduction is granted to encourage investment in foreign entities.

If the specified conditions are met, the additional tax deduction is 50 per cent of the cost of the investment. Entity A is permitted to use the deduction in the calculation of its current year's tax liability; alternatively, it can defer claiming the deduction, but only for a maximum of five years.

IAS 12:7 defines the tax base of an asset as "the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset" (see also 4.2.1).

In the circumstances described, the deduction is available independently of the recovery of the investment either through use or sale, and it is therefore not part of the tax base of the asset.

The incentive is not directly linked to any underlying asset. If deferred, it represents an unused tax deduction and, in accordance with IAS 12:34 (see 4.6.1), a deferred tax asset should be recognised to the extent that it is probable that future taxable profit will be available against which the unused tax deduction can be used.

Note that arrangements of the type described in example 2.8 are sometimes referred to as 'investment tax credits'; however, use of the term 'investment tax credit' in local tax legislation is not necessarily consistent with the term's use in IAS 12 and it is necessary to review the detailed application of tax incentives referred to as investment tax credits in order to determine whether they are within the scope of IAS 12 (see 2.6).

2.9 Classification of payments in a tax structuring transaction

When implementing tax planning strategies, entities will often incur costs payable to the designer of the strategy. In determining whether such costs meet the definition of income tax or should be treated as an operating expense, the entity will need to have regard to whether the payment is to the designer, or whether it is paid to the designer to be paid to the tax authorities on the entity's behalf.

Example 2.9

Classification of payments in a tax structuring transaction

Entity A has an effective domestic tax rate of 40 per cent. Entity A enters into a transaction with an investment bank which enables a portion of its activities (generating profit of CU1,000) to be taxed in a tax-haven jurisdiction rather than under Entity A's domestic tax regime.

The investment bank receives a 30 per cent fee based on total taxable profits before the transaction, of which it pays 10 per cent (CU30) over to the tax authorities in the tax-haven jurisdiction. The net result of the transaction on domestic tax is that tax is paid on 10 per cent of the original profit. The following table illustrates the effect of the transaction on taxable profits and tax payments.

	Before structuring CU	After structuring CU
Taxable profit before structuring	1,000	1,000
Fee payable to investment bank	—	(300)
Domestic tax (40%)	(400)	(40)
Profit after fee payable to investment bank and domestic tax	600	660

Example 2.9 (continued)

Classification of payments in a tax structuring transaction

Should the fee payable by Entity A to the investment bank be classified as income tax expense?

No, but consideration should be given to whether the tax paid by the investment bank was paid on Entity A's behalf.

Only amounts that are ultimately paid to tax authorities on Entity A's behalf should be considered as tax expenses. In the circumstances described, an evaluation needs to be performed as to whether, in substance, Entity A continues to bear the tax risk associated with the tax payment by the investment bank, or whether the bank makes the tax payment of CU30 on its own behalf. If Entity A retains substantially all of the tax risk associated with the tax payment by the investment bank, all direct and indirect payments to the tax authorities should be considered as a tax expense, resulting in the recognition of a tax expense of CU70 (CU40 domestic tax paid by Entity A and CU30 tax in the tax-haven jurisdiction paid on Entity A's behalf by the investment bank). If the investment bank takes over substantially all the tax risk, the entire fee paid to the investment bank will be an operating expense and the tax expense will be only the domestic tax of CU40.

In determining whether Entity A has retained the tax risk, the following factors should be considered:

- whether the tax authority has any power to demand payment from Entity A if the investment bank does not pay; and
- whether Entity A could be required to make further payments for the tax (or be entitled to refunds) if the onward payment proves to have been miscalculated.

2.10 Classification of payments to acquire tax losses

Example 2.10

Classification of payments to acquire tax losses

In some jurisdictions, the tax authority requires each entity to file its tax return as if it is a stand-alone tax payer which is taxed and pays income tax separately. However, within a tax group (e.g. a group of entities under common control), tax losses may be transferred between entities and used to offset the taxable income in the purchasing entity. The price to be paid for the tax losses is determined by agreement between the seller and the purchaser.

For example, Entity A and Entity B are both direct subsidiaries of Entity P. The tax rate in their jurisdiction is 30 per cent. Entity A acquires tax losses of CU100 from Entity B at an agreed price of CU50 and utilises the tax losses immediately.

In its separate financial statements, how should Entity A classify the payment made to Entity B to acquire the tax losses?

In this example, the payment of CU50 exceeds the tax benefit that Entity A has acquired (which is $30\% \times \text{CU}100 = \text{CU}30$). The payment can only be considered a settlement of Entity A's income tax liability to the extent of that tax benefit. Therefore, only CU30 of the payment should be offset against Entity A's tax liability.

The accounting treatment for the excess payment of CU20 should reflect the substance of the transaction. In particular, it is necessary to consider whether Entity A has acquired anything else from Entity B that would correspond to the excess payment of CU20. If not, the substance of the transaction would seem to be that the excess payment of CU20 represents a distribution by Entity A which has been directed to Entity B in accordance with the wishes of their common parent, Entity P. Entity A should therefore recognise the CU20 as a distribution in equity.

In practice, the losses will be included in the tax return and Entity A will have recognised a lower tax expense and tax liability on the basis of the amounts in the tax return. The entries to reflect the cash payment of CU50 will therefore be as follows.

		CU	CU
Dr	Tax expense	30	
Dr	Distribution	20	
Cr	Cash		50

3 Current tax

3.1 Definitions

Current tax is defined as the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. [IAS 12:5] It is the tax that the entity expects to pay (recover) in respect of a financial period.

Taxable profit (tax loss) is defined as the profit (loss) for a period, determined in accordance with the rules established by the tax authorities, upon which income taxes are payable (recoverable). [IAS 12:5]

3.2 Recognition of current tax assets and liabilities

3.2.1 Recognition of current tax assets and liabilities – general

IAS 12's basic requirement is that, to the extent that current tax for the current and prior reporting periods is unpaid, it should be recognised as a liability. Conversely, if the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess should be recognised as an asset. [IAS 12:12]

Similarly, an asset is recognised if a tax loss can be carried back to recover the current tax paid in an earlier period. [IAS 12:13] Thus, if an entity has a tax loss in one year (e.g. 20X3), and this is carried back and used to recover tax paid in an earlier period (e.g. 20X2), the current tax benefit of the recovery is recognised in the year in which the loss arises (i.e. 20X3).

Generally, current tax is recognised in profit or loss. There are two exceptions:

[IAS 12:58]

- when the current tax arises as a result of a transaction or event that is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see 3.2.2); and
- when the current tax arises from a business combination (other than the acquisition by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss – see 3.2.3).

3.2.2 Items recognised outside profit or loss

3.2.2.1 Items recognised outside profit or loss – general

Current tax is 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. When the current tax relates to items that are recognised in other comprehensive income, the tax is also recognised in other comprehensive income; when the tax relates to items that are recognised directly in equity, the tax is also recognised directly in equity. [IAS 12:61A]

3.2.2.2 Items recognised in other comprehensive income

Items required or permitted under IFRSs to be recognised in other comprehensive income include:

[IAS 12:62]

- revaluations of property, plant and equipment under IAS 16 *Property, Plant and Equipment*; and
- exchange differences on the translation of the financial statements of a foreign operation under IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

Other items recognised in other comprehensive income that may affect current tax are movements in fair value of a financial asset measured at fair value through other comprehensive income under IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, movements in fair value on available-for-sale securities) when gains and losses are assessed for tax in the same period in which they are recognised in other comprehensive income.

3.2.2.3 Items recognised directly in equity

Items required or permitted under IFRSs to be credited or charged directly to equity include:

[IAS 12:62A]

- an adjustment to the opening balance of retained earnings resulting from a change in accounting policy that is accounted for retrospectively or the correction of an error under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; and
- the initial recognition of the equity component of a compound financial instrument under IAS 32 *Financial Instruments: Presentation* (see 5.3.4).

Another common situation when tax is charged directly to equity is when an entity is required to pay a portion of its dividends over to the tax authorities on behalf of the shareholders (often referred to as a 'withholding tax').

The amount paid or payable to the tax authorities is charged to equity as part of dividends (see also 4.7.3.5). [IAS 12:65A]

The circumstances in which current tax is recognised directly in equity are quite limited. This treatment will be required when, under the tax rules in a particular jurisdiction, an item recognised directly in equity for accounting purposes affects the current tax expense or income for the period, for example:

- the transaction costs associated with the issue of an equity instrument are deductible for tax purposes in the period in which they are incurred;
- capital gains tax is charged relating to transactions in the entity's own equity instruments (see example 3.2.2.3); or
- the current tax deduction for an equity-settled share-based payment exceeds the cumulative profit or loss expense recognised in respect of that share-based payment (see 5.6).

Example 3.2.2.3

Tax arising on sale of treasury shares held by a subsidiary

Company S (a subsidiary) holds 10 per cent of the ordinary shares of its parent (Company P). These shares are classified as treasury shares by the group. Company P buys back the shares from Company S. After the buy-back, the shares are cancelled, and the treasury shares in the consolidated financial statements are derecognised.

In accordance with the law in the tax jurisdiction in which the group operates, an entity is liable for capital gains tax (CGT) if it sells an asset for more than its base cost. In the circumstances under consideration, Company S sells the shares for more than their base cost and, therefore, incurs CGT on the sale. The group therefore incurs CGT on the sale.

In the consolidated financial statements, a transfer from one equity classification (the treasury share reserve) to another equity classification (share capital or another reserve as required by local law) is made to reflect the cancellation of shares. The CGT represents a transaction cost relating to the cancellation and should therefore be recognised directly in equity.

3.2.2.4 Uncertainty regarding amount to be recognised outside profit or loss

If an entity cannot determine the amount of current tax that relates to items recognised outside of profit or loss (either in other comprehensive income or directly in equity), the amount may be based on a reasonable pro rata allocation, or some other method achieving a more appropriate allocation. These circumstances are assumed to arise only rarely; such an uncertainty could arise, for example, when there are graduated rates of income tax and it is impossible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed. [IAS 12:63]

Example 3.2.2.4

Pro rata allocation of tax between profit or loss and other comprehensive income

Entity A operates in a jurisdiction in which revaluations of property, plant and equipment are taxed when they are recognised for accounting purposes. In 20X1, Entity A recognises an accounting profit of CU1,000 and a revaluation gain in other comprehensive income of CU200. Total taxable profit is therefore CU1,200. Tax is charged at 20 per cent on the first CU600 of taxable profit and 30 per cent on any taxable profit above CU600.

Total tax for the year: $CU600 \times 20\% + CU600 \times 30\% = CU300$

In this graduated tax regime, it is not possible to make a determination as to which component of total taxable profit was taxed at each particular rate. Entity A therefore needs to allocate the current tax liability of CU300 between profit or loss and other comprehensive income on a reasonable pro rata basis. Entity A's overall average tax rate is 25 per cent (CU300 tax payable on CU1,200 taxable profit), and the entity could use this average rate to make a reasonable allocation. The journal entry to recognise the current tax liability for the year would be as follows.

		CU	CU
Dr	Current income tax — profit or loss (CU1,000 × 25%)	250	
Dr	Current income tax — other comprehensive income (CU200 × 25%)	50	
Cr	Taxes payable — statement of financial position		300

To recognise the current tax liability for the year.

3.2.2.5 Reclassification from equity to profit or loss of current tax effects of gains and losses previously recognised in other comprehensive income

As discussed at 3.2.2.1, IAS 12:61A requires that current tax or deferred tax relating to items that are recognised, in the same or a different period, outside of profit or loss should be recognised outside of profit or loss.

In some cases, IFRSs require that gains or losses initially recognised in other comprehensive income be subsequently reclassified to profit or loss. For example:

- specified gains and losses arising on cash flow hedges and net investment hedges previously recognised in other comprehensive income are reclassified from equity to profit or loss (subject to the conditions in IFRS 9 *Financial Instruments* or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*);
- for entities that have adopted IFRS 9, gains and losses arising on debt instruments measured at fair value through other comprehensive income are reclassified from equity to profit and loss when the asset is disposed of;
- for entities that have not yet adopted IFRS 9, gains or losses arising on available-for-sale financial assets previously recognised in other comprehensive income are reclassified from equity to profit or loss when the asset is disposed of; and
- on disposal or partial disposal of a foreign operation (other than a partial disposal of a subsidiary when control is retained), all or a portion of the foreign currency translation reserve is reclassified from equity to profit or loss as part of the gain or loss on disposal.

Whether such gains and losses are included in the determination of taxable profit in the period in which they are initially recognised in other comprehensive income depends on the rules in the particular tax jurisdiction.

If such gains and losses are subject to current tax when they are recognised in other comprehensive income, the question arises as to whether that current tax (initially recognised in other comprehensive income in accordance with IAS 12:61A) should be subsequently reclassified to profit or loss when the related gains and losses are reclassified.

The most appropriate treatment is that any current tax expense or benefit relating to the gains or losses reclassified should also be reclassified to profit or loss. Even though IAS 12 makes no reference to reclassification of the current tax effects previously recognised in other comprehensive income, the principle in IAS 12 is clear that the tax effects of a transaction (if any) should be reported in a consistent manner with the gains or losses to which they relate. This principle is applied when the gains and losses are initially recognised in other comprehensive income, and equally can be applied when the gains and losses are subsequently reclassified to profit or loss.

See example 3.2.2.5 for an illustration of this approach. Note that, in the example, there is no impact on the effective tax rate of the entity, because both the realised loss and the related tax are recognised in profit or loss.

Example 3.2.2.5

Reclassification from equity to profit or loss of current tax effects of gains and losses previously recognised in other comprehensive income

Company Y has a portfolio of financial assets classified as available for sale in accordance with IAS 39. For financial reporting purposes, unrealised gains and losses on the assets are recognised in other comprehensive income. In accordance with IAS 12, any tax consequences are also recognised in other comprehensive income.

Under local tax laws, unrealised gains and losses on investment portfolios are included in the determination of taxable income or loss; consequently, the movement in the value of financial assets each year affects the current taxes payable.

In 20X1, the unrealised loss on the assets is CU5 million. There is no movement in the market value of the assets during 20X2. On the last day of 20X2, Company Y sells the assets, thereby crystallising the previously recognised pre-tax loss of CU5 million.

The tax rate for 20X1 and 20X2 is 30 per cent. Company Y has net taxable income in 20X1.

The journal entries for 20X1 are as follows.

		CU'000	CU'000
Dr	Unrealised loss on investments (other comprehensive income)	5,000	
Cr	Investment portfolio		5,000

To recognise the unrealised loss on the available-for-sale assets in other comprehensive income.

Dr	Current tax liability	1,500	
Cr	Current tax benefit (other comprehensive income)		1,500

To recognise the tax consequences of the unrealised losses — computed based on mark-to-market accounting under local tax law (CU5 million × 30%).

The journal entries for 20X2 are as follows.

		CU'000	CU'000
Dr	Loss on sale (profit or loss)	5,000	
Cr	Unrealised loss on investments (other comprehensive income)		5,000

To recognise the reclassification from equity to profit or loss of the pre-tax loss on sale of the asset portfolio in 20X2.

Dr	Current tax expense (other comprehensive income)	1,500	
Cr	Current tax benefit (profit or loss)		1,500

To recognise the reclassification from equity to profit or loss of the tax consequences of the realised loss on sale of the assets in 20X2.

3.2.2.6 Dividends

In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits. [IAS 12:52A]

In the circumstances described in the previous paragraph, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by IAS 12:58 except to the extent that the income tax consequences of dividends arise from the circumstances described in IAS 12:58(a) and (b) (see 3.2.1). [IAS 12:52B]

3.2.3 Current tax arising from business combinations

Current tax arising from a business combination (other than the acquisition by an investment entity as defined in IFRS 10 *Consolidated Financial Statements* (see section 13 of chapter A24) of a subsidiary that is required to be measured at fair value through profit or loss) should not be recognised in profit or loss. [IAS 12:58(b)]

IAS 12 does not specifically address the appropriate treatment in the consolidated financial statements of the acquirer for adjustments arising when a business combination has direct current tax consequences for the acquiree (paragraphs IAS 12:66 to 68, to which reference is made from IAS 12:58(b), only address the accounting for deferred tax). However, it can be assumed that adjustments to current tax should be treated consistently with adjustments to deferred tax; therefore, adjustments to current tax should also be accounted for as part of the initial accounting for the business combination.

For example, a change of ownership may result in a change in tax rate or loss of tax incentives. When those consequences result in an adjustment to current tax assets or liabilities, the remeasured current tax assets or liabilities should be included in the identifiable net assets recognised for the acquiree, and the adjustment will therefore affect the amount of the goodwill or the bargain purchase gain recognised in the consolidated financial statements.

The appropriate accounting in the financial statements of the acquiree will be determined in accordance with SIC-25 *Income Taxes — Changes in the Tax Status of an Entity or its Shareholders* (see 4.7.5).

3.3 Measurement of current tax assets and liabilities

3.3.1 Measurement of current tax assets and liabilities – general

Current tax assets and liabilities for both the current and prior periods are measured at the amounts that are expected to be paid to (recovered from) the tax authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. [IAS 12:46] See section 4.5.2 for a discussion of the general issues that arise in respect of the appropriate tax rate to be used. Section 4.5.2.3 discusses the meaning of ‘substantively enacted’.

3.3.2 Discounting current tax payable

When current tax amounts fall due to be paid in future periods, the current tax should be recognised at a discounted amount if the effect of discounting is material. This may be contrasted with the accounting for deferred tax which, as required under IAS 12:53, is never discounted (see 4.5.3).

Example 3.3.2 Discounting current tax payable

Entity A is a start-up entity. The local tax authority has granted a five-year partial deferral of tax payments to new businesses in the jurisdiction, for which Entity A is eligible. Under this arrangement, Entity A must pay 60 per cent of its current year tax bill at the end of the tax year, and 40 per cent is deferred until the end of the tax year five years later.

When measuring its liability for current tax, if the effect is material, Entity A should discount the amount deferred for five years. Entity A should recognise a current tax liability of 60 per cent of the total current tax bill, plus 40 per cent of the total current tax bill discounted for five years as a non-current tax liability.

The unwinding of the discount in subsequent periods should be presented as a finance cost, because it does not meet the definition of income tax expense in IAS 12.

3.3.3 Uncertain tax positions

3.3.3.1 Uncertain tax positions – background

Entities are required to calculate and pay income taxes in accordance with applicable tax law in each relevant tax jurisdiction. However, no tax legislation can clearly articulate the tax consequences of every possible transaction. Accordingly, the application of tax rules to complex transactions is sometimes open to interpretation, both by the preparers of financial statements (and the tax return) and by the tax authorities.

The tax authorities may challenge positions taken by an entity in determining its current income tax expense and either require further payments or disallow tax losses or other tax attributes. Tax positions taken by an entity when measuring its tax assets and liabilities for financial statement purposes (and when submitting its tax return) for which the interpretation of tax law is unclear are generally referred to as ‘uncertain tax positions’.

Uncertain tax positions affect the amount recognised for current tax liabilities or assets, and are within the scope of IAS 12. IAS 12:46 provides that “[c]urrent tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities”.

3.3.3.2 Recognition and measurement of uncertain tax positions

IAS 12 does not include explicit guidance regarding the recognition and measurement of uncertain tax positions. While income taxes are outside the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the guidance in IAS 37:10 is considered relevant to uncertain tax positions because they may give rise to “a liability of uncertain timing or amount”. Consequently, preparers may use the recognition and measurement criteria of IAS 37 by analogy when determining the appropriate recognition and measurement of uncertain tax positions. It would be inappropriate, however, to present the resulting liabilities with other provisions recognised under IAS 37, because IAS 37:5(b) specifically excludes from the scope of that Standard provisions that are addressed in IAS 12.

It should be presumed that any uncertain tax positions taken by an entity in determining its current tax liabilities (assets) will be examined by the appropriate tax authority having full knowledge of all relevant information.

Accordingly, an entity should follow a two-step process in accounting for its uncertain tax positions.

- Having already presumed 100 per cent detection risk by the relevant tax authority, the entity should determine whether, under IAS 37:14(b), it is *probable* that an outflow of economic resources will occur (i.e. the entity should consider whether it is probable that upon examination of the uncertain tax position by the tax authority, the entity would, for example, not be entitled to a particular tax credit or deduction or it would be assessed for tax on a particular income stream). Note that, under IAS 37, an outflow of economic resources is considered to be ‘probable’ if it is more likely than not to occur.
- If the probability threshold is met, the entity will need to measure the potential impact of the relevant tax authority’s examination of the uncertain tax position; that is to say, the entity will need to make its best estimate of the amount of the tax benefit that will be lost. That amount may be determined in accordance with the guidance set out in IAS 37:39 and 40.

As stated in IAS 37:38, the best estimate of the amount to be provided is “determined by the judgement of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts”.

3.3.3.3 Disclosures regarding uncertain tax positions

Disclosure requirements for uncertain tax positions are governed not only by IAS 12, but also by the requirement under IAS 1:125 to disclose key sources of estimation uncertainty when there is a significant risk of a material adjustment in carrying amounts of assets and liabilities within the next financial year.

When the uncertain tax position gives rise to a contingent tax liability for which no provision is recognised (e.g. because it is not probable that a payment will be made to the tax authority), an entity must still consider the requirements of IAS 12:88, which states that “[a]n entity discloses any tax-related contingent liabilities and contingent assets in accordance with IAS 37 . . . contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities”.

The recognition and measurement in a business combination of the potential liability arising from an uncertain tax position is addressed at 5.1.9.

3.3.3.4 Recognition of an asset in relation to an uncertain tax position

Example 3.3.3.4

Recognition of an asset in relation to an uncertain tax position

Entity X is involved in a dispute with its local tax authority over a sum of CU100 and has, as required by local law, made a payment of that amount. This money will be held in escrow by the tax authority pending resolution of the dispute, at which point it will either be returned to Entity X or used to settle any tax liability arising from the dispute.

Entity X does not believe it to be probable that any tax liability will arise in relation to the disputed amount and, consequently, it has not recognised any obligation in this regard (see 3.3.3.2 for a discussion of the appropriate recognition criteria for such ‘uncertain tax positions’).

Should Entity X recognise the payment of CU100 as an asset?

Yes. This asset is not a contingent asset as defined in IAS 37 because, although the outcome of the uncertain future event (i.e. the resolution of the tax dispute) will confirm the means of recovery, there is no uncertainty regarding the ‘existence’ of the asset. The asset will either be recovered in the form of a cash refund from the tax authority or it will be used to settle the tax liability that may arise on resolution of the dispute.

Entity X should continue to monitor the underlying uncertain tax position, and should recognise an income tax expense if and when it is considered probable that the dispute will result in some or all of the CU100 being retained by the tax authority to settle any tax liability arising from the dispute.

3.4 Changes in the tax status of an entity or its shareholders

SIC-25 *Income Taxes – Changes in the Tax Status of an Entity or its Shareholders* deals with the appropriate accounting for the consequences of such changes. SIC-25, which applies equally to current and deferred taxes, is discussed in detail in 4.7.5.

4 Deferred tax

4.1 Deferred tax — general approach

IAS 12 focuses on the statement of financial position by recognising the tax effects of temporary differences, i.e. differences between the carrying amount of an asset or a liability and its tax base.

Deferred tax liabilities are defined as the amounts of income taxes payable in future periods in respect of taxable temporary differences. [IAS 12:5]

Deferred tax assets are defined as the amounts of income taxes recoverable in future periods in respect of:

[IAS 12:5]

- deductible temporary differences;
- the carryforward of unused tax losses; and
- the carryforward of unused tax credits.

Deferred tax assets and liabilities are calculated using the following formulas.

Temporary difference	=	Carrying amount	–	Tax base
Deferred tax asset or liability	=	Temporary difference	×	Tax rate

The recognition of deferred tax, therefore, relies on two central concepts:

- tax bases (as defined in 4.2.1); and
- temporary differences (as defined in 4.3).

The principal steps in arriving at deferred tax assets and liabilities under IAS 12 are as follows.

Step 1

Calculate the tax base of each asset and liability in the statement of financial position (see section 4.2). Note that temporary differences can also arise when there is no associated asset or liability recognised for accounting purposes (see 4.2.4).

Step 2

Calculate the temporary difference (if any) for each of the above items (see section 4.3).

Step 3

Identify those temporary differences that will give rise to deferred tax assets or liabilities taking into account the recognition criteria and initial exceptions laid down in the Standard (see section 4.4).

Step 4

Calculate the deferred tax attributable to those temporary differences by multiplying each temporary difference by the tax rate that is expected to apply when the temporary difference reverses based on enacted or substantively enacted tax rates (see section 4.5).

Step 5

Assess the recoverability of deferred tax assets arising from deductible temporary differences, carried forward unused tax losses and unused tax credits (see section 4.6).

Step 6

Recognise the movement between the deferred tax balances in the opening and closing statements of financial position in profit or loss, in other comprehensive income, in equity, or as part of the initial accounting for a business combination (thus affecting the goodwill or bargain purchase gain recognised) (see section 4.7).

4.2 Calculation of tax bases

4.2.1 Definition of tax base

The tax base of an asset or a liability is the amount attributed to that asset or liability for tax purposes. [IAS 12:5] IAS 12 describes separately the tax base of assets (see 4.2.2), and of liabilities and revenue received in advance (see 4.2.3).

The basic principle of IAS 12 is that, unless specifically exempted under IAS 12, entities should recognise deferred tax liabilities (assets) whenever settlement or recovery of the carrying amount of an asset or a liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences. This may be helpful to remember when the tax base of an asset or a liability is not immediately apparent. [IAS 12:10]

4.2.2 Tax base of assets

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. [IAS 12:7] Taxable economic benefits could take the form of proceeds on disposal of an asset, or income earned through the use of an asset (e.g. manufacturing profits).

Future tax consequences are always calculated based on the realisation of the asset at its carrying amount. In reality, an entity will often generate economic benefits in excess of the carrying amount through use or sale. For example, a property may have a market value that is substantially greater than its carrying amount. IAS 12 does not require an estimate of the benefits that will be generated by the asset. Rather, deferred tax is calculated on the assumption that those benefits will be equal to the carrying amount of the asset.

When the economic benefits that flow from an asset are not taxable, the tax base of the asset is equal to its carrying amount. [IAS 12:7] Deferred taxes only arise when the tax base of an asset or a liability differs from its carrying amount. If the economic benefits that flow from an asset are not taxable (and the tax base of the asset is, therefore, equal to its carrying amount), the recovery of the asset will not have any deferred tax consequences.

Paragraph 7 of IAS 12 contains the following examples of the calculation of the tax base of an asset.

Example 4.2.2A Tax base of an asset

[Examples following IAS 12:7]

- (1) A machine cost 100. For tax purposes, depreciation of 30 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes. *The tax base of the machine is 70.*
- (2) Interest receivable has a carrying amount of 100. The related interest revenue will be taxed on a cash basis. *The tax base of the interest receivable is nil.*
- (3) Trade receivables have a carrying amount of 100. The related revenue has already been included in taxable profit (tax loss). *The tax base of the trade receivables is 100.*
- (4) Dividends receivable from a subsidiary have a carrying amount of 100. The dividends are not taxable. *In substance, the entire carrying amount of the asset is deductible against the economic benefits. Consequently, the tax base of the dividends receivable is 100.^a*
- (5) A loan receivable has a carrying amount of 100. The repayment of the loan will have no tax consequences. *The tax base of the loan is 100.*

^a Under this analysis, there is no taxable temporary difference. An alternative analysis is that the accrued dividends receivable have a tax base of nil and that a tax rate of nil is applied to the resulting taxable temporary difference of 100. Under both analyses, there is no deferred tax liability.

Sometimes, the manner in which the carrying amount of an asset is recovered can affect the tax base of the asset. When this is the case, the tax base used should be consistent with the expected manner of recovery (see also 4.2.6). [IAS 12:51A]

Example 4.2.2B Expected manner of recovery of asset

[Based on IAS 12:51A, Example C]

An item of property, plant and equipment with a cost of 100 and a carrying amount of 80 is revalued to 150. No equivalent adjustment is made for tax purposes. Cumulative depreciation for tax purposes is 30. If the item is sold for more than cost, the cumulative tax depreciation of 30 will be included in taxable income and the sale proceeds in excess of an inflation-adjusted cost of 110 will also be taxed.

If the entity expects to recover the carrying amount by selling the item, the tax base is 80 (indexed cost of 110 less tax depreciation of 30).

If the entity expects to recover the carrying amount of the item by using the asset, its tax base is 70 (100 less tax depreciation of 30).

4.2.3 Tax base of liabilities

The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods. [IAS 12:8]

Future tax consequences are always calculated based on the settlement of the liability at its carrying amount. There may be occasions when the settlement of a liability is expected to exceed its current carrying amount (e.g. when a settlement premium is being accrued over the life of a debt instrument). IAS 12 does not require anticipation of the expected settlement amount. Instead, deferred tax is calculated on the assumption that the liability will be settled at its carrying amount.

When settlement of the liability at its carrying amount would have no tax consequences, the tax base of the liability is equal to its carrying amount. This will be the case when either the transaction has no tax implications (e.g. accrual of fines and penalties that are not tax deductible), or when the accounting and tax implications occur in the same period (e.g. accrued wages in respect of which a tax deduction is allowed at the same time as the expense is recognised).

Paragraph 8 of IAS 12 contains the following examples of the calculation of the tax base of a liability.

Example 4.2.3A Tax base of a liability

[Examples following IAS 12:8]

- (1) Current liabilities include accrued expenses with a carrying amount of 100. The related expense will be deducted for tax purposes on a cash basis. *The tax base of the accrued expenses is nil.*
- (2) Current liabilities include interest revenue received in advance, with a carrying amount of 100. The related interest revenue was taxed on a cash basis. *The tax base of the interest received in advance is nil.*
- (3) Current liabilities include accrued expenses with a carrying amount of 100. The related expense has already been deducted for tax purposes. *The tax base of the accrued expenses is 100.*
- (4) Current liabilities include accrued fines and penalties with a carrying amount of 100. Fines and penalties are not deductible for tax purposes. *The tax base of the accrued fines and penalties is 100.^b*
- (5) A loan payable has a carrying amount of 100. The repayment of the loan will have no tax consequences. *The tax base of the loan is 100.*

^b Under this analysis, there is no deductible temporary difference. An alternative analysis is that the accrued fines and penalties payable have a tax base of nil and that a tax rate of nil is applied to the resulting deductible temporary difference of 100. Under both analyses, there is no deferred tax asset.

In the case of revenue received in advance, the tax base of the liability is the carrying amount of the liability less the portion of the revenue received that has already been taxed (or is never taxable) and, consequently, will not be taxed in the future.

Tax base	=	Carrying amount	–	The amount of the revenue that will not be taxable in future periods
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Example 4.2.3B Revenue received in advance

On 31 December 20X1, Company A receives CU100 revenue in advance of performing services. The amount is recognised as deferred revenue in Company A's statement of financial position and it will be recognised in profit or loss as services are performed during the 20X2 reporting period. The revenue is taxed on receipt.

At 31 December 20X1, the carrying amount of the deferred revenue is CU100; the amount that will not be taxable in future periods is CU100 (because this has already been taxed). Therefore, the tax base of the deferred revenue is nil and a deductible temporary difference arises. A deferred tax asset is recognised in respect of this temporary difference subject to IAS 12's general recognition criteria; the 'initial recognition exception' (see section 4.4.6) does not apply because the recognition of the revenue affected taxable profit.

Example 4.2.3C Government grant recognised as deferred income

Company B receives a government grant of CU150 to purchase a specified property. Company B recognises the government grant as deferred income in its statement of financial position, as permitted under paragraph 24 of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

If the government grant is taxed on receipt, the same analysis as set out in example 4.2.3B applies, and a temporary difference equal to the carrying amount of the deferred income arises. A deferred tax asset is recognised in respect of this temporary difference subject to IAS 12's general recognition criteria; the 'initial recognition exception' (see section 4.4.6) does not apply because the receipt of the grant affected taxable profit.

If the government grant is taxed at the same time as it is recognised in profit or loss over the life of the related asset, all of the grant is taxable in future periods. Therefore, on initial recognition, the tax base will equal the carrying amount of the deferred income and no temporary difference arises.

If the government grant is not taxable, either on receipt or when it is recognised in profit or loss over the useful life of the related property, applying the formula above will give a tax base of nil. Consequently, a deductible temporary difference arises. However, because this difference arises on the initial recognition of the deferred income and the conditions in IAS 12:24 are met (see 4.4.3), no deferred tax is recognised.

4.2.4 Tax bases without an associated carrying amount

Some items have a tax base but have no carrying amount (i.e. they are not recognised in the statement of financial position for accounting purposes). When a transaction does not give rise to, or affect the carrying amount of, an asset or a liability, but does affect the taxable income of future reporting periods, the tax base is calculated as the amount of the effect on taxable income in future reporting periods. In this case, the carrying amount of the asset or liability associated with the tax base is zero for the purposes of calculating temporary differences. [IAS 12:9]

Examples of such items include the following:

- research costs recognised as an expense in determining accounting profit in the period in which they are incurred but for which a tax deduction is allowed in a later period (see IAS 12:9);
- goodwill or other intangible assets recognised for local tax purposes, but not meeting the recognition criteria under IFRSs; and
- reserves in the local statutory books of the entity that will be taxable upon the occurrence of certain events (e.g. reclassification of the reserve, or upon liquidation of the entity). Such reserves are generally established upon receipt of a tax benefit.

A temporary difference may also arise when a transaction has given rise to an asset or a liability in previous reporting periods that is no longer included in the statement of financial position, but will affect taxable income in future reporting periods (e.g. an asset that is fully depreciated for accounting purposes but for which tax depreciation may still be claimed).

Example 4.2.4

Pre-operating costs expensed but not deductible in current period

An entity may incur pre-operating costs. Under IAS 38 *Intangible Assets*, these costs are required to be recognised as an expense when incurred. If local tax laws do not allow an immediate deduction, but do allow a future deduction, the difference between the tax base of the pre-operating costs (i.e. the amount that the tax authorities will permit as a deduction in future periods) and the carrying amount (nil) is a temporary difference.

4.2.5 Tax bases for the purpose of consolidated financial statements

For an entity preparing consolidated financial statements, temporary differences are calculated using:

[IAS 12:11]

- carrying amounts taken from the consolidated statement of financial position; and
- tax bases as determined by reference to the method of tax computation. If the tax authorities calculate tax by reference to each individual entity in the group, the tax bases will be taken from the individual entities' tax computations. If the tax authorities calculate tax using consolidated amounts, the tax bases will be taken from the consolidated tax amounts.

Example 4.2.5

Tax base generated as a result of intragroup transfer

A group undertakes an internal restructuring whereby Subsidiary A sells an item of intellectual property with no carrying amount to Subsidiary B for CU100. Subsidiary B is able to claim a tax deduction for the amortisation of the purchased intangible asset over 5 years.

IFRS 10 *Consolidated Financial Statements* requires that intragroup profits be eliminated in full. Therefore, from the group perspective, the intellectual property has a carrying amount of nil and a tax base of CU100. Accordingly, a deductible temporary difference has arisen in respect of which a deferred tax asset should be recognised provided that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. The corresponding gain should be recognised in profit or loss.

The deferred tax impact of eliminations of unrealised profits arising on intragroup transfers is discussed in detail at 5.2.

4.2.6 Alternative tax rates and tax bases according to management intent

4.2.6.1 Tax rate and tax base to reflect the manner in which the entity expects to recover the asset or settle the liability

When the amount of tax payable or receivable is dependent upon how the entity recovers the asset or settles the liability, the rate and tax base used to calculate the deferred tax balances should reflect the manner in which the entity expects, at the end of the reporting period, to recover the asset or settle the liability. [IAS 12:51] IAS 12:51A indicates that the manner of recovery or settlement may affect either, or both, the applicable tax rate and the tax base of an asset or a liability.

Specific rules apply in relation to the recovery of non-depreciable assets (see 4.2.6.2) and investment property (see 4.2.6.3).

Example 4.2.6.1A

Alternative tax rates for use and disposal of an item of property, plant and equipment (1)

The carrying amount of an item of property, plant and equipment is CU400,000 (cost of CU500,000 less accumulated depreciation of CU100,000). The asset's tax base is CU300,000 (tax depreciation of CU200,000 having been claimed to date).

Income generated from the use of the asset is taxed at 25 per cent and, therefore, the tax depreciation will be recovered at 25 per cent. If the asset were sold, any excess of the disposal proceeds over the asset's tax base would be taxed at 30 per cent.

The taxable temporary difference is CU100,000. If the entity intends to continue to use the asset in its business, generating taxable income, the deferred tax liability is CU25,000 (CU100,000 at 25 per cent). If, instead, the entity intends to dispose of the asset, the deferred tax liability is CU30,000 (CU100,000 at 30 per cent).

Further examples are given in IAS 12:51A.

Example 4.2.6.1B

Alternative tax rates for use and disposal of an item of property, plant and equipment (2)

The facts are as in example 4.2.6.1A, except that the entity intends to use the asset until its carrying amount is CU300,000 and its tax base is CU100,000. At that point, the entity will sell the asset, and will be taxed on the difference between the amount recovered through sale and the tax base.

In accordance with the general principles of IAS 12, deferred tax is calculated on the assumption that the value of the asset will be recovered at its carrying amount. The entity will therefore recover another CU100,000 from the asset through its use, and receive CU200,000 of allowable deductions during that period. The entity will then recover CU300,000 from the sale of the asset, and receive CU100,000 of allowable deductions. In total, the entity expects to recover CU400,000 from the asset and receive CU300,000 of deductions.

The tax rate applicable at the time the temporary difference reverses is 25 per cent in respect of use and 30 per cent in respect of sale. The entity must therefore use both tax rates in determining the deferred tax balance to take account of the fact that the temporary difference will reverse at different rates. Accordingly, the entity's deferred tax liability in respect of the asset is calculated as follows.

$$[(CU100,000 - CU200,000)] \times 25\% + [(CU300,000 - CU100,000)] \times 30\% = CU35,000$$

A more complicated situation arises when, in a particular tax jurisdiction, the recovery of an asset through use is subject to one type of income tax and recovery through sale is subject to another type of income tax (potentially at a different rate). In such circumstances, it is often necessary to consider separately the tax bases and temporary differences arising from recovery through use and recovery through sale, particularly when the tax regime is such that there are effectively two distinct tax systems applicable to the recovery of the asset. Any deductible temporary differences need to be assessed for recognition in accordance with the usual requirements, separately from any taxable temporary difference arising. This is illustrated in example 4.2.6.1C.

Example 4.2.6.1C
Recovery through sale and use under different income taxes

Company D acquires machinery in a business combination. The machinery is initially recognised in the consolidated financial statements at its fair value at the date of acquisition of CU150. Company D is not entitled to claim any tax deductions if the machinery is used in its operations and, therefore, the machinery's tax base for recovery through use is nil.

Company D expects to use the asset for a number of years and then sell it for its currently estimated residual value of CU50. The income on sale of the machinery is subject to a different type of income tax and, when the machinery is sold, a tax deduction of CU100 (the original cost of the asset when purchased by the acquiree) will be available. Therefore, the asset's tax base for recovery through sale is CU100.

The tax rates expected to apply when the temporary differences reverse are 10 per cent in respect of use and 30 per cent in respect of sale. In the tax jurisdiction in which Company D operates, losses on sale of this type of property, plant and equipment can only be recovered against gains on disposal of similar assets and not against general operating profits.

Company D should recognise deferred tax as follows.

	Carrying amount CU	Tax base CU	Taxable (deductible) temporary difference CU	Deferred tax liability (asset) CU
Recovery through use	100	Nil	100	10
Recovery through sale	50	100	(50)	(15)*

* The possible deferred tax asset that is expected to arise from the sale of the machinery must be assessed for recoverability. If it is not probable that suitable future taxable profit will be available against which the deductible temporary difference can be utilised, the deferred tax asset should not be recognised.

4.2.6.2 Non-depreciable assets measured under the revaluation model in IAS 16

A specific issue arises in respect of non-depreciable assets. As discussed in 4.2.6.1, the measurement of deferred tax should generally reflect the manner in which the entity intends to recover the carrying amount of the asset. However, when an asset has an unlimited life (i.e. it is non-depreciable), the question arises as to how the term 'recovery' should be interpreted.

The measurement of deferred tax liabilities or assets arising from non-depreciable assets measured at a revalued amount under IAS 16 should reflect the tax consequences of recovering the carrying amount of the non-depreciable asset through sale, regardless of the basis of measuring the carrying amount of that asset. [IAS 12:51B]

Accordingly, if the tax consequences that would arise from the sale of a revalued non-depreciable asset differ from the tax consequences of using the asset, the deferred tax asset or liability arising should be measured based on the assumption that the asset will be sold. [IAS 12:51B]

Generally, the future economic benefits will be derived from an asset (and, therefore, the carrying amount of the asset will be recovered) through sale, through use, or through use and subsequent sale. Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. Consistently with this, the carrying amount of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale. In other words, because the asset is not depreciated, no part of its carrying amount is expected to be recovered (i.e. consumed) through use. [IAS 12:BC6]

Example 4.2.6.2A Non-depreciable asset — freehold land

Company E holds freehold land and accounts for it on a revaluation basis under IAS 16. The carrying amount of the land is CU900,000, which is its current market value. The tax base on sale of the land will be its original cost of CU500,000. The land is used for the storage of Company E's raw materials. The tax rate applicable to manufacturing income is 25 per cent but, on disposal of a capital asset, any proceeds in excess of cost are taxed at 30 per cent. There is currently no intention to sell the land.

The taxable temporary difference between the carrying amount and the tax base of the freehold land is CU400,000. Although the asset is being used by Company E to generate manufacturing income, the carrying amount of the land is not being recovered in that way; the value of the land does not diminish over time through use. All of the value of the land will be recovered through its eventual sale and, therefore, the applicable tax rate is 30 per cent, and the deferred tax liability arising is CU120,000.

If, for tax purposes, there was an indexation allowance on the land for the purposes of calculating the gain on disposal of the land, this indexed amount would be the tax base of the land.

IAS 12:BC6 points to land having an unlimited life and being non-depreciable. Land is the only asset that should be assumed to be non-depreciable (with some exceptions such as quarries and landfill sites - see IAS 16:58). Assets such as some intangible assets that are simply not being depreciated because they have an indefinite life, or because their current residual value is at or above carrying amount, are not non-depreciable for the purposes of these requirements. IAS 12's general principles apply to such assets, namely that temporary differences should be recognised based on the expected manner of recovery.

Example 4.2.6.2B Brand with an indefinite useful life

Company F has a brand that is considered to have an indefinite useful life and, in accordance with the requirements of paragraph 107 of IAS 38 *Intangible Assets*, is therefore not being amortised. The carrying amount of the brand is its original cost of CU900,000. Under local tax law, the brand is being amortised over 10 years. At 31 December 20X3, the tax base of the brand after three years' tax amortisation is CU630,000. This tax base is either deductible over the life of the asset or upon sale. The tax rate applicable to trading profits is 25 per cent but, if the intangible asset were to be disposed of, the capital gain arising would be taxed at 30 per cent. There is currently no intention to dispose of the brand.

In accordance with the general requirements of IAS 12:51, the measurement of deferred tax should reflect the tax consequences that would follow from the manner in which the entity expects to recover the asset. In the circumstances described, the brand is expected to be recovered through use in Company F's trading operations. The brand is not considered to be a non-depreciable asset for the purposes of IAS 12:51B (see discussion above).

On this basis, the taxable temporary difference between the carrying amount and the tax base of the brand is CU270,000. The applicable tax rate is 25 per cent and the deferred tax liability arising is CU67,500.

4.2.6.3 Investment property measured at fair value

If a deferred tax liability or asset arises from investment property that is measured using the fair value model in IAS 40, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Accordingly, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset is required to reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. [IAS 12:51C]

The rebuttable presumption established in IAS 12:51C is rebutted if the investment property is depreciable and the investment property is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. [IAS 12:51C]

Provided that sufficient evidence is available to support the rebuttal, the presumption can be rebutted in circumstances other than those explicitly described in IAS 12:51C.

This conclusion was confirmed by the IFRS Interpretations Committee in November 2011. The Committee noted that a presumption is a matter of consistently applying a principle (or an exception) in IFRSs in the absence of acceptable reasons to the contrary and that it is rebutted when there is sufficient evidence to overcome the presumption. Because IAS 12:51C is expressed as a rebuttable presumption, and because the sentence explaining the rebuttal of the presumption does not express the rebuttal as ‘if and only if’, the Committee considered that the presumption could be rebutted in other circumstances, provided that sufficient evidence is available to support that rebuttal.

If the presumption is rebutted, the general requirements of IAS 12:51 and IAS 12:51A apply (i.e. expected manner of recovery is based on management intent — see 4.2.6.1).

The rebuttable presumption in IAS 12:51C also applies when a deferred tax liability or a deferred tax asset arises from measuring investment property in a business combination if the entity will use the fair value model when subsequently measuring that investment property. [IAS 12:51D]

For entities applying the specific requirements for investment properties measured at fair value in accordance with IAS 12:51B to 51D, the general principles regarding the recognition and measurement of deferred tax assets in IAS 12:24 to 36 still apply. [IAS 12:51E]

Example 4.2.6.3, which is reproduced from IAS 12, illustrates the application of IAS 12:51C.

The example illustrates the distinction, when the presumption in IAS 12:51C is rebutted, between the treatment of buildings, which are depreciable, and land, which is not depreciable.

Example 4.2.6.3 Investment property measured at fair value

[Example illustrating IAS 12:51C]

An investment property has a cost of 100 and fair value of 150. It is measured using the fair value model in IAS 40. It comprises land with a cost of 40 and fair value of 60 and a building with a cost of 60 and fair value of 90. The land has an unlimited useful life.

Cumulative depreciation of the building for tax purposes is 30. Unrealised changes in the fair value of the investment property do not affect taxable profit. If the investment property is sold for more than cost, the reversal of the cumulative tax depreciation of 30 will be included in taxable profit and taxed at an ordinary tax rate of 30%. For sales proceeds in excess of cost, tax law specifies tax rates of 25% for assets held for less than two years and 20% for assets held for two years or more.

Because the investment property is measured using the fair value model in IAS 40, there is a rebuttable presumption that the entity will recover the carrying amount of the investment property entirely through sale. If that presumption is not rebutted, the deferred tax reflects the tax consequences of recovering the carrying amount entirely through sale, even if the entity expects to earn rental income from the property before sale.

The tax base of the land if it is sold is 40 and there is a taxable temporary difference of 20 (60 – 40). The tax base of the building if it is sold is 30 (60 – 30) and there is a taxable temporary difference of 60 (90 – 30). As a result, the total taxable temporary difference relating to the investment property is 80 (20 + 60).

In accordance with [IAS 12:47], the tax rate is the rate expected to apply to the period when the investment property is realised. Thus, the resulting deferred tax liability is computed as follows, if the entity expects to sell the property after holding it for more than two years:

	Taxable Temporary Difference	Tax Rate	Deferred Tax Liability
Cumulative tax depreciation	30	30%	9
Proceeds in excess of cost	50	20%	10
Total	80		19

Example 4.2.6.3 (continued)

Investment property measured at fair value

If the entity expects to sell the property after holding it for less than two years, the above computation would be amended to apply a tax rate of 25%, rather than 20%, to the proceeds in excess of cost.

If, instead, the entity holds the building within a business model whose objective is to consume substantially all of the economic benefits embodied in the building over time, rather than through sale, this presumption would be rebutted for the building. However, the land is not depreciable. Therefore the presumption of recovery through sale would not be rebutted for the land. It follows that the deferred tax liability would reflect the tax consequences of recovering the carrying amount of the building through use and the carrying amount of the land through sale.

The tax base of the building if it is used is 30 ($60 - 30$) and there is a taxable temporary difference of 60 ($90 - 30$), resulting in a deferred tax liability of 18 (60 at 30%).

The tax base of the land if it is sold is 40 and there is a taxable temporary difference of 20 ($60 - 40$), resulting in a deferred tax liability of 4 (20 at 20%).

As a result, if the presumption of recovery through sale is rebutted for the building, the deferred tax liability relating to the investment property is 22 ($18 + 4$).

In many jurisdictions, it is common for an investment property to be held within a corporate structure that holds only one material asset, the investment property itself. When the parent disposes of the property, it will dispose of it within that corporate shell because, in many cases, this will shield the parent entity from adverse tax consequences.

IAS 12:11 requires temporary differences in the consolidated financial statements to be determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base (see 4.2.5). These amounts are sometimes referred to as 'inside basis differences'. In the case of an asset or a liability of a subsidiary that files separate tax returns, the tax base is the amount that will be taxable or deductible on the recovery (settlement) of the asset (liability) in the tax returns of the subsidiary.

In addition, IAS 12:38 requires the determination of the temporary difference related to the shares held by the parent in the subsidiary by comparing the parent's share of the net assets of the subsidiary in the consolidated financial statements, including the carrying amount of goodwill, with the tax base of the shares for the purposes of the parent's tax returns (see section 4.4.7). This amount is sometimes referred to as an 'outside basis difference'. IAS 12 includes no exception to these requirements for single asset subsidiaries and, consequently, both components of deferred tax are required to be recognised in consolidated financial statements (subject to the requirements of IAS 12:39 and 44 limiting the recognition of outside basis differences, and the general recognition criteria in IAS 12 for any deferred tax assets) even if the parent expects to sell an investment property within a corporate shell.

This conclusion was confirmed by the IFRS Interpretations Committee in July 2014.

4.2.6.4 Convertible instrument with different tax treatments on redemption and conversion

Under IAS 32 *Financial Instruments: Presentation*, the requirement to separate the equity and financial liability components of a compound instrument is consistent with the principle that a financial instrument should be classified in accordance with its substance, rather than its legal form. The expected manner of recovery is not taken into account in establishing this classification.

In some jurisdictions, the tax treatment for a convertible instrument may differ depending on whether the instrument is settled in cash or by the delivery of shares. Unlike IAS 32, IAS 12:51 and 51A require that the tax base and the rate used to determine the deferred tax assets and liabilities reflect the manner in which the entity expects to settle the instrument.

However, when settlement is outside the control of the issuer, the presumed settlement should be aligned with the IAS 32 classification (i.e. cash settlement should be presumed) unless there is strong evidence that the instrument will be settled by the delivery of shares.

4.2.6.5 Change in management's expectation as to the manner in which an asset will be recovered, or a liability settled

When there is a change in management's expectation as to the manner in which an asset will be recovered, or a liability settled, the change may affect the measurement of the related deferred tax balances.

The deferred tax impact should be remeasured based on management's revised intentions and the adjustment recognised in profit or loss or, to the extent that it relates to items previously recognised outside profit or loss, in other comprehensive income or directly in equity. Amounts reported in prior periods are not restated.

4.2.7 Rollover relief

In some jurisdictions, an entity may be entitled to 'rollover relief' when it disposes of a capital asset for a profit and replaces it with an equivalent asset. In such circumstances, the gain on disposal may not have any impact for tax purposes until the replacement asset is disposed of, when it is taken into account via the 'capital' (or sale) tax base of the replacement asset. When the entity disposes of the replacement asset, it is required to pay the tax on the gain on disposal of the replacement asset together with the tax on the gain on disposal of the original asset.

In many cases, the 'rollover' of the gain on the disposal of the original asset into the tax base of the replacement asset merely postpones, rather than eliminates, the payment of tax, and IAS 12:20(b) requires that a deferred tax liability be recognised.

In some jurisdictions, the manner of recovery of the replacement asset will determine whether the rollover relief gives rise to a postponement of tax or to permanent relief. However, until the replacement asset is acquired, deferred tax should be recognised on the basis that rollover relief will give rise only to postponement of tax, i.e. the potential permanent relief should not be anticipated. If the original asset is sold and there is a time delay before the replacement asset is acquired, the entity should continue to recognise the deferred tax.

If the replacement asset is recovered entirely through use, an entity should give careful consideration to the effect of rollover relief on the tax payments flowing from its recovery when determining the tax base of a replacement asset based on the expected manner of recovery.

4.2.8 Revaluation of the tax base

The tax base of an asset may change as a result of a revaluation of the asset for tax purposes. For example, local tax law may specify that the tax base of a particular type of asset is adjusted for inflation each year (see 4.4.7.9). The effects of other revaluations for tax purposes are discussed at 4.7.3.9.

See also 4.4.7.8 for the impact of foreign currency adjustments when the tax base of an asset or a liability is determined in a currency other than the entity's functional currency.

4.3 Calculation of temporary differences

4.3.1 Temporary differences – general

Under IAS 12, deferred tax balances are recognised in respect of temporary differences. A temporary difference arises when the carrying amount of an asset or a liability differs from its tax base. For many transactions, there is no difference between the accounting and the tax treatment; no temporary difference and, consequently, no deferred tax balance arises.

4.3.2 Definition of temporary difference

IAS 12 defines a temporary difference as the difference between the carrying amount of an asset or a liability in the statement of financial position and its tax base. [IAS 12:5]

Temporary differences can arise in a number of circumstances, for example:

- when income or expenses are included in accounting profit in one period but included in taxable profit in a different period (i.e. timing differences);
- in a business combination, when the carrying amounts of assets and liabilities are adjusted to their fair values at the date of acquisition, but the tax bases of those assets and liabilities are not affected by the business combination or are affected differently;

- when an asset or a liability is revalued, but the tax base of the asset or liability is not adjusted;
- when the tax authority permits indexation of, or other adjustments to, the cost of an asset for tax purposes, but the asset is not revalued for accounting purposes;
- in respect of non-tax deductible goodwill which arises in a business combination; and
- on the initial recognition of an asset or a liability, for example, if part or all of the cost of an asset will not be deductible for tax purposes.

Temporary differences are determined by reference to the carrying amount of an asset or a liability. [IAS 12:55]

The carrying amounts used in the calculation of temporary differences are determined from the accounting records. If applicable, carrying amounts are calculated net of any allowances or deductions, such as allowances for doubtful debts or impairment losses.

There are two types of temporary differences — taxable temporary differences and deductible temporary differences. These are discussed in detail in the following sections.

4.3.3 Taxable temporary differences

Taxable temporary differences are temporary differences that will result in taxable amounts in determining the taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. [IAS 12:5]

Taxable temporary differences are, therefore, differences that will give rise to taxable income in the future; they increase future taxable profit, and so give rise to deferred tax liabilities.

In the context of an asset, a taxable temporary difference arises when the carrying amount of the asset exceeds its tax base (e.g. an asset is depreciated more quickly for tax purposes than for accounting purposes). As the carrying amount of the asset is recovered, the economic benefits subject to tax (i.e. the profits generated by the use of the asset equal to the carrying amount of the asset) will exceed the remaining future tax deductions available (the tax base). The tax effect of this taxable temporary difference gives rise to a deferred tax liability.

In the context of a liability, a taxable temporary difference arises when the tax base of the liability exceeds its carrying amount (e.g. a foreign currency loan payable which has been reduced for accounting purposes by an exchange gain that will be taxable when the loan is settled). If the loan is settled at its carrying amount, a taxable gain will arise; this is a taxable temporary difference.

4.3.4 Deductible temporary differences

Deductible temporary differences are temporary differences that will result in amounts that are deductible in determining the taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. [IAS 12:5]

Deductible temporary differences are, therefore, differences that decrease taxable income in the future, and so they give rise to deferred tax assets.

IAS 12:26 gives some examples of deductible temporary differences that result in deferred tax assets, as follows.

- Retirement benefit costs may be deducted in determining accounting profit as service is provided by the employee, but deducted in determining taxable profit either when contributions are paid to a fund by the entity or when retirement benefits are paid by the entity. A temporary difference exists between the carrying amount of the liability and its tax base — the tax base of the liability is usually nil. Such a deductible temporary difference results in a deferred tax asset because economic benefits will flow to the entity in the form of a deduction from taxable profits when contributions are made to the plan or retirement benefits are paid.
- Research costs are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base of the research costs (i.e. the amount the tax authorities will permit as a deduction in future periods) and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset.
- With limited exceptions, an entity recognises the identifiable assets acquired and liabilities assumed in a business combination at their fair values at the acquisition date. When a liability assumed is recognised at the acquisition date but the related costs are not deducted in determining taxable profits until a later period,

a deductible temporary difference arises which results in a deferred tax asset. A deferred tax asset also arises when the fair value of an identifiable asset acquired is less than its tax base. In both cases, the resulting deferred tax asset affects the goodwill or bargain purchase gain recognised.

- Assets may be carried at fair value, or may be revalued, without an equivalent adjustment being made for tax purposes. A deductible temporary difference arises if the tax base of the asset exceeds its carrying amount.

In the context of an asset, a deductible temporary difference arises when the tax base of the asset exceeds its carrying amount (e.g. when the carrying amount of a financial asset has been reduced by an allowance for irrecoverable amounts, but the allowance is not deductible for tax purposes until settlement). If the asset is settled at its carrying amount, a net deduction will arise; this is a deductible temporary difference.

In the context of a liability, a deductible temporary difference arises when the carrying amount of the liability exceeds its tax base (e.g. when interest payable has been accrued, but no tax deduction is available until the interest is paid). If the liability is settled at its carrying amount, a net deduction will arise; this is a deductible temporary difference.

A useful guide for determining whether temporary differences are taxable or deductible is set out below.

	Carrying amount — tax base	Type of temporary difference	Gives rise to . . .
Asset	Positive	Taxable	Deferred tax liability
Asset	Negative	Deductible	Deferred tax asset
Liability	Positive	Deductible	Deferred tax asset
Liability	Negative	Taxable	Deferred tax liability

4.4 Recognition of deferred taxes on temporary differences identified

4.4.1 Recognition of temporary differences – general

Having identified all of the temporary differences that exist at the end of the reporting period (see section 4.3), the next step is to pinpoint those temporary differences that will give rise to deferred tax assets or liabilities in the statement of financial position, using the recognition criteria laid down in the Standard.

Sections 4.4.2 and 4.4.3 set out the requirements for recognition of taxable temporary differences and deductible temporary differences, respectively. Sections 4.4.4 to 4.4.6 provide more detail regarding the circumstances in which identified temporary differences are not recognised.

4.4.2 Recognition of taxable temporary differences

A deferred tax liability should be recognised for all taxable temporary differences, unless the deferred tax liability arises from:

[IAS 12:15]

- the initial recognition of goodwill; or
- the initial recognition of an asset or a liability in a transaction which:
 - is not a business combination; and
 - at the time of the transaction affects neither accounting profit nor taxable profit (tax loss).

An entity should recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:

[IAS 12:39]

- the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and
- it is probable that the temporary difference will not reverse in the foreseeable future.

4.4.3 Recognition of deductible temporary differences

A deferred tax asset should be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or a liability in a transaction that:

[IAS 12:24]

- is not a business combination; and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

IAS 12 is silent with regard to the meaning of 'probable' in the context of IAS 12:24. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines the term 'probable' as 'more likely than not'. [IAS 37:23] The footnote to IAS 37:23 acknowledges that this definition is not necessarily applicable to other IFRSs. However, in the absence of any other guidance, the term 'probable' should be applied as 'more likely than not'.

In March 2009, the IASB issued an exposure draft (ED) containing proposals for an IFRS that would replace IAS 12. Although a replacement Standard was not finalised, the ED provides useful guidance on the meaning of 'probable' because it uses the term 'more likely than not' and notes in the Basis for Conclusions that this is consistent with the term 'probable' as used in IAS 37 and IFRS 3 *Business Combinations*.

See section 4.6.2 for a discussion of factors to be considered when assessing the availability of future taxable profit.

An entity should recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint arrangements, to the extent that, and only to the extent that, it is probable that:

[IAS 12:44]

- the temporary difference will reverse in the foreseeable future; and
- taxable profit will be available against which the temporary difference can be utilised.

The availability of future taxable profits is discussed in section 4.6.2.

4.4.4 Recognition exceptions — general

As detailed in 4.4.2 and 4.4.3, deferred tax assets and liabilities should be recognised on all temporary differences except for those arising from:

- in relation to deferred tax liabilities only, the initial recognition of goodwill (see section 4.4.5); or
- the initial recognition of an asset or a liability in a transaction which (i) is not a business combination and (ii) at the time of the transaction affects neither accounting profit nor taxable profit (tax loss) (see section 4.4.6); or
- certain differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements (see section 4.4.7).

In addition to the exceptions noted, a further condition must be met before a deferred tax asset can be recognised in respect of deductible temporary differences — it must be probable that taxable profit will be available against which the deferred tax asset can be utilised. This probability criterion is discussed in detail in 4.6.1.

Deferred tax liabilities are recognised for all taxable temporary differences except for those meeting the exceptions described above. Tax planning opportunities, as referred to in IAS 12:30 and discussed at 4.6.5, relate only to the determination of taxable profits available to support the recognition of deferred tax assets. Tax planning opportunities should not be used to justify non-recognition of a deferred tax liability on a taxable temporary difference that exists at the end of the reporting period.

4.4.5 Recognition exceptions — the initial recognition of goodwill

4.4.5.1 Taxable temporary differences arising on the initial recognition of goodwill

The tax deductibility of reductions or impairments in the carrying amount of goodwill varies among jurisdictions according to the tax laws. When a reduction of goodwill is not deductible against taxable income, the tax base of the goodwill is nil, and a taxable temporary difference arises equal to the carrying amount of the goodwill.

Although a taxable temporary difference exists at initial recognition, IAS 12 prohibits the recognition of the resulting deferred tax liability. The underlying rationale for this exception is that, if a deferred tax liability were set up in respect of the goodwill at the time of the business combination, this would decrease the total for the net assets recognised. Because goodwill is a residual, this would further increase goodwill and the increase would also need to be tax-effected. [IAS 12:21 & 21A]

Subsequent reductions in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill are also regarded as arising from the initial recognition of goodwill and, therefore, they are not recognised. [IAS 12:21A]

In contrast, deferred tax liabilities associated with goodwill are recognised to the extent that they do not arise from the initial recognition of that goodwill. [IAS 12:21B] This is illustrated in examples 4.4.5.1A to C.

Example 4.4.5.1A

Taxable temporary difference arising on the initial recognition of non-tax deductible goodwill

Company A acquires Company B for consideration of CU500. The fair value of the identifiable net assets of Company B at the acquisition date is CU400, resulting in goodwill of CU100. The goodwill is not tax deductible and, therefore, has a tax base of nil, but IAS 12:15 prohibits the recognition of the resulting deferred tax liability on the temporary difference of CU100.

Subsequently, the goodwill is impaired by CU20 and, therefore, the amount of the taxable temporary difference relating to the goodwill is reduced from CU100 to CU80, with a resulting decrease in the value of the unrecognised deferred tax liability. The decrease in the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill and is not recognised.

Example 4.4.5.1B

Taxable temporary difference arising on goodwill that is wholly tax deductible

The facts are as for example 4.4.5.1A, except that the goodwill is deductible for tax purposes at 20 per cent per year starting in the year of acquisition. Thus, the tax base of the goodwill is CU100 on initial recognition and CU80 at the end of the year of acquisition. If the carrying amount of goodwill at the end of the year of acquisition remains unchanged at CU100 (i.e. it has not been impaired), a taxable temporary difference of CU20 arises in that year. That taxable temporary difference does not relate to the initial recognition of the goodwill and, therefore, the resulting deferred tax liability is recognised. The temporary difference will reverse when the acquired business (including the goodwill) is sold or the goodwill is impaired.

Example 4.4.5.1C

Taxable temporary difference arising on goodwill that is partially tax deductible

The facts are as for example 4.4.5.1A, except that CU80 of the goodwill is deductible for tax purposes at 25 per cent per year starting in the year of acquisition. The carrying amount of the goodwill that is non-tax deductible is CU20, but no deferred tax liability is initially recognised on this temporary difference of CU20. The tax rate is 30 per cent.

At the end of the year of acquisition, the carrying amount of the total goodwill remains CU100 (i.e. it has not been impaired). No deferred tax liability is recognised for the initial temporary difference of CU20 in relation to the non-tax deductible goodwill. A deferred tax liability of CU6 ($30\% \times \text{CU20}$) is recognised for the temporary difference between the carrying amount (CU80) and the tax base (CU60) of the tax deductible goodwill because that taxable temporary difference does not relate to the initial recognition of the goodwill. The temporary difference will reverse when the acquired business (including the goodwill) is sold or the goodwill is impaired.

4.4.5.2 Deductible temporary differences arising on the initial recognition of goodwill

As discussed above and illustrated in examples 4.4.5.1A to 4.4.5.1C, IAS 12:15 prohibits the recognition of a deferred tax liability in relation to a taxable temporary difference arising on the initial recognition of goodwill. There is no equivalent prohibition on the recognition of deferred tax assets arising from deductible temporary differences in such circumstances.

IAS 12:32A specifically addresses the circumstances in which the carrying amount of goodwill arising in a business combination is less than its tax base and states that the difference gives rise to a deferred tax asset that should be recognised as part of the accounting for the business combination to the extent that it is probable that it will be recovered.

Example 4.4.5.2

Tax deductible goodwill exceeds the carrying amount of goodwill

Company A acquires Company B for consideration of CU500. The fair value of the identifiable net assets of Company B at the acquisition date is CU400, resulting in goodwill of CU100 (before any adjustment for a deferred tax asset arising on that goodwill). For tax purposes, a deduction of CU120 is available in respect of the goodwill. The tax rate is 30 per cent.

Following the requirements of IAS 12:32A, a deferred tax asset is recognised for the deductible temporary difference between the carrying amount and tax base of the goodwill, subject to the general recognition requirements of IAS 12. Because the carrying amount of goodwill is generally the residual purchase price over fair value of identifiable assets acquired and liabilities assumed (including deferred tax balances), a simultaneous equation (as illustrated below) is used to determine the final carrying amount of goodwill to be recognised in the business combination.

Equation 1 — Calculation of goodwill

	CU
Consideration	500
Less: Fair value of identifiable net assets	(400)
Less: Deferred tax asset on goodwill	(DTA)
Goodwill (GW)	100 – DTA

Equation 2 — Calculation of deferred tax asset

	CU
Tax base of goodwill	120
Less: Carrying amount of goodwill	(GW)
Deductible temporary difference	120 – GW
Tax rate	30%
Deferred tax asset on goodwill (DTA)	0.3 × (120 – GW)

Substituting Equation 2 into Equation 1

$$GW = 100 - DTA = 100 - 0.3(120 - GW) = 100 - 36 + 0.3(GW) = 64 + 0.3(GW)$$

Rearranged to

$$0.7(GW) = 64 \rightarrow GW = \text{CU}91.43$$

The calculated goodwill figure is then used to determine the deferred tax asset.

$$DTA = 0.3(120 - GW) = 0.3(120 - 91.43) = \text{CU}8.57$$

Therefore, the final goodwill calculation is as follows.

	CU
Consideration	500.00
Less: Fair value of identifiable net assets	(400.00)
Deferred tax asset	<u>(8.57)</u>
Goodwill (GW)	<u><u>91.43</u></u>

See section 7.2.16 of chapter A3 for a discussion of the accounting, on transition to IFRSs, for deferred tax relating to goodwill that has previously been written off directly to equity.

4.4.6 Recognition exceptions — initial recognition of an asset or a liability

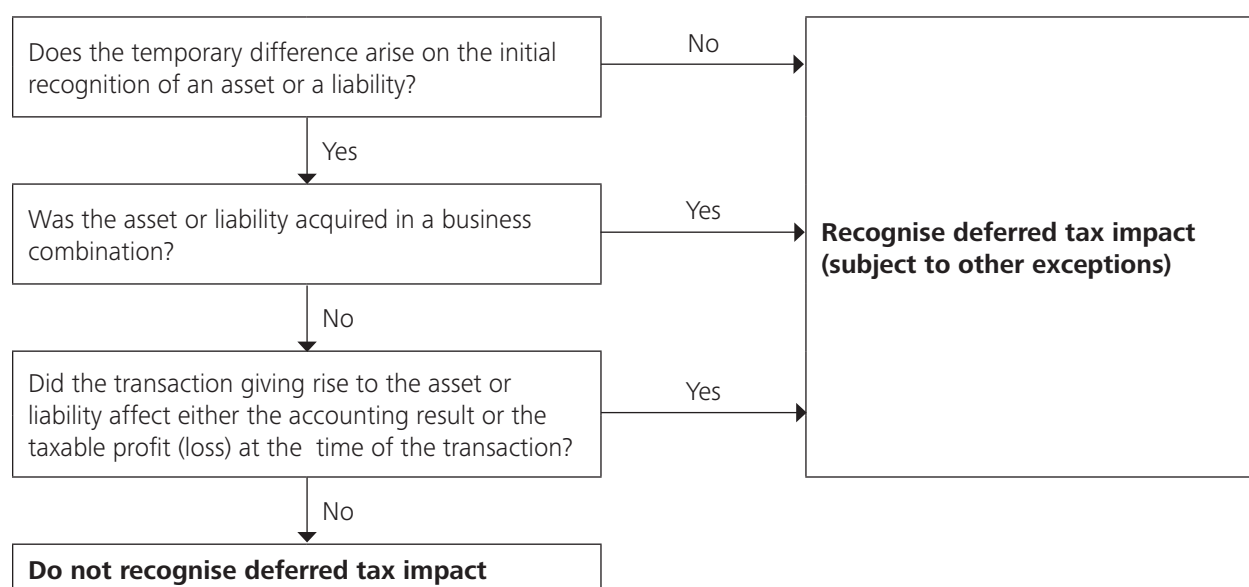
4.4.6.1 Conditions for application of the initial recognition exception

IAS 12 requires the recognition of deferred tax in respect of temporary differences arising when an asset or a liability results from any one of the following:

- a transaction that affects accounting profit (e.g. anticipation of income receivable (asset), or accrual of costs payable (liability)); or
- a transaction that affects taxable profit (e.g. expenditure on assets such as computer equipment allowed for tax purposes when paid (asset), or deferral of income recognition in respect of funds that are taxable when received (liability)); or
- a business combination.

IAS 12 prohibits the recognition of deferred tax on the initial recognition of an asset or a liability in any other circumstances. [IAS 12:22] The following flowchart illustrates these rules.

Temporary difference arising on the initial recognition of an asset or a liability



One example given in IAS 12 is that of an asset for which there is no deduction against taxable profits for depreciation. Assuming that the entity intends to recover the value of the asset through use, the tax base of the asset is nil. Therefore, a taxable temporary difference equal to the cost of the asset arises on initial recognition. However, the Standard does not permit a deferred tax liability to be recognised because the initial recognition of the asset is not part of a business combination and does not affect either accounting profit or taxable profit. Further, no deferred tax is recognised as a result of depreciating the asset.

The prohibition on recognition is based on the argument that, if a deferred tax liability were recognised, the equivalent amount would have to be added to the asset's carrying amount in the statement of financial position, or be recognised in profit or loss at the date of initial recognition, and this would make the financial statements 'less transparent'. [IAS 12:22(c)] This exception is based on pragmatism and the desire to avoid the particular financial statement effects discussed, rather than any particular conceptual basis. The exception has a particular effect in jurisdictions where some or all of the initial expenditure on assets is disallowed for tax purposes.

4.4.6.2 Application of the initial recognition exception

The following examples illustrate the application of the initial recognition exception.

Example 4.4.6.2A

Deferred tax liability arising on the recognition of an asset — asset depreciated at the same rate for tax and accounting purposes

Company A purchases an asset for CU100,000 at the end of 20X0. Only CU60,000 is qualifying expenditure for tax purposes. The carrying amount of the asset will be recovered through use in taxable manufacturing operations. The asset is depreciated on a straight-line basis at 25 per cent for both tax and accounting purposes.

Year	Carrying amount CU	Tax base CU	Temporary difference CU	Unrecognised temporary difference CU	Recognised temporary difference CU	Deferred tax liability CU
	A	B	$A - B = C$	D*		
20X0	100,000	60,000	40,000	40,000	—	—
20X1	75,000	45,000	30,000	30,000	—	—
20X2	50,000	30,000	20,000	20,000	—	—
20X3	25,000	15,000	10,000	10,000	—	—
20X4	—	—	—	—	—	—

* The unrecognised temporary difference reflects the proportion of the asset's carrying amount that represents the original unrecognised temporary difference, as reduced by subsequent depreciation. No deferred tax is ever recognised in respect of the original temporary difference.

Subsequent to initial recognition, additional temporary differences may arise in respect of the same asset or liability (e.g. due to different depreciation rates for accounting and tax purposes). In such circumstances, the deferred tax effect of those additional temporary differences is recognised in accordance with the usual requirements.

Effectively what is required, as illustrated in example 4.4.6.2B, is to deduct from the temporary difference at each period end the proportion of the asset's (or the liability's) carrying amount that represents the unrecognised temporary difference at the date of acquisition, as reduced by subsequent depreciation or amortisation. Deferred tax is provided in respect of the remainder of the temporary difference (the recognised temporary difference) in accordance with the usual requirements.

Example 4.4.6.2B

Deferred tax liability arising on the recognition of an asset — different depreciation rates for tax and accounting purposes

The facts are as per example 4.4.6.2A, but the asset is depreciated on a straight-line basis at 25 per cent for accounting purposes and 33 1/3 per cent for tax purposes. The tax rate is 30 per cent.

Year	Carrying amount CU	Tax base CU	Temporary difference CU	Unrecognised temporary difference CU	Recognised temporary difference CU	Deferred tax liability CU
	A	B	$A - B = C$	D*	$C - D = E^{**}$	$E \times 30\%$
20X0	100,000	60,000	40,000	40,000	—	—
20X1	75,000	40,000	35,000	30,000	5,000	1,500
20X2	50,000	20,000	30,000	20,000	10,000	3,000
20X3	25,000	—	25,000	10,000	15,000	4,500
20X4	—	—	—	—	—	—

* As per example 4.4.6.2A

** The recognised temporary difference reflects the difference between cumulative tax and cumulative accounting depreciation on the original tax base of the asset.

Additional temporary differences will also arise when the asset is subsequently revalued, as illustrated below.

Example 4.4.6.2C

Deferred tax liability arising on the recognition of an asset — asset subsequently revalued

The facts are as per example 4.4.6.2A (i.e. depreciation on a straight-line basis at 25 per cent for both tax and accounting purposes), but the asset is revalued for accounting purposes to CU120,000 at the end of 20X1. The tax rate is 30 per cent.

Year	Carrying amount CU	Tax base CU	Temporary difference CU	Unrecognised temporary difference CU	Recognised temporary difference CU	Deferred tax liability CU
	A	B	$A - B = C$	D*	$C - D = E^{**}$	$E \times 30\%$
20X0	100,000	60,000	40,000	40,000	—	—
20X1	120,000	45,000	75,000	30,000	45,000	13,500
20X2	80,000	30,000	50,000	20,000	30,000	9,000
20X3	40,000	15,000	25,000	10,000	15,000	4,500
20X4	—	—	—	—	—	—

* As per example 4.4.6.2A

** The recognised temporary difference is the amount by which the asset has been revalued upwards in comparison with the depreciated original cost (i.e. the difference between CU120,000 and CU75,000, being the carrying amount of the asset at the time of the revaluation), less depreciation of the revaluation uplift.

4.4.6.3 Available tax deductions exceed the cost of the asset ('super deductions')

Example 4.4.6.3A

Additional tax deduction available when assets are brought into use

On 31 December 20X0, Manufacturing Entity A enters into a capital expansion project that qualifies for tax deductions based on 150 per cent of the cost of new manufacturing assets (CU80,000). The deduction in excess of the cost of the assets (the additional tax deduction) is deductible in the determination of taxable income in the period when the assets are brought into use (20X1).

The carrying amount of the assets will be recovered through use in taxable manufacturing operations. The cost of the assets is depreciated on a straight-line basis at 25 per cent for accounting purposes and 33 1/3 per cent for tax purposes.

The tax rate is 30 per cent.

Note that the tax deduction in excess of the cost of the assets (available when the assets are brought into use in 20X1) satisfies the conditions for the initial recognition exception under IAS 12:24 because the transaction (i.e. the incurrence of capital expenditure) (1) is not a business combination, and (2) affects neither accounting nor taxable profit on initial recognition.

Year	Carrying amount CU	Tax base CU	Temporary difference CU	Unrecognised temporary difference CU	Recognised temporary difference CU	Deferred tax liability CU
	A	B	$A - B = C$	D*	$C - D = E$	$E \times 30\%$
20X0	80,000	120,000	−40,000	−40,000	—	—
20X1	60,000	53,333	6,667	—	6,667	2,000
20X2	40,000	26,667	13,333	—	13,333	4,000
20X3	20,000	—	20,000	—	20,000	6,000
20X4	—	—	—	—	—	—

* The unrecognised temporary difference represents the proportion of the additional tax deduction not yet claimed.

The accounting treatment described results in a lower effective tax rate in 20X1 when the assets are brought into use (and the additional tax deduction of CU40,000 is claimed) and a constant effective tax rate from 20X2 to 20X4.

Example 4.4.6.3B

Additional tax deduction available over several periods

The facts are as per example 4.4.6.3A, except the additional tax deduction is claimed evenly over three years, commencing when the assets are brought into use in 20X1.

Year	Carrying amount CU	Tax base CU	Temporary difference CU	Unrecognised temporary difference CU	Recognised temporary difference CU	Deferred tax liability CU
	A	B	$A - B = C$	D*	$C - D = E$	$E \times 30\%$
20X0	80,000	120,000	-40,000	-40,000	—	—
20X1	60,000	80,000	-20,000	-26,667	6,667	2,000
20X2	40,000	40,000	—	-13,333	13,333	4,000
20X3	20,000	—	-20,000	—	20,000	6,000
20X4	—	—	—	—	—	—

* The unrecognised temporary difference reflects the proportion of the additional tax deduction not yet claimed.

The additional tax deduction is allowed over several periods, resulting in the reversal of the temporary difference that is subject to the initial recognition exception over time. This reduces the effective tax rate evenly throughout the period over which the tax deductions are realised.

4.4.6.4 Acquisition of investment property

At the time of acquisition of an investment property, an entity should determine whether the acquisition is considered to be the acquisition of a single asset, or whether it is considered to be a business combination as defined in accordance with IFRS 3. The acquisition of a single asset is a transaction to which the initial recognition exception would generally apply and, if so, no deferred tax would be recognised for any taxable temporary difference at the date of acquisition. Conversely, the acquisition of assets in a business combination does not attract the initial recognition exception and, therefore, deferred tax would be recognised on any taxable temporary differences arising at the date of acquisition.

In determining whether the acquisition of an investment property is a business combination, an entity should refer to the guidance in IAS 40:14A (see 3.2 in chapter A8).

The deferred tax accounting for the acquisition will automatically follow the accounting determination as to whether the acquisition meets the definition of a business combination under IFRS 3; it is not an independent decision for the purposes of applying IAS 12.

4.4.6.5 Government grants

Deferred tax assets can arise on the initial recognition of an asset, although more rarely than deferred tax liabilities. The example cited in IAS 12 for a deferred tax asset arising on initial recognition is when a non-taxable government grant related to an asset is deducted in arriving at the carrying amount of the asset but, for tax purposes, is not deducted from the asset's depreciable amount (i.e. its tax base). The carrying amount of the asset is less than its tax base, giving rise to a deductible temporary difference. Under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, the government grant may also be set up as deferred income, in which case the difference between the deferred income and its tax base of nil is a deductible temporary difference. Whichever method of presentation is adopted, the entity does not recognise the resulting deferred tax asset. [IAS 12:33]

4.4.6.6 Recognition exceptions applied by an acquirer prior to a business combination

An entity acquired in a business combination may not have recognised deferred taxes on temporary differences related to some assets or liabilities in its individual financial statements because, when the asset or liability was first recognised, the initial recognition exception applied.

Although the acquired entity does not recognise deferred tax on these items in its individual financial statements, the recognition exception does not apply when the assets and liabilities of the acquired entity are initially recognised in the new consolidated group. Deferred tax will be recognised on any temporary differences at the date of acquisition because, from the group's perspective, the assets and liabilities are initially recognised as part of a business combination and, therefore, the conditions for the initial recognition exception are not met.

4.4.6.7 Transfers of assets between group entities

In some circumstances, an entity within a group will acquire assets and liabilities in a business combination and subsequently transfer one or more of the acquired assets to another entity within the group. In the consolidated financial statements of the group, because the assets were acquired in a business combination, the initial recognition exception does not apply and deferred tax should be recognised on any taxable temporary difference arising at the date of acquisition and subsequently (including any difference arising on the subsequent transfer of the assets between entities within the group).

However, from the perspective of the individual entity within the group to which assets have been subsequently transferred, often the transfer will not constitute a business combination, but rather the acquisition of individual assets. In such circumstances, in the individual financial statements of the entity to which the assets have been transferred, any taxable temporary difference arising on the initial recognition of the assets is subject to the initial recognition exception and no deferred tax liability should be recognised at the point of transfer. In the consolidated financial statements of the group, the unrecognised deferred tax liability would then be reinstated as a consolidation adjustment.

A similar analysis applies when an intragroup transfer results in a deductible temporary difference, with the recognition of any deferred tax asset in the consolidated financial statements being subject to IAS 12's general recognition criteria (see 4.6.1).

4.4.6.8 Temporary differences arising as a result of changes in tax legislation

Temporary differences may arise as a result of changes in tax legislation in a variety of ways, for example:

- when a new income tax is introduced to replace or complement the existing income tax regime; or
- when an allowance for depreciation of specified assets is amended or withdrawn.

The initial recognition exception in IAS 12:15(b) does not apply in respect of temporary differences that arise as a result of changes in tax legislation. IAS 12:15(b) provides an exception from the general requirement to recognise a deferred tax liability for all taxable temporary differences that arise on the initial recognition of an asset or a liability in a transaction which (1) is not a business combination, and (2) at the time of the transaction affects neither accounting profit nor taxable profit (tax loss). Therefore, it can only be applied when an asset or a liability is first recognised.

Accordingly, when additional temporary differences arise as a result of the introduction of a new tax, and not when an asset or a liability is first recognised, the deferred tax effect of the additional temporary differences should be recognised. The deferred tax effect of any additional temporary difference arising in such circumstances will be recognised (subject to the general recognition criteria in IAS 12 for deferred tax assets) and presented as required by IAS 12:58.

The fact that the initial recognition exception can only be applied when an asset or a liability is first recognised results in inconsistent accounting under IAS 12 for assets owned by an entity when a change in tax legislation is introduced as compared to assets acquired after that date.

4.4.7 Recognition exceptions — investments in subsidiaries, branches and associates, and interests in joint arrangements

4.4.7.1 Temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements

Temporary differences arise when the carrying amount of an investment differs from its tax base (which is often cost). Examples of circumstances in which temporary differences may arise include:

[IAS 12:38]

- the existence of undistributed profits in the subsidiary, branch, associate or joint arrangement (when profits have been consolidated or accounted for using the equity method);
- movements in the carrying amount of a foreign operation due to changes in foreign exchange rates when a parent and its subsidiary have different functional currencies; or
- a reduction in the carrying amount of an investment in an associate to its recoverable amount without a corresponding change in its tax base.

Additionally, temporary differences can arise due to adjustments made to the tax base of the investment as a result of local tax law. These may include adjustments as a result of controlled foreign company laws, deemed taxable distributions of dividends, or tax elections.

A temporary difference arising in consolidated financial statements may be different from that in the parent's separate financial statements if the parent carries the investment at cost or revalued amount. [IAS 12:38]

Differences associated with investments in subsidiaries, associates and joint arrangements generally arise in consolidated financial statements because the profits of the investee have been recognised (whether by consolidation or the equity method) but the tax base of the investment remains unchanged. The tax effects that would arise if those profits were distributed (e.g. withholding tax) should be considered. Unlike the 'general' recognition exceptions (see 4.4.4), IAS 12 does not prohibit the recognition of deferred tax assets and liabilities in respect of these differences. Instead, it imposes particular conditions for such recognition.

4.4.7.2 Recognition of taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements

An entity should recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:

[IAS 12:39]

- the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and
- it is probable that the temporary difference will not reverse in the foreseeable future.

4.4.7.3 Recognition of deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements

An entity should recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint arrangements, to the extent that, and only to the extent that, it is probable both:

[IAS 12:44]

- that the temporary difference will reverse in the foreseeable future; and
- that taxable profit will be available against which the temporary difference can be utilised.

IAS 12 does not define 'foreseeable future'. However, it is reasonable to analogise to the guidance in IAS 1 *Presentation of Financial Statements* regarding the going concern assumption underlying the preparation of financial statements. IAS 1:26 refers to a period that "is at least, but not limited to, twelve months from the end of the reporting period". Therefore, for the purposes of applying IAS 12, it is reasonable to expect that the 'foreseeable future' would be at least twelve months from the end of the reporting period. However, depending on the facts and circumstances (including management intent), it may be a longer period.

4.4.7.4 Recognition of temporary differences associated with investments in subsidiaries

For investments in subsidiaries, the temporary difference generally represents the difference between the net investment accounted for in the consolidated financial statements (effectively the parent's share of the subsidiary's net assets including any associated goodwill) and the tax base of the investment.

A parent/subsidiary relationship involves the parent controlling its subsidiary, including the subsidiary's dividend policy. Accordingly, IAS 12 provides that when a parent has determined that it is probable that undistributed profits in a subsidiary will not be distributed in the foreseeable future, the parent does not recognise deferred tax on those undistributed profits. The same considerations apply to investments in branches. [IAS 12:40]

The Standard provides no specific guidance regarding the factors to be considered by the parent in order to determine whether distribution of the subsidiary's profits (and, therefore, reversal of a taxable temporary difference) is probable. Factors that might be considered in making the assessment include, but are not limited to:

- any plans for reinvestment to grow the business of the subsidiary;
- the past pattern of dividend payments;
- whether the parent needs the funds that would be generated by a dividend from its subsidiary to enable it to make a dividend payment or satisfy any other cash requirement;
- whether cash and distributable profits are available to pay dividends;
- whether a binding agreement exists regarding the amount of dividends to be paid out;
- whether there is a policy of paying out a certain percentage of profits each year;
- whether there is intent to dispose of the subsidiary before any distribution is made; and
- whether any legal or taxation requirements effectively create an economic compulsion to pay distributions.

When a parent requires its subsidiary to remit only a portion of undistributed earnings, the parent should recognise a deferred tax liability only for the portion of the undistributed earnings expected to be remitted in the foreseeable future.

If circumstances change, and it becomes probable that some or all of the undistributed earnings of the subsidiary in respect of which deferred tax has not been recognised will be remitted in the foreseeable future, the parent should recognise the additional deferred tax liability as an expense of the current period; prior year amounts are not restated.

If a subsidiary is classified as a discontinued operation under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (see chapter A20), this does not affect the requirements regarding the recognition of deferred tax assets. Therefore, a deferred tax asset should be recognised to the extent that it is probable that a temporary difference will reverse in the foreseeable future, and that taxable profit will be available against which the temporary difference can be utilised.

If a parent has recognised deferred tax in relation to its investment in a subsidiary classified as a discontinued operation, that deferred tax should be included in the accounting for the disposal of the subsidiary through sale or otherwise. Particular considerations apply when the parent retains an interest such that the investee is accounted for subsequently as an associate (see 4.4.7.7).

Example 4.4.7.4A

Profits in a subsidiary not expected to be distributed in the foreseeable future

Company A has a subsidiary with a carrying amount of CU200 and a tax base of CU100. Company A controls the distribution of dividends by the subsidiary. Company A does not have any need for the subsidiary to make a distribution, and in fact has active plans for the undistributed profits to be reinvested to grow the business of the subsidiary. In these circumstances, Company A should not recognise a deferred tax liability in respect of the temporary difference of CU100, because Company A can control the timing of the reversal and the temporary difference is not expected to reverse in the foreseeable future.

Example 4.4.7.4B

Profits in a subsidiary expected to be distributed in the foreseeable future

The facts are as per example 4.4.7.4A, except that Company A has encountered a cash flow problem. In order to resolve this problem, Company A needs to extract the increased value in the subsidiary in the form of cash dividends. In these circumstances, Company A should recognise the deferred tax liability for the portion of the earnings to be remitted because, although it can control the timing of the reversal, it is probable that the temporary difference will reverse in the foreseeable future.

Example 4.4.7.4C

Parent does not control timing of payment of dividends

The facts are as per example 4.4.7.4A, except that the subsidiary operates in a foreign jurisdiction. In that jurisdiction, the determination as to whether profits are returned to foreign investors or are reinvested in the business is made through regulatory channels. While Company A can express a preference, it is the local regulator who determines when profits are paid out as dividends. In these circumstances, Company A should recognise the deferred tax liability for all unremitted earnings of the subsidiary because it does not control the timing of the reversal of the temporary difference.

Example 4.4.7.4D

Temporary difference arising in relation to a loan forming part of net investment

Company B has a functional currency of US dollars. It makes a loan in Euro to its wholly-owned subsidiary, Company D, which has a functional currency of Euro. The loan is assessed under IAS 21 *The Effects of Changes in Foreign Exchange Rates* to be part of Company B's net investment in Company D.

In Company B's separate financial statements, in accordance with IAS 21:32, the loan is retranslated at the end of the reporting period, with exchange differences recognised in profit or loss. The exchange differences arising from the loan will only be assessed for tax purposes when the loan is repaid.

Because the loan forms part of Company B's net investment in Company D, the requirements of IAS 12:39 (see 4.4.2) should be applied in relation to the loan.

Company B can control the repayment of the loan which forms part of its net investment in the subsidiary. Therefore, Company B is able to control when tax will be incurred on the exchange differences, and is able to control the timing of the reversal of the temporary difference. Because settlement is neither planned nor likely to occur in the foreseeable future (a condition for the loan to qualify as part of Company B's net investment under IAS 21:15), it is probable that the temporary difference arising from the exchange differences will not reverse in the foreseeable future.

Consequently, Company B should not recognise deferred tax on the exchange differences arising on the foreign currency loan to Company D. In addition, Company B should comply with the disclosure requirements of IAS 12:81(f).

Example 4.4.7.4E

Deferred tax on overseas income derived from a subsidiary that is only taxed on repatriation

Company A has a subsidiary, Company C, which operates in a foreign tax jurisdiction. During the year, Company A made an interest earning loan of CU100,000 to Company C that is not considered to be part of its net investment in Company C for the purposes of IAS 21:15. The interest income from the loan is not taxable while held in the foreign tax jurisdiction and is only taxed on repatriation. Company A has no current intention to repatriate the interest income.

At the end of the current financial year, the total interest earned is CU10,000 and the carrying amount of the loan is CU110,000. The tax base of the interest earned is nil.

Company A should recognise a deferred tax liability in respect of the interest earned on the loan; Company A is required to recognise a tax liability on the difference between the carrying amount of CU10,000 and the tax base of nil.

The exception in IAS 12:38 to 45 relates to differences between the carrying amount and the tax base of investments in subsidiaries, branches, associates, and interests in joint arrangements; the exception does not apply to temporary differences that exist between the carrying amount of amounts receivable from or payable to the investee and their tax bases.

4.4.7.5 Recognition of temporary differences associated with investments in associates

In consolidated financial statements, investments in associates are generally accounted for using the equity method of accounting. Under the equity method, the investment is initially recognised at cost and the carrying amount is then increased or decreased by the investor's share of the profit or loss and other comprehensive income of the investee, less any distributions received from the associate. The tax arising in respect of the investee's profit or loss and other comprehensive income is recognised in the financial statements of the investee, and is therefore reflected in the amounts accounted for by the investor using the equity method of accounting, which are reported

net of tax. Any additional tax arising on any dividends received by the investor from the associate will also be reflected in the investor's own financial statements.

It may be that additional tax implications would arise if the investor were to realise its investment in the associate — whether through distribution of the retained profits of the associate or through disposal. For example, dividend income might be taxable or partially taxable in the hands of the investor; withholding taxes might be applied in the associate's country of operation; capital gains tax might be payable on disposal of the investment. In any of these circumstances, a temporary difference may exist.

Under IAS 12's recognition rules (see 4.4.2), taxable temporary differences associated with investments in associates should be accounted for except when:

- the investor controls the timing of the reversal of the temporary difference; and
- it is probable that the temporary difference will not reverse in the foreseeable future.

Because an investor/associate relationship does not involve control, an investor in an associate should normally recognise deferred tax arising in relation to the undistributed profits of an associate, unless there is strong evidence of an agreement that profits will not be distributed in the foreseeable future.

Example 4.4.7.5A **Undistributed profits in an associate**

Company B has an associate, Company A, which operates in Country Z. In its consolidated financial statements for the year ended 31 December 20X3, Company B recognised its CU20,000 share of the profits of Company A for that period using the equity method of accounting.

During the period, Company A paid interim dividends of CU5,000 to Company B out of its current year profits. No tax arises in Company B's country of operation on receipt of the dividends. However, under the laws of Country Z, additional tax is payable on distributed profits at 25 per cent and is not recoverable.

Because Company B is not able to control the timing of the reversal of the taxable temporary difference, in its consolidated financial statements it must also recognise the tax consequences that would arise if the remainder of its share of Company A's current year profits (i.e. CU15,000) were distributed. A deferred tax liability of CU3,750 ($\text{CU15,000} \times 25\%$) should therefore be recognised in the consolidated financial statements to 31 December 20X3, in addition to the recognition of the tax consequences arising from the remittance of CU5,000.

Example 4.4.7.5B **Investment in associate – determination of the expected manner of recovery**

Company A has a 20 per cent interest in Company B and exercises significant influence over Company B. The investment in Company B is accounted for in the consolidated financial statements of Company A using the equity method of accounting. Dividends received from Company B are not taxable; however, any capital gain on disposal of the investment in Company B would be taxed at a rate of 15 per cent.

IAS 12.51A requires that an entity should measure deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery of an asset. Accordingly, the tax rate should reflect the expected manner of recovery of the asset.

How should the 'expected manner of recovery' of Company A's investment in Company B (and, consequently, the appropriate rate for measurement of the deferred tax liability) be determined?

The carrying amount of an investment in an associate can be recovered in a variety of ways, for example by:

- receiving dividends (or other distribution of profit);
- sale to a third party; or
- receiving residual assets upon liquidation of the associate.

The determination of the expected manner of recovery of an investment in an associate will often require careful judgement. In the circumstances described, factors to consider in making this judgement include, but are not limited to:

- whether Company A intends to sell its interest in Company B;
- the dividend yield on the investment; and
- the reason for acquiring and holding the investment.

When, for example, there has been a regular flow of dividends from the investment in the past, and there is no evidence of an intention to dispose of the associate (even though a disposal may be a possibility at some future point), this may lead to a determination that the investment will be recovered through remittance of earnings by dividend.

Example 4.4.7.5B (continued)

Investment in associate – determination of the expected manner of recovery

If the investment is expected to be recovered partly through dividends and partly upon sale or liquidation (e.g. if Company A has a plan to sell its investment in Company B at a later date and expects to receive dividends until the sale of the investment), the temporary difference should be disaggregated and different tax rates applied to each part in order to be consistent with the expected manner of recovery. See example 4.2.6.1B for an illustration of the calculation of a deferred tax liability when an asset is expected to be recovered partly through use and partly through sale.

The conclusions above were confirmed by the IFRS Interpretations Committee in the March 2015 *IFRIC Update*.

For deductible temporary differences arising in relation to investments, it is not necessary to consider the investor's ability to control distributions from the investee. Recognition of the deferred tax asset is only required if it is probable that the temporary difference will reverse in the foreseeable future and that taxable profit will be available against which the temporary difference can be utilised.

4.4.7.6 Recognition of temporary differences associated with interests in joint arrangements

Under IFRS 11 *Joint Arrangements*, the accounting for a joint arrangement is determined by whether the arrangement is classified as a joint venture or a joint operation (as defined in that Standard).

Irrespective of the method of accounting for joint arrangements, the same general considerations apply in respect of deferred tax.

The arrangement between the parties to a joint arrangement usually deals with the distribution of the profits and identifies whether decisions on such matters require the consent of all of the parties or a group of the parties. When the joint venturer or joint operator can control the timing of the distribution of its share of profits of the joint arrangement, and it is probable that its share of the profits will not be distributed in the foreseeable future, a deferred tax liability is not recognised. [IAS 12:43]

Interests in joint ventures

The determination as to who controls the timing of the reversal of the temporary difference in the case of joint ventures is not as clear-cut as it is for associates (see 4.4.7.5). Investments in joint ventures involve joint control, i.e. there is a contractual agreement to share control and no joint venturer exercises unilateral control.

The arrangements for distributions or disposals of shareholdings are generally dealt with in the joint venture agreement. In most cases, although each joint venturer cannot unilaterally declare a dividend, neither can such dividend be declared without each joint venturer's agreement. Therefore, each joint venturer has the ability to prevent distributions and, accordingly, prevent the reversal of the temporary difference. If this is the case, no deferred tax liability should be recognised if the joint venturer does not anticipate that it will authorise such distributions in the foreseeable future.

Interests in joint operations

Under IFRS 11, the determination of the tax implications for joint operations will depend on whether the joint operation is structured through a legal entity.

For joint arrangements that are structured through a legal entity but are determined to be joint operations because of other facts and circumstances (see chapter A27), the same considerations apply as above for joint ventures.

For joint operations that are not structured through a legal entity, the absence of a legal entity would mean that the joint operator does not generally have the ability to control the reversal of the temporary difference. Accordingly, deferred tax should normally be recognised.

4.4.7.7 Change in investment from subsidiary to associate

A parent may cease to have control over a subsidiary (e.g. because the parent sells a portion of the investment or because the subsidiary issues additional shares to a third party) but may retain some of its ownership interest such that the investment is subsequently classified as an associate and is, therefore, accounted for using the equity method. This change from subsidiary to associate may have deferred tax consequences.

When the parent did not previously recognise deferred tax in respect of temporary differences associated with the investment in the subsidiary (on the basis that it could control the timing of the reversal of such differences and it was not considered probable that the temporary differences would reverse in the foreseeable future), the change in status will generally require this determination to be revisited. Because an investor/associate relationship does not involve control, it will be determined in the majority of cases that the investor no longer has control over the timing of the reversal of the temporary differences associated with the investment, and deferred tax will need to be recognised in respect of the difference between the carrying amount of the investment in the associate and its tax base.

Under IFRS 10 *Consolidated Financial Statements*, when a transaction results in a parent losing control of a subsidiary, any investment retained in the former subsidiary is recognised at its fair value at the date when control is lost. In such circumstances, there is a change in the temporary differences associated with the investment; after the transaction, the temporary differences will include not only the investor's share of the undistributed profits of the associate and foreign exchange differences etc., but also the fair value uplift of the investment.

4.4.7.8 Foreign currency adjustments

The non-monetary assets and liabilities of an entity are measured in its functional currency (see chapter A19). If an entity's taxable profit or tax loss (and, consequently, 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 asset (subject to the general recognition criteria). The resulting deferred tax is recognised in profit or loss. [IAS 12:41]

IAS 12 is clear that when the tax base of a non-monetary asset is determined in a different currency from the functional currency of the entity, temporary differences will arise and deferred tax should be calculated. However, there is no guidance on how the deferred tax should be calculated.

In general, the most appropriate methodology will be to convert the tax base into the functional currency using the closing rate. This should be compared with the asset's carrying amount in the financial statements, which will have been converted at the rate ruling on the date of recognition. The deferred tax is then calculated at the tax rate expected to apply when the temporary difference reverses.

Example 4.4.7.8A

Tax base of asset denominated in a foreign currency

Company B, a Sterling functional currency entity, owns an asset in the United States. At 1 January 20X1, the tax base of the asset is US\$120 and the carrying amount is £50. The exchange rate is £0.5 = US\$1, resulting in a temporary difference of £10 (US\$120 × 0.5 = £60 less £50).

At 31 December 20X1, the carrying amount and the US\$ tax base of the asset have not changed, but the exchange rate is now £0.52 = US\$1, resulting in a temporary difference of £12 (US\$120 × 0.52 = £62 less £50). The movement of £2 represents an increase in the temporary difference as a result of the movement in the exchange rate.

Company B's tax rate will be applied to the movement of £2 and the resulting value recognised in profit or loss as part of deferred tax expense for the year, even though the movement is attributable to an exchange rate movement.

In practice, it is likely that the asset would be subject to depreciation; if so, part of the movement in the temporary difference would arise from the depreciation of the carrying amount.

When an entity owns a subsidiary that is taxed in a currency other than that subsidiary's functional currency, a translation difference will arise on the calculated deferred tax balance in that subsidiary's financial statements. On consolidation, that exchange difference is recognised in profit or loss; it is not transferred to the foreign currency translation reserve because the translation difference does not result from the accounting for the reporting entity's net investment in a foreign operation.

Example 4.4.7.8B

Tax base of subsidiary's assets and liabilities denominated in a foreign currency

Group A prepares consolidated financial statements which are presented in Sterling, and include a subsidiary with a functional currency of US dollars. However, that subsidiary pays taxes that are calculated and denominated in Sterling (the local currency of the subsidiary). Accordingly, the tax bases of the assets and liabilities in the subsidiary's financial statements are denominated in Sterling. Therefore, changes in exchange rates give rise to temporary differences. The resulting deferred tax is recognised in profit or loss in the financial statements of the subsidiary.

The amount is also recognised as part of the tax expense (income) in profit or loss in Group A's consolidated financial statements (rather than being recognised in other comprehensive income) because it reflects the genuine foreign currency exposure between the functional currency of the subsidiary and the tax cash flows of that subsidiary.

In some jurisdictions, tax returns and tax bases are permitted to be calculated in an entity's functional currency, even if that currency is not the local currency. The current tax liability is then translated into local currency for payment to the tax authorities. In such circumstances, foreign exchange gains and losses will not generally arise on the entity's temporary differences (which are computed in the functional currency), but a foreign exchange gain or loss can arise on differences between the accrual of the income tax provision in the functional currency and the payment of the liability in local currency. This is a genuine foreign currency exposure between the functional currency and the tax cash flows and is recognised in profit or loss.

4.4.7.9 Inflation adjustments

The tax law for a particular foreign jurisdiction may permit or require the taxpayer to adjust the tax base of an asset or a liability to take into account the effects of inflation. The inflation-adjusted tax base of an asset or a liability would be used to determine the future taxable or deductible amounts. If a foreign subsidiary has such inflation-indexed assets or liabilities, it cannot use the exceptions from recognition of deferred tax associated with investments in subsidiaries under IAS 12:39 and IAS 12:44 (see 4.4.2 and 4.4.3) to avoid recognising the related deferred tax liabilities or assets.

The temporary differences relate to the foreign operation's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation. Consequently, the foreign subsidiary recognises the resulting deferred tax liability or asset as appropriate in its domestic financial statements. The resulting deferred tax is recognised in profit or loss.

Example 4.4.7.9

Tax base of assets adjusted for inflation

Company X (with Sterling as its functional currency) has an overseas subsidiary (in a country where the inflation rate is not considered hyperinflationary) whose functional currency is the Euro.

At the beginning of 20X2, the foreign jurisdiction enacted tax legislation that increased the tax base of depreciable assets by 10 per cent. That increase will permit the overseas subsidiary to deduct additional depreciation in the current and future years. Immediately prior to the change in tax legislation, the base of the overseas subsidiary's depreciable assets is €1,000 for both tax and financial reporting purposes; the foreign tax rate is 50 per cent, and the current exchange rate between Sterling and the Euro is £1 = €2.

Therefore, at the beginning of 20X2, the overseas subsidiary should recognise a deferred tax asset resulting from the temporary difference between the carrying amount of the depreciable asset and the indexed tax base of €50 ($(€1,000 \times 10 \text{ per cent}) \times 50\%$) (subject to IAS 12's general recognition criteria for deferred tax assets).

In the consolidated financial statements, the deferred tax asset of the subsidiary should be translated to £25 ($€50 \times 0.5$) based on the current exchange rate.

In certain jurisdictions, the indexation allowance is only available upon sale, and does not affect the tax base available for tax depreciation. Therefore, if the expected manner of recovery of the asset (and, consequently, the deferred tax associated with the asset) is based on use, the indexation allowance should not be considered.

4.5 Measurement of deferred tax assets and liabilities

4.5.1 Computation of deferred tax assets and liabilities

To calculate the amount of a deferred tax asset or liability, the following formula may be useful:

Deferred tax asset or liability	=	Taxable or deductible temporary difference	×	Tax rate
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A deferred tax asset can also arise from unused tax losses and tax credits that have been carried forward. These deferred tax assets are calculated as follows.

Deferred tax asset	=	Unused tax losses and / or tax credits	×	Tax rate
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Thus, an important consideration is what tax rate should be used. This is considered in section 4.5.2.

4.5.2 Tax rates and laws

4.5.2.1 Tax rates and laws — general

Deferred tax balances are calculated using the tax rates that are expected to apply to the reporting period or periods when the temporary differences reverse, based on tax rates and tax laws enacted or substantively enacted at the end of the reporting period. [IAS 12:47]

When the tax rates that will apply to the entity are expected to vary in coming years (e.g. in start-up situations when tax concessions are granted in the early years), it is necessary to anticipate the year in which the temporary difference will reverse so that the deferred tax asset or liability can be calculated at the appropriate rate.

4.5.2.2 Progressive or graduated tax rates

In some jurisdictions, the tax rate varies according to the amount of taxable profit earned in a period. This creates a potential issue when it is necessary to predict the tax rate that will apply when a temporary difference reverses. IAS 12 addresses this situation and requires that, in such circumstances, deferred tax assets and liabilities should be measured using the average rates that are expected to apply in the periods in which the temporary differences are expected to reverse. [IAS 12:49]

For entities that expect graduated tax rates to be a significant factor, careful judgement should be exercised in determining the appropriate average tax rate to be used when measuring deferred tax assets and liabilities.

The determination of the appropriate tax rate may require an estimate of 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:

- income or loss excluding reversals of temporary differences; and
- reversals of existing taxable and deductible temporary differences.

The following example illustrates the measurement of deferred tax assets and liabilities when graduated tax rates are a significant factor.

Example 4.5.2.2 Graduated tax rates

At the end of 20X1, Company X has CU30,000 of deductible temporary differences that are expected to result in tax deductions of CU10,000 for each of the next three years — 20X2, 20X3 and 20X4.

Company X operates in a jurisdiction that has a graduated tax rate structure. The graduated tax rates are as follows.

Income > CU	Income ≤ CU	Tax rate
—	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	—	34%

Company X's estimates for pre-tax income for the three years 20X2, 20X3 and 20X4 are CU410,000, CU110,000 and CU60,000, respectively, exclusive of reversing temporary differences. The estimated taxable income and income taxes payable for those years is computed as follows.

	Future years		
	20X2 CU	20X3 CU	20X4 CU
Estimated pre-tax income	410,000	110,000	60,000
Reversing deductible temporary differences	<u>(10,000)</u>	<u>(10,000)</u>	<u>(10,000)</u>
Estimated taxable income (A)	<u>400,000</u>	<u>100,000</u>	<u>50,000</u>
Tax based on graduated tax rates:			
(CU50,000 × 15%)	7,500	7,500	7,500
(CU25,000 × 25%)	6,250	6,250	—
(CU25,000 × 34%)	8,500	8,500	—
(CU235,000 × 39%)	91,650	—	—
(over CU335,000 × 34%)	<u>22,100</u>	<u>—</u>	<u>—</u>
Estimated tax (B)	<u>136,000</u>	<u>22,250</u>	<u>7,500</u>
Applicable tax rate (C = B/A)	<u>34%</u>	<u>22.25%</u>	<u>15%</u>
Deferred tax credit (CU10,000 × C), CU	<u>3,400</u>	<u>2,225</u>	<u>1,500</u>

Provided that the probable realisation criterion established under IAS 12 is met, Company A should recognise a deferred tax asset at the end of 20X1 of CU7,125 (CU3,400 + CU2,225 + CU1,500).

4.5.2.3 Substantively enacted tax rates

IAS 12 requires that deferred tax assets and liabilities be measured based on rates and laws that have been 'enacted or substantively enacted' by the end of the reporting period. It is not appropriate to anticipate changes to tax rates or laws that have not been substantively enacted.

Whether or not a law has actually been enacted by the end of the reporting period is a fact that will be immediately clear. However, when a new rate or law is announced at or before the end of the reporting period, but the formalities of the enactment process have not been finalised, it will be necessary to determine whether such announcement and any procedures or processes that have occurred prior to the end of the reporting period constitute substantive enactment.

The determination as to whether new tax rates are considered to be ‘substantively enacted’ is a matter requiring careful judgement, based on the specific facts and circumstances. Factors to consider in assessing that determination include, but are not limited to, the following:

- the legal system and related procedures or processes necessary for enactment of the tax law change;
- the nature and extent of the remaining procedures or processes;
- the extent to which the remaining procedures or processes are perfunctory; and
- the timing of the remaining procedures or processes.

IAS 12 acknowledges that, in some jurisdictions, the announcement of new tax rates and tax laws by the government may have the substantive effect of enactment, even if formal enactment takes place some months later. In these circumstances, tax assets and liabilities are measured using the announced rates. [IAS 12:48] In other countries, it may be necessary for virtually all of the legal stages towards enactment to have been completed before the rates can be considered to be substantively enacted.

The IASB decided as part of the US/IFRS convergence project to clarify that ‘substantively enacted’ means that any expected change in the tax rate is virtually certain. This proposed clarification was included in the exposure draft for the replacement Standard for IAS 12 (which, although a replacement Standard was not finalised, provides useful guidance on the meaning of ‘substantive enactment’). The IASB noted that in some jurisdictions (e.g. the US) enactment may not be virtually certain until the change is signed into law. The Board discussed whether ‘substantively enacted’ should be based on the probability of enactment or on the process of enactment. The Board decided that reaching a specified stage in the process should be required. It further decided that the specified stage should be that the process of enactment is complete, which is when the remaining steps will not change the outcome.

4.5.2.4 Changes in tax rates after the reporting period

When there is a change in tax rates or laws after the reporting period, no adjustment is made to the carrying amounts of deferred tax assets and liabilities. However, when the effect of the change is such that “non-disclosure could influence the economic decisions of users taken on the basis of the financial statements”, disclosure will be required in accordance with IAS 10 *Events after the Reporting Period*. [IAS 10:21]

Example 4.5.2.4 **Change in tax rate after the reporting period**

Company D has recognised interest receivable of CU1,000 in its statement of financial position as at 31 March 20X3. The interest will be taxed when it is received, which will be during the year ending 31 March 20X4. At 31 March 20X3, the tax rate is 16 per cent. On 5 April 20X3, it is announced that the tax rate for the year ending 31 March 20X4 will be increased to 17.5 per cent; the change is enacted on 25 April 20X3. The financial statements for the year ended 31 March 20X3 are authorised for issue on 30 June 20X3.

The taxable temporary difference in respect of the interest receivable is CU1,000. A deferred tax liability of CU160 will be included in Company D’s financial statements for the year ended 31 March 20X3. Although it is known at the time that the financial statements are authorised for issue that the interest income will be taxed at 17.5 per cent when it is received, IAS 12 precludes using the 17.5 per cent rate to calculate the deferred tax liability because this rate was neither enacted nor substantively enacted by 31 March 20X3. If the effect of the change is sufficiently significant, disclosure will be required in accordance with IAS 10.

4.5.2.5 Phased-in tax rates

A phased-in change in tax rates occurs when the tax law specifies that in future periods the tax rate applied to taxable income will change (e.g. the tax law provides that the corporate tax rate will be 43 per cent in 20X1, 38 per cent in 20X2 and 35 per cent for 20X3 and later years).

IAS 12:47 requires deferred tax assets and liabilities to be measured using the enacted (or substantively enacted) tax rates expected to apply to taxable income in the years in which the temporary differences are expected to reverse. Consequently, enacted or substantively enacted changes in tax laws or rates that become effective for particular future years must be considered when determining the tax rate to apply when measuring the tax consequences of temporary differences that are expected to reverse in those years. This exercise may require assumptions to be made regarding tax elections that will be made in future years (based on management expectations), and estimates to be made for the amounts of profit or loss anticipated in the future years when those temporary differences are expected to reverse.

4.5.2.6 Tax rate varies according to whether profits are distributed

In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings are paid out as a dividend to shareholders. Equally, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In such circumstances, IAS 12 stipulates that the rate to be used for the purposes of measurement of both current and deferred tax assets and liabilities is the tax rate applicable to undistributed profits. [IAS 12:52A]

The income tax consequences of a dividend should only be accounted for when the dividend is recognised as a liability in the financial statements. [IAS 12:52B]

Example 4.5.2.6A

Higher income tax rate on undistributed profits

Company G has undistributed profits of CU1,000 in its statement of financial position at 31 December 20X3. Under local tax regulations, income taxes are payable at a higher rate on undistributed profits (50 per cent) than on distributed profits (35 per cent). Company G has traditionally paid dividends to shareholders equivalent to 25 per cent of the taxable profit for the year. It continues that dividend policy by paying an interim dividend in March 20X4, before the 31 December 20X3 financial statements are authorised for issue.

A current tax liability of CU500 ($\text{CU1,000} \times 50 \text{ per cent}$) will be included in the financial statements for the year ended 31 December 20X3, even though Company G knows that a portion of the taxable profit will be taxed at a lower rate due to the interim dividend payment.

In accordance with IAS 10, the liability for the 20X4 interim dividend is not recognised in the financial statements for the year ended 31 December 20X3 and, therefore, the tax consequences of that dividend are not taken into account at 31 December 20X3. The impact of the reduction in tax rates will be recognised at the time the dividend is recognised, which will be when the criteria for recognition of a liability are met.

Although the current and deferred tax assets and liabilities of an entity are always measured at the undistributed rate in its individual financial statements, future distributions are anticipated to some extent when those financial statements are subsequently incorporated into consolidated financial statements of a group or are incorporated into the financial statements of an investor using the equity method. If, for example, Entity A is an associate of Investor I and Entity A's financial statements are incorporated into the financial statements of Investor I using the equity method, the application of IAS 12:39 and IAS 12:44 (see 4.4.2 and 4.4.3) may require deferred tax to be recognised presuming the distribution of earnings from Entity A. To the extent that such distribution is assumed, Investor I should use the 'distributed tax rate' to measure the resulting deferred tax assets or liabilities.

IAS 12:52B clarifies that the income tax consequences of dividends are more directly related to the past events and transactions that gave rise to the tax liability or asset than to the distributions to owners. If additional income taxes are payable or refundable when profits are distributed, although the timing of the recognition of the rate change is related to the recognition of the dividend in the financial statements, the incremental tax effect should not be dealt with in equity. Rather, it should generally be dealt with in profit or loss for the period, unless it arose as a result of an underlying transaction or event recognised outside profit or loss, or a business combination, in line with the general rules set out in IAS 12:58 (see section 4.7).

Example 4.5.2.6B
Recognition of incremental tax effect of dividend payment

Company A has undistributed profits of CU1,500 in its statement of financial position at 31 December 20X3, all distributable under local law. CU500 of those profits were recognised in other comprehensive income because they arose from the revaluation of an item of property, plant and equipment that was subsequently sold (the revaluation uplift of CU500 was transferred from revaluation surplus to retained earnings when the asset was disposed of and was not recognised in profit or loss). Under local tax regulations, income taxes are payable at a higher rate on undistributed profits (50 per cent) than on distributed profits (35 per cent).

Prior to any dividend being declared, at 31 December 20X3, a current tax liability of CU750 was recognised on these earnings. Of this amount, CU250 (CU500 × 50%) was recognised in other comprehensive income and CU500 (CU1,000 × 50%) was recognised in profit or loss.

The distribution of all available profits in March 20X4 results in a reduction of the tax liability of CU225 [CU1,500 × 15%]. The reduction should be allocated between profit or loss and other comprehensive income based on the original recognition of the tax liability, resulting in the following journal entry.

	CU	CU
Dr Current tax liability	225	
Cr Income tax (profit or loss)		150
Cr Income tax (other comprehensive income)		75

To recognise the reduction in the tax liability.

4.5.2.7 Tax holidays

When a tax jurisdiction grants an exemption from an income tax for a specified period, the event is sometimes referred to as a ‘tax holiday’. For example, the jurisdiction may, for economic reasons, provide the exemption from income taxes for a specified period if an entity constructs a manufacturing facility located within the jurisdiction.

IAS 12 does not specifically address the subject of tax holidays; consequently, the general principles of IAS 12 should be applied.

An entity that is entitled to a tax holiday should calculate temporary differences in the usual manner if temporary differences originating during the tax holiday period will affect future taxable income. However, assuming that the conditions for exemption from taxation continue to be met, deferred tax should not be recognised in respect of temporary differences that are scheduled to reverse during the tax holiday period, because no net expense or benefit will result (e.g. because a zero per cent tax rate will apply to taxable income or deduction upon reversal).

See example 4.5.2.7A for two illustrative examples of tax holiday regimes.

Example 4.5.2.7A
Tax holidays — examples

Example 1

In Jurisdiction X, under the terms of its tax holiday programme, an entity meeting the required criteria will be exempt from income taxes for the first 5 years of operation in Jurisdiction X.

During the tax holiday period, an entity is required to compute its tax liability in the usual manner, but a zero per cent tax rate is applied to the taxable profit. If an entity incurs tax losses during the tax holiday period, the losses will be available for carryforward and use after the tax holiday without restriction.

Under this system, temporary differences may arise during the tax holiday and reverse after the tax holiday, with tax consequences. To the extent that temporary differences are expected to reverse after the tax holiday, deferred tax assets and liabilities should be recognised for any temporary differences. Similarly, tax losses generated during the tax holiday period that are expected to be utilised after the tax holiday should be recognised as deferred tax assets (subject to the general recognition criteria for deferred tax assets).

Example 2

In Jurisdiction Y, under the terms of its tax holiday programme, an entity meeting the required criteria will be exempt from income taxes for the first 5 years of operation in Jurisdiction Y.

Example 4.5.2.7A Tax holidays — examples (continued)

During the tax holiday period, an entity is not required to compute an income tax liability (e.g. it may file no income tax return or simply file an income tax return reporting its statutory profit and with a copy of the tax holiday agreement). If an entity incurs losses during the tax holiday period, the losses are not available for carryforward after the tax holiday. Tax depreciation (capital allowances) on the entity's assets commences following the tax holiday. Once the tax holiday expires, the entity computes its tax liabilities in the usual manner.

Under this system, no deferred tax assets will be recognised for losses arising during the tax holiday. The tax base of assets and liabilities may not change during the tax holiday, but the carrying amounts of the entity's assets and liabilities will still change, and temporary differences may arise. Deferred taxes should be recognised for any temporary differences arising during the tax holiday period that will reverse after the tax holiday.

Example 4.5.2.7B Tax holiday period not yet commenced

Entity A is a start-up entity. The tax laws in the relevant jurisdiction state that start-up entities are exempt from taxation for five years, commencing from the year in which the entity begins to generate taxable income.

Entity A is currently generating losses and it expects to continue to do so for three years. Therefore, it expects that it will not be required to pay tax for the next eight years.

When determining to what extent deferred tax should be recognised, when should Entity A assume that the tax holiday period begins?

As discussed above, deferred tax should not be recognised in respect of temporary differences that are scheduled to reverse during a tax holiday period, assuming that the conditions for exemption from taxation continue to be met.

In the circumstances described, when considering which temporary differences will reverse during the tax holiday period, Entity A should assume that the holiday period begins immediately and lasts for five years. To extend the assumed holiday period to take account of future periods in which losses are anticipated (i.e. in this example, to extend the holiday period to eight years) would be equivalent to anticipating future tax losses, which is not permitted.

In the circumstances described, at each reporting date until the entity produces taxable profit, the applicable tax holiday period should be assumed to be five years from that date.

4.5.3 Discounting

IAS 12 prohibits the use of discounting for the measurement of deferred tax assets and liabilities. [IAS 12:53]

This prohibition is not based on any conceptual argument. Rather, it reflects the practical issues involved in arriving at a reliable determination of deferred tax assets and liabilities on a discounted basis, which would require detailed scheduling of the expected timing of the reversal of every temporary difference. Having concluded that such detailed scheduling would be impracticable or highly complex in many circumstances (and, therefore, that it would be inappropriate to require discounting), the Standard removes the option to discount deferred tax balances because that would reduce comparability of deferred tax balances between entities.

4.6 Recognition of deferred tax assets

4.6.1 Recognition of deferred tax assets – general

Deferred tax assets can arise from deductible temporary differences (e.g. when the carrying amount of an asset is less than its tax base), or from the ability to carry forward unused tax losses and unused tax credits.

Under IAS 12, subject to the exceptions listed at 4.4.3, deferred tax assets are recognised for all deductible temporary differences and all unused tax losses and tax credits, to the extent that it is probable that future taxable profit will be available against which they can be utilised. [IAS 12:24 & 34]

When an entity has a deferred tax asset that has not been recognised because it failed this recoverability test, the entity is required to reassess the position at the end of each subsequent reporting period. When the test is subsequently met, the asset is recognised at that later date; this may occur, for example, if there is an improvement in trading conditions such that it becomes more likely that sufficient taxable profits will be generated in the future. [IAS 12:37]

Conversely, when a deferred tax asset has been recognised in the statement of financial position, its carrying amount should be reviewed at the end of each subsequent reporting period and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to enable its recovery. [IAS 12:56]

4.6.2 Availability of future taxable profits

A deferred tax asset represents a future tax deduction. It is, therefore, only valuable if the entity will have sufficient future taxable profits against which the deduction can be offset. Therefore, an important question to answer is when it can be considered probable that an entity will have sufficient taxable profits available in the future to enable the deferred tax asset to be recovered.

The term 'probable' is not defined in IAS 12. As noted at 4.4.3, the term is subject to varying interpretations, but is generally agreed to mean at least more likely than not (i.e. a probability of greater than 50 per cent).

IAS 12 states that it is probable that an entity will have sufficient taxable profit available in the future to enable a deferred tax asset to be recovered when:

- there are sufficient taxable temporary differences relating to the same tax authority and the same taxable entity that are expected to reverse either in the same period as the expected reversal of the deductible temporary difference or in periods into which a tax loss arising from the deferred tax asset can be carried back or forward; [IAS 12:28] or
- it is probable that the entity will have sufficient taxable profit, relating to the same tax authority and the same taxable entity, in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In making this evaluation, taxable amounts arising from deductible temporary differences that are expected to originate in future periods should be ignored (because these will need further future taxable profits in order to be utilised); [IAS 12:29(a)] or
- tax planning opportunities are available to the entity that will create taxable profit in appropriate periods. [IAS 12:29(b)]

Thus, when looking for future taxable income to justify the recognition of a deferred tax asset, entities can look to:

- future reversals of existing taxable temporary differences (see 4.6.3);
- future taxable profit (see 4.6.4); and
- tax planning opportunities, i.e. actions that the entity could take to create or increase taxable profits in future periods so as to utilise the available tax deductions before they expire (see 4.6.5).

4.6.3 Future reversals of existing taxable temporary differences

As noted above, in order to justify the anticipated recovery of a deductible temporary difference against existing taxable differences, the following conditions must be met:

[IAS 12:28]

- the taxable differences must relate to the same tax authority and the same taxable entity; and
- the taxable differences must be expected to reverse either in the same period as the deferred tax asset reverses, or in a period into which any tax loss arising from the reversal of the deferred tax asset can be carried forward or back.

IAS 12 does not specifically address how an entity should schedule the reversal pattern for existing temporary differences. It is generally only necessary to schedule the reversal of taxable temporary differences when deferred tax assets have limited lives (i.e. they are subject to expiry). Because of cost benefit considerations, there may be more than one approach to scheduling reversal patterns. However, it is apparent from the discussion in IAS 12:35 and 36 that two concepts underlie the determination of the reversal patterns for existing temporary differences:

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

Note that an entity may not take account of future originating temporary differences (e.g. planned future capital expenditure) when assessing future reversals of temporary differences, because those differences will only arise as a result of future events or transactions.

Example 4.6.3A

Forecasting future reversals of existing taxable temporary differences

Company C has made a tax loss for the year and has identified the following temporary differences at 31 December 20X3:

- taxable temporary differences related to accelerated tax depreciation, expected to reverse in 20X4 and 20X5 – CU4,000; and
- deductible temporary differences in respect of pre-operating costs expensed for accounting purposes in 20X3 but allowed for tax purposes over five years – CU2,800.

Company C is expected to make losses for the foreseeable future. Tax is payable at 20 per cent. Tax losses may be carried forward, but not back.

Anticipated reversals of Company C's existing temporary differences are as follows.

	20X4	20X5	20X6	20X7
	CU	CU	CU	CU
Accelerated tax depreciation	(2,000)	(2,000)	—	—
Pre-operating costs	700	700	700	700

At 31 December 20X3, a deferred tax liability is recognised in respect of the accelerated tax depreciation, amounting to CU800 (CU4,000 × 20%). The deferred tax asset recognised in respect of the pre-operating costs is limited to CU280 (CU1,400 × 20%). Future tax deductions are available for the remainder of the pre-operating costs. However, because the reversals occur in periods when they cannot be used against existing taxable temporary differences, their recognition cannot be justified on the basis of those temporary differences. Other expected sources of taxable income or tax planning opportunities would need to be identified in order to support the recognition of the remainder of the deferred tax asset. In the above example this seems unlikely because Company C is, and is forecast to continue to be, a loss-making entity (see 4.6.4.4).

Example 4.6.3B

Impact of expected future tax losses on the recognition of deferred tax assets when there are reversing taxable temporary differences

During the year ending 31 December 20X1, Entity A incurs tax losses of CU100. At 31 December 20X1, Entity A has tax losses carried forward of CU100 and accumulated taxable temporary differences of CU150. Entity A estimates that the accumulated taxable temporary differences will reverse over the following three years. Entity A also expects to incur further tax losses of CU200 over the same period. The tax rate is 30 per cent.

Assume that, in the jurisdiction in which Entity A operates, tax losses are permitted to be carried forward for a maximum of five years to be offset, without restriction, against future taxable profits. At 31 December 20X1, is Entity A required to recognise a deferred tax asset in respect of the tax losses carried forward?

Yes. Given that suitable reversing taxable temporary differences are available, Entity A is required to recognise a deferred tax asset of CU30 (CU100 × 30 per cent) in respect of the losses carried forward at 31 December 20X1, regardless of its expectations of future losses.

In accordance with IAS 12:28 and 35, a deferred tax asset is recognised to the extent that taxable temporary differences of an appropriate type are available and expected to reverse in the relevant period. The reversing taxable temporary differences enable the utilisation of the accumulated tax losses and are sufficient to justify the recognition of a deferred tax asset. Consequently, future tax losses are not taken into consideration.

Example 4.6.3B (continued)

Impact of expected future tax losses on the recognition of deferred tax assets when there are reversing taxable temporary differences

However if, at a reporting date, unused tax losses exceed the amount of suitable available taxable temporary differences, a deferred tax asset is only recognised in respect of losses to the value of the taxable temporary differences, unless it is probable that the entity will have appropriate future taxable profit or tax planning opportunities are available to the entity that will create appropriate taxable profit.

Assume the same facts, except that the applicable tax law restricts the recovery of tax losses to 60 per cent of taxable profit in each year. Is the deferred tax asset to be recognised by Entity A restricted to 60 per cent of the taxable temporary differences?

Yes. When tax laws limit the extent to which unused tax losses can be recovered against future taxable profits in each year, the amount of the deferred tax asset recognised is similarly restricted. This is because when the taxable temporary differences reverse, the amount of tax losses that can be utilised by that reversal is reduced as specified by the tax law.

Therefore, in the circumstances under consideration, the deferred tax asset required to be recognised in respect of the available taxable temporary differences is CU27 ($\text{CU150} \times 60\% \times 30\%$). Entity A should consider future taxable profits and tax planning opportunities before the tax losses expire to determine whether recognition of an additional deferred tax asset in respect of the remaining CU10 ($\text{CU100} - (\text{CU150} \times 60\%)$) of tax losses carried forward is appropriate.

The conclusions above were confirmed by the IFRS Interpretations Committee in the May 2014 *IFRIC Update*.

4.6.4 Future taxable profits

4.6.4.1 Assessment of future taxable profits — consideration of future events

In general, entities should consider all currently available information about the availability of future taxable profits. However, certain future events should not be anticipated or considered in determining the realisability of deferred tax assets. These items include, but are not limited to, the following:

- changes in tax laws or rates (except those that are substantively enacted);
- expected business combinations;
- anticipated future income from events beyond the entity's control and that are non-recurring or unusual in nature (e.g. forgiveness of indebtedness for purposes of avoiding derecognition of a deferred tax asset); and
- events dependent on future market conditions or otherwise not within the entity's control.

4.6.4.2 Indicators of future taxable profits

In evaluating whether it is probable that taxable profit will be available, the nature and timing of such profit should be considered.

The following are some examples of factors that may support the assertion that it is probable that taxable profit will be available.

Contracts or firm sales backlog that will produce sufficient taxable income to realise the deferred tax asset based on existing sales prices and cost structures:

- an entity enters into a long-term contract that will generate sufficient future taxable income to enable it to utilise all existing operating loss carryforwards; or
- during the current year, an entity acquired another entity that operates in a different industry that is characterised by stable profit margins. Assuming that the group is taxed on a consolidated basis or that group relief is available, the acquiree's existing contracts will produce sufficient taxable income to enable utilisation of the loss carryforwards.

An excess of appreciated asset value over the tax bases of an entity's net assets in an amount sufficient to realise the deferred tax asset:

- an entity has invested in land that has appreciated in value. If the land were sold at its current market value, the sale would generate sufficient taxable income to utilise all tax loss carryforwards. The entity will sell the land and realise the gain if the operating loss carryforward would otherwise expire unused.

A strong earnings history exclusive of the loss that created the future deductible amount coupled with evidence indicating that the loss is not a continuing condition:

- an entity incurs operating losses that result in a carryforward for tax purposes. The loss resulted from the disposal of a subsidiary whose operations are not critical to the continuing entity and the entity's historical earnings, exclusive of the subsidiary losses, have been strong.

Conversely, there may be indicators that future taxable profits will not be available. The following are some examples of factors that may rebut the assertion that it is probable that taxable profit will be available.

History of losses in recent years (see also 4.6.4.4):

- an entity has incurred operating losses for financial reporting and tax purposes during recent years. The losses for financial reporting purposes exceed operating income for financial reporting purposes as measured on a cumulative basis from the most recent preceding years; or
- 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 (or otherwise obtaining group relief) from its parent or other group entities; or
- the entity is a start-up business or development stage enterprise or is emerging from a financial reorganisation or bankruptcy. In the early years of operation, these types of entities will frequently have a history of losses coupled with limited evidence of ability to meet budgets.

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 that originated in prior years expired unused. There are no available tax planning strategies that would enable the entity to utilise the tax benefit of the carryforwards.

Unsettled circumstances that if unfavourably resolved would adversely affect profit levels on a continuing basis:

- 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, management is concerned about the appropriateness of continuing to sell the product and that product generates significant revenue.

4.6.4.3 Non-recurring items

Frequently, entities will extrapolate from current profit levels to forecast future taxable profits (having due regard to anticipated growth levels etc.). When assessing the sustainability of current profit levels, it is important to make appropriate adjustments for past non-recurring items, which generally are not indicative of an entity's ability to generate taxable income in future years.

Non-recurring items that will affect the level of profitability in future accounting periods should also be considered (however, as discussed in 4.6.4.1, this does not extend to anticipating future events).

Examples of non-recurring items that should be excluded include, but are not limited to, the following:

- one-time restructuring charges;
- 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; and
- severance payments relating to management changes.

Examples of items that may have an impact on the determination of future profit or loss for a number of years include, but are not limited to, the following:

- poor operating results caused by an economic downturn, government intervention or changes in regulation; and
- operating losses attributable to a change in the focus of a subsidiary or business unit.

4.6.4.4 History of recent losses

When an entity has incurred losses in recent years, additional caution should be exercised before a deferred tax asset is recognised. IAS 12 points out that “the existence of unused tax losses is strong evidence that future taxable profit may not be available”. It goes on to say that, if there are insufficient deferred tax liabilities reversing in appropriate periods and entities, there must be “convincing other evidence” that there will be sufficient taxable profit. [IAS 12:35]

In assessing the probability that taxable profits will be available, the following should be considered:

[IAS 12:36]

- whether the entity has sufficient taxable temporary differences relating to the same tax authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;
- whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;
- whether the unused tax losses result from identifiable causes that are unlikely to recur; and
- whether tax planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

The assessment as to whether an entity will have sufficient taxable profits in the future to realise a deferred tax asset is a matter requiring careful judgement based on the facts and circumstances available.

The very existence of losses calls future profitability into question and IAS 12:36(c) notes that preparers need to consider whether unused tax losses result from identifiable causes that are unlikely to recur. When the losses are expected to recur, it is unlikely that a deferred tax asset can be recognised. However, the source of the losses may have been addressed, for example, through disposal of loss-making operations, restructurings, or reductions of ongoing costs.

A history of recent losses is objectively verifiable evidence and, as a result, carries more weight than other evidence that embodies some degree of subjectivity. For this reason, whenever an entity has suffered cumulative losses in recent years, it is difficult to support the recognition of a deferred tax asset based on forecasts of future profits without a demonstrated turnaround to operating profitability. In other words, an entity that has cumulative losses will not generally be able to use forecast future profits to support a conclusion that realisation of an existing deferred tax asset is probable, unless that forecast is supported by strong evidence (which will need to be disclosed in accordance with IAS 12:82 – see 6.2.2). Examples of such evidence may include significant new contracts, an increase in the level of orders, or the disposal of an unprofitable segment.

In addition to these considerations, particular attention needs to be paid to restrictions on:

- the number of years for which the losses can be carried forward; and
- the types of profit against which the losses can be offset.

There is no specific time restriction in IAS 12 regarding the length of the ‘look-forward’ period which is used to determine whether taxable profits will be available. The length of the period used will depend on a number of entity-specific factors, including the entity’s historical profitability, accuracy of budgetary controls and expected future activities.

The entity assesses whether any portion of the total available unused tax losses or tax credits is likely to be utilised before they expire. To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not recognised. [IAS 12:36]

4.6.5 Tax planning opportunities

Tax planning opportunities are actions that the entity can take to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carryforward. [IAS 12:30] Although such opportunities are future actions, the entity is entitled to consider them in justifying the recognition of a deferred tax asset.

Examples of tax planning opportunities include:

[IAS 12:30]

- being able to elect to have an income source taxed at an earlier point (e.g. electing to have interest income taxed on a receivable, rather than a receipts, basis);
- being able to defer to a future period the claim for certain tax deductible items (e.g. waiving a claim to first year allowances on an item of equipment, and instead taking annual allowances on the full amount in future periods);
- selling and leasing back assets that have appreciated in value, but for which the tax base has not been adjusted to reflect the appreciation; and
- selling an asset that generates non-taxable income in order to purchase another investment that generates taxable income.

In order to use a tax planning opportunity as support for the recognition of a deferred tax asset, the entity must have the ability to implement the chosen tax planning strategy. For example, a plan to take a pension holiday in order to boost taxable profit in a particular period so as to utilise tax losses that are about to expire can only be taken into account if the strategy can be controlled by the entity (e.g. it cannot be prevented by pension regulations, and is likely to be accepted by the pension fund trustees and the workforce).

The amount of the future taxable profits expected to be generated by such proposed strategies must be reduced by the cost of the strategies. The actions must be commercially viable and without significant adverse consequences — otherwise, it is unlikely that management would proceed.

4.6.6 Acquisition of tax losses at less than fair value

Example 4.6.6

Acquisition of tax losses at less than fair value

Company A acquires Company B, which is a shell entity with valuable unused tax losses. Company B does not meet the definition of a business under IFRS 3 *Business Combinations* and, therefore, the transaction is not a business combination for the purposes of that Standard.

Company A acquires Company B (and, therefore, the tax losses) for CU100,000. This is significantly lower than the tax asset that would be recognised in respect of the tax losses under IAS 12 (CU1 million). Company A expects to be able to utilise all of the available losses.

On the date of acquisition, Company A should recognise the deferred tax asset acquired at the amount paid (i.e. at CU100,000).

Subsequently, the unused tax losses in Company B are available for use against Company A's taxable profits. Accordingly, the deferred tax asset recognised at the date of acquisition should be assessed and measured in accordance with IAS 12:34 which requires that "[a] deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and tax credits can be utilised".

Therefore, Company A should determine the extent to which it is probable that future taxable profits will be available against which the unused tax losses can be utilised and the deferred tax asset should be remeasured to reflect this amount. Any remeasurement should be recognised in profit or loss for the period.

In the circumstances described, if it is probable that Company A will be able to utilise all of the tax losses, the deferred tax asset should be remeasured to CU1 million with the resulting gain of CU900,000 recognised in profit or loss.

The assessment as to whether it is probable that the tax losses will be utilised should be based on the guidance provided in IAS 12:35 and IAS 12:36 (see 4.6.4.4).

4.7 Recognition of movement in deferred tax balances

4.7.1 Recognition of movement in deferred tax balances — general principle

In determining how the deferred tax effects of a transaction or other event should be recognised, the underlying principle is that the accounting for such deferred tax effects should follow the accounting for the transaction or event itself. [IAS 12:57]

4.7.2 Recognition of deferred tax in profit or loss

Deferred tax should be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

[IAS 12:58]

- a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see section 4.7.3); or
- a business combination (other than the acquisition by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss – see 5.1).

Most deferred tax liabilities and deferred tax assets arise when income or expense is included in accounting profit in one period, but is included in taxable profit (tax loss) in a different period. The resulting deferred tax is recognised in profit or loss. Examples are when:

[IAS 12:58]

- interest, royalty or dividend revenue is received in arrears and is included in accounting profit in accordance with IFRS 15 *Revenue from Contracts with Customers* or IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*), but is included in taxable profit (tax loss) on a cash basis; and
- costs of intangible assets have been capitalised in accordance with IAS 38 and are being amortised in profit or loss, but were deducted for tax purposes when they were incurred.

For entities that have not yet adopted IFRS 15 *Revenue from Contracts with Customers*, the accounting for interest, royalty and dividend revenue is dealt with in IAS 18 *Revenue*.

4.7.3 Recognition of deferred tax outside profit or loss

4.7.3.1 Deferred tax recognised outside profit or loss — general

Deferred tax is 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. When the deferred tax relates to items that are recognised in other comprehensive income, the tax is also recognised in other comprehensive income (see 4.7.3.2). When the deferred tax relates to items that are recognised directly in equity, the tax is also recognised in equity (see 4.7.3.3).

[IAS 12:61A]

4.7.3.2 Items recognised in other comprehensive income

Items required or permitted under IFRSs to be recognised in other comprehensive income include:

- exchange differences on the translation of the financial statements of a foreign operation under IAS 21 *The Effects of Changes in Foreign Exchange Rates*;
- the recognition of fair value movements on some financial assets (see 5.3.3);
- the revaluation of property, plant and equipment under IAS 16 *Property, Plant and Equipment* (see 4.7.3.3); and
- actuarial gains and losses relating to defined benefit pension obligations (see section 5.8).

Exchange differences arising on the translation of financial statements only give rise to deferred tax when the criteria in IAS 12:39 and IAS 12:44 are met, and an entity has accrued for the reversal of the temporary difference between the carrying amount of its investment (including foreign exchange gains and losses) and its tax base (see section 4.4.7).

4.7.3.3 Revaluations of property, plant and equipment

The most common example of deferred tax recognised in other comprehensive income is when an item of property, plant and equipment is revalued (see also section 5.4).

When an entity accounts for a class of assets on a revaluation basis under IAS 16, fair value movements are generally recognised in other comprehensive income and accumulated in a revaluation reserve. While the carrying amount of the asset changes, the associated tax base may not, resulting in the creation of a, or a change in an existing, temporary difference. Under IAS 12:61A, deferred tax arising on a revaluation that is recognised in other comprehensive income is also recognised in other comprehensive income. This deferred tax is generally offset against the revaluation reserve (although such offset is not required, and the entity may choose to offset the deferred tax against another equity reserve).

While the original deferred tax arising on the revaluation is recognised in other comprehensive income, the subsequent release of that deferred tax liability due to the depreciation of the increased carrying amount is not credited in other comprehensive income, but in profit or loss, along with the depreciation expense.

This is an important principle. The deferred tax liability is initially recognised in other comprehensive income. However, because the effects of recovering the asset through use (the recognition of a depreciation expense and the generation of taxable profits) are dealt with in profit or loss, the release of the deferred tax liability (against the current tax liability arising) is also dealt with in profit or loss.

These principles are illustrated in example 4.7.3.3.

Example 4.7.3.3

Asset revaluation and subsequent recovery of asset — recognition of deferred tax

Company I revalues an item of property, plant and equipment from a carrying amount of CU95,000 to CU150,000. The tax base of the asset, which is not affected by the revaluation, is CU90,000. The carrying amount of the property is expected to be recovered through use. The applicable tax rate is 30 per cent. A deferred tax liability of CU1,500 ($\text{CU}5,000 \times 30\%$) has been recognised in respect of the taxable temporary difference of CU5,000 prior to the revaluation.

An additional taxable temporary difference of CU55,000 ($\text{CU}150,000 - \text{CU}95,000$) arises on revaluation, giving rise to an additional deferred tax liability of CU16,500 ($\text{CU}55,000 \times 30\%$). The following entries recognise the revaluation and the additional deferred tax liability.

		CU	CU
Dr	Property, plant and equipment	55,000	
Cr	Revaluation gain (other comprehensive income)		55,000
Dr	Income tax (other comprehensive income)	16,500	
Cr	Deferred tax liability		16,500

To recognise the revaluation and the deferred tax liability.

In subsequent periods, the property will be depreciated for both accounting and tax purposes, changing the temporary difference. Any movements in the deferred tax liability are recognised in profit or loss. For example, if the carrying amount of the property at the end of the next reporting period is CU130,000 and the tax base is CU85,000, there is a taxable temporary difference of CU45,000 and a deferred tax liability of CU13,500 ($\text{CU}45,000 \times 30\%$). The movement for the year is recognised as follows

		CU	CU
Dr	Deferred tax liability ($\text{CU}1,500 + \text{CU}16,500 - \text{CU}13,500$)	4,500	
Cr	Income tax (profit or loss)		4,500

To recognise the movement for the year.

IAS 16 does not specify whether an entity should transfer each year from revaluation surplus to retained earnings an amount equal to the difference between the depreciation or amortisation on a revalued asset and the depreciation or amortisation based on the historical cost of that asset. If an entity makes such a transfer, the amount transferred is net of any related deferred tax. Similar considerations apply to transfers made on the disposal of an item of property, plant or equipment. [IAS 12:64]

4.7.3.4 Items recognised directly in equity

Items required or permitted under IFRSs to be credited or charged directly to equity include:

- an adjustment to the opening balance of retained earnings resulting from a change in accounting policy that is accounted for retrospectively under IAS 8 or the correction of an error (see chapter A5);
- the initial recognition of the equity component of a compound financial instrument under IAS 32 *Financial Instruments: Presentation* (see 5.3.4);
- when the expected tax deduction for an equity-settled share-based payment exceeds the cumulative profit or loss expense recognised in respect of that share based payment (see section 5.6); and
- when a withholding tax is charged on dividend distributions (see 4.7.3.5).

4.7.3.5 Withholding tax

A tax jurisdiction may assess an entity with a ‘withholding tax’, which is paid to the tax authorities on behalf of the shareholders when the entity makes a dividend distribution. Such withholding tax is charged to equity as part of the dividends. [IAS 12:65A]

When a ‘withholding tax’ is neither paid on behalf of the shareholders nor gives rise to a future benefit for the entity, it should be dealt with as a higher rate of tax applied to distributed profits — see 4.5.2.6.

If an entity obtains a future benefit as a result of withholding the tax from amounts distributed (e.g. if the tax withheld is deductible against future dividend receipts), the initial payment to the tax authorities is not a withholding tax as contemplated in IAS 12 ; in such circumstances, the initial payment to the tax authorities should be recognised as an increase in income tax expense (rather than being accounted for as part of the dividend distribution), with the future tax benefit likewise recognised as a component of tax in profit or loss. The resulting tax asset will be considered for recoverability — see 4.6.1.

Example 4.7.3.5 illustrates the appropriate treatment for two types of withholding tax.

Example 4.7.3.5 Withholding tax

Scenario 1 – withholding tax as contemplated in IAS 12:65A

Company Y decides to pay dividends of CU100 to its shareholders. Local tax law requires Company Y to withhold 35 per cent of the dividends and to pay the amount withheld over to the tax authorities. The tax is paid to the tax authorities on behalf of the shareholders and does not give rise to a future benefit for Company Y.

Company Y should record the following journal entries.

		CU	CU
Dr	Retained earnings – distribution	100	
Cr	Cash		65
Cr	Payable		35

To recognise the dividend payment and related liability to pay tax on shareholders’ behalf.

		CU	CU
Dr	Payable	35	
Cr	Cash		35

To recognise payment of the taxes withheld.

Example 4.7.3.5 Withholding tax (continued)

Scenario 2 – withholding tax with future benefit for entity paying dividends

Company Z decides to pay dividends of CU100 to its shareholders. Local tax law requires Company Z to withhold 35 per cent of the dividends and to pay the amount withheld over to the tax authorities. Company Z obtains a future tax credit equal to the amount paid to the tax authorities in connection with the dividends; the tax credit can be used to offset tax liabilities arising over the following three years.

Company Z should record the following journal entries.

		CU	CU
Dr	Current tax expense	35	
Dr	Retained earnings – distribution	65	
Cr	Cash		65
Cr	Taxes payable		35

To recognise the dividend payment and the liability to pay tax on the distribution.

		CU	CU
Dr	Deferred tax asset	35	
Cr	Deferred tax income		35

To recognise the future tax benefit.

		CU	CU
Dr	Taxes payable	35	
Cr	Cash		35

To recognise payment of the taxes withheld.

As with any other deferred tax asset, the recognition of the deferred tax is dependent on meeting the recognition criteria in IAS 12:24. If those criteria are not met, Company Z would not recognise the deferred tax asset upon payment of the tax, but rather if and when the recognition criteria are met.

IAS 12:65A addresses the treatment of withholding tax by the entity paying the withholding tax; the Standard does not address how the recipient of the dividend should account for the withholding tax. However, to the extent that withholding tax is paid entirely on behalf of the recipient, the recipient should recognise the dividend income at its gross amount (i.e. before deduction of withholding tax); the tax suffered on the dividend income should be recognised by the recipient in profit or loss as part of its tax expense.

4.7.3.6 Uncertainty regarding the amount to be recognised outside profit or loss

When, in exceptional circumstances, an entity is unable to determine the amount of deferred tax that relates to items recognised outside profit or loss, IAS 12 allows the entity to base the amount on a reasonable pro rata allocation or some other method achieving a more appropriate allocation.

Such uncertainty can arise, for example, when:

[IAS 12:63]

- there are graduated rates of income tax, and it is impossible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed; or
- a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously recognised outside profit or loss; or
- an entity determines that a deferred tax asset should be recognised, or should no longer be recognised in full, and the deferred tax asset relates (in whole or in part) to an item that was previously recognised outside profit or loss.

An example of how such an allocation might be made is set out in 3.2.2.4.

4.7.3.7 Reversal of deferred tax expense on reclassification from equity to profit or loss of gains and losses previously recognised in other comprehensive income

IAS 12:61A requires that current or deferred tax relating to items that are recognised, in the same or a different period, outside of profit or loss should be recognised outside of profit or loss.

In some cases, IFRSs require that gains or losses initially recognised in other comprehensive income be subsequently reclassified to profit or loss. For example:

- specified gains and losses arising on cash flow hedges and net investment hedges previously recognised in other comprehensive income are reclassified from equity to profit or loss (subject to the conditions in IFRS 9 *Financial Instruments* or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*);
- for entities that have adopted IFRS 9, gains and losses arising on debt instruments measured at fair value through other comprehensive income are reclassified from equity to profit and loss when the asset is disposed of;
- for entities that have not yet adopted IFRS 9, gains or losses arising on available-for-sale financial assets previously recognised in other comprehensive income are reclassified from equity to profit or loss when the asset is disposed of; and
- on disposal or partial disposal of a foreign operation (other than a partial disposal of a subsidiary when control is retained), all or a portion of the foreign currency translation reserve is reclassified from equity to profit or loss as part of the gain or loss on disposal.

Whether such gains and losses are included in the determination of taxable profit in the period in which they are initially recognised in other comprehensive income depends on the rules in the particular tax jurisdiction.

If such gains and losses give rise to temporary differences (and, consequently, deferred tax balances) when they are recognised in other comprehensive income, when the gains and losses are subsequently reclassified to profit or loss and any current tax arising at that point is recognised in profit or loss, the deferred tax balance will be reversed. The question arises as to whether the reversal of the deferred tax balance should be recognised in other comprehensive income or in profit or loss.

The most appropriate treatment is that the reversal should be recognised in other comprehensive income because that is where the deferred tax was initially recognised.

See example 4.7.3.7 for an illustration of this approach. Note that in the example there is no impact on the effective tax rate of the entity.

Example 4.7.3.7

Reversal of deferred tax expense on reclassification from equity to profit or loss of gains and losses previously recognised in other comprehensive income

Company Y has a portfolio of financial assets classified as available for sale in accordance with IAS 39. For financial reporting purposes, unrealised gains and losses on the assets are recognised in other comprehensive income. In accordance with IAS 12, any tax consequences are also recognised in other comprehensive income.

Under local tax laws, unrealised gains and losses on investment portfolios are not included in the determination of taxable income or loss; rather, taxable gains or losses arise only when a financial asset is disposed of. Because the movement in the value of financial assets does not affect current tax, deferred taxes should be computed in respect of the resulting temporary differences between the carrying amount of the financial assets (fair value) and their tax base.

In 20X1, there is unrealised loss on the assets of CU10 million. There is no movement in the market value of the assets during 20X2. On the last day of 20X2, Company Y sells the assets, thereby crystallising the previously recognised pre-tax loss of CU10 million.

The tax rate for 20X1 and 20X2 is 30 per cent. Company Y has net taxable income in 20X1.

The journal entries for 20X1 are as follows.

		CU'000	CU'000
Dr	Unrealised loss on investments (other comprehensive income)	10,000	
Cr	Investment portfolio		10,000

To recognise the unrealised loss on the available-for-sale assets in other comprehensive income.

Dr	Deferred tax asset	3,000	
Cr	Deferred tax benefit (other comprehensive income)		3,000

To recognise the tax consequences of the temporary difference resulting from the unrealised losses on the assets (CU10 million × 30 per cent – IAS 12's general recognition criteria assumed to be met).

Note – there is no impact on the effective tax rate of the entity, because both the unrealised loss and the related deferred tax are recognised outside profit or loss.

The journal entries for 20X2 are as follows.

		CU'000	CU'000
Dr	Loss on sale (profit or loss)	10,000	
Cr	Unrealised loss on investments (other comprehensive income)		10,000

To recognise the reclassification from equity to profit or loss of the pre-tax loss on sale of the asset portfolio in 20X2.

		CU'000	CU'000
Dr	Deferred tax benefit (other comprehensive income)	3,000	
Cr	Deferred tax asset		3,000
Dr	Current tax liability	3,000	
Cr	Current tax benefit (profit or loss)		3,000

To recognise the current tax benefit on realisation of the loss on the asset portfolio, and deferred tax expense representing utilisation of the deferred tax asset previously recognised.

4.7.3.8 Recognition of deferred tax arising from a business combination

When a business combination occurs, deferred tax balances can arise from a number of sources. These are described in detail in section 5.1.

The amount of deferred tax arising from each of these sources is recognised and included as part of the identifiable net assets at the date of acquisition. The combined effect, therefore, affects the amount of the goodwill or bargain purchase gain arising on acquisition.

4.7.3.9 Revaluations for tax purposes

When an asset is revalued for tax purposes and that revaluation is related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of both the asset revaluation and the adjustment of the tax base are recognised in other comprehensive income in the periods in which they occur. [IAS 12:65]

When an asset is revalued for tax purposes but there has not been, and is not to be, an accounting revaluation, the tax effects of the adjustment of the tax base are recognised in profit or loss. [IAS 12:65]

The most common examples of revaluations for tax, but not accounting, purposes are as follows:

- when tax authorities calculate the taxable gain on disposal of a capital asset by reference to a base cost that represents the original cost of the asset uplifted by an allowance to reflect inflation over the period of ownership or the market value of value of the asset at a specified date (see examples 4.7.3.9A and 4.7.3.9B); and
- when a group undertakes a transaction between two group entities which is internal to the group (and hence does not change group carrying amounts) but gives rise to a new tax base (see example 4.2.5 for an illustration).

Example 4.7.3.9A

Tax base increased by inflation index in each period

Company J purchases an investment property for CU10,000 and accounts for it using the fair value model under IAS 40 *Investment Property* (i.e. recognising changes in the property's fair value in profit or loss and not depreciating it). The carrying amount of the property will be recovered through sale. The allowable cost for tax purposes is increased by an agreed inflation index in each period.

The tax rate for capital profits is 30 per cent and the agreed inflation increment in each period under consideration is 5 per cent and there are no changes in the fair value of the property (i.e. its carrying amount remains at CU10,000). The deferred tax consequences for the first three years are calculated as follows.

Year	Carrying amount CU	Tax base CU	Deductible temporary difference CU	Deferred tax asset CU
20X0	10,000	10,000	—	—
20X1	10,000	10,500	500	150
20X2	10,000	11,025	1,025	308

The recognition of the resultant deferred tax asset is dependent on the availability of future profits against which the capital loss can be offset.

If the deferred tax asset is recognised, the resulting credit is to profit or loss. Therefore, at the end of 20X1, the required journal entry is as follows.

		CU	CU
Dr	Deferred tax asset	150	
Cr	Income tax (profit or loss)		150

To recognise the deferred tax asset.

Example 4.7.3.9B

Accounting for increased allowances based on market value uplifts

Entity B operates in the extractives industry. At the beginning of 20X1, Entity B's local tax authority introduces new legislation that permits Entity B to calculate tax depreciation for certain mining assets using the market value of the assets at a specified date, rather than the cost or carrying amount of the assets. The tax depreciation calculated on the basis of the market value at the specified date is referred to as the 'starting base allowance'. The carrying amount of the assets in the financial statements of Entity B is not adjusted.

If there is insufficient profit against which the annual tax depreciation allowance can be used in any taxable period, the excess is carried forward and is available for use as a deduction against taxable profit in future periods.

How should Entity B recognise the market value uplift (i.e. the adjustment to the available tax depreciation as a result of applying the market value approach)?

Entity B should recognise the market value uplift as part of the tax base of the related mining assets so that, at the specified date, the tax base of the assets is increased to the starting base allowance.

The amount of the starting base allowance, including the market value uplift, is attributed to the related assets under the tax regime and becomes the basis for tax depreciation allowances in future periods. Therefore, the market value uplift forms part of the tax base of the related assets as defined in IAS 12:7 (i.e. "the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset").

Because the carrying amount of the assets in the financial statements is not adjusted, a deductible temporary difference arises because the tax base of the assets is higher than their carrying amount. A deferred tax asset should be recognised to the extent that the recognition criteria in IAS 12:24 are met (see 4.4.3), and the corresponding credit is recognised in profit or loss in accordance with IAS 12:65.

Because the temporary difference arises when the new tax legislation is introduced, rather than on initial recognition of the mining assets, the initial recognition exception does not apply (see also 4.4.6.8).

The conclusions above were confirmed by the IFRS Interpretations Committee in the July 2012 *IFRIC Update*.

4.7.4 Changes in the carrying amount of a deferred tax asset or liability

The carrying amount of a deferred tax asset or liability may change for reasons other than a change in the temporary difference itself. Such changes might arise as a result of:

- a change in tax rates or laws; or
- reassessment of the recoverability of a deferred tax asset; or
- a change in the expected manner of recovery of an asset or the expected manner of settlement of a liability.

In such circumstances, IAS 12 requires that the change in deferred tax balances be recognised in profit or loss, except to the extent that it relates to items previously recognised outside profit or loss. [IAS 12:60]

For example, when a deferred tax amount has previously been recognised in other comprehensive income at the time of the revaluation of an asset, and the deferred tax liability subsequently changes because of a change in tax rates, the adjustment to the deferred tax liability to reflect the revised tax rates is also recognised in other comprehensive income.

The same principle applies to a change of intention. For example, when an entity has previously estimated the deferred tax liability arising on the revaluation of an owner-occupied property on the basis that it would continue to be used to generate taxable manufacturing profits, and a decision is subsequently made to dispose of the property, thus reducing the deferred tax liability, the adjustment to the deferred tax liability is also reflected in other comprehensive income.

4.7.5 Changes in the tax status of an entity or its shareholders

A change in the tax status of an entity or its shareholders may have consequences for the entity by increasing or decreasing its tax assets or liabilities. This may occur, for example, when an entity's equity shares are publicly listed for the first time, or when a controlling shareholder moves to a foreign country. As a result of such an event, the entity may be taxed differently, which may have an immediate effect on its current and deferred tax assets and liabilities. SIC-25 *Income Taxes — Changes in the Tax Status of an Entity or its Shareholders* prescribes the accounting treatment for such changes.

SIC-25 requires that the current and deferred tax consequences of a change in tax status be included in profit or loss for the period, unless those consequences relate to transactions or events that result, in the same or a different period, in a direct credit or charge to the recognised amount of equity or in amounts recognised in other

comprehensive income. Those tax consequences that relate to changes in the recognised amount of equity, in the same or a different period (not included in profit or loss), should be charged or credited directly to equity. Those tax consequences that relate to amounts recognised in other comprehensive income should be recognised in other comprehensive income. [SIC-25:4]

Effectively, this means that an analysis is required of the original accounting for the transactions or events that gave rise to the current and deferred tax balances. To the extent that those transactions or events were charged or credited directly in equity (e.g. withholding tax on dividend payments), any incremental tax effects should also be charged or credited directly to equity. To the extent that those transactions or events were recognised in other comprehensive income (e.g. certain asset revaluations), any incremental tax effects should also be recognised in other comprehensive income. Thus, the aggregate amount of tax recognised outside profit or loss will be the amount that would have been recognised outside profit or loss if the new tax status had applied previously.

Example 4.7.5
Change in the tax status of an entity

Entity P has a deferred tax liability of CU1,000 arising in respect of total temporary differences of CU4,000. A CU800 temporary difference exists in respect of a previous revaluation of property, plant and equipment. All other temporary differences relate to items recognised in profit or loss.

Entity P is sold into foreign ownership and, as a consequence, the tax rate increases from 25 per cent to 30 per cent. To recognise the resulting increase in the deferred tax liability, the following journal entry is recorded.

	CU	CU
Dr Income tax (profit or loss) [(30% – 25%) × (CU4,000 – CU800)]	160	
Dr Income tax (other comprehensive income) [(30% – 25%) × CU800]	40	
Cr Deferred tax liability		200

To recognise the increase in the deferred tax liability resulting from the change in tax status.

When there is uncertainty as to the amount that was previously dealt with outside profit or loss, it may be necessary to make an allocation on a reasonable basis (see 3.2.2.4 and 4.7.3.6).

Note that SIC-25 does not permit the effect on deferred tax balances that arose at the time of a previous business combination to be dealt with as an adjustment to goodwill. The change in tax status is a post-acquisition event, and so is accounted for post-acquisition. Because the original deferred tax was not dealt with in equity or in other comprehensive income, the incremental effect is required to be dealt with in profit or loss.

If the change in tax rate is a result of an entity being acquired in a business combination, in the individual financial statements of the entity (the acquiree), the adjustments to current and deferred tax assets and liabilities will be accounted for in accordance with SIC-25, as discussed in the previous paragraphs. However, in the consolidated financial statements of the new parent (the acquirer), the accounting for the acquisition will reflect the current and deferred tax assets and liabilities measured using the revised tax rates — and, consequently, the incremental effect of the acquisition will be reflected as an adjustment to goodwill or the bargain purchase gain arising on acquisition. [IAS 12:58(b)]

The effect of a voluntary change in the tax status of an entity should be recognised when the change is approved or, if no approval is necessary, when the election is formally notified (e.g. if approval of the change is perfunctory). A change in tax status that results from a change in tax law will be recognised on the enactment date or the substantively enacted date if applicable. Substantively enacted tax rates are discussed further at 4.5.2.3.

5 Specific applications

5.1 Business combinations

5.1.1 *Deferred tax arising from business combinations – general*

When a business combination occurs, new or adjusted deferred tax balances can arise from the following sources:

- fair value adjustments on consolidation resulting in carrying amounts of assets or liabilities in the consolidated financial statements that differ from the carrying amounts in the acquiree's financial statements and, consequently, from their tax bases when equivalent adjustments are not recognised for tax purposes (see 5.1.2);
- additional assets or liabilities recognised on acquisition that are not recognised in the financial statements of the acquiree (see 5.1.3);
- additional deferred tax balances recognised on acquisition that are not recognised by the acquiree, because of the initial recognition exception (see 5.1.4); and
- deferred tax assets not previously recognised by the acquiree because the recoverability criteria could not be met at the entity level but can be met at a group level, e.g. potential for offsetting taxable profits and losses between group entities (see 5.1.5).

When deferred tax arises at the time of a business combination, and it has not been recognised by the acquiree prior to the acquisition, it must be recognised and taken into account in the initial accounting for the business combination. It will, therefore, affect the measurement of the goodwill or the bargain purchase gain arising on acquisition.

Reverse acquisitions (see section 12 of chapter A25) occur when a business combination results in the legal subsidiary obtaining control.

Under IFRS 3 *Business Combinations*, a reverse acquisition is accounted for as a business combination in which the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the guidance in paragraphs B13 to B18 of that Standard. In such circumstances, the requirements of IFRS 3 to recognise assets and liabilities of the acquiree at fair value are applied to the assets and liabilities of the legal parent.

When accounting for a reverse acquisition, deferred tax should be recognised in the consolidated financial statements in the same way as for other business combinations. In some jurisdictions, tax law may permit the legal parent to adjust the tax values of its assets and liabilities and these amounts should be used to determine the tax base of each item for the business combination accounting. If the tax law permits an adjustment to the carrying amount of the legal subsidiary's tax values, in IFRS 3 terms these changes relate to the acquirer's assets and liabilities rather than to those of the acquiree (i.e. because the legal subsidiary is the accounting acquirer); consequently, the deferred tax impact of adjustments to the legal subsidiary's tax values should be recognised outside of the accounting for the business combination (i.e. in profit or loss or other comprehensive income, as appropriate).

In the separate financial statements of the legal parent (if prepared), deferred tax should be measured on the basis of the carrying amounts of the assets and liabilities in those financial statements.

5.1.2 Fair value adjustments

With limited exceptions, the identifiable assets, liabilities and contingent liabilities of the acquiree are recognised in the consolidated financial statements at their fair values at the acquisition date. This will often result in different carrying amounts from those recognised in the acquiree's individual financial statements. However, the tax bases of the assets and liabilities may remain unchanged.

For example, when the fair value of an asset at the date of acquisition is higher than its carrying amount in the acquiree's financial statements, and the asset is recognised at the higher amount for consolidation purposes, the tax base of the asset is unlikely to be affected. In these circumstances, a taxable temporary difference arises as a result of the acquisition. The deferred tax liability arising from the taxable temporary difference is recognised in the consolidated financial statements to reflect the future tax consequences of recovering the recognised fair value of the asset. This is illustrated in example 5.1.5.

5.1.3 Additional assets or liabilities recognised on acquisition

On acquisition, additional assets and liabilities may be identified that are not recognised in the financial statements of the acquiree. This will commonly be the case, for example, in respect of intangible assets. When such additional assets or liabilities are recognised, the deferred tax implications should also be recognised. The newly recognised assets or liabilities reflect economic benefits and outflows of the acquiree; therefore, any deferred tax should be measured at the acquiree's tax rate. These additional assets and liabilities recognised, and any related deferred tax, will be included as part of the identifiable net assets acquired. This is illustrated in example 5.1.5.

The recognition of goodwill may also have deferred tax implications — see section 4.4.5 for discussion and illustrative examples.

5.1.4 Additional deferred tax balances recognised on acquisition

In some circumstances, the deferred tax impact of temporary differences may not have been recognised in the acquiree's financial statements because those differences fell within one of IAS 12's recognition exceptions. For example, the differences may have arisen on the initial recognition of an asset or a liability (see section 4.4.6) and, consequently, may not have been recognised. In these circumstances, the deferred tax impact of such temporary differences should be recognised in the consolidated financial statements even though it is not recognised in the individual financial statements of the acquiree.

These additional deferred tax balances are recognised on acquisition because, from the group's perspective, the initial recognition of the asset or liability results from a business combination and, therefore, under the rules set out at section 4.4.6, the deferred tax impact should be recognised. This is illustrated in example 5.1.5.

5.1.5 Deferred tax assets not previously recognised by the acquiree

In some circumstances, deferred tax assets (e.g. in respect of tax losses) may not have been recognised by the acquiree due to concerns about the recoverability of the assets in the light of anticipated levels of profitability. However, following the acquisition, in some tax jurisdictions, the losses may become available for use by other group entities, and therefore be considered recoverable. Because the asset is now recoverable from a group perspective, the deferred tax asset is recognised at the time of acquisition.

Conversely, as a result of the acquisition, some deferred tax assets previously recognised by the acquiree may no longer be available due to restrictions imposed by tax law following a change of ownership. In such cases, the deferred tax asset should not be recognised in the acquiree's statement of financial position and would, therefore, result in increased goodwill.

The example below illustrates the deferred tax effects discussed at 5.1.2 to 5.1.5.

Example 5.1.5 Deferred tax arising on a business combination

Company K acquires 100 per cent of Company L, which holds two properties and sundry other assets. Property A (carrying amount CU100 in Company L's financial statements) and property B (carrying amount CU150 in Company L's financial statements) are, for tax and accounting purposes, depreciated over 10 years and will be recovered through use in taxable manufacturing activities. The tax rate is 30 per cent.

The following information is relevant at the date of acquisition:

- Company K pays cash consideration of CU380 for the acquisition.
- The fair values of properties A and B are measured at CU130 and CU140, respectively.
- An additional intangible asset is identified for recognition in respect of patents held by Company L; the fair value of the intangible asset is CU50 and its tax base is nil.
- Company L has other net assets with a carrying amount of CU30; the fair value of the other net assets is also CU30 and the tax base is also CU30.
- The tax bases of properties A and B are CU50 and CU150, respectively. A temporary difference arose on the acquisition of property A by Company L and, therefore, no deferred tax liability was recognised due to the initial recognition exception.
- Company L has tax losses available for offset against the future profits of any group entity amounting to CU20. It is probable that future taxable profit will be available within the group to absorb these losses. No deferred tax asset has previously been recognised by Company L in respect of these tax losses.

The goodwill arising on the acquisition of Company L is calculated as follows.

Net assets of Company L	Carrying amount in Company L's financial statements CU	Fair value CU	Tax base CU	Temporary difference CU	Tax rate CU	Deferred tax liability (asset) CU
Property A	100	130	50	80	30%	24
Property B	150	140	150	(10)	30%	(3)
Intangible asset	—	50	—	50	30%	15
Other net assets	30	30	30	—	—	—
Tax loss c/f	—	—	—	(20)	30%	(6)
Total	<u>280</u>	<u>350</u>	<u>230</u>	<u>100</u>		<u>30</u>
Deferred tax arising on acquisition		(30)				
Identifiable net assets acquired		320				
Consideration		<u>380</u>				
Goodwill		<u>60</u>				

5.1.6 Deferred tax assets not previously recognised by the acquirer

Circumstances may also arise when, as a result of an acquisition, the probability of realising a pre-acquisition deferred tax asset of the acquirer changes so that the acquirer considers it probable that it will recover its own deferred tax asset that was not recognised prior to the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profits of the acquiree. In such circumstances, the acquirer recognises a deferred tax asset, but does not include it as part of the accounting for the business combination, and it is not taken into account in measuring the goodwill or bargain purchase gain arising in the business combination. [IAS 12:67]

5.1.7 Intangible assets recognised for accounting but not tax purposes

Depending on the tax jurisdiction and on how a business combination is structured, the carrying amounts of goodwill and intangible assets recognised under IFRS 3 may be greater than, less than, or equal to their tax bases. For example, due to differences between accounting rules and tax legislation, the amounts recognised in a business combination as separately identifiable intangible assets under IFRSs may not be separately recognised for tax reporting purposes, and may instead be included within goodwill.

In a business combination, IFRS 3 requires the recognition, separately from goodwill, of identifiable intangible assets. The local tax laws may not permit the recognition of intangible assets for tax purposes in determining the amount of tax deductible goodwill.

In such circumstances, when comparing the carrying amounts of the assets acquired to their respective tax bases in order to identify temporary differences, the intangible assets and goodwill should not be aggregated; they should be analysed separately for IAS 12 purposes. This is so even if it would otherwise appear that the tax base for goodwill corresponds to amounts recognised as intangible assets under IFRSs. This is illustrated in the following example.

Example 5.1.7

Deferred tax on intangible assets and goodwill arising on a business combination

Entity A acquires the net assets of Entity B on 15 September 20X9 in a transaction accounted for as a business combination under IFRS 3. As part of the recognition and measurement of identifiable assets and liabilities, intangible assets (customer lists) of CU15 million are identified and recognised; goodwill of CU5 million is also recognised.

For local tax reporting purposes, however, no intangible assets are recognised; instead tax deductible goodwill of CU20 million is recognised.

When comparing the carrying amounts of the assets acquired to their individual tax bases for the purpose of computing temporary differences at the date of acquisition, should the carrying amount of the customer lists and the goodwill as recognised in the consolidated financial statements be aggregated and compared with the tax base of the goodwill?

No. While it would appear that the CU15 million of additional tax deductions available for goodwill equates to the tax base of the customer lists recognised, the intangible assets and goodwill should not be aggregated, but analysed separately under IAS 12.

The result is a taxable temporary difference of CU15 million on the intangible assets for which a deferred tax liability is recognised. In addition, a deferred tax asset is recognised for the excess tax deductible goodwill (CU20 million) over the recognised goodwill (CU5 million) to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

The deferred tax asset and liability will continue to be analysed separately over their respective lives.

5.1.8 Post-acquisition recognition of acquiree's deferred tax assets

At the date of acquisition, there may be tax losses in the acquiree available for carryforward or deductible temporary differences that do not qualify for recognition as deferred tax assets when the business combination is initially accounted for. These items may subsequently meet the criteria for recognition, and IAS 12 requires that the entity should recognise such acquired deferred tax benefits that it realises after the business combination as follows:

[IAS 12:68]

- acquired deferred tax benefits recognised within the 'measurement period' (i.e. within one year after the acquisition date) that result from new information about facts and circumstances that existed at the acquisition date reduce the amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits are recognised in profit or loss; and
- all other acquired deferred tax benefits realised are recognised in profit or loss (or outside profit or loss if otherwise required by IAS 12).

Example 5.1.8

Realisation of tax loss carryforward after a business combination

Company Q, with a December year end, acquires a new subsidiary, Company R, on 31 March 20X1. Company R has tax losses accumulated in previous periods giving rise to a potential deferred tax asset of CU50 million. In the initial accounting for the business combination, Company Q takes the preliminary view that these losses are not available for offset against the profits of other group entities, and does not recognise a deferred tax asset. The goodwill arising on the acquisition amounts to CU20 million.

In February 20X2 (i.e. within the 'measurement period'), upon request from Company Q, the tax authority provides its opinion that Company R's losses can be offset against certain of the profits of other group entities — the relevant profits amounting to a deferred tax asset of CU30 million at the date of acquisition. This opinion reflects the tax authority's view on how the existing tax legislation at the date of acquisition should be applied to the circumstances of Company Q and Company R at that date; accordingly, it is judged to be new information about facts and circumstances that existed at the acquisition date.

In the circumstances described, had Company Q sought advice from the tax authority at the time of the acquisition, a deferred tax asset of CU30 million could potentially have been recognised in the initial accounting for the business combination. Under IAS 12:68, because the additional information was obtained during the measurement period and it reflects facts and circumstances at the acquisition date, goodwill should be adjusted for the subsequent recognition of the deferred tax asset. However, the retrospective adjustment of goodwill is limited to the amount of the goodwill; therefore, only CU20 million is adjusted directly against goodwill in the 20X2 financial statements and the balance of CU10 million is recognised in profit or loss.

If the other group entities earn profits subsequent to the date of acquisition against which more of Company R's losses can be utilised, the effect is recognised in profit or loss.

The discussion in example 5.1.8 reflects the requirements of IAS 12 following consequential amendments arising from IFRS 3 (as revised in 2008). Prior to those amendments, the subsequent realisation of all deferred tax assets acquired in a business combination was recognised in profit or loss with a consequential reduction in the carrying amount of goodwill to the amount that would have been recognised if the deferred tax asset had been recognised as an identifiable asset from the acquisition date, regardless of the date of realisation.

IAS 12:93 and 94 set out the transition provisions regarding the application of the revised requirements. Under those provisions, the revised IAS 12:68 applies to changes in recognised deferred tax assets occurring after the date of adoption of IFRS 3 (as revised in 2008), arising from business combinations that occurred before or after the date of adoption of IFRS 3 (as revised in 2008). This means that an acquirer does not adjust the accounting for prior business combinations for changes in previously recognised deferred tax assets outside the relevant 'measurement period'. Instead, from the date when IFRS 3 (as revised in 2008) is applied, the acquirer recognises changes in recognised deferred tax assets as an adjustment to profit or loss (or, if IAS 12 requires, outside profit or loss). Goodwill is no longer adjusted.

5.1.9 Recognition and measurement in a business combination of the potential liability arising from an uncertain tax position

Example 5.1.9

Recognition and measurement in a business combination of the potential liability arising from an uncertain tax position

Entity A acquires Entity B in a business combination. Entity B has an uncertain tax position at the acquisition date which could result in a cash outflow of CU100. Entity B estimates that at the date of acquisition the probability that an outflow will result from the uncertain tax position is 30 per cent.

For the purposes of its consolidated financial statements, at the date of acquisition of Entity B, how should Entity A account for the potential liability arising from Entity B's uncertain tax position?

Neither IAS 12 nor IFRS 3 addresses this issue specifically. In the absence of definitive guidance, Entity A should select one of the following alternatives:

- Option 1 — the potential tax liability could be recognised when the economic outflow is probable (an 'IAS 12 approach') (see section 3.3.3); or
- Option 2 — the potential tax liability could be recognised at its fair value at the acquisition date (an 'IFRS 3 approach').

Entity A should select one of these approaches as an accounting policy choice and apply it consistently in all business combinations. The alternatives are discussed in more detail below.

Option 1 — IAS 12 approach

This option is based on the view that the uncertain tax position is outside the scope of the recognition and measurement requirements of IFRS 3 and that the potential tax liability should be accounted for in accordance with IAS 12. This view is supported by IFRS 3:IN9 which states that assets and liabilities falling within the scope of IAS 12 should be accounted for at acquisition in accordance with the recognition and measurement requirements of that Standard rather than in accordance with IFRS 3.

If Entity A selects this approach, it applies the method described at section 3.3.3 both initially and for subsequent measurement.

Consequently, if Entity A selects this option as its accounting policy, it should not recognise a liability in respect of the uncertain tax position at the date of acquisition because, at that date, it is not probable (i.e. less than 50 per cent probability) that an outflow of economic resources will occur. If, subsequent to the acquisition date, it becomes probable that an outflow of resources will occur, Entity A will recognise the tax liability at its best estimate of that outflow, with the resulting charge recognised in profit or loss.

Option 2 — IFRS 3 approach

This option is based on the view that the general principles of IFRS 3 should be applied because IFRS 3 does not explicitly exclude current tax assets and liabilities from the scope of its recognition and measurement requirements. Although, as discussed under Option 1, the introduction to IFRS 3 appears to scope out all tax balances, within the body of the Standard there is no reference to excluding current tax balances — only deferred tax balances in accordance with IFRS 3:24 and 25.

IFRS 3 requires the recognition of contingent liabilities at fair value if they can be measured reliably. Under Option 2, Entity A recognises and measures the uncertain tax liability in the business combination by analogy to the treatment of contingent liabilities acquired in a business combination. The tax liability is therefore measured at its fair value at the acquisition date, which takes into account the likelihood that the tax will become payable. Thereafter, in line with the treatment of contingent liabilities under IFRS 3:56, the liability arising from the uncertain tax position should be recognised at the higher of (1) the amount initially recognised, and (2) the amount that would be recognised by analogy to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see section 3.3.3).

5.1.10 Tax deductible goodwill of the acquiree in a business combination

Example 5.1.10

Tax deductible goodwill of the acquiree in a business combination

Entity A acquires 100 per cent of Entity B for consideration of CU100. At the acquisition date, Entity B has:

- goodwill from a previous business combination with a tax base of CU40 in a jurisdiction with a tax rate of 20 per cent; and
- other identifiable assets and liabilities with a total fair value of CU50.

Following its acquisition by Entity A, Entity B will be entitled to continue to claim tax deductions on the previously recognised goodwill and expects to have sufficient taxable profits available to utilise those deductions as they arise. The relevant tax rate is 20 per cent.

How should the effect of the tax deductions available on the goodwill previously recognised by Entity B be treated in the consolidated financial statements of Entity A at the acquisition date?

It depends. Because goodwill represents the economic benefits arising from intangible assets that are not individually identified and separately recognised in a business combination, it may not be apparent whether the goodwill recognised on the acquisition of Entity B by Entity A arises from the same factors that gave rise to the goodwill previously recognised by Entity B. There may be circumstances when it is clear that there is no link between the previously recognised goodwill and the goodwill arising on the current business combination. There may be less common circumstances when it is clear that the goodwill recognised by Entity A is the 'same' goodwill as that previously recognised by Entity B. However, in most cases, it will not be obvious whether there is a link between the goodwill previously recognised by Entity B and the goodwill arising when Entity A acquires Entity B. In such circumstances, if the pre-existing goodwill tax deductions are to be treated as relating to the goodwill arising on the current acquisition, it must be demonstrated that the factors that gave rise to the pre-existing goodwill continue to exist and contribute to goodwill on the current acquisition.

Scenarios 1 and 2 below illustrate contrasting circumstances.

Scenario 1 – no link identified

Entity B is a holding company with two subsidiaries — one an active manufacturing entity and the other a financial services entity in 'run-off' (i.e. no longer operating other than to hold existing financial assets to their maturity). The tax deductible goodwill recognised by Entity B arose on the acquisition of the financial services entity.

In this scenario, it is evident that any goodwill arising on the acquisition of Entity B by Entity A relates to the manufacturing subsidiary. Because there is no link between the goodwill recognised by Entity A and the tax deductible goodwill previously recognised by Entity B, for the purposes of Entity A's consolidated financial statements, the tax base of CU40 does not have an associated carrying amount.

The goodwill of CU50 recognised by Entity A (i.e. consideration of CU100 less net fair value of identifiable assets and liabilities of CU50) has a tax base of CUnil, giving rise to a taxable temporary difference of CU50. No deferred tax is recognised in respect of this taxable temporary difference because it arises on the initial recognition of goodwill (see 4.4.5.1). In addition, the goodwill previously recognised by Entity B has a tax base of CU40 and a carrying amount of CUnil, giving rise to a deductible temporary difference of CU40 which is not subject to the initial recognition exception. Consequently, subject to IAS 12's general recognition criteria, a deferred tax asset of CU8 ($CU40 \times 20\%$) is recognised in respect of Entity B's original goodwill.

At acquisition, therefore, Entity A recognises a deferred tax asset of CU8, Entity B's other identifiable assets and liabilities at their net fair value of CU50 and goodwill of CU42.

After the acquisition date, as tax deductions are claimed by Entity B in respect of the goodwill, the deferred tax asset reduces and the deferred tax expense in profit and loss offsets the current tax deduction claimed. When all available deductions have been claimed (or have expired unclaimed), no deferred tax asset will remain.

Scenario 2 – link identified

Entity B is a shell entity which acquired another entity in a transaction giving rise to tax deductible goodwill immediately before, and in anticipation of, its own acquisition by Entity A.

In this scenario, it is clear that the goodwill recognised by Entity A is substantially the same as the tax deductible goodwill previously recognised by Entity B. Consequently, the tax deductible goodwill previously recognised by Entity B gives rise to a tax base considered to relate to the goodwill recognised by Entity A.

The goodwill of CU50 recognised by Entity A therefore has a tax base of CU40, giving rise to a taxable temporary difference of CU10. No deferred tax is recognised in respect of this taxable temporary difference because it arises on the initial recognition of goodwill (see 4.4.5.1).

At acquisition, therefore, Entity A recognises Entity B's identifiable assets and liabilities at their net fair value of CU50 and goodwill of CU50.

After the acquisition date, as tax deductions are claimed by Entity B in respect of the goodwill, a deferred tax expense will be recognised in profit or loss and a deferred tax liability will be recognised in Entity A's consolidated financial statements. The deferred tax expense offsets the current tax deductions claimed. When all available deductions have been claimed (or have expired unclaimed), a deferred tax liability of CU8 (i.e. temporary difference of CU40 not covered by the initial recognition exception at 20 per cent) will remain in place until the goodwill recognised by Entity A is either impaired or disposed of.

5.2 Eliminations of unrealised profits

When a group entity sells goods to another group entity, the seller recognises profits made on those sales in its individual financial statements. If those goods are still held in inventories by the purchaser at the end of the reporting period, the profit recognised by the seller, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealised profit on closing inventories is eliminated from the group’s profit, and the closing inventories of the group are recognised at cost to the group. The tax consequences to the seller (both current and deferred, if any), however, are not eliminated. If tax is charged on the results of individual entities, and not on the group, the seller will pay tax on any profits generated from the intragroup sales, even though some of those profits may be unrealised from the group’s perspective.

Such consolidation adjustments may have a deferred tax impact in the consolidated financial statements. The intragroup elimination is made as a consolidation adjustment and not in the financial statements of any individual reporting entity. Therefore, the elimination will result in the creation of a temporary difference as far as the group is concerned between the carrying amount of the inventories in the consolidated financial statements and the tax base (assumed to be the carrying amount in the purchaser’s individual financial statements). The deferred tax effects arising in respect of this temporary difference should be recognised in accordance with the usual principles.

The tax rate to be used when recognising the deferred tax balance arising from the elimination of unrealised profits on intragroup transactions is determined by reference to the tax jurisdiction where the temporary difference will reverse. This will generally be the tax rate in the purchaser’s jurisdiction, because the deduction is available at that rate when the unrealised profit is realised from the sale to an unrelated third party. If the tax rate in the purchaser’s jurisdiction differs from that in the seller’s, the deferred tax recognised may not equal the tax currently payable by the seller.

Example 5.2
Elimination of intragroup profits in inventories

Company P sells inventories costing CU200 to its overseas subsidiary, Company S, for CU300. Company P’s tax rate is 40 per cent, Company S’s is 50 per cent. At the end of the reporting period, Company S still holds the inventories.

Company P recognises a current tax liability of CU40 ($\text{CU}100 \times 40\%$) relating to the profit on sale of the inventories but does not recognise any deferred tax balances because there are no future tax consequences from Company P’s point of view.

Company S is entitled to a future deduction for the CU300 paid for the inventories and this is therefore the asset’s tax base from Company S’s perspective. Consequently, in Company S’s individual financial statements, the tax base is equal to the carrying amount and no temporary difference arises. Company P prepares consolidated financial statements and, for financial reporting purposes, gains and losses on intragroup transactions are eliminated on consolidation. Therefore, on consolidation, the carrying amount of the inventories is reduced from CU300 to CU200 (to eliminate the unrealised profit). A CU100 deductible temporary difference arises, representing the difference between the carrying amount (CU200) and the tax base (CU300). A deferred tax asset is calculated by multiplying the temporary difference of CU100 by 50 per cent, because the deduction is available to Company S at that rate when the unrealised profit is realised outside the group on sale of the inventories by Company S. Available evidence supports a conclusion that realisation of the deferred tax asset representing the tax benefit of Company S’s deductible temporary differences is probable. The deferred tax asset arising of CU50 is therefore recognised on consolidation.

The impact of this intragroup transaction on Company P’s consolidated financial statements is shown below in the following journal entries.

		CU	CU
Dr	Current tax expense ($\text{CU}100 \times 40\%$)	40	
Dr	Deferred tax asset ($\text{CU}100 \times 50\%$)	50	
Cr	Current tax payable		40
Cr	Deferred tax benefit		50

To recognise the impact of the intragroup transaction.

Example 5.2

Elimination of intragroup profits in inventories (continued)

In a subsequent period, Company S sells the inventories that it acquired from Company P to an unrelated third party for the same amount that it had previously paid Company P, i.e. CU300. The journal entry to reflect the sales and related tax consequences to be reflected in the consolidated financial statements of Company P is as follows.

		CU	CU
Dr	Cash	300	
Dr	Cost of goods sold	200	
Dr	Income tax expense	50	
Cr	Sales		300
Cr	Inventories		200
Cr	Deferred tax asset		50

To recognise the sales and related tax consequences.

5.3 Financial instruments

5.3.1 Investments in securities — general

Investments in securities can often give rise to significant temporary differences. In order to determine the deferred tax implications for various types of investments, it is necessary to understand the tax rules relating to those investments. Particularly, an entity should take care to understand the tax implications that arise from the recovery of the investment through dividends ('use'), sale, or a combination of the two. It is then necessary to determine how the carrying amount of the investments will be recovered.

When an entity has an investment in an equity instrument it may be appropriate to presume that the carrying amount will be recovered through sale. This will be the case if the dividends anticipated from the investment are not expected to represent a realisation of part of the carrying amount of the investment.

Sometimes it will be necessary to consider how a financial asset has been classified under IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*). For example, financial assets measured at amortised cost under IFRS 9 are so classified based on the premise that the entity's business model objective is to hold those assets to collect contractual cash flows. Similarly, financial assets classified as held-to-maturity under IAS 39 are so classified based on the premise that they will not be sold prior to their maturity. When considering any tax implications, the same assumptions should be used.

5.3.2 Financial instruments at fair value through profit or loss or classified as held for trading

For financial instruments that are measured at fair value through profit or loss in accordance with IFRS 9 (see chapters B2 and B3) or, for entities that have not yet adopted IFRS 9, that are classified as held for trading or at fair value through profit or loss in accordance with IAS 39 (see chapters C2 and C3), fair value gains and losses are recognised in profit or loss. If these gains and losses are taxable, they may be taxed when they are recognised in the financial statements, or it may be that they are not reflected in tax computations until the instrument is sold or settled. When tax is assessed based on fair value movements recognised in profit or loss, there are no deferred tax implications because the gains and losses are assessed for tax in the same period in which they are recognised in profit or loss. In contrast, when gains and losses are not reflected in tax computations until the instrument is sold or settled, deferred tax consequences may arise.

5.3.3 Financial assets measured at fair value through other comprehensive income and available-for-sale financial assets

Similar issues will arise in relation to financial assets measured at fair value through other comprehensive income under IFRS 9 (see chapters B2 and B3) or, for entities that have not yet adopted IFRS 9, that are classified as available for sale (AFS) under IAS 39 (see chapters C2 and C3). The main difference is that the change in fair value on these assets is reported in other comprehensive income (apart from dividend income that does not clearly represent a recovery of part of the cost of the investment under IFRS 9; under IAS 39, changes in fair value recognised in other comprehensive income exclude impairment losses, exchange gains and losses, and interest and dividend income). Thus, if a deferred tax balance arises on an asset measured at fair value through other comprehensive income, or an available-for-sale asset, the deferred tax impact may also be dealt with in other comprehensive income (rather than in profit or loss) in the same manner as the deferred tax effects of revaluations of other assets.

See 4.7.3.7 for a more detailed consideration of the deferred tax implications when fair value movements on financial assets measured through other comprehensive income (under IFRS 9) and available-for-sale financial assets (under IAS 39) are subsequently reclassified to profit or loss.

The assessment regarding the realisation of tax benefits from unrealised losses on available-for-sale financial assets often depends on the inherent assumptions used for financial reporting purposes concerning the ultimate recovery of the carrying amount of the securities.

IAS 12:16 concludes that it is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. Therefore, ordinarily, an entity should assume recovery of the carrying amount of its investments in equity instruments measured at fair value through other comprehensive income (or, under IAS 39, its available-for-sale debt securities) at their fair values at the end of each reporting period. Generally, whenever there is an unrealised holding loss, recovery at fair value would result in a capital loss deduction.

In some jurisdictions, the tax law may allow utilisation of capital losses only through offset against capital gains. In such circumstances, entities need to assess whether realisation of the loss is probable based on available evidence. For example, evidence considered might include (1) 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 gain income. In these situations, available evidence should be evaluated to determine if it is probable that the entity would have sufficient capital gain income during the carryback and carryforward periods prescribed under tax law. However, in making such an assessment, the carryback and carryforward periods do not commence until the loss is realised.

5.3.4 Compound financial instruments

IAS 12 contains guidance on calculating deferred tax in relation to compound financial instruments that are accounted for under IAS 32 *Financial Instruments: Presentation*. Compound financial instruments are instruments that an entity has issued that contain both a liability and an equity component (e.g. issued convertible debt). In the case of convertible debt, the separate components are a liability component (representing borrowing with an obligation to repay), and an equity component (representing the embedded option to convert the liability into equity of the entity).

Under IAS 32, the equity and liability components of a compound instrument are accounted for separately — the proceeds of issue are allocated between the separate elements. The amount initially recognised as a liability is the present value of the cash flows discounted at a market rate for equivalent debt without the equity feature. Because the holders of the compound instrument are effectively purchasing an equity interest, the coupon on the compound instrument is almost always lower than it would be for the equivalent debt without the equity feature. Therefore, the value assigned to the debt portion of the compound instrument will be lower than the total proceeds received. For example, CU100 proceeds from the issue of a convertible bond could be allocated CU90 to debt and CU10 to equity — the carrying amount of the liability component (CU90) is less than the face value of the instrument (CU100). The detailed requirements for accounting for compound instruments are considered in chapter B3 (or, for entities that have not yet adopted IFRS 9, in chapter C3).

In some jurisdictions, the tax base of the liability component on initial recognition is equal to the initial carrying amount of the sum of the liability and equity components (i.e. CU100 in the above example). If the instrument were settled at an amount equal to the carrying amount of its liability component (which is generally less than the face value and, therefore, less than the tax base), a taxable gain arises, and so a deferred tax liability arising from this taxable temporary difference is recognised. In the example cited above, if the bond were settled for CU90 (its carrying amount), a gain of CU10 would arise which could be taxable.

IAS 12's 'initial recognition exception' (see section 4.4.6) does not apply in this situation — a deferred tax liability should be recognised. This is because the temporary difference arises not from the initial recognition of the instrument, but rather from the separate recognition of the equity component. [IAS 12:23]

Because the equity component of the compound financial instrument is recognised directly in equity, the deferred tax liability arising is also recognised directly in equity. The deferred tax should be charged directly to the carrying amount of the equity component.

However, as the discount associated with the liability component of the compound financial instrument unwinds, the reduction of the associated deferred tax liability is recognised in profit or loss and not directly in equity. The recognition of the deferred tax credit in profit or loss is consistent with the recognition of the associated expense in profit or loss related to unwinding the discount on the liability component. [IAS 12:23]

In jurisdictions where any gain on settlement of the liability would not be taxable, the tax base of the liability is always equal to its carrying amount, and no temporary difference arises.

Example 5.3.4 Convertible note accounted for as a compound instrument

On 31 December 20X0, Company R issues a convertible note with a face value of CU10,000 that matures in three years. There is no interest payable during the period, but the holder has the option to convert the note into a fixed number of shares at the end of the three-year period. Had Company R issued debt with no conversion rights that matured in three years, the interest rate on the bonds would have been 9 per cent.

Under IAS 32, the note is split into its liability and equity components. Using a discount rate of 9 per cent (i.e. the rate at which Company R could have issued equivalent debt with no conversion rights), the present value of the instrument is CU7,722. This is taken to be the value of the liability component, giving rise to an amount recognised directly in equity of CU2,278.

There are no tax consequences if the note is repaid at its face value, and a taxable gain arises if the note is settled for less than its face value. Therefore, the tax base of the instrument is CU10,000. The tax rate is 17.5 per cent.

If the liability were settled at its carrying amount (CU7,722), a taxable profit would arise. Thus, on the initial separation of the liability and equity components, a taxable temporary difference of CU2,278 arises. This gives rise to a deferred tax liability of CU399 (CU2,278 × 17.5%). This amount is netted against the amount recognised in respect of the equity component of the note.

The following entries are recognised at the date of issue of the convertible note.

		CU	CU
Dr	Cash	10,000	
Cr	Convertible note payable		7,722
Cr	Equity		2,278
Dr	Equity	399	
Cr	Deferred tax liability		399

To recognise the issue of the convertible note.

Each year, imputed interest on the liability will be recognised, increasing the carrying amount of the liability component and reducing the associated deferred tax liability. The reduction in the deferred tax liability is recognised in profit or loss.

The movements over the life of the convertible note can be summarised as follows.

	20X0	20X1	20X2	20X3
	CU	CU	CU	CU
<i>Liability and interest</i>				
Opening liability		7,722	8,417	9,174
Imputed interest (9%)		695	757	826
Closing liability	7,722	8,417	9,174	10,000

Example 5.3.4
Convertible note accounted for as a compound instrument (continued)

	20X0	20X1	20X2	20X3
	CU	CU	CU	CU
<i>Deferred tax liability</i>				
Convertible note carrying amount	7,722	8,417	9,174	10,000
Tax base	10,000	10,000	10,000	10,000
Taxable temporary difference	2, 278	1,583	826	—
Deferred tax liability (at 17.5%)	399	277	145	—
Deferred tax income (profit or loss)	—	122	132	145

5.3.5 Impact of IFRS 9 or IAS 39 hedging requirements on non-financial items

The recognition of a ‘basis adjustment’ for a non-financial asset or liability in accordance with IFRS 9:6.5.11(d)(i) (or, for entities that have not yet adopted IFRS 9, IAS 39:98(b)) may cause the carrying amount of the asset or liability to be different from its tax base. This may occur when the tax value ascribed to the asset or liability under the relevant tax jurisdiction is determined other than by reference to the carrying amount in the financial statements (e.g. the basis adjustment is not recognised for tax purposes at the same time as the carrying amount of the asset is adjusted for accounting purposes). Deferred tax should generally be recognised for the temporary difference arising from the difference between the carrying amount in the financial statements and the tax base.

When the different accounting and tax treatments are due to a basis adjustment, the temporary difference arises after the initial recognition of the asset or liability. Accordingly, the initial recognition exceptions in IAS 12:15 (taxable temporary differences — see 4.4.1) and IAS 12:24 (deductible temporary differences – see 4.4.2) do not apply and deferred tax should be recognised (subject to IAS 12’s general recognition criteria).

For further information regarding deferral of hedging gains and losses into non-financial assets see 2.2.3 in chapter B9 (or, for entities that have not yet adopted IFRS 9, see 2.2.3 in chapter C9).

Example 5.3.5 Cash flow hedge of forecast purchases

On 4 January 20X2, Company D has forecast purchases of 100,000 kg of cocoa on or about 31 December 20X2 from a Brazilian supplier, Company B, for a price of US\$180,000. Company D's functional currency is Sterling, and Company B has a US\$ functional currency. On 4 January 20X2, Company D designates the cash flow of the forecast purchase as a hedged item and enters into a currency forward contract to buy US\$180,000 based on the forecast payment (100,000 kg at US\$1.8 per kg). The forward contract locks in the value of the US\$ amount to be paid at a rate of US\$1.8:£1. At inception of the hedge, the derivative is on-market (i.e. fair value is zero). The terms of the currency forward contract and the forecast purchase match each other, and the entity designates the forward foreign exchange risk as the hedged risk.

On 31 December 20X2, the transaction occurs as expected. The fair value of the forward contract is positive £12,500 because the US dollar has continued to strengthen against Sterling. The forward contract has been fully effective in hedging the forward rate of the forecast transaction and, accordingly, all of the gain of £12,500 has been recognised in other comprehensive income.

Company D is required to reclassify such gains and losses and include them in the initial cost of the non-financial asset in accordance with IFRS 9:6.5.11(d)(i). (For entities that have not yet adopted IFRS 9, the treatment is available as an accounting policy choice in accordance with IAS 39:98(b).)

The inventories are recognised in Company D's financial statements at £100,000, being the cash payment of £112,500 (US\$180,000 translated at the spot rate on 31 December 20X2), net of the gain on the forward contract of £12,500. The applicable tax rate is 30 per cent and the local tax law does not permit a reduction of the inventories for the gain on the hedging instrument. Accordingly, the tax base of the inventories is £112,500. Company D should, subject to the normal recoverability criteria, recognise a deferred tax asset of £3,750 (£12,500 × 30%) in respect of the temporary difference arising from the inclusion of the hedging gains in the initial cost of the inventories. Because the £3,750 arises on the reclassification of the hedging instrument (rather than on initial recognition of the inventories), the initial recognition exception does not apply. Under local tax law, fair value gains and losses on the hedging instrument result in taxable gains and losses when they are realised.

The journal entries to be recorded as at 31 December 20X2 are as follows.

		£	£
Dr	Forward contract	12,500	
Cr	Other comprehensive income		12,500
<i>To recognise the unrealised gain on the forward contract in other comprehensive income.</i>			
Dr	Other comprehensive income	3,750	
Cr	Deferred tax liability		3,750
<i>To recognise the tax consequences arising from the unrealised gain on the forward contract.</i>			
Dr	Inventories	112,500	
Cr	Cash		112,500
<i>To recognise the purchase of cocoa as inventory.</i>			
Dr	Cash	12,500	
Cr	Forward contract		12,500
<i>To recognise the settlement of the forward contract.</i>			
Dr	Deferred tax liability	3,750	
Cr	Other comprehensive income		3,750
Dr	Income tax expense	3,750	
Cr	Current tax payable		3,750
<i>To recognise the current tax payable on settlement of the forward contract.</i>			
Dr	Other comprehensive income	12,500	
Cr	Inventories		12,500
<i>To recognise the gain on the forward contract as a 'basis adjustment' for the inventories.</i>			
Dr	Deferred tax asset	3,750	
Cr	Income tax expense		3,750
<i>To recognise the deferred tax asset arising from the temporary difference on the inventories.</i>			

5.4 Properties carried at a revalued amount under IAS 16

5.4.1 Revaluation of properties

When a property is revalued under IAS 16 *Property, Plant and Equipment*, its carrying amount is increased or decreased, but there is generally no effect on the tax base of the property. As a result, deferred tax balances arise. Generally, the recognition of deferred tax arising on a revaluation is consistent with the treatment of the revaluation itself.

5.4.2 Upward revaluations

The upward revaluation of a property accounted for under IAS 16 generally gives rise to a deferred tax liability. By increasing the carrying amount of the property, the entity is acknowledging that it expects to generate returns in excess of the original carrying amount, which will lead to future taxable profits, and so tax payable.

When an upward revaluation is recognised, the deferred tax liability arising is calculated by reference to the expected manner of recovery of the property. The upward revaluation is recognised in other comprehensive income (unless it represents the reversal of a downward revaluation previously recognised in profit or loss). The deferred tax expense should, therefore, also be recognised in other comprehensive income.

Over the period of use when the temporary difference reverses, the release of the deferred tax liability will be credited to profit or loss (see 4.7.3.3). The deferred tax liability recognised at the date of revaluation represents a provision for the tax expected to arise on those benefits. The release of the deferred tax liability to profit or loss over the period in which those future economic benefits (i.e. taxable profits) are earned offsets the current tax expense in those years to the extent that it was anticipated at the date of the revaluation. This is illustrated in example 5.4.2.

Example 5.4.2

Deferred tax impact of property revaluation

An item of property, plant and equipment is acquired for CU1,000. It is depreciated for tax and accounting purposes over five years. At the end of the third year, it is revalued to CU1,200. The value of the property is expected to be recovered through use in a taxable manufacturing activity. The tax rate is 30 per cent.

	Carrying amount	Tax base	Temporary difference	Deferred tax liability	Movement for the year
	CU	CU	CU	CU	CU
01/01/20X1	1,000	1,000	—	—	—
31/12/20X1	800	800	—	—	—
31/12/20X2	600	600	—	—	—
31/12/20X3	1,200	400	800	240	240
31/12/20X4	600	200	400	120	(120)
31/12/20X5	—	—	—	—	(120)

The required journal entries at the end of 20X3 are as follows.

		CU	CU
Dr	Property, plant and equipment	200	
Dr	Property, plant and equipment — accumulated depreciation	600	
Cr	Gain on revaluation (other comprehensive income)		800
Dr	Income tax (other comprehensive income)	240	
Cr	Deferred tax liability		240

To recognise the required entries at the end of 20X3.

In both 20X4 and 20X5, the following entry will be recorded, to reflect the reversal of the temporary difference arising on revaluation.

		CU	CU
Dr	Deferred tax liability	120	
Cr	Income tax (profit or loss)		120

To recognise the tax effect of the reversal of the temporary difference arising on revaluation.

5.4.3 Downward revaluations and impairment losses

Recognition of downward revaluations and impairments of properties accounted for under IAS 16 is either in profit or loss or other comprehensive income, depending on where previous gains and losses recognised on the property have been presented. The accounting for properties under IAS 16 is discussed in further detail in chapter A7.

The write-down of a property for accounting purposes can give rise to a deferred tax asset, or a reduction in a deferred tax liability, depending on the tax base of the property. Any deferred tax asset arising is recognised to the extent that it is probable that sufficient taxable profit will be available in the future to allow the benefit of that deferred tax asset to be recovered.

When a property accounted for in accordance with IAS 16 has previously been revalued, and a downward valuation subsequently occurs that is recognised in other comprehensive income (i.e. to the extent that the subsequent downward valuation does not exceed the amount held in the revaluation surplus in respect of that same asset), the deferred tax effects previously recognised in other comprehensive income are reversed through other comprehensive income. If the downward revaluation exceeds the amount of revaluation surplus, the excess is recognised in profit or loss. In such circumstances, the deferred tax movement should also be split between amounts recognised in other comprehensive income and profit or loss.

Impairments are treated in the same manner as downward revaluations.

These principles are illustrated in example 5.4.3.

Example 5.4.3 Downward revaluation

An item of property, plant and equipment is acquired for CU1,000. It is depreciated for tax and accounting purposes over 10 years on a straight-line basis. The value of the property is expected to be recovered through use in a taxable manufacturing activity. The entity is a profitable manufacturing entity with its deferred tax assets fully recognised.

At the end of the third year (when the carrying amount is CU700), the asset is revalued to CU1,050 but no adjustment is made to its tax base. At the end of the sixth year, when the carrying amount of the asset is CU600 (i.e. $CU1,050 - (3 \times CU150)$), it is revalued downward to CU200. The tax rate is 30 per cent.

The impact of these events is summarised as follows.

Initially, the revaluation uplift and the related deferred tax are recognised in other comprehensive income and accumulated in the revaluation reserve. Each year a transfer is made from the revaluation reserve to retained earnings equal to the depreciation of the revaluation surplus net of tax.

At the time of the downward revaluation, the balance in the revaluation reserve is CU140. This is calculated as follows.

	CU
Original revaluation uplift	350
Deferred tax thereon ($CU350 \times 30\%$)	<u>(105)</u>
	245
Three years' depreciation on net uplift ($CU245 \times 3/7$)	<u>(105)</u>
	<u>140</u>

Therefore, the first CU200 of the downward revaluation is recognised as a loss in other comprehensive income, net of CU60 related tax. The remaining downward revaluation of CU200 is recognised in profit or loss (along with CU60 related tax).

The downward revaluation reduces the carrying amount below the tax base, resulting in a deferred tax asset which is recognised because the entity has forecast taxable profits.

Example 5.4.3
Downward revaluation (continued)

	Carrying amount				Deferred tax liability (asset)	Movement for the year	Recognised in	
	Historical cost	Revaluation uplift	Tax base	Temporary difference			Other comp. income	Profit or loss
	CU	CU	CU	CU	CU	CU	CU	CU
20X0	1,000	—	1,000	—	—	—	—	—
20X1	900	—	900	—	—	—	—	—
20X2	800	—	800	—	—	—	—	—
20X3	700	350	700	350	105	105	105	—
20X4	600	300	600	300	90	(15)	—	(15)
20X5	500	250	500	250	75	(15)	—	(15)
20X6	200	—	400	(200)	(60)	(135)	(60)	(75)
20X7	150	—	300	(150)	(45)	15	—	15
20X8	100	—	200	(100)	(30)	15	—	15
20X9	50	—	100	(50)	(15)	15	—	15
20Y0	—	—	—	—	—	15	—	15

If a decision is subsequently taken to dispose of the property, then the deferred tax implications will need to be re-examined. Because the temporary difference is calculated on the basis of management expectations as to the manner of recovery of the property, when those expectations change the deferred tax position may also change.

5.4.4 Properties to be recovered through disposal — ‘clawback’ of tax depreciation

It may be anticipated that the carrying amount of a revalued property will be recovered through sale (whether based on management intent or on the presumptions established in IAS 12 for non-depreciable properties and investment properties — see section 4.2.6). In such cases, the deferred tax implications are determined on the basis of the tax consequences of disposal of the property. It may be that the profit on disposal will be fully taxable, in which case the deferred tax liability arising on any revaluation of the property will be equal to the revaluation uplift multiplied by the tax rate. However, frequently, the taxation of capital gains is on a different basis (e.g. the taxable gain arising may be limited to the amount of tax depreciation previously claimed). This is often referred to as a ‘claw-back’.

In such circumstances (i.e. when the disposal is not itself subject to income tax, but any deduction for tax depreciation previously claimed is taxable as a ‘claw-back’), the tax base is the carrying amount less future taxable amounts. This may or may not be equal to the cost less tax depreciation to date. This point is illustrated in example 5.4.4.

Example 5.4.4 Property to be recovered through disposal

A building (classified as property, plant and equipment) is acquired for CU1,000 on 1 January 20X1. No deferred tax arises on initial recognition of the property, which is to be depreciated (both for tax and accounting purposes) over five years. At the end of 20X1, when its carrying amount and tax written down value is CU800, the property is remeasured to its fair value of CU1,200. At that date, it is expected that the carrying amount of the property will be recovered through disposal.

If the property were disposed of, the taxable gain arising would be limited to the amount of the tax depreciation previously claimed. The tax rate is 30 per cent.

At 31 December 20X1:

Carrying amount (fair value) = CU1,000

Tax base = CU1,000*

Temporary difference = CU1,200 – CU1,000 = CU200

Deferred tax liability = CU200 × 30% = CU60

* The tax base is the carrying amount of CU1,200 less future taxable amounts (i.e. the allowances that would be clawed back on disposal) of CU200. In these circumstances, the tax base for IAS 12 is not equal to the tax written down value of CU800 (cost less accumulated tax depreciation to date).

Therefore, at the end of 20X1, a deferred tax liability of CU60 is recognised; because it relates to the revaluation of the property, the debit of CU60 is recognised in other comprehensive income.

5.5 Foreign currency translation

5.5.1 Assets or liabilities held directly

When an entity holds a foreign-currency denominated monetary asset or liability directly, retranslation at each period end results in a change in the carrying amount for accounting purposes, and a foreign exchange gain or loss that is generally recognised in profit or loss. When applicable tax law does not allow for an equivalent change in tax base, and recovery of an increased carrying amount would be taxable, a temporary difference arises on retranslation which is required to be recognised. In most circumstances, the related deferred tax is recognised in profit or loss. However, when the exchange gain or loss is itself recognised in other comprehensive income, the deferred tax is also recognised in other comprehensive income.

When the entity holds a non-monetary asset that is located overseas, the asset is recognised at its historical cost, being the original foreign currency purchase price translated at the rate on the date of purchase. When the realisation of that asset will give rise to tax consequences in the foreign country, the tax base of the asset will change as the exchange rate changes. This will give rise to a temporary difference because the recognised carrying amount of the asset does not change (see also 4.4.7.8).

5.5.2 Consolidated financial statements

When a reporting entity incorporates the financial statements of foreign operations in its consolidated financial statements (whether by the equity method or consolidation), the deferred tax consequences will need to be evaluated. A foreign operation is defined as an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity. [IAS 21:8]

Once a foreign operation's own financial statements have been prepared in its functional currency, they must then be translated into the presentation currency of the investing entity or group, before they can be incorporated into the group's consolidated financial statements. This is dealt with in IAS 21 *The Effects of Changes in Foreign Exchange Rates* and discussed further in chapter A19.

The basic approach is to translate the statement of financial position using the closing rate of exchange, and income and expenses at the rates ruling on the date of transaction (or an average rate can often be used as an approximation). Exchange differences arising are recognised in other comprehensive income.

From a deferred tax perspective, this approach should not give rise to any additional temporary differences on the assets and liabilities of the foreign operation itself. This is because the carrying amounts and the tax bases of the assets and liabilities of the foreign operation are all translated using the same year-end exchange rate, and any deferred taxes will have already been recognised by the foreign operation.

Although temporary differences do not result directly from the translation of the financial statements of these foreign operations, temporary differences can still arise on their consolidation due to differences between the net investment accounted for in the consolidated financial statements (effectively the parent's share of the net assets of the operation), and the tax base of the investment itself held by the parent (see section 4.4.7).

When a parent has a loan to a foreign subsidiary that is considered to be part of the net investment in the foreign operation, the parent will assess the likelihood of reversal of the temporary difference relating to the loan in the same manner as the temporary differences relating to the subsidiary's equity are considered. Therefore, if the parent is able to control the timing of the reversal of those temporary differences and the reversal is not expected to occur in the foreseeable future, the deferred tax would not be recognised. Conversely, if the parent has an interest-earning deposit in the subsidiary, the deferred tax arising from temporary differences would be recognised, as the exception relates to investments in subsidiaries and not to individual assets within those subsidiaries (see examples 4.4.7.4D and 4.4.7.4E).

5.6 Share-based payments

5.6.1 Deferred tax arising from share-based payment transactions — general

In some jurisdictions, entities receive tax deductions for share-based payments, although the deduction may not always equal the accounting expense, nor be in the same period as the accounting expense is recognised. For example, an entity may operate a share option scheme whereby the tax deduction occurs when the share options are exercised, and the amount is based on the entity's share price on the exercise date. [IAS 12:68A]

The difference between the tax base of the employee services received to date (being the amount accrued to date that the tax authorities will permit as a deduction in future periods), and the carrying amount for accounting purposes (i.e. nil), is a deductible temporary difference that results in a deferred tax asset. If the amount of the future tax deduction is not known at the end of the period, it should be estimated, based on information available at the end of the period. For example, if the deduction is based on the entity's share price on the exercise date (or some other future date), the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period. [IAS 12:68B]

Example 5.6.1A

Calculation of deductible temporary difference arising from share-based payment transactions

On 1 January 20X1, Entity A grants share options to its employees that vest after three years of service. Under the tax law of the jurisdiction in which Entity A operates, a tax deduction will arise when the options are exercised and will be based on the intrinsic value of the options at that time.

At 31 December 20X2 (i.e. two years into the three-year vesting period), 100 options remain outstanding but Entity A expects that only 50 of these will be exercised; the remainder are expected either not to vest (due to employees leaving service before the end of the vesting period) or to expire unexercised (due to employees choosing not to exercise their rights under the options). The intrinsic value of each option, which is based on Entity A's share price at 31 December 20X2, is CU10 and the tax rate is 30 per cent.

Consistent with IAS 12:68B and Example 5 in the Illustrative Examples accompanying IAS 12, Entity A is required to calculate a deductible temporary difference that is based on the intrinsic value of the options at the end of the reporting period and the proportion of the service period which has elapsed.

When Entity A applies the requirements of IAS 12:68B, should the deductible temporary difference be calculated based on the total number of options outstanding at the end of the reporting period, or on the number of options expected to be exercised?

The deductible temporary difference should be calculated based on the number of options expected to be exercised. This is consistent with the requirements of IAS 12:68B, which states that "the amount the taxation authorities will permit as a deduction in future periods . . . shall be estimated, based on information available at the end of the period".

In the circumstances described, Entity A should therefore calculate a deductible temporary difference of CU333 (50 options expected to be exercised \times CU10 \times 2/3) and should recognise a deferred tax asset of CU100 (CU333 \times 30 per cent), subject to the general recognition criteria in IAS 12 for deferred tax assets.

Note that, in applying these requirements, it will generally be the case that the number of options expected to be exercised will be the same as the number expected to vest because the options will only give rise to a deductible temporary difference if they are 'in the money' and, logically, an employee would be expected to exercise an option to purchase a share for less than its market value. In addition, assumptions made about vesting of instruments for the purpose of these calculations should be consistent with expectations used when calculating the IFRS 2 expense.

If the amount of the accrued tax deduction exceeds the amount of the related cumulative remuneration expense, this indicates that the deduction relates not only to the remuneration expense but also to an equity item. Hence, in accordance with IAS 12:58, the excess of the associated current or deferred tax should be recognised directly in equity. [IAS 12:68C]

Example 5.6.1B

Current and deferred tax arising from cash-settled share-based payments

Company A grants its employees cash-settled share appreciation rights (SARs) that vest after three years of service. The relevant tax authority of the country in which Company A is established allows a tax deduction not equal to the cash paid, but based on a different formula. To calculate the corresponding deferred tax under IAS 12:68B, Company A must estimate the amount of the tax deduction to be received in future periods by using information available at the end of the reporting period. Sometimes the amount of the estimated tax deduction measured in accordance with IAS 12:68B or ultimately received may exceed the cumulative remuneration expense recognised under IFRS 2 *Share-based Payment*.

In a cash-settled scheme of this nature, would recognition of the amount of the tax deduction in excess of the cumulative remuneration expense result in recognition, directly in equity, of the current or deferred tax arising from this excess in accordance with IAS 12:68C?

No. Although IAS 12:68C does not explicitly state that it relates only to equity-settled share-based payments, the justification given for the accounting treatment is that the excess deduction indicates that the deduction relates to an equity item as well as to the remuneration expense. In the case of cash-settled share-based payments, such awards are classified as liabilities. Therefore, there is no equity item recognised to which the deduction could relate and, accordingly, it is appropriate to recognise the entire deduction in profit or loss.

IAS 12 Appendix B contains an example of how to calculate the deferred tax asset associated with an employee share remuneration scheme.

In some cases tax deductions may be expected upon the exercise by the holder of vested share options. Because a tax deduction is expected, a deferred tax asset may have been recognised. If the holder fails to exercise the option (i.e. the share options lapse), the tax deductions cease to be expected, although the IFRS 2 expense will remain. Accordingly, there ceases to be a deductible temporary difference and the deferred tax asset should be written off to profit or loss, or to equity, consistent with the manner in which the asset was recognised (e.g. profit or loss to the extent of compensation expense, equity for any excess).

Sometimes employee share schemes are modified (e.g. from equity-settled to cash-settled). These modifications can change the accounting for the scheme (e.g. by requiring that a liability be recognised). The accounting implications of employee share schemes are considered in chapter A16. However, it is important to note that the modification may also affect any deferred tax balances recognised.

5.6.2 Changes in deferred tax on share awards replaced in a business combination

Often, as part of a business combination, the acquirer will issue equity-settled share-based payment awards to replace share options held by the employees of the acquiree. A portion of the market-based measure of the replacement awards is attributed to pre-combination services and, therefore, forms part of the consideration transferred in the business combination.

If the replacement awards are tax deductible, a deferred tax asset is recognised at the acquisition date based on the estimated tax deduction that will be received. Subsequent to the acquisition date, the acquirer's share price may change, in which case the deferred tax asset should be remeasured to reflect the anticipated tax deduction.

There are two acceptable methods of accounting for the subsequent remeasurement of the deferred tax asset related to pre-combination services. An entity should select one as an accounting policy choice to be applied consistently to all similar transactions.

Alternative 1: apply the principle established in IAS 12:68A – 68C

IAS 12:68C states that, in the context of share-based payments, “[i]f the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax should be recognised directly in equity”.

In the context of replacement awards granted as part of a business combination, the cumulative remuneration expense is comprised of the amount attributed to pre-combination services at the acquisition date (as determined in accordance with paragraph B58 of IFRS 3 *Business Combinations*) and the amount of compensation expense recognised for the replacement awards since the date of the business combination, if any. Therefore, the tax deduction related to the excess over the acquisition-date market-based value would be recognised in equity under the principle in IAS 12:68C.

Alternative 2: recognise all changes to the deferred tax assets related to pre-combination services in profit or loss

This alternative is based on the fact that Example 6 of IAS 12 does not appear to apply the principle in IAS 12:68C to distinguish whether a portion of the increase in the deferred tax asset should be recognised in equity rather than in profit or loss. The example indicates that, subsequent to the business combination, the intrinsic value of the options has increased above the market-based value of the replacement awards measured on the acquisition date. In the example, the entire change in the deferred tax asset appears to be recognised as “deferred tax income”. Accordingly, based on Example 6 of IAS 12, it appears acceptable to recognise all movements in deferred tax assets related to pre-combination services in profit or loss.

Example 5.6.2 provides a numerical illustration of both of these approaches.

Example 5.6.2

Changes in tax deductions for share awards replaced in a business combination

On 1 January 20X1, Company A acquires Company B in a business combination. On the acquisition date, the employees of Company B hold fully vested share options with a market-based value of CU120. As part of the business combination, the share options held by employees of Company B are replaced by fully vested share options of Company A with a market-based value of CU120. In accordance with paragraphs B56 to B62 of IFRS 3, the market-based value of the replacement awards is determined to relate to pre-combination services and forms part of the consideration transferred to acquire Company B.

A tax deduction is available when the share options are exercised, based on the intrinsic value of the awards on the date of exercise. The tax rate applicable to Company A is 40 per cent. On the acquisition date, the intrinsic value of the awards is CU100 and, accordingly, a deferred tax asset of CU40 is recognised on that date.

On 31 December 20X1, the intrinsic value of the replacement awards has increased to CU150 such that the deferred tax asset related to the replacement awards is CU60. The increase in the deferred tax asset is recognised using either of the following two alternatives.

Alternative 1: apply the principle established in IAS 12:68A – 68C

The estimated future tax deduction of CU150 exceeds the amount of the cumulative remuneration expense of CU120 (the cumulative remuneration expense being equal to the acquisition-date market-based value because no compensation expense in respect of the replacement awards relates to the post-combination period).

Accordingly, the deferred tax asset related to the excess of CU30 is recognised in equity. Therefore, the increase of CU20 in the deferred tax asset is recognised as follows.

Increase in deferred tax asset for the year	CU20	(CU60 – CU40)
Excess recognised in equity	<u>CU12</u>	(CU30 × 40%)
Deferred tax income recognised in profit or loss	<u><u>CU8</u></u>	

Alternative 2: recognise all changes in the deferred tax assets related to pre-combination services in profit or loss

Under this alternative, the increase of CU20 in the deferred tax asset is recognised in profit or loss.

Either of the above treatments is acceptable as an accounting policy choice to be applied consistently to all similar transactions.

5.6.3 Changes in deferred tax on share awards recognised on first-time adoption

Paragraph D2 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* provides an exemption that allows entities not to apply IFRS 2 retrospectively to specified share-based payment awards on transition to IFRSs (see 7.3 of chapter A3).

Therefore, for a share option scheme awarded prior to the date of transition to IFRSs that meets the specific requirements of the exemption, an entity that recognised a remuneration expense under its previous GAAP is permitted not to restate that expense, but recognises no further expense.

The entity may be entitled to receive a tax deduction when the options are exercised based on the intrinsic value of the options at the date of exercise. IAS 12:68A to 68C require that a deferred tax asset should be recognised on all deductible temporary differences relating to share options. On the date of transition to IFRSs, the entity recognises a deferred tax asset based on the difference between the fair value of the underlying shares and the exercise price of the options. Because this is an adjustment on transition to IFRSs, it is recognised in equity.

Subsequent changes in the amount of the deferred tax asset (based on the difference between the fair value of the underlying shares on the valuation date and the exercise price of the options) should be recognised in profit or loss or in equity, depending on the expense actually recognised for the awards.

The entity should determine the 'cumulative remuneration expense' related to the estimated future tax deduction, as referred to in IAS 12:68C, by reference to the original remuneration expense recognised under previous GAAP. If the amount of the estimated future tax deduction on a subsequent reporting date is higher than the remuneration expense recognised under previous GAAP, this implies that the tax deduction relates not only to the remuneration expense but also to an equity item. In such circumstances, the changes in the deferred tax asset should be recognised partially in profit or loss (to the extent that the deferred tax asset relates to the cumulative remuneration expense recognised), with the residual recognised in equity. Similarly, if the amount of the estimated future tax deductions on a subsequent reporting date falls below the remuneration expense recognised under previous GAAP, the resulting reduction in the deferred tax asset should be recognised in equity to the extent of any amounts previously recognised in equity, with any excess recognised in profit or loss. If no remuneration expense was recognised prior to transition to IFRSs, the 'cumulative remuneration expense' under IFRSs would be considered to be nil and all subsequent changes in the deferred tax asset would be recognised in equity. This is illustrated in example 5.6.3.

Example 5.6.3

Changes in deferred tax assets for share awards recognised on first-time adoption of IFRSs

Entity A granted 100 share options with an exercise price of CU1 per share option to employees on 1 January 2001 (i.e. before the mandatory application of IFRS 2 *Share-based Payment* on 7 November 2002). The arrangement involved a five-year vesting period, following which employees have the right to exercise the options for 10 years. Entity A adopted IFRSs in 2008, with a transition date of 1 January 2007. A tax deduction is available when the share options are exercised, based on the intrinsic value of the awards at the date of exercise.

Entity A recognised a remuneration expense of CU400 for this arrangement under its previous GAAP. As permitted by IFRS 1:D2, Entity A did not apply IFRS 2 retrospectively to these share options at the date of transition to IFRSs.

On 1 January 2007, the date of transition, the fair value of Entity A's shares is CU3 per share, and all of the share options have vested and remain outstanding. Accordingly, the share options have an intrinsic value of CU2 per share (i.e. fair value of CU3 – exercise price of CU1). Assuming a tax rate of 30 per cent, on transition to IFRSs Entity A recognises a deferred tax asset of CU60 (CU2 × 100 share options × 30 per cent), with an offsetting adjustment to equity.

On 31 December 2007, Entity A's share price has increased to CU8 per share such that the share options have an intrinsic value of CU7 per share option. The deferred tax asset relating to the share-based payment arrangement is now calculated as CU210 (i.e. CU7 × 100 share options × 30 per cent), resulting in a deferred tax credit of CU150 (i.e. deferred tax asset of CU210 at the end of the period less CU60 at the date of transition). The deferred tax credit is recognised partly in profit or loss and partly in equity as follows.

Estimated future tax deductions (CU7 × 100 share options)	CU700
Cumulative remuneration expense (previous GAAP)	<u>CU400</u>
Excess deduction	<u>CU300</u>
Deferred tax income for the period	CU150
Amount recognised directly in equity (CU300 × 30%)	<u>CU90</u>
Recognised in profit or loss	<u>CU60</u>

If, however, the cumulative remuneration expense recognised under previous GAAP had been reversed on transition to IFRSs, then the entire CU150 of tax benefit would be recognised in equity.

On 31 December 2008, Entity A's share price has decreased to CU4 per share, resulting in an intrinsic value of the options of CU3 (CU4 – CU1). Accordingly, the estimated future tax deductions are now CU300 (CU3 intrinsic value × 100 share options) and the deferred tax asset is measured at CU90 (CU300 × 30 per cent). The resulting deferred tax debit of CU120 (CU210 deferred tax asset at 31 December 2007 less deferred tax asset of CU90 at 31 December 2008) is recognised partly in profit or loss and partly in equity as follows.

Deferred tax expense for the period	CU120
Amount in excess of cumulative remuneration expense previously recognised directly in equity (CU300 × 30%)	<u>CU90</u>
Recognised in profit or loss	<u>CU30</u>

If no remuneration expense was recognised prior to transition to IFRSs, then the entire CU120 of tax expense would be recognised in equity.

5.7 Finance leases

5.7.1 *Deferred tax arising from finance leases — general*

Leasing transactions frequently give rise to deferred tax effects, but IAS 12 does not provide any specific guidance on how to account for those effects.

The appropriate accounting treatment for leases is established in IAS 17 Leases and is discussed in detail in chapter A17.

If a lease is classified as a finance lease, the lessee recognises the leased asset and a corresponding lease liability in its statement of financial position; it also recognises the asset's depreciation and finance costs related to the lease liability in profit or loss.

In some jurisdictions, the tax treatment of finance leases is consistent with the accounting treatment. In other jurisdictions, however, a finance lease may be classified as an operating lease for tax purposes and tax deductions may be available only for the lease payments as they are paid (i.e. no deduction for asset depreciation or finance costs).

Sections 5.7.2 and 5.7.3 discuss the appropriate accounting for the two most common tax treatments for finance leases.

5.7.2 *Finance lease treatment for tax and financial reporting purposes*

When the entity receives tax deductions in respect of the leased asset (depreciation allowance) and the lease liability (deduction for finance costs) in the same way as if the asset had been purchased using a loan, no special tax considerations arise. The requirements of IAS 12 are applied separately to the leased asset and the lease liability.

When the leased asset is recognised initially, if the tax base of the asset is the same as the carrying amount under IFRSs, no temporary difference arises. If the tax base ascribed to the asset is different from the carrying amount, a temporary difference arises, but no deferred tax is recognised due to the application of the initial recognition exception under IAS 12:22(c) (see section 4.4.6). As the asset is depreciated, accounting and tax depreciation rates may differ, resulting in new deductible or taxable temporary differences for which deferred tax may be recognised in accordance with the general principles of IAS 12.

The lease liability is likely to have a tax base equal to its carrying amount because deductions are given in future for the finance cost portion of the lease payment, which is not reflected in the carrying amount of the lease liability at inception.

5.7.3 Finance lease under IAS 17 but tax deductions based on rental payments

When the lease is treated as an operating lease for tax purposes and tax deductions are received for the lease payments as they are paid (and not for depreciation or finance costs), the appropriate accounting is more complex. Given the lack of guidance in the existing literature, alternative approaches may be acceptable.

Two acceptable approaches to accounting for the deferred tax consequences in such circumstances are explained below.

Approach 1 — apply the IAS 12 requirements to the leased asset and the lease liability separately

The leased asset has a tax base of zero; the lease liability also has a tax base of zero because the lease payments are deductible in future (as lease rental payments). This gives rise to a temporary difference on initial recognition of both the leased asset and the lease liability that is not recognised due to the application of the initial recognition exception in IAS 12:22(c).

Subsequently, the temporary differences decrease as the asset is depreciated and the liability is repaid. No deferred tax is recognised on either the leased asset or the lease liability due to continued application of the initial recognition exception (assuming no new temporary differences arise).

Therefore, this approach may result in no deferred tax being recognised either initially or over the term of the lease. The impact of this may be that while the profit on the lease generally increases over time, as the interest expense decreases, the tax deductions are timed more evenly.

Approach 2 — apply the IAS 12 requirements to the leasing transaction as a whole

An alternative approach that results in the recognition of deferred tax is also seen in practice. This approach seeks to reflect the linkage between the leased asset and the lease liability and recognise deferred tax on an aggregate temporary difference basis. This method yields an effective tax rate that more closely reflects the economics of the overall lease transaction.

At inception of the lease, there is no net lease asset or liability, no tax base and, therefore, no temporary difference.

Subsequently, as depreciation on the asset (generally straight-line) initially exceeds the rate at which the debt reduces (due to lease payments made less interest recognised under the effective interest method), a net liability arises resulting in a deductible temporary difference on which a deferred tax asset should be recognised if recoverable. Assuming that the lease liability is not repaid in advance, the total discounted cash outflows should equal the total rental payments deductible for income tax purposes.

5.8 Post-retirement benefits

5.8.1 Temporary differences arising from post-retirement benefits — general

The accounting for defined benefit retirement benefit plans and other post-retirement benefits often gives rise to temporary differences.

Tax deductions for payments into defined benefit retirement benefit plans are often allowed on a different measurement basis and in a different time period compared to the expense recognised in the financial statements under IAS 19 *Employee Benefits*. For example, the tax deduction may be available:

- when cash contributions are paid (in some jurisdictions, the deduction is spread over a period of time); or
- when the actual benefits are paid to individuals (this usually applies for unfunded schemes).

As a result temporary differences are likely to arise.

5.8.2 *Deferred tax asset*

A net defined benefit liability can be considered to represent the future funding the entity will be required to provide for the defined benefit scheme. If the entity will be able to claim future tax deductions for such funding, the tax base of the net defined benefit liability will be zero.

This will give rise to a deductible temporary difference. In addition, a deductible temporary difference will arise if tax deductions for contributions to a retirement benefit plan are not given in the year the contribution is paid but in later years (e.g. when the benefits are paid). In accordance with IAS 12, the entity should recognise a deferred tax asset for this temporary difference to the extent it is recoverable (see section 4.6).

5.8.3 *Deferred tax liability*

When an entity has a net defined benefit asset in respect of a surplus in its retirement benefit plan, this represents over-funding for which tax deductions may have been received; consequently, a taxable temporary difference arises and a deferred tax liability should be recognised.

The manner of recovery of a surplus may affect the tax consequences; for example, in some jurisdictions, refunds from a retirement benefit plan may be subject to tax at a rate different from the normal income tax rate.

IFRIC 14 *IAS 19 — the Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* provides guidance on how to assess the recoverability of a net defined benefit asset (see section 7.4 of chapter A15). Application of this guidance may result in the recognition of an asset because there is legally an unconditional right to a refund. Such a refund may be taxable at a rate other than the normal income tax rate.

A net defined benefit asset may be recovered through the receipt of a taxable refund or through reduced contributions. IAS 12 requires deferred taxes to be assessed based on the expected method of recovery of the underlying asset.

IFRIC 14 states that “the economic benefit available does not depend on how the entity intends to use the surplus”. Accordingly, recognition of an asset under IFRIC 14 because there is legally an unconditional right to a refund does not necessarily imply that the entity expects to recover the asset through a refund.

If it is expected that the asset will be recovered through reduced contributions, the normal income tax rate may be the most appropriate rate to be applied to the temporary difference. However, if a refund is expected, the rate applicable to refunds should be applied.

Note, however, that it would not be appropriate (in the absence of other negative factors) to argue that no deferred tax should be recognised in relation to the net defined benefit asset on the basis it may be eliminated by future market movements or other measurement factors. This is because deferred taxes are measured by reference to the carrying amount at the reporting date, not a theoretical, possible or even probable future carrying amount.

5.8.4 *Allocation of tax between profit or loss and other comprehensive income*

IAS 12 requires that current and deferred tax should be recognised outside profit or loss if the tax relates to items that are recognised outside profit or loss (see 3.2.2.1). To the extent that gains or losses are recognised in other comprehensive income under IAS 19, it is necessary to consider what amount of the current or deferred tax relates to those gains and losses. In addition, it is often not possible to determine whether contributions paid (generally the basis for tax deductions) relate to items recognised in profit or loss or items recognised in other comprehensive income. When there is no clear relationship between the expense recognised in profit or loss and the tax deductions received in the period, the current and deferred tax expense will need to be allocated between profit or loss and other comprehensive income on a reasonable basis. [IAS 12:63]

One acceptable methodology is to allocate tax deductions arising during the period first to items recognised in profit or loss, and then to allocate the remainder, if any, to the items in other comprehensive income. However, if the total tax exceeds all retirement benefit items recognised multiplied by the tax rate, that excess may be taken to profit or loss because it does not clearly relate to items reported in other comprehensive income.

Example 5.8.4
Defined benefit liability with an actuarial loss

	Defined benefit liability CU	Current tax deduction (30%) CU	Deferred tax asset (30%) CU
Brought forward	(200)		60
Profit or loss – net pension cost	(50)	15	
Other comprehensive income — actuarial loss	(30)	<u>6^(a)</u>	3 ^(b)
Contribution paid / deduction received	<u>70</u>	<u>21</u>	
Carried forward	<u>(210)</u>		<u>63</u>

^(a) This amount represents the remainder of the total tax deduction of CU21 in the current period after the maximum possible amount of CU15 has been allocated to amounts recognised in profit or loss.

^(b) The movement between the amounts of deferred tax asset brought forward and carried forward in this case is deemed to arise on the actuarial loss because the total tax recognised in other comprehensive income is not in excess of tax on the actuarial loss (CU30 × 30% = CU9).

5.9 Decommissioning obligations

Under IAS 16 *Property, Plant and Equipment*, the cost of an item of property, plant and equipment includes the initial estimate of the costs of any decommissioning, restoration or similar obligation established under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The total cost of the asset is depreciated over its useful economic life unless the asset is measured under a revaluation model.

At the time of initial recognition of the asset, the carrying amount of the asset includes the estimated decommissioning cost capitalised on acquisition; however, the tax authorities may only permit tax deductions for the purchase price of the asset, with tax deductions for decommissioning costs allowed only as the decommissioning costs are paid.

IAS 12 contains no specific guidance on decommissioning obligations and there are two acceptable approaches. One approach is to apply the requirements of the Standard in the normal way to the separate asset and liability. The alternative approach views the asset and its related decommissioning liability together. Both of these methods are seen in practice.

Approach 1: view asset and liability separately

Under this approach, at initial recognition the tax base of the asset is generally its purchase price and excludes the capitalised decommissioning costs, thereby creating a taxable temporary difference. Because the temporary difference arises on the initial recognition of the asset, no deferred tax liability is recognised on acquisition in accordance with IAS 12:15. Assuming the asset is not being remeasured, if there are subsequent increases in the estimate of the decommissioning obligation, this will result in an increase in the carrying amount of the asset in accordance with IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. This increases the temporary difference associated with the asset and a deferred tax liability is recognised in accordance with the general principles of IAS 12. Changes in the temporary difference giving rise to deferred tax may also arise in subsequent periods if the depreciation period differs from the period over which tax deductions are received.

Any subsequent decreases in the estimate of the decommissioning obligation would lead to a corresponding reduction in the carrying amount of the asset. If this reduces the temporary difference that existed at initial recognition, there are no deferred tax consequences.

The tax base of the decommissioning liability is the carrying amount less deductions to be received as the costs are incurred. Assuming deductions will be received when the costs are paid, the tax base of the liability is nil. Therefore, at initial recognition a deductible temporary difference exists but, similar to the asset above, no deferred tax asset is recognised because the temporary difference arises on initial recognition of the decommissioning liability.

The carrying amount of the decommissioning obligation will subsequently be increased by the unwinding of the discount, and will also be adjusted for any change in estimate of the ultimate cash outflows. An increase in the temporary difference associated with the liability will give rise to the recognition of a deferred tax asset in accordance with the general principles of IAS 12.

An increase in estimate of the decommissioning obligation will, therefore, lead to the recognition of a deferred tax liability in respect of the related asset and a deferred tax asset in respect of the decommissioning liability.

Approach 2: view asset and liability together

The other acceptable approach seen in practice is to view the asset and its related decommissioning liability in aggregate. This approach seeks to reflect the linkage between the asset and the related decommissioning liability and recognises deferred taxes on the aggregate temporary difference, rather than the two individual temporary differences. This method yields an effective tax rate that more closely reflects the economics of the asset ownership over its life.

This approach is based on the view that the decommissioning asset and the obligation are related and, therefore, should be viewed as a whole. The temporary differences related to the asset and the liability are aggregated and deferred taxes are recognised only on an overall temporary difference.

Subsequently, as the asset is depreciated and the decommissioning liability increases with the unwind of interest (using the effective interest method), a temporary difference will arise in respect of which deferred taxes should be recognised.

5.10 Hedge of net investment in a foreign operation

Entities sometimes enter into transactions to hedge their net investment in a foreign subsidiary (e.g. through the use of a foreign currency loan, or a forward contract). Under IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*), such a transaction may be designated as a hedge of the foreign currency exposure of a net investment in a foreign operation (see chapter B9 or, for entities that have not yet adopted IFRS 9, see chapter C9). Gains and losses on the effective portion of such hedging transactions are recognised in other comprehensive income in the entity's consolidated financial statements.

If the tax base of the hedging instrument is different from its carrying amount, this creates a temporary difference and deferred tax should be recognised. This is the case regardless of whether deferred tax has been provided in respect of the parent's investment in a foreign subsidiary. To the extent that the hedge is effective, the tax consequences of establishing a deferred tax asset or liability for the hedging transaction are reported in other comprehensive income in accordance with IAS 12:61A. Recognition of amounts outside profit or loss is discussed further at section 4.7.3.

Example 5.10

Hedge of a net investment in a foreign subsidiary

Company A (functional currency Sterling) has a wholly-owned US subsidiary, Company B (functional currency US\$), which has net assets of US\$120,000. Company A hedges its net investment in Company B using a US\$100,000 loan. Assuming that the hedge is perfectly effective and that all the other hedge accounting requirements of IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39) are met, the exchange gain or loss on retranslating the loan will be recognised in other comprehensive income in Company A's consolidated financial statements. When the retranslation of the loan changes its carrying amount, but not its tax base, deferred tax on the resulting temporary difference is also recognised in other comprehensive income.

5.11 Deferred tax resulting from impairment of assets

As discussed in chapter A10, IAS 36 *Impairment of Assets* requires that a review for impairment be carried out if events or changes in circumstances indicate that the carrying amount of certain assets within the scope of IAS 36 may not be recoverable. An asset is considered to be impaired when its recoverable amount declines below its carrying amount. The recoverable amount of an asset is the higher of its fair value less costs of disposal and its value in use.

The calculation of the impairment loss is based on an assumption that the entity will choose to recover the carrying amount of the asset in the most beneficial way. Therefore, if the entity could earn more by selling the asset rather than by continuing to use it, it would choose to sell the asset, and vice versa.

Although an impairment loss may be measured under IAS 36 by reference to fair value less costs of disposal, rather than value in use, this does not necessarily mean that, for the purposes of measuring the related deferred tax asset or liability, management must change its expected manner of recovery in accordance with IAS 12:51A, and now use the tax base applicable to recovery through sale rather than use.

Impairment losses recognised in respect of assets carried on a historical cost basis are recognised in profit or loss; for assets carried at a revalued amount, impairment losses are treated as revaluation decreases (which may or may not lead to an expense being recognised in profit or loss).

Because an impairment loss affects the carrying amount of an asset, it affects the relationship between the asset's carrying amount and its tax base. Therefore, any deferred tax asset or liability is determined by comparing the revised carrying amount of the asset with its tax base. [IAS 36:64]

In many jurisdictions, tax deductions for assets are received at a faster rate than expense is recognised for financial reporting purposes, either because of differing depreciation methods or because different useful lives are ascribed under tax law. While this generally results in a deferred tax liability position, the recognition of an impairment loss in a reporting period may cause the carrying amount of the asset to fall below its tax base (see example 9.1 in chapter A10).

In accordance with IAS 12, an entity recognises a deferred tax asset to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised (see section 4.6 for recognition of deferred tax assets).

5.12 Group relief

The deferred tax position of each group entity should be determined separately and the results aggregated (with some adjustments) to determine the group position. Adjustments may need to be made to reflect the deferred tax consequences of the availability of group relief altering the view of recoverability of deferred tax assets.

When losses are expected to be surrendered to another group entity that is expected to pay for the group relief then the 'deferred tax asset' may well be assessed as recoverable and recognised even though the 'asset' is actually a receipt from another group entity that recovers it from the tax authority. When losses are expected to be surrendered to another group entity but no payment is likely to be received, the entity surrendering the losses would not normally be able to assess the asset as recoverable. However, the deferred tax asset would be recognised on consolidation to the extent that the other entity is expected to utilise the losses.

When a payment is made between group entities in consideration for the transfer of tax losses, it is necessary to exercise judgement to determine the substance of the transaction (see 2.10).

6 Presentation and disclosure

6.1 Presentation

6.1.1 Tax expense

The tax expense or income related to profit or loss from ordinary activities should be presented as part of profit or loss in the statement(s) of profit or loss and other comprehensive income. [IAS 12:77]

IAS 12 notes that, although IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires certain exchange differences to be recognised as income or expense, that Standard does not specify where such differences should be presented in the statement of comprehensive income. Therefore, IAS 12 states that when exchange differences on deferred foreign tax liabilities or assets are recognised in the statement of comprehensive income, such differences may be classified as deferred tax expense (income) if that presentation is considered to be the most useful to financial statement users. [IAS 12:78]

An entity may incur expenses that are linked to the income tax expense, for example, fees payable to tax consultants for their tax advice (see also 2.9) and to accountants who assist the entity in preparing its tax returns.

Amounts paid other than to the tax authority in connection with an entity's tax expense do not represent income taxes. Therefore, such amounts should be treated as either an administrative or other expense in the entity's statement of comprehensive income depending on the format adopted, i.e. classification of expenses either by function or by nature.

When a payment is made between group entities in consideration for the transfer of tax losses, it is necessary to exercise judgement to determine the substance of the transaction (see 2.10).

Example 6.1.1

Presentation of payments of non-income taxes that can be claimed as an allowance against taxable profit

Entity A is required to make production-based royalty payments to Taxing Authority 1. These payments can be claimed as an allowance against taxable profit for the computation of income taxes payable to Taxing Authority 2. The production-based royalty payments do not, in themselves, meet the definition of income tax and, therefore, are outside the scope of IAS 12 (see 2.1), whereas the income tax payable to Taxing Authority 2 is within the scope of IAS 12.

Should the production-based royalty payments to Taxing Authority 1 be presented as a tax expense in Entity A's statement of comprehensive income?

No. The 'tax expense' line item required to be presented under paragraph 82(d) of IAS 1 is intended to require an entity to present taxes that meet the definition of income taxes under IAS 12. Because the production-based royalty payments are not income taxes, they should not be presented within that line item.

The conclusions above were confirmed by the IFRS Interpretations Committee in the July 2012 *IFRIC Update*.

It is possible for an entity to designate a derivative as a cash flow hedge of the cash flow variability of a tax liability arising on the foreign exchange gain or loss on a foreign currency borrowing. Provided that such a hedge has been appropriately designated and documented, the hedge is a qualifying cash flow hedge of a non-financial liability (the tax liability) under IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*).

Both IFRS 9 and IAS 39, the Standards which prescribe the hedge accounting rules in terms of recognition and measurement, are silent on where the gains and losses on derivatives designated as hedging derivatives should be presented within profit or loss. It has become customary, and is useful to the users of the financial statements, for the hedging effects of derivatives to be presented in the statement of comprehensive income in the same line as the item that they hedge. Therefore, although the hedging gain or loss is clearly not an income tax as defined by IAS 12, an argument can be made for including the effects of the derivatives, which an entity has entered into as hedges of its tax liability, in the tax line in the statement of comprehensive income.

When an entity chooses to present derivative gains/losses relating to designated tax hedging derivatives within the tax line, this accounting policy choice should be applied consistently from period to period. Furthermore, appropriate separate disclosure in the notes of the amount attributable to hedging gains/losses should be made.

6.1.2 Presentation of the release of a deferred tax liability on disposal of an asset

Example 6.1.2

Presentation of the release of a deferred tax liability on disposal of an asset

Entity X owns an asset and has recognised a deferred tax liability resulting from accelerated tax depreciation on that asset.

Entity Y purchases the asset from Entity X and, as permitted by local tax law, elects to retain the tax base of the asset as it was when held by Entity X. As a result of this election, Entity X pays no tax on the disposal of the asset, but the proceeds of disposal received from Entity Y are lower than would otherwise be expected to reflect the reduced tax allowance available to Entity Y.

When Entity X derecognises the related deferred tax liability on disposal of the asset, should this reversal be presented as part of the gain or loss on disposal of the asset or as part of tax expense (tax income)?

The reversal of the deferred tax liability should be presented as part of Entity X's tax expense (tax income) because it falls within the definition of tax expense (tax income) in IAS 12:5 ("the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax").

The deferred tax expense previously recognised reflected the expected tax consequences with regards to the recovery of the asset. Actual recovery of the value of the asset has been achieved with no tax payable. Therefore, from Entity X's perspective, the temporary difference has reversed and the effect of that reversal should be reflected as part of tax expense (tax income).

6.1.3 Statement of financial position

The presentation of both current and deferred tax in the statement of financial position is addressed in IAS 1 (and not in IAS 12) as follows:

- liabilities and assets for current tax should be presented in the statement of financial position; [IAS 1:54]
- deferred tax liabilities and deferred tax assets should be presented in the statement of financial position; [IAS 1:54] and
- 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 should not classify deferred tax assets (liabilities) as current assets (liabilities). [IAS 1:56]

Liabilities or assets arising from uncertain tax positions should be included in the statement of financial position within the amounts for current tax liabilities (or assets) and presented as current or non-current based on the general principles of IAS 1. The effect of uncertain tax positions on profit or loss or other comprehensive income (depending on the nature of the uncertain tax position) should be included in the same line item as tax expense (income).

Although uncertain tax positions are similar in nature to provisions as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see 3.3.3.3), it would be inappropriate to present the resulting liabilities with other provisions recognised under IAS 37, because they are explicitly excluded from the scope of IAS 37.

6.1.4 Offset of tax assets and liabilities

6.1.4.1 Offset of tax assets and liabilities — general

In a similar approach to that taken in IAS 1, IAS 12 takes a strong line on the extent to which tax assets and liabilities can be offset against one another to present only a net figure in the statement of financial position.

6.1.4.2 Offset of current tax assets and liabilities

An entity should offset current tax assets and current tax liabilities if, and only if, the entity:

[IAS 12:71]

- has a legally enforceable right to set off the recognised amounts; and
- intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

IAS 12 explains that an entity normally has a legally enforceable right to set off current tax assets against current tax liabilities when they relate to income taxes levied by the same tax authority, and that authority permits the entity to make or receive a single net payment. [IAS 12:72]

When an entity is preparing consolidated financial statements, current tax assets and liabilities arising from different group entities should not be offset unless:

[IAS 12:73]

- the entities concerned have a legally enforceable right to make or receive a single net payment; and
- the entities intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously.

6.1.4.3 Offset of deferred tax assets and liabilities

An entity should offset deferred tax assets and deferred tax liabilities if, and only if:

[IAS 12:74]

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same tax authority on either:
 - the same taxable entity; or
 - different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

Under the above rules, deferred tax assets and liabilities arising in the same legal entity (which is also a single taxable entity) can generally be offset. However, when, for example, the taxable entity has capital losses carried forward that can only be used to reduce future capital gains, those losses can only be offset against deferred tax liabilities to the extent that recognised deferred tax liabilities arise from unrealised capital gains.

In a consolidation situation, the first condition to overcome is the requirement for the balances to be levied by the same tax authority. This effectively prohibits the offset of deferred tax assets and liabilities arising in different jurisdictions.

Even for entities operating within the same jurisdiction, except when there are formal group relief or consolidated taxation arrangements, it will be unusual for the tax authority to permit net settlement between different taxable entities.

Therefore, in preparing consolidated financial statements, the deferred tax balances of the separate entities will generally be aggregated without further setting off the deferred tax balances of one entity against those of another.

The above rules mean that, for disclosure purposes, there is no need for detailed scheduling of the timing of reversals of each temporary difference. In rare circumstances, an entity may have a legally enforceable right of set-off, and an intention to settle net, for some periods but not for others. In such situations, detailed scheduling may be required to establish reliably whether the deferred tax liability of one taxable entity will result in increased tax payments in the same period in which a deferred tax asset of another taxable entity will result in decreased payments by that second taxable entity. [IAS 12:75 & 76]

When an entity is required to offset deferred tax assets and deferred tax liabilities in its statement of financial position because it meets the conditions in IAS 12:74 (see above), the entity is not necessarily entitled to offset the related deferred tax income and deferred tax expense. IAS 12:58 requires the individual components of tax expense or tax benefit to be allocated to profit or loss for the period except to the extent that the tax arises from a transaction or event which is recognised in the same or a different period outside of profit and loss, either in other comprehensive income or directly in equity. The ability to offset the amounts in the statement of financial position does not override the requirement for the income and expense to be appropriately classified.

Example 6.1.4.3 Offsetting deferred tax income and expense

During the year, Company A revalues an item of property, plant and equipment upward by CU1,000 to CU21,000, recognising the increase in other comprehensive income. The tax base of the property, plant and equipment is CU20,000.

At the same time, Company A incurs an operating tax loss of CU800 during the period which, under the relevant tax legislation, can be carried forward indefinitely. The requirements for recognition of the deferred tax asset arising from the tax loss carried forward are satisfied. In addition, the requirements for offsetting deferred tax assets and liabilities in IAS 12:74 are met. The tax rate is 30 per cent.

Company A recognises a deferred tax liability of CU300 (CU1,000 temporary difference \times 30%) and a deferred tax asset of CU240 (CU800 loss \times 30%). The two amounts are set off in the statement of financial position so that a net deferred tax liability of CU60 (CU300 – CU240) is recognised. However, the deferred tax arising on the revaluation is recognised in other comprehensive income and the effect of the current year's loss is recognised in profit or loss.

6.2 Disclosure

6.2.1 Statement of comprehensive income

6.2.1.1 Major components of tax expense (income)

The major components of tax expense (income) should be disclosed separately, including:

[IAS 12:79 & 80]

- current tax expense (income);
- any adjustments recognised in the period for current tax of prior periods;
- the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;
- the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;
- the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
- the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;
- deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset in accordance with IAS 12:56; and
- the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, because they cannot be accounted for retrospectively.

In respect of discontinued operations, the financial statements should disclose separately the tax expense relating to:

[IAS 12:81(h)]

- the gain or loss on discontinuance; and
- the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented.

For each type of temporary difference, and each type of unused tax losses and unused tax credits, the financial statements should disclose the amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the statement of financial position. [IAS 12:81(g)(ii)]

6.2.1.2 Reconciliation of tax expense or income

IAS 12 requires the presentation of an explanation of the relationship between the tax expense (income) and accounting profit in either or both of the following forms:

[IAS 12:81(c) & 86]

- a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
- a numerical reconciliation between the average effective tax rate (being the tax expense (income) divided by the accounting profit) and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

An explanation is required of changes in the applicable tax rate(s) compared to the previous accounting period.

[IAS 12:81(d)]

6.2.2 Statement of financial position

For each type of temporary difference, and each type of unused tax losses and unused tax credits, the financial statements should disclose the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented. The amount of deferred tax income or expense recognised in profit or loss in respect of each temporary difference must also be disclosed where it is not apparent from the changes in the amounts recognised in the statement of financial position. [IAS 12:81(g)(i)]

The following should also be disclosed:

[IAS 12:81(e) & (f)]

- the amount (and expiry date, if any) of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the statement of financial position; and
- the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint arrangements, for which deferred tax liabilities have not been recognised.

It would often be impracticable to compute the amount of unrecognised deferred tax liabilities arising from investments in subsidiaries, branches and associates and interests in joint arrangements, so IAS 12 requires an entity to disclose the aggregate amount of the underlying temporary differences but does not require disclosure of the deferred tax liabilities. Nevertheless, when practicable, entities are encouraged to disclose the amounts of the unrecognised deferred tax liabilities because financial statement users may find such information useful.

[IAS 12:87]

An entity should disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

[IAS 12:82]

- the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
- the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

When current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits, but the net income taxes payable will be affected if part of the retained earnings is paid out as a dividend to shareholders, the entity should disclose:

[IAS 12:82A & 87A]

- the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. This includes the important features of the income tax systems and the factors that will affect the amount of the potential income tax consequences of dividends;
- the amounts of the potential income tax consequences that are practicably determinable; and
- whether there are any potential income tax consequences that are not practicably determinable.

It is not always practicable to compute the total amount of the potential income tax consequences that would result from the payment of dividends to shareholders (e.g. when an entity has a lot of overseas subsidiaries). However, even in such circumstances, usually some consequences may be easily determinable, and these should

be disclosed. IAS 12 cites the example of a consolidated group, when the parent and some of its subsidiaries may have paid income taxes at a higher rate on undistributed profits and are aware of the amount that would be refunded on the payment of future dividends to shareholders from consolidated retained earnings. In this case, the refundable amount is disclosed.

When some or all potential income tax consequences cannot be determined, the entity should disclose that there are additional potential income tax consequences not practicably determinable. In the parent's separate financial statements, the disclosure of the potential income tax consequences relates to the parent's retained earnings. [IAS 12:87B]

When current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits, but the net income taxes payable will be affected if part of the retained earnings is paid out as a dividend to shareholders, an entity required to provide the disclosures listed above may also be required to provide disclosures related to temporary differences associated with investments in subsidiaries, branches and associates or interests in joint arrangements. For example, an entity may be required to disclose the aggregate amount of temporary differences associated with investments in subsidiaries for which no deferred tax liabilities have been recognised. [IAS 12:81(f)] If it is impracticable to compute the amounts of unrecognised deferred tax liabilities there may be amounts of potential income tax consequences of dividends not practicably determinable related to these subsidiaries. [IAS 12:87C]

6.2.3 Other disclosure requirements

Other disclosure requirements include:

- the aggregate current and deferred tax relating to items that are charged or credited directly to equity; [IAS 12:81(a)]
- the amount of income tax relating to each component of other comprehensive income (revaluation surplus, foreign exchange reserve etc.); [IAS 12:81(ab)]
- the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements; [IAS 12:81(i)]
- if a business combination in which the entity is the acquirer causes a change in the amount recognised for its pre-acquisition deferred tax asset (under IAS 12:67 — see 5.1.6), the amount of that change; [IAS 12:81(j)]
- if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date (under IAS 12:68 — see 5.1.8), a description of the event or change in circumstances that caused the deferred tax benefits to be recognised; [IAS 12:81(k)]
- any tax-related contingent liabilities and contingent assets in accordance with IAS 37 (e.g. from unresolved disputes with the tax authorities); [IAS 12:88] and
- when changes in tax rates or tax laws are enacted or announced after the reporting period, any significant impact on the entity's current and deferred tax assets and liabilities. [IAS 10:22(h) & IAS 12:88]

The disclosure for uncertain tax positions is governed not only by the requirements of IAS 12 but also by the requirement under IAS 1:116 to disclose key sources of estimation uncertainty when there is a significant risk of a material adjustment in carrying amounts of assets and liabilities within the next financial year (see 7.3 in chapter A4).

When the uncertain tax position gives rise to a contingent tax liability for which no provision is recognised (e.g. because it is not probable that a payment will be made to the tax authority), an entity must still consider the requirements of IAS 12:88, which states that "[a]n entity discloses any tax-related contingent liabilities and contingent assets in accordance with IAS 37 . . . contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities".

7 Future developments

In August 2014, the IASB issued exposure draft ED/2014/3 *Recognition of Deferred Tax Assets for Unrealised Losses (Proposed amendments to IAS 12)*. The exposure draft proposes amendments to IAS 12 to clarify the recognition of deferred tax assets for unrealised losses related to debt instruments measured at fair value.

The proposed amendments would clarify the following:

- that unrealised losses on debt instruments measured at fair value and measured at cost for tax purposes can give rise to deductible temporary differences; and
- that the carrying amount of an asset does not limit the estimation of probable future taxable profits. The amended Standard would specify that, when comparing deductible temporary differences with future taxable profits, the future taxable profits would exclude tax deductions resulting from the reversal of those deductible temporary differences.

The comment period on this exposure draft ended on 18 December 2014. At the time of writing, final amendments are expected late in 2015 or early in 2016.